MNP LLP

SUBMISSION TO THE DEPARTMENT OF FINANCE FEBRUARY 4, 2022 DRAFT LEGISLATIVE PROPOSALS

April 4, 2022

Submitted electronically at: Consultation-Legislation@fin.gc.ca

MNP LLP (MNP) is pleased to make a submission in response to the Department of Finance (the "Department") request for comments on the draft legislative proposals to the *Income Tax Act* ("ITA") and other legislation released on February 4, 2022 (the "Draft Proposals"). We appreciate the opportunity to provide our comments and recommendations.

MNP is a leading national accounting, tax and business consulting firm in Canada. MNP proudly serves and responds to the needs of our clients which include more than 280,000 private enterprise and small business clients throughout Canada.

Given the existing complexity of Canada's income tax system, as well as the challenges in interpreting and applying the related legislation, it is important to ensure that certainty and predictability are considered when introducing legislation. Effective legislation must address its intended objective without creating unintentional adverse consequences for taxpayers and must be concisely written so that it is not subject to differing interpretations. The elements of certainty and predictability in tax legislation must also be considered from the taxpayers' perspective in order for the legislation to be understood and complied with.

In our view, certain provisions of the Draft Proposals, if enacted in their current form, will cause significant uncertainty for taxpayers as it is unclear how the proposed rules are to be applied by taxpayers and even more unclear as to how they will be applied by the Minister of National Revenue (the "Minister"). Our submission addresses the concerns and challenges we anticipate our clients will face if the Draft Proposals are enacted in their current form.

Specifically, our submission will focus on the following measures:

A. Mandatory Disclosure Rules
B. Reporting Requirements for Trusts
C. Audit Authorities
D. Electronic Filing and Certification of Tax and Information Returns

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A. Mandatory Disclosure Rules

Definition of "Reportable Transaction"

The amended definition of "reportable transaction" (ITA subsection 237.3(1)) provides that only one of three hallmarks need be present to cause a transaction to be reportable. In particular, the amendment to paragraph (c) of the definition and the link to the definition of "contractual protection" (ITA subsection 237.3(1)) is broad and could inadvertently encompass many common *bona fide* commercial transactions and deem them as an abusive transaction. For example, it is common practice for a vendor in a share sale transaction to provide representations and indemnity clauses regarding the tax attributes of its target corporations. In addition, sale transactions often require temporary non-disclosure agreements between parties until a sale is reached and could contain certain terms that could arguably cause them to create confidential protection (as defined in ITA subsection 237.3(1)), which could then create a reporting obligation. We submit this could cause many taxpayers to be subject to unnecessary, costly and unintended reporting obligations on *bona fide* transactions.

Through a Taxpayer Lens

Mark and Jennifer own a poultry farm just outside of Regina, Saskatchewan. Mark and Jennifer are in the process of finalizing the sale of the shares of their farm corporation to a third-party purchaser. There were some operating assets in the farm that the purchaser does not want as part of the deal, so it was agreed that these assets would be disposed of prior to the share sale. As a result, the purchaser requested that a term be included in the contract so that Mark and Jennifer agree to indemnify the purchaser for any taxes of the corporation that are attributable to any pre-closing transactions. Mark and Jennifer's lawyer and tax advisor, both of whom are sole proprietors in town, assured Mark and Jennifer that the indemnity is common in this type of transaction.

However, the lawyer and tax advisor seem to disagree as to whether the indemnity causes the sale to be considered a "reportable transaction" under the new rules: the lawyer thinks the sale is reportable, but the tax advisor disagrees as there is no mischief or abuse of tax rules arising from the sale.

Mark and Jennifer are not sure how to proceed. While they are hesitant to incur any costs relating to the additional work to report the sale, they are afraid of how punitive the potential penalties will be for failure to report, based on what their lawyer has advised. The tax advisor is also uneasy; although he does not believe he is subject to the reporting requirements for the sale, he is not 100 percent confident of his view.

Definition of "Notifiable Transaction"

An equitable tax system should be one in which the law is applied consistently to all taxpayers. Two elements that should be present in Canada's self-assessing tax regime are predictability and certainty. There are some aspects of the Mandatory Disclosure Rules ("MDR") which lack clarity and are open to subjective interpretation by individuals, which will lead to inconsistently applied expectations of taxpayer reporting obligations.

The proposals indicate that disclosure for a notifiable transaction will be required in respect of a transaction that is *substantially similar* to a transaction or a series of transactions designated by the Minister (ITA subsection

237.4(1)), and that term is to be interpreted broadly in favour of disclosure (ITA paragraph 237.4(2)(b)). The objective of the MDRs is to ensure disclosure of aggressive tax planning; the legislation as drafted lacks clarity and leaves open the potential for the rules to be applied in situations beyond the intended scope. Pursuant to proposed ITA subsection 237.4(3), the Minister may designate transactions or series of transactions in such a manner as the Minister considers appropriate; it is unclear on how much advance notice the Minister would be required to provide in respect of any such designations as the definition of "notifiable transaction" in proposed subsection 237.4(1) simply refers to "at that time". This effectively removes the rules from legislative or Parliamentary oversight, as it provides the possibility for other transactions to be designated as requiring disclosure without having those transactions first discussed in Parliament, included in the ITA and objectively tested in the tax courts.

In addition, the retroactive application of these proposals to transactions entered into after 2021 is unfair to taxpayers due to the magnitude of information requiring to be reported and the uncertainty surrounding reporting obligations. A more practical approach would be to have the reporting requirements apply to transactions entered into on or after Royal Assent.

Reporting Timeline

The 45-day deadline outlined in proposed ITA subsections 237.3(5) and 237.4(5) for the required disclosure for reportable and notifiable transactions will be problematic for the parties involved given the level of information required to be disclosed. Details on a transaction can change right up until the transaction closes, so earlier information that is disclosed in respect of a transaction may not be accurate anymore when the transaction is completed; the usefulness of the disclosed information would be questionable. From a practical perspective, there is also uncertainty as to when a taxpayer is considered contractually obligated to enter into a transaction. For example, does a taxpayer become contractually obligated to enter into a transaction upon signing a letter of intent? Even after the signing of such a letter, a purchaser and a vendor can enter into negotiations that extend beyond 45 days, only to have the sale not be completed at the end or to be structured in a different manner. Clarity is also needed on how the reporting deadline will be determined where there is a series of transactions that straddle the effective date of legislation.

Requiring multiple parties to a transaction, as well as any involved advisors, to disclose information for the same transaction will create many inefficiencies and potentially confusion, resulting in information that can be contradictory. If the purpose of the proposals is to streamline the work of the Minister, these rules may have the opposite effect, causing a negative impact on service delivery standards and difficulty in cross-referencing information returns filed by separate parties for the same information and transactions.

Additionally, where there is uncertainty in determining if reporting requirements exist, as in the case of notifiable transactions as discussed above, it is not reasonable to effectively penalize taxpayers with the application of an indefinite extension of the normal reassessment period (ITA subsections 152(4) and (4.01)). It is extremely difficult for taxpayers to comply if there is uncertainty in the rules and the application of those rules to their transactions.

Parties Subject to MDR Reporting

It is inherent in our system that taxpayers have the right to seek out unbiased, undisguised advice, opinions or counsel from tax and legal professionals and the measures proposed in the draft legislation do not appear to support this. For example, for reportable transactions, reporting by one party will no longer discharge another person's obligation to report. This appears to infringe on the ability of the involved parties to independently determine if these obligations should apply to them. If one party determines that reporting is necessary, are other impacted parties also effectively compelled to do so even though they were of the view that the transaction in question was not subject to the reporting requirements? In some cases, professionals may be reluctant to discuss matters with a taxpayer if it could trigger a reporting requirement under the proposed rules, which would be unfair to Canadian taxpayers, most of whom require professional assistance in navigating the complex legislation in the ITA.

Disclosure of Uncertain Tax Positions

Under the Draft Proposals, taxpayers that are already required to disclose uncertain tax positions in the notes to audited financial statements will now also be required to prepare an information return to disclose this information pursuant to proposed ITA subsection 237.5(2). Financial statement information, including notes to the financial statements, is required to be submitted annually with the *T2 Corporation Income Tax* Return. As this information is currently readily available to the Minister, it is unclear as to why taxpayers are expected to expend additional resources to provide the same information.

Minister's Expectations of Taxpayers

These latest proposals appear to signal a move towards taxpayers being required to self-audit, which is a concept that has previously been rejected in the tax courts. The tax courts have expressed that, when faced with an issue that is reasonably open to debate, taxpayers are entitled to file their tax return on the basis most favourable to them, and it is up to the Minister to verify such amounts with "reasonable assistance" from the taxpayers. In our view, the effort required to navigate the proposed rules to (i) determine if a transaction is subject to the reporting requirements, (ii) comply with the information disclosure requirements, and (iii) do so within a short period of time, would not be commensurate to the level of effort involved in providing "reasonable assistance".

RECOMMENDATIONS

- Clarify the proposed rules - If the intended outcome is to increase meaningful disclosure, more specificity is required.
    - For notifiable transactions: Identify and codify specific transactions that are not open to interpretation by different parties rather than using subjective terms such as "substantially similar". Furthermore, the determination of what is notifiable should not be left to the Minister's sole discretion.

  - For reportable transactions: Clarity is required with respect to many definitions in the proposed rules. The term "contractual protection" should be modified to ensure common contractual terms used in *bona fide* commercial transactions are not inadvertently caught.

- Amend legislation - If the intended outcome is to identify aggressive tax strategies or eliminate specific tax planning that is currently allowed under the legislation, then specific amendments to the legislation should be made.
- Eliminate the proposed multi-party disclosure requirement for the same transaction or series and maintain the current system of a single reporter.
- Narrow the application of the legislation with respect to reportable and notifiable transactions to those entered into on or after the date of Royal Assent to be consistent with the proposed application of penalties.
- Extend the deadline for disclosing reportable and notifiable transactions from 45 days to the due date of the tax return.
- Eliminate the redundant reporting proposed for uncertain tax positions; the Minister can look to developing improved capability to analyze this information from the current information collection systems already in place.

B. Reporting Requirements for Trusts

The Draft Proposals significantly expand trust filing and reporting obligations, requiring trusts to file annual returns that were previously exempt, as well as imposing significant additional disclosures. Trusts that were previously exempt from filing, such as those that are inactive, have nominal assets, made no distributions in a year, and had no tax liability in a year, will now be required to file annual returns.

Bare Trusts

Proposed ITA subsection 150(1.3) extends the new trust filing and reporting obligations to "bare trusts". The additional tax and information reporting for bare trust arrangements creates a significant compliance burden for impacted parties and redundancy in reporting, as:

- Any income or loss from property in such arrangements is already reported by the beneficial owners in their respective income tax filings, and would not be captured in the trust return; and
- Information on trustees in such arrangements that is required to be disclosed in proposed Income Tax Regulations to the ITA ("ITR") subsection 204.2(1) is likely already available to the Minister through separate annual tax filings. For example, corporate trustees (nominees) in bare trust arrangements involving real estate are required to file *T2 Corporation Income Tax Returns* annually.

There is also uncertainty as to how the proposed rules will be applied to informal, or even unintentional, bare trust family arrangements.

Through a Taxpayer Lens

Roy and his brother Kevin purchased a home together 10 years ago. Roy and Kevin both lived in the home up until two years ago when Kevin married Sue. Kevin and Sue bought Roy's interest in the home at fair market value ("FMV") and Roy recorded the disposition for tax purposes. At this point in time, Roy did not consider himself to have any interest in the home and considered his name to simply be on title as an agent/ nominee for Kevin and Sue. Roy purchased a new property with his proceeds in the same neighbourhood. However, the brothers and Sue never removed Roy from legal title on the original property.

Based on the Draft Proposals, the bare trust created by Roy, Kevin and Sue could be required to file annual returns for the 2022 taxation year.

Effective Date of Proposed Reporting Requirements

The Draft Proposals will apply the new reporting requirements to all trusts with taxation years ending after December 30, 2022. This does not appear to be a practical approach to implement the new rules. As an example, consider a trust that was created ten years ago that has been exempt from annual T3 reporting for the past five years as it holds property of nominal value, has not incurred any income tax liability, and has not made distributions to beneficiaries during this period. Under the Draft Proposals, this trust would be required to file a T3 and provide the required disclosures in proposed ITR subsection. 204.2(1) each year. Where the trust will essentially have no activity until it is terminated, the information provided in the required filings would be of little value to the Minister. Furthermore, as the trust has been inactive for a period of time and has not been required to file annual returns for some time, information to prepare the returns going forward – including the required disclosures in proposed ITR subsection 204.2(1) – will likely not be readily available, which will require additional taxpayer resources in order to comply. We strongly urge the Department to instead apply the proposed reporting rules on a prospective basis, for new trusts settled on or after January 1, 2022, where the required information will be readily available.

Penalties

Proposed ITA subsection 163(6) imposes penalties equal to the greater of $2,500 and 5% of the highest FMV of trust property held during the year if a false statement, omission, or failure to file a return was made by any person knowingly or under circumstances amounting to gross negligence. In our view, the new penalties proposed are excessively punitive and are inconsistent with penalties imposed for other information reporting measures in the ITA, such as foreign reporting.

Existing failure to file penalties for foreign reporting in the ITA are generally capped at a maximum dollar amount pursuant to ITA subsection 162(7). Additional failure to file penalties for foreign reporting only come into effect after 24 months pursuant to ITA subsection 162(10.1). The gross negligence penalty for false statements and omissions in foreign reporting determined according to ITA subsection 163(2.4) depends on what the false statement or omission is related to and generally relies on cost amounts. A due diligence exception is also available in some cases under ITA section 233.5 for taxpayers who make diligent efforts to obtain the required information and disclose the information that is unavailable.

The brevity of proposed ITA subsections 163(5) and (6) create taxpayer uncertainty with respect to how the penalties will be applied. No consideration appears to be given to the magnitude of the false statement or omission, which can result in a significant penalty being disproportionately applied to a minor omission. No clear guidance is provided as to how the highest FMV of the assets in the trust will be determined. In such instances, will the Minister be responsible for making the FMV determination?

Further, it is our view that these rules should distinguish between the first year of the new disclosure requirements and subsequent years, rather than applying to taxation years ending after December 30, 2022, for all trusts. Some penalty relief should be available in at least the first year the new rules are in effect, given the expected challenges of compiling historical records to meet the new information disclosure requirements.

Given the severity of the proposed penalty structure, it is very likely that taxpayers unable to comply with the new rules will look to the Voluntary Disclosures Program (“VDP”) to seek relief from penalties. This can lead to an unexpected increase in VDP requests, which can adversely impact existing Canada Revenue Agency (“CRA”) service standards and deny taxpayers the ability to resolve tax compliance matters on a timely basis.

RECOMMENDATIONS

- Narrow the scope of trusts subject to the proposed reporting and disclosure rules to reduce uncertainty, ease the compliance burden on taxpayers and facilitate the collection of meaningful information by the Minister by:
    - Applying the mandatory reporting rules and proposed additional gross negligence penalty structure on a prospective basis (e.g., for new trusts settled on or after Royal Assent);
    - Eliminating proposed ITA subsection 150(1.3) in respect of bare trust arrangements; and
    - Continuing to provide exemptions from annual reporting for trusts with limited activity and/or nominal assets.
- Adjust the proposed penalty measures to be consistent with other gross negligence penalties imposed in the ITA, including adding a timing threshold (e.g., 24 months), for such penalties to come into effect.
- Add a due diligence exception where the taxpayer makes reasonable efforts and discloses what information is unavailable.
- Consider disclosures of trustees, beneficiaries and settlors as required in proposed ITR subsection 204.2(1) to be done outside of annual reporting (e.g., upon trust creation or with the application for a trust account number).
- Simplify disclosure requirement in proposed ITR subsection 204.2(1) by narrowing definition of “settlor” [the definition in ITA subsection 17(15) being used for this purpose is broader than the commonly understood concept of settlor].

C. Audit Authorities

The Draft Proposals will provide CRA officials the authority to require persons to respond to questions in any form specified by the relevant CRA official, including by an oral interview, at a place or through other means as designated by the authorized person.

It is our view that the new proposals with respect to oral interviews create ambiguity and lead to unfair taxpayer consequences for the following reasons:

- Oral responses, where not formally recorded, can be susceptible to misinterpretation due to factors such as incomplete context, bias, English as a second language, etc.
- Taxpayers and "any other person" required to provide reasonable assistance to CRA may feel pressured to respond in an oral interview and may misspeak or guess, which could lead to incorrect information being provided, or for isolated statements to be taken out of context. If CRA does not reasonably allow for taxpayers to refute or correct any such misinformation, the only recourse for taxpayers will be in the tax courts. Placing an increased burden on the judicial system for a simple response that could have been otherwise accurately provided in writing at the audit level is costly to the Government and to taxpayers.
- The Tax Court of Canada has procedures in place with respect to oral discovery to impose limits where appropriate and to provide some certainty in how oral discovery is to be applied. Allowing CRA representatives to compel oral interview without any procedural safeguards would undermine those currently in place in the tax courts.
- The Minister has other more reliable means of obtaining required information during the audit process, including through written responses, compelling documents and information from third parties, and reviewing books and records.

Through a Taxpayer Lens

Xiaoming immigrated to Canada five years ago with her two children and started a company in Canada which imports goods from their family business in China. Xiaoming works with an accountant and tax advisor in Vancouver who speaks Mandarin and English fluently. The advisor handles all of Xiaoming's company and personal tax work. Xiaoming's accountant also helped explain the setup of the company and the related Canadian tax consequences in a way that Xiaoming understood. Xiaoming appreciates how her advisor can explain the ideas simply and in the context of the differences and similarities between China and Canada as Xiaoming finds the Canadian tax requirements complex. Xiaoming's company is now under audit and they received a letter from CRA requesting a lot of documentation and an on-site interview. Xiaoming sent the letter to her accountant and trusts the accountant will have all the documentation required but is not comfortable with the interview given the language barriers. Xiaoming is very nervous about making a mistake and would feel more comfortable responding to questions in writing so that she can review the responses with her accountant. Even if she were to have her advisor present at the interview, Xiaoming is concerned there would not be an opportunity to discuss the responses to ensure accuracy. Xiaoming is also concerned that preparation for the interview will take a very long time as she doesn't know what the auditor will ask. Xiaoming knows this will take time and focus away from her business.

RECOMMENDATIONS

Taxpayers should have certainty that any information provided to the Minister will not be misinterpreted or taken out of context when used in the Minister's assessment process. To uphold fairness for taxpayers, to avert the additional unnecessary burden on the judicial system, and to prevent the circumvention of the rules of

procedure in the Tax Court of Canada, the Department should eliminate the broad authority given to the Minister in compelling oral responses from taxpayers or other persons. At a minimum, formal procedures, such as the required recording of oral communications, should be put in place to ensure such communications are accurately captured.

D. Electronic Filing and Certification of Tax and Information Returns

Various measures have been introduced in the Draft Proposals with respect to administration and compliance matters to improve CRA's ability to operate in the current digital environment. While these are generally welcome changes, we would like to express our concerns with respect to the specific measures below.

Electronic Notices of Assessment for E-filed T1s

Eliminating the option to receive a paper notice of assessment ("NOA") for electronically filed T1 personal tax returns creates challenges for taxpayers that are unable to sign up for online mail and to access CRA's MyAccount services. Senior individuals that are not computer literate, persons with disabilities preventing easy and regular access to computer usage, and individuals in rural areas with no reliable Internet access instead have to rely on third parties to receive this information. Not only will this likely result in additional costs to the taxpayer, but it can also make the confidential taxpayer information more susceptible to fraud when passing through third parties.

Date of When Electronic Communications Considered to Have Been Sent

Proposed ITA subsection 244(14.1) considers electronic notices to be sent by the Minister and received by a person or partnership on the date that an e-mail notification is sent to that person or partnership, regardless of when that person or partnership is actually able to access the notice through their secure electronic account. Similar to the concerns expressed above, those without regular access to computer or Internet usage likely cannot access the available notices in a timely manner, which will impede their ability to complete any actions required by such notices; this is critical given that the period in which a taxpayer may object to an assessment by the Minister will begin on the day the e-mail notification is sent, and not the day the relevant notice of assessment is actually accessed.

Through a Taxpayer Lens

Geneviève, a 70-year-old retiree, visits the public library every Sunday and uses the computers there to check for emails from her grandchildren. Geneviève's grandson recently helped her register for CRA's MyAccount services. Geneviève was contacted in June that the 2021 T1 she had filed was being audited. Geneviève had provided all the information requested by the auditor at that time, including all receipts for medical expenses claimed. On Monday, July 11, an email notification was sent by CRA to Geneviève's email account to inform her that she had new mail from CRA available for viewing through MyAccount. As Geneviève was not feeling

well that week, she did not go into the library for her next visit until Sunday, July 24. She saw an email notification from CRA but had trouble accessing MyAccount. Eventually on her next visit on July 31, Geneviève was able to view and print the correspondence, which was a proposal letter from the CRA auditor. She called her accountant and booked a time to drop off the letter on August 5th. At the meeting, Geneviève's accountant informed her that the auditor was proposing to deny more than half of the medical expenses claimed on her tax return. The denied expenses would have a significant impact on Geneviève's modest fixed income. The accountant is confident that all medical expenses claimed should be deductible, but Geneviève and her accountant are now left with only a few days to prepare a response to the proposal letter. If she misses this deadline, her accountant will have to prepare an objection to the reassessment and Geneviève is worried about the additional costs of the objection.

Increased Cost of Compliance to Taxpayers

Where a taxpayer is, for various reasons, unable to register for CRA electronic services, the administrative burden of managing electronic notices and other communications will likely fall on the tax preparer. For example, under the current system, "Express NOAs" for personal tax returns are not immediately available after electronic filing, nor is the process to subsequently retrieve the Express NOA streamlined through tax preparation software. This creates inefficiencies for the tax preparer, which will likely generate additional costs for the taxpayer. Conceptually, it does not make sense that a taxpayer is expected to incur additional costs to access information that they should be entitled to receive directly.

RECOMMENDATIONS

- The Draft Proposals should allow for situations where the Minister is required to provide a paper NOA to a taxpayer, even where the corresponding T1 was electronically filed, to accommodate taxpayers without reliable computer or Internet access.
- The date of when electronic communications are considered to have been sent by the Minister should allow for a reasonable amount of time (e.g., 10 business days) following the date of the e-mail notification to avoid penalizing taxpayers without reliable computer or Internet access where interest, penalties, or a reduced period of time to respond to a request or file a notice of objection result from delayed access.

As a high-volume tax preparer, MNP would be pleased to work with CRA in developing procedures to streamline current processes to access electronic taxpayer notices and other information.

While the proposed removal of the requirement for manual signatures on Forms T2200, T1223 and T183 is a welcome change, we strongly recommend this measure also be extended to all other prescribed returns, forms, and elections to better accommodate the use of electronic signatures.

CONCLUSION

Based on the concerns raised above, the measures introduced in the Draft Proposals lack clarity. As a result, this creates significant taxpayer uncertainty as to how the measures apply, and whether this will be consistent to how the same measures will be applied by the Minister. We request that our recommendations for each of the Draft Proposals discussed above be given consideration. Furthermore, we recommend the Department reconsider policy decisions going forward to address its concerns specifically within legislation, rather than giving broad assessment authority to the Minister, to prevent the legislation from being applied inconsistently. Allowing for certainty and predictability will help ensure taxpayers remain compliant without fear of incurring punitive costs to do so.

MNP is pleased to continue to work with the Government, other members of Parliament and policy makers across Canada to further discuss our observations, comments and recommendations in this submission.