

Hidden Agendas - A Month in the Life

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When I was very young, much younger than today, I used to cringe every time new tax legislation came out. But after a few years, I got over it[1]. Now, it's just another surprise announcement, technical bill, mini-budget. Whatever. Sometimes I even look forward to the stuff. What I find interesting is figuring out the agenda behind the announcements. The last month or so has been particularly intriguing in this respect.

We started the month with the income trust proposals[2]. Talk about a surprise! The reason why everyone was caught off guard is that, with an election probably in the wings, nobody thought this would be on the government's agenda. Go figure! Maybe it's that, after years of Liberal politics, it's hard to believe that a party would actually believe it should govern, as opposed to trying to cling to power indefinitely (a case in point being the Liberals' deathbed eligible dividend proposals that, as everyone knows, did little to address the problem). So is this the agenda? Or is the four-year grandfathering period just a set-up for a pre-election concession grandfathering existing income trusts for, say, a decade?

Carry That Weight

Barely a week later, the Department of Finance released the mother of all technical bills.[3] Even by tax law standards, it's a behemoth: CCH's Special Report is nearly 900 pages long – gotta be a record. The reason for the prodigious size and weight is the convergence of two pre-existing streams of proposals – a sort of Perfect Storm for tax drones.

The first part of the legislation deals with offshore trusts and foreign investment entities. Here, the agenda is obvious. The inevitable news release trumpeted that the proposals are designed “to prevent tax deferral and avoidance through the use of foreign investment funds and trusts. The Motion proposes to tighten the income tax rules, responding to concerns raised by the Auditor General”. Of course, this is precisely the right kind of press for a right-wing minority government. I don't mean to be presumptuous, but I think there are two tiny problems with the press release and the inevitable news articles that followed. First, the legislation dates back to 1999 – and stems from the former Liberal government. Second, this round of legislation is actually more favourable to offshore planning than its previous incarnations. How so? The effective date of the provisions has largely been rolled back from 2003 to 2007[4], thus letting affluent taxpayers with international schemes off the hook for four years of chicanery.

The other part of the Motion contains the technical amendments - which date back only a few years. When everyone was finished pouring through the hundreds of pages of fine print, it turns out that, with only one or two possible exceptions[5] the only really noteworthy changes were to the restrictive covenant proposals in section 56.4.

The principal application of these rules is to non-competition covenants given on the sale of a business. The tiny space I have available precludes me from explaining these rules in detail. But as always, what I find interesting is figuring out the agenda behind these proposals.

Let me explain. From the elysian fields of tax-free status for non-competes - which taxpayers enjoyed just a few years ago - the rules have been turned into the tax version of a living hell – an Iraqi-like minefield where unwitting taxpayers can face harsh penalties. Having spent a couple of mornings trying to figure out how the rules apply to a given situation, I think it is fair to say that, even by income tax standards, the rules are difficult to fathom and could greatly complicate sales of businesses.

One of the sorest points is that the proposals can allow a reallocation^[6] and full taxation^[7] to individuals giving restrictive covenants, to the extent that the allocation to the covenant, if any, is unduly low.

In some cases, there are elections that can be made to fend-off the tax exposure. However, in the latest incarnation, the government has seen fit to limit a couple of key elections, where the value reasonably regarded as attributable to a restrictive covenant is received or receivable^[8] by a non-arm's length individual^[9]. For example, if a spouse holds shares and an insufficient amount is allocated to the restrictive covenant, then the spouse can be considered to receive a portion of the consideration attributable to the restrictive covenant, and the election is not available.^[10]

I Should Have Known Better

So is there an agenda here? In recent months, a number of colleagues have remarked that the restrictive covenant proposals feel like "punishment": a sort of tax purgatory for evil taxpayers – or more likely their advisors - for claiming the former tax-free status. And based on the latest changes, it seems that you are further punished if, for, example, you've decided to income/capital gains split, e.g., with your spouse or a family trust. Could this really be the agenda - a sort of S&M for tax drones? Or are we imagining the whole thing? The prospect of tax practitioners being admonished for their (perceived) transgressions, and deterred from such future action implies a Borg-like collective consciousness, which - come to think of it - may not be a bad analogy.

Of course, the most recent major government release was the (so-called) Economic and Fiscal Update, 2006. For days, rumours swirled that the government was going to make major tax changes, particularly to the income splitting rules. But while the Update itself turned out to be a non-event, tax-wise, the agenda is clear enough – the election campaign has begun. But I would not elevate the tax content of the announcement even to a campaign promise: at least a campaign promise contains some detail. About all that was announced was a cut in the GST sometime in the next five years, a reduction of capital gains tax sometime down the line, and a "pledge" to make our taxes the lowest tax rate on "new business investment" in the G7^[11] - in plain words, not much of anything.

[1] Unless, of course, it affects one of my files.

[2] Actually, the announcement was on October 31st, but that evening hardly anyone discovered a detailed release posted on Finance's website; so I count this as a November announcement.

[3] Now Bill C-33; originally: Notice of Ways and Means Motion – Non-resident Trusts and Foreign Investment Entities and Technical Amendments, November 9th, 2006.

[4] This was not mentioned in the "Backgrounder", which purported to summarize the major changes to the proposals.

[5] Notably, some clean-up to proposed section 143.3.

[6] Pursuant to proposed amendments to section 68 of the Act.

[7] Pursuant to proposed subsection 56.4(2).

[8] Directly or indirectly, in any manner whatever.

[9] Or by another taxpayer in which the non-arm's length individual holds, directly or indirectly, an interest.

[10] If this is a problem, a “secondary election” to ameliorate the harsh effects of a section 68 reallocation is available in proposed subsection 56.4(9). It doesn’t knock out section 68, but may turn the reallocated amount into a capital gain or “goodwill amount”. However, if the actual payment is received at the corporate level, there could be additional tax resultant from a subsequent distribution of the amount in question. By filing the election, is the taxpayer conceding that there is an insufficient amount allocated to the restrictive covenant, thus inviting further scrutiny, including a review of what is a reasonable allocation?

[11] The “pledge”, contained in chapter 2 of *Advantage Canada* is as follows: “Step one is to create a meaningful tax advantage over the United States, our closest economic partner. Step two is to achieve the lowest tax rate on new business investment in G7 countries.”