STEP

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DELIVERED BY E-MAIL ONLY

Gerard Lalonde
Director
Tax Legislation Division
Department of Finance Canada
19th floor, East Tower
140 O'Connor Street
Ottawa, Ontario K1A 0G5

Dear Mr. Lalonde,

On behalf of the 2,000 members of the Society of Trust and Estate Practitioners (Canada) ("STEP Canada"), we are pleased to submit our comments in response to the proposals to require reporting regarding certain transactions ("the Proposals").

STEP Canada is the Canadian branch of the leading international organization of trust and estate professionals, which is comprised of lawyers, accountants, financial planners, insurance advisors and trust officers. Its members regularly advise Canadian taxpayers with respect to the income tax implications of structuring and reporting transactions. Accordingly, STEP Canada is uniquely positioned to respond to the request from the Department of Finance ("the Department") to comment on the Proposals.

In this letter we review various elements of the Proposals and offer comments. We look forward to making technical recommendations once the Department has released draft legislation. To that end we would also be pleased to participate in consultations regarding the implementation of draft legislation.

1. Aggressive Tax Planning and Reportable Transactions

In the 2010 Federal Budget ("the Budget"), the Department expressed the view that combating aggressive tax planning and achieving fairness in the Canadian tax system requires the introduction of rules that will mandate taxpayers and their advisors to report certain types of tax avoidance transactions.

As stated in the Budget the purpose of these Proposals is to provide the Canada Revenue Agency ("the CRA) with more effective ability to enforce existing provisions of the *Income Tax Act* ("the Act) intended to counter aggressive tax planning. The Department issued a Backgrounder on May 7, 2010, which describes its initial approach to these Proposals, and sought the views of stakeholders such as STEP Canada.

The approach taken in the proposals is to automatically equate a "reportable transaction" with an "avoidance transaction." Assuming a tax benefit arises from the transaction, a taxpayer will be required to determine whether the transaction was undertaken "primarily for *bona fide* purposes other than to obtain the tax benefit." If the taxpayer can establish convincing arguments that substantiate the transaction as *bona fide*, there is no obligation to report.

In the Proposals, it is stated that simple disclosure of a reportable transaction would not be determinative of whether it will or will not be allowed under the Act. Nor would it serve as "an admission that the [general anti-avoidance rule ("GAAR")] applies to the transaction, or that the transaction is an avoidance transaction for the purpose of the GAAR." These statements appear to provide some comfort to taxpayers. However, the term "avoidance transaction" only appears in the Act, under ss. 245(3), when defining transactions that could be subjected to the GAAR.

Observations

The efficacy of proposed rules designed to uncover aggressive tax planning should not depend on the subjective assessment of a taxpayer's motives. This could result in inconsistent application of reporting rules, as well as contrivance to avoid the rules through the artful devising of *bona fide* purposes.

More to the point, it is likely to result in taxpayer reluctance to comply based on fear that an *a priori* acknowledgement that a reportable transaction is an "avoidance transaction" undertaken solely for the purpose of securing a tax benefit will inevitably result in the CRA characterizing the transaction as abusive. The approach set out in the Proposals that automatically equates a reportable transaction with an avoidance transaction is inconsistent with the Supreme Court of Canada's decision in *Canada Trustco Mortgage Co. v. The Queen*. In that decision it was noted that the Act must be interpreted in a manner that achieves "consistency, predictability and fairness so that taxpayers can manage their affairs intelligently."

Finally, as previously noted, the association that "avoidance transaction" has with the Act's GAAR provisions makes the use of this term troublesome. The definition of an avoidance transaction for the purpose of identifying a "reportable transaction" should be distinguished from the definition of an avoidance transaction for the purpose of establishing the application of the GAAR. STEP Canada recommends that the definition of a reportable transaction be based on the definition of a "tax benefit" in ss. 245(1), rather than an avoidance transaction as per ss. 245(3).

2. Hallmarks

In order to facilitate reporting, the Proposals identify certain "hallmarks" which the Department considers to be characteristic of reportable avoidance transactions. They include arrangements based on a contingency fee, "confidential protection" and/or "contractual protection." As stated in the Budget, the hallmarks "are not themselves evidence of abuse..." Instead, the Department associates their presence with transactions which it believes should be brought to its attention. This approach appears to be similar to the approaches taken by the U.S. and Quebec tax authorities.

Observations

The American and the Quebec systems for dealing with aggressive tax planning appear to focus on the hallmarks deemed to be necessary to achieve the ultimate goal of early detection of transactions that are undertaken for the sole purpose of avoiding payment of tax.

This approach to defining reportable transactions, rather than focusing on the term "avoidance transaction," may be the better approach. However, we offer the following observation: Hallmarks identified with potentially abusive tax planning invite manipulation of the circumstances which surround the design and implementation of tax mitigation strategies. Irrespective of how particular hallmarks may be representative of abusive planning, promoters of aggressive tax plans will be encouraged to circumvent the application of the Proposals by "re-engineering" to avoid the strict application of any "hallmark test."

3. *De minimis* transactions

Under the Proposals all reportable transactions must be disclosed no matter what the amount of the tax benefit involved. This places an onerous burden on the CRA to review transactions which do not, by virtue of their nominal economic significance, threaten the integrity of the Canadian tax base. Similarly it places an unreasonable compliance burden on taxpayers and their advisors. This will result in an ineffective reporting regime that will detract from the CRA's ability to review more economically significant transactions in a timely fashion.

Observations

If some *de minimis* thresholds were established, the focus would be on transactions that are most likely to result in collecting significant tax revenue. Therefore, STEP Canada recommends that the following transactions should not be reportable: when the tax benefit resulting from the transaction is less than $25,000 in any one year or less than $50,000 over all the years affected by the transaction; when promoter or advisor fees connected to the transaction are less than $25,000 in one year or less than $50,000 over all the years affected by the transaction.

4. Advisor Reporting Obligation and Penalties

The Proposals state that the CRA will publish guidance regarding how a transaction should be reported and what information will be required. Meanwhile, an advisor will have an independent reporting obligation if the transaction must be reported and the advisor's fee is contingent on securing the desired tax benefit. Further, an advisor will be jointly and severally liable with the client for the penalty for non-disclosure of a reportable transaction, calculated with reference to the advisor's fee. Finally, it is also stated in the Proposals that the prohibition against "confidential protection" in the first hallmark "would not extend to a requirement that the advisor's professional liability exists only toward the taxpayer in the capacity of client..."

Observations

A reportable transaction could involve a series of transactions that occurs over a period of years. An advisor whose fee arrangement depends on performance (referred to in the Proposals as a "contingent fee arrangement"), may no longer be acting for the client at the time the tax benefit arises. In most provinces, the client's file belongs to the client and the advisor may no longer have the client's file at the time a reporting obligation arises. The reporting requirement is triggered when the "tax benefit arises," however, the advisor may be unable to secure the information required to effect reporting compliance.

"Performance based" compensation arrangements are normal commercial practice in the context of rendering professional services. This provides clients with the reasonable expectation of sharing risk with their service providers. Similarly, contingent fee arrangements in tax-based transactions are normal commercial practice. The presence of such an arrangement is not necessarily indicative of nefarious intent on the part of a taxpayer and his or her advisors.

According to the Proposals, it would appear that an advisor engaged to provide specialized (non-tax) advice in respect of a reportable transaction may have a reporting obligation, even if that advisor's fee is not a performance based fee. For example, a lawyer engaged to draft a will, a trust indenture or a unanimous shareholders agreement, each of which is a component of what may be determined to be a reportable transaction, would appear to have an independent reporting obligation. Even though that lawyer's fee is not a performance fee, that lawyer is not giving tax advice, that lawyer is not privy to the advice which the tax advisors are providing and even if that lawyer were privy to the advice which the tax advisors are giving, that lawyer would not be capable of determining if the transaction is otherwise reportable.

An advisor should not be jointly and severally liable with a client to pay the penalty for non-disclosure of a reportable transaction. There is no legal principle that would justify an advisor having to underwrite a client's failure to comply with the law. Meanwhile, the existing third-party civil penalty regime set out in the Act already provides a strong deterrent to advisors from acting irresponsibly when advising clients.

Otherwise, joint and several liability will fundamentally alter the advisor-client relationship. First, it could result, from a practical point of view, in some clients neglecting to report a transaction because they know their advisor will also be held accountable. Second, lawyers in particular have a statutory responsibility to protect the confidentiality of their clients' affairs. They are not permitted to waive solicitor-client privilege. It would contravene a fundamental tenet of the Canadian legal system. Legislation that enacts these Proposals must respect this limitation.

Concern about the extent of disclosure necessary in order for taxpayers and advisors to be in compliance will remain until the reporting requirements are clearly stated. Unless the limits of disclosure are well defined, the result could be indiscriminate denial of tax benefits by the CRA, and disclosure of information that is not necessary for the CRA to achieve its intended compliance goals. STEP Canada recommends that the information to be divulged in connection with a reportable transaction be limited to the facts, rather than the rationale, analysis or a solicitor's opinion regarding the arrangement in question. Finally, we recommend that a variety of stakeholders, including STEP Canada be asked to participate with Department officials in a committee mandated to design the information return.

5. Reporting by Others

The Proposals indicate that persons who have entered into a transaction for the benefit of others could also have a reporting obligation and may be jointly and severally liable to pay the penalty for non-disclosure of a reportable transaction.

Observation

Trustees, agents, executors, committees and guardians ("Representatives") are persons who routinely enter into transactions on behalf of others. They usually have little or no economic interest in the transaction. Instead, they are acting in a purely representative capacity. The Proposals appear to impose reporting obligations and liability on such individuals, despite the entirely gratuitous nature of their involvement. Further, as noted above, the Proposals state that a reporting obligation will arise in the year in which the tax benefit arises. A Representative who entered into a transaction for the benefit of a taxpayer may have no continuing involvement with the taxpayer many years later when the tax benefit arises. It would be unfair to impose a reporting obligation and liability on such Representatives in those circumstances.

6. Application Date

The Proposals state that they will apply to individual or any one of series of reportable transactions completed after 2010.

Observations

"Completion after 2010" is an ambiguous term. It could extend to:

a) Filing before the normal filing due date for 2010, but in 2011;
b) Late filing;
c) Voluntary disclosure subsequent to 2010;
d) Payment of legal fees in 2011 for a transaction implemented in 2010;
e) Implementation several years after 2010 of: an emigration strategy, a section 104(4) mitigation strategy, or an estate freeze.

To avoid these uncertainties, we recommend that only transactions implemented after 2010 be subject to the Proposals.

In closing, STEP Canada commends Finance for inviting stakeholders to comment on the Proposals. We trust that you will find our observations useful. We would be pleased to expand upon them at your convenience.

Yours very truly,

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