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July 8, 2010

Department of Finance Canada
19th Floor, East Tower
140 O'Connor Street
Ottawa, Ontario
K1A 0G5

Attention: Gerard Lalonde,
Director, Tax Legislation Division

Dear Sirs:

Re: Finance Proposals Relating to Information Reporting of Tax Avoidance Transactions

I am writing on behalf of the Conference for Advanced Life Underwriting (CALU) and the Financial Advisors Association of Canada, which operates under the name of Advocis™. Advocis is the largest voluntary professional membership association of financial advisors in Canada, representing more than 10,000 financial advisors across Canada. Advocis members provide comprehensive financial and retirement planning, wealth management, estate and tax planning, risk management and employee benefits planning products and advice to millions of Canadians.

CALU was formed to meet the needs of Advocis members who specialize in advanced applications of life insurance and related financial services, including such areas as estate planning, business succession, employee benefits, wealth accumulation and retirement planning.

Background for this Submission

In the 2010 Federal Budget, the Department of Finance ("Finance") announced that it would engage in public consultation on proposals concerning an information reporting regime for certain tax avoidance transactions. This information reporting regime would be in addition to other provisions of the *Income Tax Act (Canada)* (the "Act") that are geared to preventing aggressive tax planning strategies including the general anti-avoidance rule ("GAAR") and the tax-shelter rules.

On May 7, 2010 the Honourable James Flaherty, Minister of Finance, released for public consultation more detailed proposals that are designed to "help the Canada Revenue Agency identify instances of aggressive tax planning, which can undermine the integrity of our tax reporting system." These proposals provide details on who is subject to the reporting rules; the transactions that will be required to be disclosed; the proposed form, content and timing of disclosure; and the consequences of failure to disclose a reportable transaction.

The purpose of this submission is to provide CALU's feedback to Finance as part of the consultation process on these proposals and to offer recommendations which could allow the Department to accomplish its policy goals.

Policy Background

The rationale for the proposed reporting rules is set out in the Finance Backgrounder released on May 7, 2010:

"These proposals seek to address concerns about the impact of aggressive tax avoidance transactions on the fairness of the tax system. Canada is not the only jurisdiction that has acted to address the impact of aggressive tax planning. Notably, the United Kingdom, the United States and the province of Quebec have introduced reporting regimes that identify aggressive tax planning by reference to "hallmarks" of such planning, to assist their respective tax administrations in identifying potentially abusive transactions and their participants. In general terms, the particular hallmarks reflect certain circumstances that commonly exist in the context of tax avoidance transactions. The presence of these hallmarks often indicates a greater likelihood that the underlying transactions are one that could be challenged under the existing provisions of the tax law."

Overview of CALU's Position

CALU accepts the need for both Finance and the Canada Revenue Agency (CRA) to curtail the proliferation of aggressive tax avoidance schemes that undermine the goal of protecting the tax base and of stabilizing income tax revenues, and that also create the perception that the tax system is subject to abuse by a select group of planners and taxpayers. CALU is also supportive of proposals that will help the CRA identify such arrangements by reference to specific "hallmarks" that are typically associated with such schemes. However, we cannot support the current proposals for the following reasons:

- The reporting requirements require that the parties involved determine that the transaction is an "avoidance transaction", and will apply even if where there are reasonable grounds for believing the transaction or series of transactions was not an "avoidance transaction"

- The definition of "avoidance transaction" includes a "series of transactions" and could therefore include a specific transaction that alone would not, in and of itself, be an "avoidance transaction." This in turn could result in a reporting and penalty tax obligation on tax and financial advisors who have implemented a transaction for *bona fide* purposes and without direct involvement in (or even detailed knowledge of) the step or series of steps that are taken that cause the bona fide transaction to become an avoidance transaction
- The hallmark definitions are so broadly worded that a normal commercial transaction could trigger the reporting requirements
- It is unclear from the proposals what process the CRA will follow to determine if a taxpayer failed to meet its reporting obligation, and the "review process" where the CRA has determined that a transaction is subject to the reporting requirements and the determination of the applicable penalty
- The proposals create significant uncertainty and financial risk for both the taxpayer and other parties that are engaged in *bona fide* tax and estate planning transactions

Each of these issues is discussed in further detail below.

1. Definition of Avoidance Transactions

a) Is the Transaction an Avoidance Transaction?

There currently is significant uncertainty concerning whether a specific tax planning strategy will be considered by the courts to be an avoidance transaction in the context of the GAAR. To address these concerns taxpayers will often seek tax and legal opinions to determine if a transaction could be considered an avoidance transaction as defined for purposes of the GAAR, and in turn the client's advisors may contact the CRA for a technical interpretation or ruling on the matter. Based on the advice of professional advisors (who may in turn be relying on a CRA interpretation) the taxpayer could in good faith agree to implement a tax planning strategy without reporting the transaction under these proposals.

Subsequent events such as a change in the CRA's interpretation or a court decision could result in the type of transaction being considered to be an avoidance transaction (but not necessarily subject to GAAR or other legislative provisions). Assuming two of the three hallmarks are also satisfied (see discussion below) it would appear that the tax benefit of the transaction can be suspended by the CRA until the transaction is reported and the penalty is paid for failure to disclose the transaction. This would appear to be an unfair and inappropriate result.

To avoid this type of situation from arising we propose that the taxpayer and other parties to the transaction be provided with a defence to the requirement to report where it can be demonstrated that an appropriate standard of care was exercised in determining whether a specific transaction is an "avoidance transaction" (a "due diligence defence.")

b) Series of Transactions

The definition of an avoidance transaction includes “any transaction that is part of a series of transactions that, but for GAAR, would result directly or indirectly in a tax benefit…”

The proposals indicate that a reportable transaction would include all the transactions in a series of transactions, if at least one of the transactions in that series is an avoidance transaction.

This can result in the net being cast very widely in terms of who is required to report, and the amount of the penalty that would be payable if there is non-compliance. For example, assume a licensed insurance advisor is working with a team of advisors and sells the client an insurance policy for estate planning purposes. The client and/or other advisors utilize the insurance policy as part of a series of transactions where at least one of the transactions is an avoidance transaction. Assuming two of the hallmark tests are satisfied, and the insurance advisor falls within the definition of a “promoter or tax advisor”, the insurance advisor would appear to be jointly and severally liable for the penalty tax to the extent of fees paid or payable to the insurance advisor. This appears to be the case even where the sale of the insurance policy was primarily for *bona fide* purposes, and the insurance advisor may or may not even be aware of the other transactions being entered into by the client (due to the use of the word “indirect” in the definition of promoter or tax advisor).

To deal with this situation, a promoter or tax advisor should be provided with a defence to the requirement to report the transaction and/or pay a penalty, where that person can demonstrate that his or her involvement was limited to one or more transactions in the series that is not the particular avoidance transaction tainting the series of transactions, and that person did not otherwise participate directly in the other series of transactions that resulted in the series being categorized as an avoidance transaction.

2. Definition of the Three Hallmarks

(a) Hallmark One - Entitlement to Fees

In our view the definitions of key words and terms in the first hallmark are too broad and could result in the CRA determining that fees earned on common tax and estate planning transactions meet the requirements of this hallmark.

We will first review the definitions, and then discuss how they could apply to transactions which CALU members commonly undertake on behalf of their clients:

> "tax benefit" has the meaning under section 245 of the Act and has been given a very broad interpretation by the Courts.
>
> "fee" means *any consideration* received or receivable by a promoter or tax advisor in respect of a transaction for a variety of defined services.
>
> A fee would be attributable to a tax benefit if the fee is based *in whole or in part*, on the amount of the tax benefit sought under the transaction.
>
> A fee of a promoter or tax advisor that is *"to any extent"* contingent upon the obtaining of a tax benefit would include a fee that is refundable based upon the obtaining of the tax benefit, *in whole or in part, in any manner whatever*.
>
> A "promoter" is defined to be a person who *directly or indirectly* engages in an activity that is the promoting or selling …of an arrangement, plan or scheme (an "arrangement"), or accepts … consideration in respect of the promotion or sale of an arrangement, where it can reasonable be considered that the arrangement *includes or relates to* an avoidance transaction.
>
> A "tax advisor" means a person who, *directly or indirectly,* provides any aid, assistance or advice with respect to organizing or implementing an avoidance transaction, or any contractual protection in respect of an avoidance transaction. A person who provides such aid, assistance or advice to another tax advisor or promoter in respect of an avoidance transaction would also be considered a tax advisor in respect of the transaction. More than one person may be a tax advisor in respect of the same avoidance transaction.

CALU members are typically licensed or registered to sell life insurance and/or investment products. They may receive "fees" directly from the client for financial, retirement or estate planning advice, and/or compensation directly from the product manufacturer (such as an insurance or mutual fund company) for the successful placement of an insurance or investment product.

In a general sense this compensation is not normally attributable to the amount of any *tax benefit* arising from the planning advice or sale of a product, or contingent upon the obtaining of a *tax benefit* from the transaction. However, given that the amount of compensation can increase with the number or amount (premium, face amount or deposit size) of products sold, and such products can produce certain tax benefits, it might be argued that the advisor is entitled to fees "attributable to the number of taxpayers who participate in the transaction…"

As noted above, these products are typically purchased by clients for *bona fide* non-tax purposes such as insurance protection for family, retirement or succession planning. However, the client and his or her other advisors may combine the insurance or investment product with other planning transactions, with the result that the series of transactions may be considered an avoidance transaction. It would appear that the CALU member could have a reporting obligation and liability for a penalty, despite not being directly involved in any of the transactions resulting in it being considered an avoidance transaction. In turn, the CALU member could be responsible for paying a penalty equal to all compensation and fees earned from providing advice and service to the particular client.

It is our position that this hallmark should exclude from the definition of “fee”, any compensation paid by the manufacturer of an insurance and investment product where such products are generally available to the public, as well as any fees payable by the client for a review of their financial situation, and advice as to the suitability of those products for their particular situation.

(b) Hallmark Two - Confidential Protection

To fall under this hallmark, the promoter or tax advisor in respect of the transaction requires “confidential protection” with respect to the transaction.

“Confidential protection” is defined to mean *any limitation on disclosure to any other person, including the CRA that* is placed by a promoter or tax advisor on the taxpayer…in respect of the details or structure of the avoidance transaction that gives rise to any tax benefit.

CALU members may become involved in the design and/or marketing of proprietary insurance and investment programs. These programs often require a significant amount of due diligence concerning the legal, accounting and tax consequences of the arrangements, supported by various opinion letters. These opinion letters may be made available to prospective clients and their advisors with the request that they not be copied or otherwise disclosed to other parties without the consent of the person who obtained the opinion. The purpose for this limitation is to maintain and protect the intellectual capital and investment that has been made in developing the program from market competitors, and not to hide or prevent disclosure of the program to the CRA. We don’t believe the proposals should apply to these types of arrangements and there should be a specific exemption where it can be demonstrated that there was a *bona fide* business purpose for the limitation on disclosure (including the preservation of solicitor-client privilege) or it can be demonstrated that such limitation was not meant to extend to the CRA.

It also appears possible for a promoter or tax advisor to become subject to the reporting requirements as a result of another party to the transaction requiring confidential protection. For example, a promoter might specifically forbid the requirement of confidential protection with respect to the transaction. However, a tax advisor providing advice on the matter may require confidential protection without advising the promoter. In these circumstances we don’t believe this hallmark should apply to potentially create a reporting requirement on the promoter (although it may create a reporting requirement on the tax advisor and taxpayer).

c) Hallmark Three – Contractual Protection

The final hallmark contemplates that the taxpayer or person who entered into the transaction for the benefit of the taxpayer obtains "contractual protection" in respect of the transaction (otherwise than a result of the fee described in the first hallmark).

Contractual protection means *any form* of insurance, indemnity or compensation

(a) that protects against the failure of the transaction to result in any portion of the tax benefit being sought from the transaction
(b) pays for or reimburses any expenses to be incurred in respect of a tax benefit arising from a transaction; or
(c) is intended to guarantee a return of, or in respect of, the cost of any property acquired by the taxpayer in the course of the transaction.

Again, the main concern relating to this hallmark is that it is so broadly defined that it could include certain contractual guarantees available under certain products including those distributed by CALU members.

For example, the following might be considered a contractual guarantee as a consequence of the purchase of an insurance policy:

a) guarantees associated with the credited rates of return on the cash surrender value of the policy
b) guarantees relating to the cash surrender value of the policy
c) contractual provisions that may provide the client with additional values in relation to the investment income tax upon the taxable surrender of the policy.

A segregated fund policy also provides certain guarantees relating to the value of the investments in the policy in the event of termination or death of the policyowner, and is considered a key product feature.

We would also note that a financial advisor may engage an outside consultant to assist a taxpayer with accounting, tax or legal advice concerning the transaction (i.e. the appropriateness of an insurance solution) or implementing other planning transactions (i.e. the completion of wills or trusts). The financial advisor may agree to fully or partially fund the costs of these services. In this case it might be argued that the financial advisor has "paid or reimbursed an expense to be incurred in respect of a tax benefit" with the result that this hallmark has been satisfied. We don't believe this is or should be considered a "contractual protection", and is another example of how the proposals could inadvertently apply to a taxpayer, promoter and/or tax advisor.

Again, it is our view that the proposals should be clarified to ensure that the definition of contractual guarantees excludes any form of indemnity or compensation arising from contractual provisions within a financial product where such guarantees are normally included in products available to the general public, or where the reimbursement is on commercial terms and not directly related to the tax benefit.

3. Reporting Requirement and Imposition of a Penalty

We have a general concern relating to the process that will be followed by the CRA to determine whether a taxpayer has a failed to meet its reporting requirements, and/or in determining the size of the penalty where this requirement has not been met. From CALU's perspective, it would be preferable to have an approach similar to that taken for the review of the application of the GAAR, with a committee being established to ensure the proper review and standardization of processes in applying these rules.

It is also not clear what appeal process will be available to a taxpayer, promoter or tax advisor in challenging the CRA's assertion that the taxpayer was involved in an avoidance transaction, that two of the three hallmarks were present as part of the avoidance transaction, and the amount of the penalty that must be paid (as well as the possible allocation to other parties under the joint and several liability provisions). We believe there should be a legislative right to appeal this determination to the Tax Court of Canada by any affected party, without first requiring the reporting of the transaction and payment of the penalty.

Uncertainty and Financial Risk

We believe the uncertainty and financial risk associated with the current proposals could add a significant layer of regulatory burden on individual taxpayers and business owners who wish to undertake transactions for *bona fide* personal or business reasons. As noted above, it is also a potential trap for financial advisors who facilitate a transaction that is not itself an avoidance transaction, and who has no direct knowledge of other planned transactions that could create a reporting obligation under these proposals.

Summary and Recommendations

While CALU agrees with the general principles relating to the reporting of avoidance transactions, we believe there must be significant changes in the approach to ensure that the reporting and penalty requirements do not apply in unintended ways to normal commercial transactions involving the sale of financial products that are acquired for *bona fide* non-tax purposes. In particular, we would request Finance revise the proposals as follows:

- A taxpayer and other parties to the transaction be provided with a defence to the requirement to report where it can be demonstrated that an appropriate standard of care was exercised in determining whether a specific transaction was an "avoidance transaction"

- A promoter or tax advisor be provided with a defence to the requirement to report the transaction and/or pay a penalty, where that person can demonstrate that his or her involvement was limited to one or more transactions in the series that is not the particular avoidance transaction tainting the series of transactions, and that person did not otherwise participate directly in the other series of transactions that resulted in the series being categorized as an avoidance transaction.
- Exclude from the definition of "fee" in the first hallmark any compensation paid by the manufacturer of an insurance and investment product where such products are generally available to the public, as well as any fees payable by the client for a review of their financial situation and advice as to the suitability of those products for their particular situation.
- The second hallmark should not apply where it can be demonstrated that there was a *bona fide* business purpose for the limitation on disclosure (including the preservation of solicitor-client privilege) or it can be demonstrated that such limitation was not meant to extend to the CRA. As well, this hallmark should not create a reporting or penalty obligation on a promoter or tax advisor if that person took active steps to ensure there was no requirement for confidential protection
- The definition of contractual guarantees in the third hallmark should exclude any form of indemnity or compensation arising from contractual provisions within a financial product where such guarantees are normally included in products available to the general public, or where the reimbursement is on commercial terms and not directly related to the tax benefit.
- The CRA should establish a committee similar to the GAAR committee to ensure the proper review and standardization of processes in applying these rules. As well, there should be a legislative right to appeal any determination by the CRA under these proposals to the Tax Court of Canada by any affected party, without first requiring the reporting of the transaction and payment of the penalty.

We thank you for your consideration of this submission and we would be pleased to discuss this matter with you at your convenience.

Yours truly,

Kevin Wark, LLB
Chair of CALU Tax Policy