Clear and Present Danger - The Saga Continues

by David Louis, B. Com., J.D., C.A., Tax Partner
Minden Gross LLP, a member of MERITAS Law Firms Worldwide.

*(*This release is based on an article published in Tax Notes #530, March 2007, CCH Canadian Limited)*

_____

If you ask me, the still ongoing saga of the federal budget's restricted interest proposals could be the most bizarre incident coming out of the Department of Finance since Alan MacEachan's 1981 federal budget. Because of budget secrecy, it is doubtful we will ever know the full story behind these ill-fated proposals. But what is on the record raises some serious questions about the inner workings of the group of bureaucrats in whose hands responsibility for our tax laws reside.

In case you've been in hibernation, here's a brief rundown of the events to date: On March 19th, the federal budget announced the now-infamous restricted interest proposals - that did nothing less than disallow interest deductions in respect of investments in foreign affiliates**[1]**.

It took the financial press a couple of days to figure out what was going on, but once they did, the proposals rightfully became big news, with Canada's financial establishment heaping derision on the beleaguered Finance Minister. On Monday May 14th, the proposals were withdrawn, replaced by the announcement of measures specifically directed against tower and double dip financing structures.**[2]** (These structures use interest charges to drain an affiliate's profits subject to foreign tax without having to pay Canadian tax on interest income on "the other end".) These proposals would be delayed until 2012 - and vetted, Flaherty promised - by a panel of experts. Even so, it took less than 24 hours before establishment CA and law firms started to issue releases protesting the new proposals**[3]**.

On Thursday of that week, Flaherty addressed the International Fiscal Association meeting - populated by members of the aforesaid firms. How can you kill double-dips – reps of the organization beseeched - when they don't cost Canadian taxpayers a cent? (They actually asked twice.) Finance Minister Flaherty said something about "morality", plus some hints that the heat could be coming from his G8 colleagues.

This was rapidly followed by a bizarre article in Friday's Globe**[4]** in which Flaherty recognized that tax advisors would be able to figure out ways to get around the narrowly-focused legislation – almost an invitation to Bay Street drones to do so**[5]**. The article also cited Jack Mintz for saying that the new proposals could hamper Canada's global competitiveness. Huh? Wasn't it his committee that came up with the original budget proposals a decade earlier?

Unanswered Questions

Actually, this is just one of many unanswered questions raised by the saga. Are the double-dip proposals an attempt by Flaherty to save face? Is he really under pressure from other countries, as he hinted? Or is this an exercise in "tax morality" as the Finance Minister has now indicated on a number of occasions? If so, isn't the job of a Finance Minister to advance Canadian business interests?

But as I indicated in my article on the original proposals**[6]**, what disturbs me is the process by which the legislation came to pass.

It is true that mention in Auditor General's reports and the Mintz Committee gives the original proposals some pedigree. But if the more constrained double-dip/tower proposals are to be vetted by a panel of experts, shouldn't there have been even more safeguards with respect to the original – much farther reaching – proposals? Changes this fundamental should be the subject of extensive consultation, as was the case in their previous incarnation as part of the Mintz Committee recommendations.

So why weren't they? On budget night, did the Finance Minister *really* understand the proposals? Or was he ultimately forced to defend the doing of bureaucrats who did not fully appreciate their widespread effect?

If I were in Mr. Flaherty's shoes, I would be taking a close look at the goings on in my department. If so, he may find that these are not the only troublesome items that have gotten all the way through the Tax Policy bureaucracy. Consider, for example, some other international tax proposals that are passing through Parliament even as I speak**[7]**:

- A Canadian beneficiary of a foreign estate or trust will normally have to report annual imputed interest (currently 7%) based on the total carrying values of the assets in the estate or trust, even though he or she may ultimately receive little or none of the income or capital (i.e., because there are other beneficiaries).**[8]**

- A person who has immigrated to Canada with a foreign life insurance policy will ultimately have to revalue the policy every year and pay tax on the increase.**[9]**

How many people will (can?) actually comply with these off-the-wall rules? The obvious answer begs the question of continued respect for the self assessment system.

You may recall *Dr. Strangelove*, a movie which centered around a deranged lower-level military officer who was given the power to drop nukes. Is something like this going on in Ottawa? Is anyone minding the Tax Policy Store?

---

[1] This would occur in the vast majority of situations. Deductions could be allowed to the extent of taxable income in respect of the foreign affiliate.

[2] Release 2007-041 ("Canada's New Government Improves Tax Fairness with Anti-Tax-Haven Initiative") and related documents, May 14, 2007. In a nutshell, the proposals restrict deductions for interest relating to investments in foreign affiliates in respect of periods beginning after 2011, to the extent of the corporation's "double dip income" for the taxation year. Double dip income is based on "recharacterized income" which in turn is based on deemed active business income per paragraph 95(2)(a) that is attributable to a "specified debt" owing to the foreign affiliate.

[3] Including the use of terms such as "disturbing", "inherently unfair" and "destructive" – pretty strong stuff.

[4] "Flaherty says double-dipping not doomed", May 18, 2007.

[5] The article indicates that Flaherty stated: "There are other issues that we could focus on. ... There are other ways, I'm sure. Lots of people get paid lots of money to develop tax avoidance schemes, and that's to be expected. . ."

A presentation on the Anti-Tax Haven Initiative by Angelo Nikolakasis and Penny Woolford at the IFA conference points out numerous anomalies in the legislation. Accordingly, it can be expected that the legislation will be more complex than the proposals might suggest.

[6] "The Federal Budget's Interest Restrictions – Clear and Present Danger?" *Tax Notes* #531.

[7] Bill C-33.

[8] See, in particular the definition of "specified interest" in a trust (which exempts an interest in a totally-discretionary trust), per proposed subsection 94.1(1), and paragraph 94.1(2)(c) re the calculation of "designated cost". These provisions appear to potentially affect the beneficiaries of so-called "five-year immigration trusts". Paragraph (c) of the definition of "exempt taxpayer" contains a 60 month exclusion from the FIE rules for new Canadian residents. However, besides the recent immigrant, the beneficiaries of an immigration trust may also include beneficiaries that are longer-standing Canadian residents.

[9] See proposed subsection 94.2(10) *et seq*. Paragraph (c) the definition of "exempt taxpayer" mentioned in the previous note would exempt new Canadian residents – i.e., for the first 60 months of residence. However, it seems that a pre-existing exemption, potentially applicable to persons who acquire a policy more than five years before becoming a Canadian resident, has been removed in Bill C-33.