Tax Notes
Buckaroo Bureaucracy

By: David Louis, J.D., C.A., Tax Partner.
Minden Gross LLP

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I have made no secret of the fact that, when it comes to recent federal tax legislation, I'm not a happy fella. Like most practitioners, I have pretty well accepted the stunning complexity of tax legislation. Overly-broad drafting, on the other hand, is another story - which I have *kvetched* about on previous occasions.**[1]**

Crime and Punishment

But when I look at the currently-proposed legislation, I see other disturbing themes emerging. For one thing, I can't help but get the feeling that many provisions are designed to punish taxpayers. For example, courtesy of the non-resident trust proposals, if Canadians transact with structures involving non-resident trusts, the trust will be in jeopardy of being treated as a Canadian resident**[2]** - and the hapless Canadians could find themselves jointly and severally liable for the trust's taxes.**[3]** Non-resident trusts are often used in a legitimate manner by international investors,**[4]** but the non-resident trust proposals effectively make them a pariah.

Another example: until recently, court cases supported the position that non-competition covenants could often be received tax-free. Finance put an end to this in the fall of 2003. But rather than restore the tax treatment that most practitioners figured applied before the cases came along, the "final solution" was considerably more Draconian: a complete reversal, making restrictive covenants fully taxable unless certain conditions are met, along with broad powers to reallocate amounts to these covenants. One of the few exceptions is that eligible capital treatment may apply instead (i.e., on an asset sale). But losing this treatment is as easy as falling off a log: both the vendor and the purchaser must elect to apply paragraph 56.4(3)(b) and both must include the election in their tax returns for the relevant taxation year. Another – remarkable - requirement: both parties must actually *file* the return on or before the filing deadline. Late filing by *either* the vendor or purchaser will knock out the election. Although there are many elections that must be filed with tax returns, relatively few impose an absolute time deadline on filing.

Another punitive provision, that came in with the last round of the FIE amendments, is the denial of rollovers of FIEs under subsections 85(1), 85.1(3) and 86(1).**[5]** Apparently, Finance was concerned that these rollovers were being used to defer the application of proposals.**[6]** So they zapped them completely.

The feeling I get when I look at these provisions is crime and punishment.**[7]** It's as if taxpayers (and their advisors) have done something evil by taking advantage of what Finance surely perceives as loopholes, so the appropriate legislative response is to enact harsh and punitive provisions. It's almost like an old Clint Eastwood movie: *Feel lucky - punk? Win a court case on non-competes? Go ahead, make my day. I'll stick it to ya* (with fully-taxable status) *and zap ya* (with a reallocation).

More Retroactivity leads to . . .

Another disturbing trend is the increasingly retrospective aspects of proposals. Until recently, it was not certain whether the General Anti-Avoidance Rule may override a tax treaty. To settle the matter, Finance decreed that this was indeed the case: the proposal in question indicates that GAAR applies in this manner - *from its inception*. While they were at it, they decreed that GAAR applies to tax regulations and the like, thus knocking out some jurisprudence – again on a retrospective basis. Plain and simple, this is a retroactive change which has attracted the protest of virtually the entire tax community. In spite of this, Finance has not shown any intention of changing this provision.

More Uncertainty

Another form of retroactivity pertains to proposals which may (or may not) be changed, but, nevertheless purport to have retrospective effect. The FIE and non-resident trust proposals are prime examples – which continue to attract criticism from the tax community both for their complexity and technical problems. Finance has been tight-lipped as to whether there would be another round of legislation (that would be the fifth) or when, for that matter, these rules would be enacted. The FIE and non-resident trust proposals are already retroactive to nearly two and one-half years ago. And with the current political uncertainty, it is highly unlikely that they will become law any time soon. Tax advisors are thus put in the position of having to stick-handle through these complex provisions and hope that any structures that are set up in reliance thereon will not be subject to some sort of adverse retroactive change.

Another provision that is up in the air is proposed section 3.1. This is the legislative "reasonable expectation of profit" test. It has attracted a storm of criticism; for example, business ventures which suffer an unexpected reversal of fortune could face the additional penalty of losses being disallowed once profits are no longer expected. Finance has been tight-lipped about the nature of changes (if any) to this provision; however, the proposals were scheduled to start taking effect at the beginning of this year. So we are the better part of six months into a regime which may – or may not – undergo wholesale changes.

What is Finance's response to all of these criticisms? Well – to be unresponsive. In fact, a leading tax lawyer recently used this label in terms of its attitude towards policy criticisms from practitioners. Tax planning is not a crime. But I keep wondering whether Finance's real agenda is to make it one.

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[1] See "Still More Overkill", *Tax Notes*, No. 503, December 2004.

[2] For most purposes – see proposed paragraph 94(3)(a).

[3] See "NRT Rules: Harsher Than You Think", *Tax Notes,* No. 502, November 2004.

[4] For a recent discussion of how a non-resident trust can be used for structuring inbound investments, see "Cross-Border Financing Structures for Inbound Investments" by John M. Ulmer, 2004 Canadian Tax Foundation Annual Conference draft papers, paper No. 10.

[5] The denial applies to "specified participating interests", as defined in subsection 248(1), which excludes "exempt interests".

[6]See "Overview of the Foreign Investment Entity Legislation", Albert Baker, *International Tax Seminar, May 10, 2004, Text of Seminar Papers*, International Fiscal Association, p. 2:15.

[7] The FIE and non-resident trust proposals include some particularly heavy-handed requirements. For example, a number of paragraphs near the end of subsection 94.1(2) give the Minister the power to knock-out various exemptions from the application of the FIE rules if "information satisfactory to the Minister" to make a determination of whether the exemption applies is not received within 60 days (or within any longer periods that are acceptable to the Minister) after the Minister sends the demand.