

Revising the System of Corporate Tax Loss Transfers in Canada

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ABSTRACT

This report reviews the evolving discussion on implementing a system of Canadian tax loss transfers or tax loss consolidation for closely held corporate groups. Significant commentary is available on this topic because it is an area of widespread debate in the tax community at the present time and has been ongoing since the retraction of a previously existing tax loss regime that existed in Canada in the 1940's. The aim of this report is to compare and contrast the published opinions of various stakeholders and increase coverage of review where there are deficiencies. Benefits to be gained, potential costs, and regime mechanics are discussed. Existing models are investigated to provide comparatives for Canada's use in designing an optimal system. Although Canada's most recent position is that a revised tax loss regime will not be pursued, the reflections contained in this report will be useful when and if the topic is revisited once more.

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TABLE OF CONTENTS

ABSTRACT.....	ii
ACKNOWLEDGMENT.....	iii
TABLE OF CONTENTS.....	iv
LIST OF FIGURES	v
LIST OF CHARTS.....	vi
1.0 INTRODUCTION	1
1.1 Background.....	1
1.2 Current System.....	2
2.0 LITERATURE REVIEW.....	5
2.1 Benefits	5
2.2 Provincial Allocation of Resources.....	11
2.3 Proposal Mechanics.....	14
2.4 Critique.....	24
3.0 IDENTIFICATION OF LOSS TRANSFER STRATEGIES.....	26
3.1 Introduction.....	26
3.2 Strategies.....	27
3.3 Observable Themes.....	33
4.0 COST ANALYSIS.....	36
4.1 Acceleration of Loss Recognition.....	36
4.2 Recognition of Previously Expiring Losses.....	39
4.3 Interprovincial Planning.....	40
5.0 INTERNATIONAL MODELS.....	44
5.1 Introduction.....	44
5.2 Country Comparisons.....	46
5.3 Recent Conversions.....	53
6.0 CONCLUSIONS & AREAS OF FUTURE RESEARCH.....	58
6.1 Conclusions.....	58
6.2 Areas of Future Research.....	59
7.0 REFERENCES.....	63
8.0 ENDNOTES.....	65
CURRICULUM VITAE or CV	

LIST OF FIGURES

1.0 INTRODUCTION

Figure 1.....	3
• Basic Structure of Sister Companies Under a Common Corporate Parent	

2.0 LITERATURE REVIEW

Figure 2.....	20
• Basic Structure of Sister Companies Under a Common Individual Parent	

3.0 IDENTIFICATION OF LOSS TRANSFER STRATEGIES

Figure 3.....	27
• Loss Transfers Accomplished Through Financing Arrangements	

Figure 4.....	30
• Loss Transfers Accomplished Through Fees for Services	

Figure 5.....	31
• Loss Transfers Accomplished Through Income Producing Asset Transfers	

6.0 CONCLUSIONS & AREAS OF FUTURE RESEARCH

Figure 6.....	61
• Example of Treaty Shopping	

LIST OF CHARTS

4.0 COST ANALYSIS

Chart 1	.....	37
	• Calculation of Annual Unsaturated Income	
Chart 2	.....	38
	• Statistics on Canadian Taxpayers	
Chart 3	.....	43
	• Canadian Provincial Tax Rates	

5.0 INTERNATIONAL MODELS

Chart 4	.....	44
	• Countries Which Employ or do Not Employ a Tax Loss Transfer System	
Chart 5	.....	47
	• Countries Which Use a Loss Consolidation or Loss Transfer System	
Chart 6	.....	49
	• Ownership Threshold for Eligibility	
Chart 7	.....	51
	• Participation Requirement Levels	

1.0 Introduction

1.1 Background

Examination of the topic of creating a method to simplify the movement of corporate income tax losses between corporations has been ongoing for many years. Canada's tax system once allowed for consolidated filing of corporate groups in the 1930's and 1940's (Laurin, 2009) but has not for a considerable time. Although there are currently methods that tax practitioners and business owners can use to utilize the losses of corporations against income in other corporations, these methods require planning and can be costly. Because of the simplicity which a codified system of transfers between corporations would grant, debate on this topic has been ongoing for many years. A 1985 Department of Finance White Paper called "A Corporate Loss Transfer System for Canada" considered re-implementing the concept but the proposal was never implemented.

The current debate on implementing a tax loss regime for members of a corporate group began in 2009 with the publication of Alexandre Laurin's article *Cleaning Up the Books: A Proposal for Revamping Corporate Group Taxation in Canada*. Laurin's (2009) work with the C.D. Howe Institute as a Senior Policy Analyst gave this article a high profile and access to esteemed peers groups. In the 2010 Canadian Federal Budget the Government of Canada announced that it would explore implementing a system of loss transfers or consolidated reporting (Department of Finance: Canada, 2010). This sparked a series of public and private commentaries on whether this system might improve Canada's tax competitiveness.

The intention of this report is to review documents pertaining to the modern discussion (2009 and forward) on implementing a tax loss regime in Canada to determine if any consistent themes appear in stakeholder opinion and to determine where variances in opinion exist. These stakeholder opinions are expressed on the desired benefits of the proposed tax loss regime and the mechanics surrounding how the tax loss regime might operate. An attempt is made to calculate the impact of implementing a tax loss regime in Canada on government revenues on an annual and present value basis. International models are reviewed in order to determine what best practices exist and to analyze the perceived results other countries have experienced from a similar implementation.

1.2 Current System

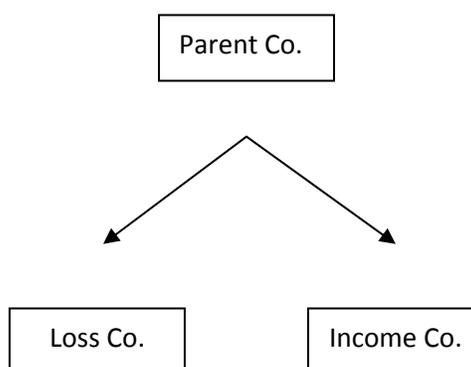
Currently in Canada the corporate tax system is based on economic and legal entities. Corporations, individuals, trusts or partnerships are subject to reporting and filings guidelines for all transactions that occur within that singular entity (this study focuses primarily on corporations). Although consideration is given to entities having close ties to others through rules around connected, related, associated, and affiliated status, each entity is looked at separately for computation and payment of income taxes.

Where this system becomes onerous is in the application of losses against years where positive earnings occur. Canada's system allows for unused capital or non-capital losses to be carried backwards and/or forwards and applied against taxation years where taxable income resulted within the same corporate entity. Where taxes were payable, those taxes can be recovered or offset but only within the singular filing entity. Where there are

sister corporations (Loss Co. and Income Co. as illustrated in Figure 1, below), the losses of one entity cannot offset the income of the other. A tax obligation will result (in Income Co.) despite the fact that as a whole the economic ‘group’ has not earned income.

Tax practitioners have devised methods of circumventing this result of having built up loss pools and immediate taxation within the same economic group (but split into two separate corporations) by shifting income from the income producing entity into the loss entity until taxable income of each approximates zero (or as close as can be managed). A full review of methods used to effect income shifting will be discussed below and include loans, management fees, rental property schemes, amalgamations and windups.

Figure 1: Basic Structure of Sister Companies Under a Common Parent Corporation



Laurin (2009) proposes that a subsidiary (like Loss Co. and Income Co.) of another corporation (Parent Co.) compute their taxable income and attributes such as loss carry-forward balances and federal tax credits separately, after which these amounts are used in

the filing of a group tax compliance form at the parent level. Similar to consolidated financial statements, only one corporate tax return would be required for a corporate group regardless of the individual entities it contains.

The inequity in our tax system stems from Canada's non-refundable loss system (Laurin, 2009). Were a refund available for losses sustained in the year that they occurred, and without the need to have incurred taxable income in either the previous three or future years, the system would be self correcting. Loss Co. would receive a refund and Income Co. would pay taxes resulting in a net zero across the corporate group; the same result as if consolidated group filing was instituted. Although this system would be the simpler to implement over a consolidated filing system, there are some valid reasons for why it has not been considered including the two below:

- 1) Implementing this system may lead to cash flow problems for the government in years of economic difficulty. When the tax base is lowest, the government will also incur the additional obligation of paying refunds; and
- 2) Corporations incurring years of losses may never earn profitable income with which to offset the refund they have received. The reasonable expectation of profit (REOP) rules proposed in the *Income Tax Act* where expenses are only deductible if there are incurred to earn income with an expectation of profit should work to offset this occurrence, however it is still seen in practice.

2.0 Literature Review

2.1 Benefits

Benefits espoused by Laurin (2009) as being the primary drivers of the proposed tax loss regime include “fairness, simplicity, and certainty of tax outcome for Canadian corporations”.

Fairness

Fairness is based on three major themes; the first being that corporate groups which perform essentially the same role should be taxed in similar ways regardless of the structure chosen. Fairness would dictate that they should achieve the same result otherwise there is inequity in the tax system and one structure will be the clear choice over other available options.

For example, a company set up under the structure of a partnership may flow losses out to each of its corporate partners, who could then apply those losses against corporate income. However, if the company was set up in the form of a corporation the losses could not be distributed. This results in non-business related decision factors influencing how the business is structured. The tax system should be neutral to structure with the same tax consequences arising out of any structure that is equivalent in function.

The current system of corporate taxation relying on a single entity also creates some conflicts with how a corporate group might be organized for legal purposes. A single corporation with multiple operating divisions within it would receive the tax benefits of offsetting one division’s losses against another division’s income. In this situation each

division will be subject to the legal liabilities of the other divisions because they are not separated by the limited liability of the corporate veil. For example, a corporation containing the operations of plumbing business as well as rental properties will be able to offset rental losses against plumbing profits. However, lawsuits filed against the plumbing business will gain access to the rental property to satisfy any claims. This is a simplified example, but serves to demonstrate that the motivations behind structural choices may conflict depending on whether tax motivators or legal motivators are considered most important.

Some may not wholly agree with these reasons. While it is a primary aim of the Canadian tax system to ensure that similar transactions receive similar treatment for tax purposes, tax mechanisms are also put in place to encourage specific behaviors in taxpayers. The theory of integration allows that a self-employed welder should pay the same taxes when incorporated as when operated through a sole-proprietorship. Complex rules are used to achieve this result. However, apprenticeship and manufacturing tax credits are put in place to reward specific actions. It may seem logical to conclude that current tax policy encourages one structure over another in order to encourage a specific behavior.

I would argue for the neutrality of tax structures. Where tax incentives are available to encourage behavior, they appear to be behaviors related to an operational action.

Taxpayers are encouraged to invest in new equipment, hire new graduates, and innovate in their field. Once that decision is made, the tax consequences should not be impacted by how the behavior was structured. It is the actions themselves the government desires to encourage, not the banner under which the action is taken.

The second concern around fairness is that benefits of the tax system should be equally accessible to organizations of all sizes. The tax system currently permits transfers of losses to occur under the appropriate circumstances. However, the rules to ensure all necessary conditions are met are complex. Large organizations are better able to bear the cost of the sophisticated planning techniques required to make full use of these methods (Laurin, 2009). The Canadian Chamber of Commerce (2011) also adds that small and medium sized businesses may not have the management expertise to undertake complex planning. Legislative or regulatory restrictions may also prevent corporations who would prefer to operate as a single corporation from doing so (The Canadian Chamber of Commerce, 2011).

The third concern around fairness involves uncertainty of outcome (Laurin, 2009). Because of the complexity around the current system of loss transfers, it can be sometimes difficult to determine whether a proposed plan will be approved if audited by Canada Revenue Agency because of the specific facts of that case. A fair tax system should have a predictable outcome for actions that are permitted by legislation. Taxpayers should not bear the weight of uncertainty if they are acting in the way the government desires.

Deloitte's response to the request for stakeholder input included support for the reduction of uncertainty around tax planning in this area and the increased simplicity that would come from a new system (Deloitte, 2011). As public accounting firms provide planning advice and so would be the most likely to benefit from allowing uncertainty in the tax rules, this comment shows a measure of altruism.

Economic Prosperity

Another theme of interest is that a new system may increase the economic prosperity of Canada. Of all the Group of Seven (G7) countries, only Canada does not have a system of group tax attribute sharing (Laurin, 2009). Although Canada has a tax rate as percentage of income that is very competitive on a worldwide scale, our system disadvantages corporate groups compared to other international models. This proposal would increase international competitiveness and attract foreign investment.

A system of internal loss transfers may improve the performance of Canadian based investment as well as foreign sourced. In years of economic difficulty, a loss creating corporation's activities will be bolstered by the reduced tax burden of its corporate group (Laurin, 2009). An overall reduced tax burden for the group will result in additional cash-flow available to reinvest into operating divisions experiencing economic difficulty or to fund working capital until the economic climate improves. In this way, a system of loss transfers may help to stabilize the business community and reduce the number of corporate bankruptcies.

Government tax legislation is a method of economic shifting. Policies are in place to encourage specific behaviors and guide Canadian taxpayers towards a common goal. Allowing a system of internal transfers may improve the effectiveness of government policy because of most incentives' natures as income tax reducing vehicles. Motivators such as accelerated depreciation and tax credits are only effective where there is taxable income against which these incentives can be applied (Laurin, 2009). By allowing distribution of the income and losses of a corporate group, the government will encourage

corporate taxpayers to participate in these incentives since income will be able to be shifted to utilize them even where a specific division does not result in profits.

Government policies may see higher adoption rates and shorter lead times until visible results can be observed. The four year turnover of political parties creates a short window of time for effectiveness to be shown. Shortening the lead time will allow greater flexibility to adjust policy based on visible results.

The methods imposed to allow tax loss shifting under the current rules may also not be in line with the business needs of the corporations implementing them. The mechanics required to create the benefits of offsetting losses within one corporation against the income of another corporation may be disruptive to the ordinary operations of the business (The Canadian Chamber of Commerce, 2011).

It is not surprising to find that this supporting factor is one that is prominently voiced by professional firms who responded to the Department of Finance's request for stakeholder input. Deloitte lauded the government's investigation into this area and gave an increased competitive environment for Canadian business as a key strength of the proposal (Deloitte, 2011).

Financial Impacts

There is concern that an implementation of a formalized loss transfer system would negatively impact government because of a dramatic decrease in tax revenues resulting from taxable income being offset which would previously have resulted in taxes owing (Laurin, 2009). This fear may be countermanded by the fact that corporate groups already have the ability to transfer losses and so to a limited extent those who would

benefit from this treatment may already have made efforts to implement it. For those organizations not large or sophisticated enough to take advantage of currently approved loss transfer methods, a transition to a formalized system would logically result in an acceleration of loss utilization. In the year of and shortly following transition tax losses would be used immediately where possible as opposed to being deferred until current methods could siphon them into related corporations over a long period, or residing in carry forward balances until taxable income resulted. The proposed easing provisions of delayed implementation, discussed below, would help governments absorb this short term reduction of tax revenues until loss pools stabilized.

Government will also bear the cost of converting their information systems in order to accept compliance forms submitted under formats conducive to the new legislation and of designing those forms. Man hour costs of drafting legislation that is fair but also prevents manipulation, training staff on new legislation, and editing or eliminating conflicting administration documents that support the previously approved methods will all be hidden costs of implementing a new system.

Canada Revenue Agency (CRA) may gain some efficiencies from the increased transparency of a new system. The man hour costs of audit on the multi step transactions necessary to implement loss transfers previously will be saved (Department of Finance: Canada, 2010).

Taxpayers will be saved the professional costs (accountants, lawyers, bankers, etc.) of planning required to implement these previous methods but will require additional time and expense to adapt to any new regulations. Even where loss transfer methods were

available in the past, uncertainty and complexity led to substantial planning costs and the preparation of requests for Advance Tax Rulings to confirm Canada Revenue Agency's position (Deloitte, 2011). Processing time on these rulings can be saved by both parties to these transactions.

2.2 Provincial Allocation of Resources

Concern around the income allocation across provinces has been a major detractor from the consolidation discussions because of the strong incentive for corporate groups to shift their tax base into provinces with lower corporate tax rates (Laurin, 2009). An income producing company whose income is being offset would reduce the tax base of its province of residence. Loss producing companies whose losses are being transferred would increase the tax base of its province of residence (by decreasing loss pools). This would appear to me to be demonstrative of a key weakness in our national tax system. Competing amongst the provinces for corporate investment and individual mobility using provincial tax rates creates a system of competitiveness within the country that is unnecessary. Weakening the tax base by competing against other provinces does not appear to support the overall economic interest of Canada.

The proposed shift in corporate loss reporting was not intended to serve as a discussion point for provincial tax base calculations and interprovincial transfers, therefore I will assume that some reasonable method of allocating provincial tax base would be necessary. Intra-corporate provincial taxes are currently allocated based on a province's percentage of wages expended and revenues earned within that province. A similar

system for a combined corporate group could be easily implemented but would not perfectly duplicate the results of a pre-consolidated group approach. A province containing a 'Loss company' but which supports the wages of many employees would receive an allocation of tax basis that they would not have in a singular entity filing system. However, it may be that allocating taxes based on wages and revenues results in increased fairness over the comparative system. A province which is playing host to the employees of a loss creating corporation is likely still contributing to the overall corporate economic entity's success regardless of the taxable income of that one corporation (ie. contributing to the success of Parent Co.). Inter-provincial planning is sometimes undertaken to take advantage of lower provincial tax rates and policies. Allocating taxable income based on revenues and wages may help to compensate provinces where planning has been used to artificially reduce their tax base.

The Ontario provincial government commented in their 2010 budget, delivered on March 25, 2010, on the proposed impact to their tax base from the loss transfer system. The excerpt is provided in full below to highlight the concern over which the provinces view infringement to their source of tax revenues.

“In advance of any formal changes to the tax system, Ontario calls on the federal government, in administering Ontario's corporate taxes, to ensure that tax losses are utilized by a corporation in the province where the loss takes place. This will ensure losses are treated in a fair and reasonable manner and do not distort the principles of interprovincial income allocation. Ontario will consider taking action, where appropriate and within its administrative purview, to ensure these principles are upheld.”

Ontario's 2010 Fall Economic Update, released November 18, 2010 includes further comments on the strength of their concern.

“The taxation of corporate groups must not distort the principles of interprovincial income allocation and should treat losses in a fair and reasonable manner.

While a new approach is being explored, Ontario calls upon the federal government to strengthen the integrity of the tax system by immediately taking action to prohibit transactions that result in the transfer of losses within corporate groups and across provincial borders.”

Compared to the traditional wording of tax communications, these are strongly worded missives. The instinctive desire to curb financial losses may prevent detailed review of the overall benefits to be gained from this system of taxation. As hesitant as the federal government appears to be over an implementation that drastically affects taxes collected, it appears the provincial governments will react even more strongly to any proposed changes.

Stakeholders, however, agree that any new system implemented would require mirror provincial legislation changes in order to be effective and avoid unnecessarily complicating the tax system (Deloitte, 2011). In part this is because many provincial tax legislations mirror federal legislation except in specific issues like applicable rates. This provides a simple system that is easy for corporations to comply with. It has also led to a federally administered system where a single corporate tax compliance form is completed

for both federal and provincial tax collection. A digression of tax policies may result in additional complexity over compliance.

A keen observation is that interprovincial tax planning is available and in use in many corporate groups using the current system (Deloitte, 2011). The theory of the free market can be used to cast doubt on whether the provinces have a legitimate concern. Where corporations were already capable of shifting income into provinces where it was most advantageous, it is likely that if they continued to do so under a new system that the results would be substantially the same.

2.3 Proposal Mechanics

Method of Loss Combination

One method of effecting combined income and loss filing is a consolidation system. This system would involve preparing a consolidated corporate income statement with intercompany transactions eliminated and filing a corporate tax return based on those figures. Under this method the pools of taxable income, losses, etc. are calculated in aggregate as opposed to for each separate entity. The consolidation system creates complications in that if a company were to be disengaged from the corporate group, extracting it from the tax attribute balances would require onerous calculations.

The other alternative is the tax loss transfer system. Laurin (2009) espouses the tax loss transfer system as the preferred approach to revised loss policy.

“I propose a model that would allow domestic subsidiaries of corporate groups to transfer, on paper, their taxable income, net of deductions, to their Canadian-incorporated parent company along with current-year, non-capital losses and federal credits. Once transferred, unclaimed tax losses and credits would carry forward and accumulate at the parent company level.” (Laurin, 2009).

One downfall of the loss transfer system is the temptation to do tax planning on an annual basis, or by company, since filing separate corporate tax returns makes the attributes easily compared on an annual, and by company, basis. The consolidated system prevents this possibility since the individual pools no longer exist to be manipulated.

Deloitte advocates for the loss transfer system as well because of the ease of implementation and the speed at which the current system could be converted (Deloitte, 2011). It would provide all of the benefits of the loss consolidation system without the loss of individual corporate identity and tax attribute pools that would prevent future changes in legislation.

The level of required participation will also need to be considered. Whether participation is mandatory, annually elective, or based on a corporate choice which then becomes mandatory for a certain number of years will change the effect of the policies on the provincial and federal tax base and will change taxpayer behavior. A mandatory system would decrease the likelihood that the new system simply provides additional opportunities for planning and avoidance transactions (Laurin, 2009). In the more moderate view, a minimum enrollment period would allow for increased predictability

and decreased tax planning compared to an annually elective system (Department of Finance: Canada, 2010). A fully elective system would provide the greatest flexibility and shareholder benefits, but would also leave some room for planning techniques. Deloitte is advocating for an annually elective system based on the theory that current provisions that permit or promote intergroup planning are elective (Deloitte, 2011). Implementing a mandatory system would eliminate choice that currently exists and decrease tax fairness.

What Attributes to Include

The current literature has referred to a system of combining taxable income and losses. However, the Department of Finance (2010) has stated they are willing to consider including other attributes in proposed legislation if it were to provide increased benefits and not be onerous to implement (onerous may be a relative term given the readability of some currently enacted sections of the Income Tax Act). Including all tax attribute balances such as Scientific Research and Experimental Development expense pools and various Investment Tax Credits would provide the greatest benefits and would be a true example of an integrated system.

The consolidation model would be the most easily implemented in order to recognize sharing of all tax attribute balances since all balances of the corporate group would be combined for filing purposes. In a corporate transfer model, complex rules would need to be established around each balance and tracking would become difficult where transfers were elective but not mandatory. The transfer model provides the greatest flexibility, but

also provides significant opportunity for tax schemes to develop. This would seem contrary to the Departments aims of simplification.

It is also possible that a system of income transfers only would be sufficient to enhance the utilization of various tax incentives without a separate system for them (Department of Finance: Canada, 2010). For example, if income could be shifted to a corporation with built up Investment Tax Credit balances these balances would be reduced more swiftly and applied against that income. The downside is that the income must be reported in the entity with the non-loss pools desired to be utilized.

Another factor in the decision over what tax attributes to include will be the forecasted impact on government tax revenues. Disregarding the conceptual theory above that non-loss balances could be fully utilized even where only losses are permitted to be transferred, the ability to shift tax credits and SRED pools would accelerate the application of these amounts against taxes owing and result in short term negative cash-flow issues for the government.

There will also be delayed time to implementation if a full transition system must be developed compared only to a loss transfer system. Proponents of a loss transfer system appear eager to speed the time to implementation of this system and so argue for a reduced number of tax attributes at the onset (losses & ITCs) with expansion of the scope of the program in the future (Deloitte, 2011). This approach may be motivated by a concern over the length of time this debate has been ongoing. Speeding the time to implementation may be a means of increasing the likelihood that this round of debates will be the set that sees the system realized.

Defining who will Participate

Wholly-owned corporate groups would be a logical starting place for how to define where the proposed loss measures would apply. As the true economic owners of these corporations are the same (the shareholders of the more senior parent company) the corporations' actions should be carried out in order to benefit those stakeholders regardless of each corporation's self-interest (Department of Finance: Canada, 2010).

This ignores the potential for manager self-promotion bias which would lead to focusing on the results of their 'unit'. Notwithstanding this bias, we can presume that each corporation in a wholly owned group will act on behalf of the group's benefit if given the opportunity.

Laurin (2009) proposes that the threshold be that companies controlled, directly or indirectly, 95% or more by another be considered for the proposed loss measures as it would limit adjustments required to account for the interests of minority shareholders.

Current loss utilization strategies are generally allowable by CRA where the corporate transactions are between related corporations. Related corporations are those controlled by the same economic entity (50% or more) or which are controlled by economic entities who have reason to work in tandem (ex. spouses, parent & child, siblings).

There are also transfer provisions available in the Income Tax Act that are available only to affiliated groups (Deloitte, 2011). Affiliated groups are similar to related groups however where related would consider that parents and their children, or siblings, would be considered to act in tandem, for the purposes of affiliation only spouses are considered a 'group' that could together control a corporation. Although this definition is more

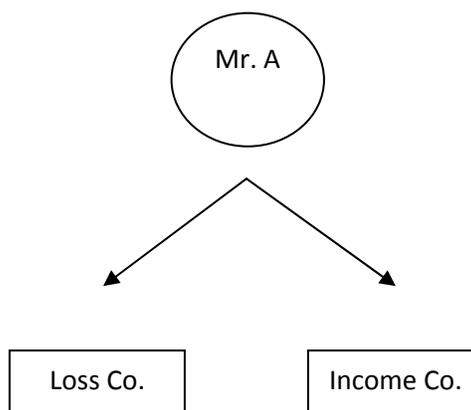
restrictive, it would appear more consistent with the ultimate control test. Two spouses are more likely to be a single financial unit than two siblings, who are likely to retain separate financial affairs.

Related and affiliated require a much lower threshold of ownership than the wholly owned or substantially wholly owned tests. Consideration of non-controlling shareholder interests would need to be thoroughly considered since a significant proportion of the loss attributes being transferred may be the economic interest of an entity outside the corporate group. However, the difference in threshold between a 5% interest (where 95% and over is required) or a 49% interest (where 51% and over is required) is immaterial to the obligation to safeguard non-controlling shareholder's rights. A similar duty of obligation will exist to an individual controlling 5% as to one who controls 49%. Where non-controlling shareholders could be appropriately compensated, it would appear the system must be robust regardless of the threshold and so any appropriate level should be acceptable if it meets the other needs of the legislation.

Consideration should be given to whether an entity's ownership interest is based on share votes, share value, or other considerations. In instances where multiple classes of shares are authorized and outstanding there may be conflicts between the owner of the voting shares and where the majority of value lies. An example of this might be where a family patriarch owns voting preferred shares of all companies but outstanding common shares have high value. This concept also highlights that the Department of Finance (2010) has considered only vertically stacked corporations for these new rules and has not given support to those controlled by a common individual shareholder (or group of shareholders) as illustrated in Figure 2, below. This broader concept of a corporate group

would likely be more useful in practice since there are negative consequences from a vertically stacked series of private companies. One such example is increased complexities to the rules around the Lifetime Capital Gains Exemption.

Figure 2: Basic Structure of Sister Companies Under a Common Individual Parent



The Department of Finance (2010) observes that international systems of loss combining do not generally apply to structures other than vertically stacked corporations. The currently proposed system of loss consolidation would not be applicable to this structure since no corporate parent would exist where tax balances could be “rolled up” to. The Department does comment that there may be other complexities arising from this method, if accepted, but additional comment from stakeholders would be welcome. Deloitte’s (2011) stakeholder input included support for corporate groups being expanded to include a broader definition of control over the vertically stacked corporations concept.

Use of Prior Benefits

Varying levels of transferability are available for application against losses (and other tax attributes) accumulated prior to transition to the new system of group taxation. Restricted access would permit accumulated balances to be used only in the corporation from which they originated (Department of Finance: Canada, 2010). This prevents the loss transfer/consolidation system from working in a retroactive manner in order to provide the espoused benefits on losses occurring pre transition. However, as mechanisms are in place prior to transition that permit planning to use these losses in a corporate group, and because this is the treatment that the transition is intended to encourage, it seems counterintuitive to be overly restrictive on the transfer of past balances. It is possible that this restriction would be put into place to ease the financial burden of transition on the government's tax base as wide spread use of past balances would have the capacity to significantly impact group taxable income.

The Department of Finance (2010) has also commented that "Another approach, followed in at least one country, is to limit the proportion of these attributes that can be used in a given year." This method would appear to support the theory that a restriction on prior accumulated balances is primarily because of fiscal restraint issues. Allowing a moderately paced transition of past balances would ease the financial burden over several years.

Use of Carryovers Post Transition

In preparing a calculation of how tax losses are to offset tax gains, the Department of Finance broached the topic of whether losses post transition should be capable of being

carried forward for use against income of other group companies in future years (or conversely carried back) (Department of Finance: Canada, 2010), or only available for use in the year that they occur. The answer to this concept seems a straightforward one. Limiting the inter-year transferability of losses would restrict their use further under the revised system than they are currently restricted under the income shifting planning routes available (Deloitte, 2011). It would also encourage sophisticated tax planning strategies in order to absorb losses fully in the year of occurrence. Neither of these impacts is in support of the aims of the proposed rules. The motivation behind restriction may be concern over the financial impact of immediate recognition of all currently existing loss carry forward balances. This is unlikely to truly occur but is undoubtedly a concern of the Department of Finance. Interestingly, the full inter-year transferability one would predict is not always seen in international contexts (Department of Finance: Canada, 2010). These comparisons will be more fully developed later in this work.

Legacy Transfer Methods

It should be considered whether the current methods of using loss pools within a corporate group will continue to be acceptable tax practice subsequent to the transition to a formalized system. Structure complexities may eliminate the formalized loss transfer or consolidation methods being proposed where the past loss transfer methods would have been permitted. An example of this might be in the case of a common individual shareholder as opposed to a single parent corporation. Retention of the prior methods will enable similar economic units to receive similar treatments.

Retention of the old methods may create the incentive to ‘double up’ on tax planning and create additional complexity as opposed to simplifying the tax system as was one driving concept behind this proposed change. Also, provincial allocation methods which are revised under the new system may encourage taxpayers to use either old methods or the new system in order to reduce the provincial tax burden (Department of Finance: Canada, 2010). Decreased transparency and increased concern over avoidance transactions may be the unintentional consequences.

If approval was retracted for old methods of loss transfers, a sufficient period of transition would be required in order to allow corporations to unwind plans currently in place. A significant administrative burden would also involve eliminating Canada Revenue Agency administrative guidance related to the approval of these methods. The Canadian Chamber of Commerce (2011) advocates for a gradual period of phasing out period for the existing, information approach to loss utilization but insist that the new system must preserve the features and benefits of the existing system so that taxpayers are not disadvantaged by the changes.

Codifying the previous system of transfers under the new model would be a way to move taxpayers away from previous models and encourage adoption of new methods (if there was a choice) (Deloitte, 2011). This transition would be best implemented if the proposed system reflected the ideals and intents of the currently existing positions to avoid taxpayer preference of one over the other. Even with the seamless transition to the new model, taxpayers will likely be best served by retention of the old methods (Deloitte, 2011) because their application is known and easily understood by many and their use in

specific situations may better suit the organization's needs than a formalized group process.

2.4 Critique

None of the articles included as part of this literature review included a rebuttal of opposing literature. As the debate to this point has been focused around idea gathering and public discourse, a true balancing of the merits and pitfalls of each contributor's recommendations has not been compiled. As this article attempts to discuss varying authors as they relate to common themes of interest, it may be the only public document where comparisons are made.

A common observation from review of the Department of Finances consultation paper requesting stakeholder input is that the benefits espoused for the new system are a clear motivator, but it appears only to the extent that they do not significantly impact the tax base of the federal and provincial government (Department of Finance: Canada, 2010). Although these motives were to be expected, it is interesting to note that even where all of the desired merits are achieved this system may never be realized because of the difficulties is rationalizing partial implementation (which may restrict prior transfer abilities or restrict the movement of prior balances) over full implementation. The logic being that if partial implementation is merited, full implementation would be more merited as it contributes even further to the ideals the system is attempting to reach. Full implementation from the date of enactment would undoubtedly be disastrous given the

accumulated economic reserve currently stored as loss balances. This issue may be one which cannot be resolved.

Consideration has also not been given to how minority shareholders (which could range from 1-49% ownership interest depending on what ownership model is chosen) will be compensated for the loss of their tax attribute balances. A financial interest model would seem likely the only one which would properly capture the loss of future benefits arising from the lost tax attributes. Immediate recognition of the benefits by controlling shareholders would reduce the need for present value calculations surrounding the benefits minority shareholders might have received in the future had the tax attributes not been transferred. Compensation models would need to include measures for indirect ownership interests to take into consideration the decline in value of a minority shareholder's investments in parent corporations whose subsidiaries had transferred loss balances.

3.0 Loss Consolidation Strategies

3.1 Introduction

It is widely known and accepted that there are valid methods of transferring tax attributes amongst corporations, or making use of the tax attributes of other corporations in a corporate group using documented planning techniques. Some opportunities to benefit from this planning are codified in legislation under the Income Tax Act and others are supported by administrative documents released by the Canada Revenue Agency in their implementation of the Income Tax Act.

“The Government has long made public that they will accept planning to transfer certain tax benefits such as a loss from one corporation to another within a closely held corporation group where the letter and spirit of the act is upheld” (Minister of Finance, 1988).

The purpose of this section is not to document all the current transfer methodologies that are currently employed, but simply to present an assortment of options available and to review common themes where planning is permitted or denied in order to better determine the underlying behaviors that governments appear to encourage and tie those themes to recommendations for the proposed loss transfer model.

3.2 Strategies

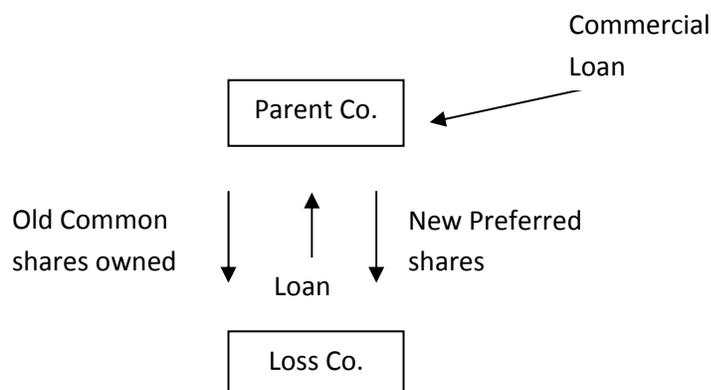
Financing Arrangements

Loss transfers through financing arrangements do not, in reality, shift losses from one corporation to another. Instead, revenue is shifted from an income producing corporation (Profit Co.) into a loss producing corporation (Loss Co.). Where the revenue shifted to Loss Co. is equal to annual losses sustained, no increase in loss carry-forward balances results and optimum saturation has occurred. Where loss carry-forward balances already exist, additional income must be shifted into Loss Co. in order to absorb this additional balance over time.

The simplest method of transferring revenue is to create a series of loans or investment purchases which result in a net profit.

For example, a scenario is presented in Figure 3, below, where a parent corporation owns shares in a subsidiary and is a profit producing entity. The subsidiary is a loss creating corporation.

Figure 3: Loss Transfers Accomplished Through Financing Arrangements



In order to shift revenue from Parent Co. into Loss Co., the following steps could be undertaken:

1. Parent Co. receives a commercial loan of \$1,000,000 from a lending institution. Parent Co. now has cash on hand of \$1,000,000.
2. Parent Co. invests that cash in new preferred shares of Loss Co. For the interest on the commercial loan to be deductible, the funds must have been used to earn income. Therefore, the preferred shares must bear a dividend rate. Typically, the rate paid is the CRA prescribed rate which as of the date of this paper was 1% annually. Subsequent to the investment in preferred shares, Loss Co. now holds the \$1,000,000 cash.
3. Loss Co. will then loan the \$1,000,000 cash back to Parent Co. in exchange for a reasonable rate of interest. This rate is typically chosen at the highest level that the market would deem reasonable. CRA requires that it be an arm's length rate, but it does not necessarily need to be at the prescribed rate or the same rate as the commercial loan. There is room for arbitrage in order to earn a net profit within Loss Co. Assume for purposes of this example that an interest rate of 5% is charged.
4. Subsequent to Parent Co. receiving back their \$1,000,000 in cash as a loan, they may repay the Commercial Loan.

The annual effect of this planning is to create interest income within Loss Co. of \$50,000 as a result of the loan outstanding to Parent Co. of \$1,000,000 bearing interest at 5%. Loss Co. will also pay annual dividends of \$10,000 to Parent Co. on the preferred shares outstanding. However, dividends are not deductible and so do not affect the tax loss

saturation of this exercise and inter-corporate dividends are paid tax free to Canadian Controlled Private Corporations under the Part IV tax provisions of the Income Tax Act. As receipts of interest payments build within Loss Co. and result in a cash balance, the preferred shares can be redeemed over time for no tax consequences (as paid up capital is equal to redemption price).

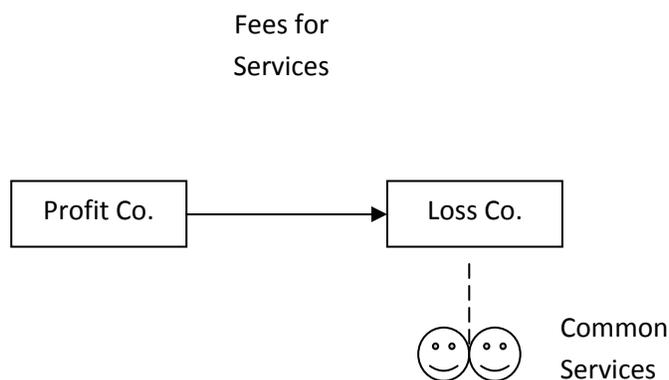
There are no rules governing which entity types are restricted from engaging in this form of income planning as it is available to all taxpayers.

Fees for Services

Management fees can be paid to loss producing corporations in order to shift income and absorb loss balances. There is no restriction on which entities are permitted to use managements fees, however in order to be deductible to the corporation who pays them management fees must be reasonable for the services performed by the recipient. It is therefore essential that a real transfer of services is taking place and the fee is not simply an arbitrary payment.

Reasonable management fee purposes include governance and management duties performed on behalf of the corporate group. If management employees or shared service employees (Payroll, Human Resources, etc.) are employees of Loss Co., it would be reasonable for other corporations in the corporate group to pay a reasonable fee for the use of those services. Market based rates would include a certain profitability ratio that would work to absorb loss balances. Figure 4, below, demonstrates this structure.

Figure 4: Loss Transfers Accomplished Through Fees for Services



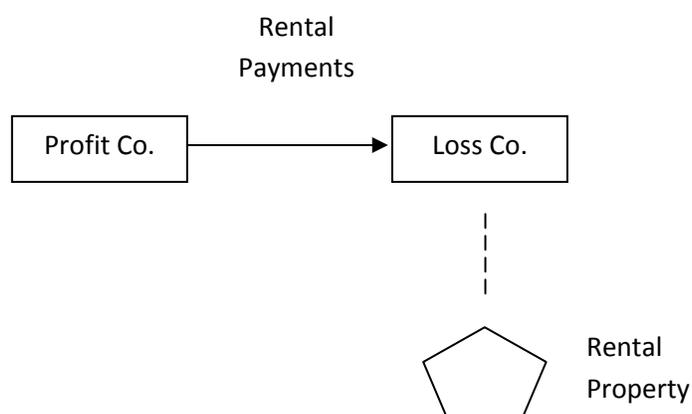
Income Producing Assets

Transferring the ownership of income producing properties to a Loss Co. is another method of shifting income and is outlined in Figure 5, below. There are no restrictions on a corporation's ability to transfer operating or non-active assets to other corporations. Restrictions that do exist work to ensure that fair market value is received for the property transferred. This means that the original owner of the property must take back consideration equal to the value of the property given up. This consideration can be in the form of cash or shares.

Using income producing properties to shift income from Profit Co. into Loss Co., the following steps could be undertaken:

1. Profit Co. owns building and land used for the operations of the business worth \$1,000,000. The market rate of rent on a building of this nature would be \$100,000 annually.
2. Profit Co. transfers ownership of the land and building to Loss Co. in exchange for preferred shares bearing a dividend at the CRA prescribed rate of 1% (as of the date of this report).
3. Profit Co. enters into a rental agreement with Loss Co. to secure use of the building for purposes of continuing the operations of the business in exchange for annual rent paid at the market rate of \$100,000.
4. Loss Co. pays the expenses of operating the land and building (including property taxes, mortgage interest, maintenance, etc.) and net profits are used to absorb accumulated losses over time.

Figure 5: Loss Transfers Accomplished Through Income Producing Asset Transfers



In order to avoid triggering any inherent capital gains on the land and building transferred, the transfer to Loss Co. must be undertaken under the provisions of Section

85 of the Income Tax Act, which allows for tax deferred rollovers. The stop loss rules described below will act to prevent any accelerated recognition of losses when the corporate group as a whole continues to own substantially the same assets before and after the transfer.

Amalgamations or Wind-Ups

An amalgamation is the combination of one or more corporations to create a single corporation. A wind-up is a vertical amalgamation where the parent corporation controls 90% or more of the subsidiary being wound up. The rules governing these two types of transactions are outlined in Section 87 and 88 of the Income Tax Act, respectively.

The treatment of tax attribute balances on amalgamations and wind-ups are very similar to the concept of a loss consolidation system. Where the ultimate ownership of the corporate group has not changed (no acquisition of control has taken place) the accumulated tax attribute balances of previously existing corporations are combined together to create a single combined pool of each type of attribute. There are several restrictions on the use of these attributes in cases where an acquisition of control does occur. Since this concept is not comparable to the closely held corporate group being considered for the loss transfer changes, I have not included details of the restrictions in this analysis.

Losses occurring subsequent to amalgamation are restricted from being carried backwards for application against pre-amalgamation earnings (ITA 87(2.1)(e)), except where the amalgamation was of a parent and a wholly owned subsidiary. In that case losses occurring subsequent to amalgamation can be carried back against parent

corporation income pre-amalgamation only (ITA 87(2.11)). This principle also applies in the case of wind ups of wholly owned subsidiaries (ITA 88).

Stop-Loss Rules

Subsections 13 and 40 of the Income Tax Act include certain ‘stop-loss’ rules. Where property which has an inherent loss attached to it was transferred between two affiliated persons, the loss cannot be recognized by the transferor.

Instead, where the transferor is a corporation the loss is held by the transferor until the property is disposed of to an arm’s length party by the new owner (the transferee). After a disposition to an entity outside the corporate group, the loss can be recognized into income.

Where the transferor is an individual, the loss is denied and ‘reattaches’ itself to the property transferred by increasing the tax cost of the property received by the transferee. This is a different method of postponing recognition, but also changes where the loss is eventually recognized.

This scenario does not involve the utilization of intergroup losses but is an example of loss creation amongst a closely held corporate group.

3.3 Observable Themes

It appears that where activities are undertaken that are in the ordinary course of operations and are not undertaken singularly for tax purposes, they are acceptable planning under CRA’s perspective. This appears consistent with the General Anti

Avoidance Rules (GAAR) covered in section 245 of the Income Tax Act, which indicate that for GAAR to apply a transaction must be an abuse or misuse of the Act, must lead to tax benefits, and must also be undertaken primarily for tax benefits. It has been shown to be the opinion of the courts and CRA that in the course of carrying on a business, a taxpayer has the right to structure their affairs in the most tax efficient manner. So long as the transactions are not clearly a sham, planning related to obtaining the most tax efficient structure is appropriate. This would appear to support the conclusion that transferability of loss attributes under a new system should not necessarily be restricted to wholly owned corporations since comparable benefits are available to loosely related corporations using the present system. Requiring a master parent corporation would create restrictions that do not parallel the current intent of tax policy.

As can be seen by the stop loss rules on property transfers, government policy restricts fabricating or accelerating the creation of tax benefits within a closely held ownership structure. Although the transfer of existing attributes appears to be acceptable, creation of benefits where the economic position of the group as a whole is the same is discouraged (for example, before and after a property transfer the corporate group continued to own the piece of property). Policy recommendations for a system of loss transfers would require review to ensure that corporate groups are not able to create benefits that would otherwise not be available to them if the transfer policies are not present.

The current restriction on losses being carried back to prior years subsequent to an amalgamation or wind up indicates that this is a potential area of concern under the proposed legislative changes. It is clear that forward looking combination of tax

attributes appears favorable but that retroactive planning based on a current event is not encouraged. I would translate this apparent policy preference into a recommendation for the new system as follows: losses occurring subsequent to a conversion should be applicable for use against future income produced. However, losses created subsequent to a conversion should not be permitted to be applied against pre-conversion income within a corporate group.

4.0 Cost Analysis

4.1 Acceleration of Loss Recognition

One of the major concerns around the implementation of a loss transfer system is the immediate reduction of government tax revenues arising from trapped losses which are now able to be utilized against taxable income of other entities.

Observations made by the Department of Finance (2010) infer that, in general, corporations use the majority of their tax losses over time; approximately 75% of losses arising in 2000 were recognized in the year of occurrence or over time prior to expiration of the remaining 25%. Therefore, although the ability to use losses which might otherwise have expired or gone unutilized is a concern, it is not the largest one. The greatest impact on tax revenues will be caused by:

- The early recognition of losses carried forward from prior to transition to a new system; as well as
- Losses occurring post transition that are utilized in the year of occurrence as opposed to being absorbed gradually over time.

If the value of all current balances of non-capital losses were able to be realized against taxable income subsequent to transition, the impact on the tax base could range from approximately \$31.9 to 92 billion depending on whether the losses are applied to reduce active income subject to the small business deduction, general rate income, manufacturing and processing income, or non-active income. See Chart 2 for information on annual income, losses and accumulated loss balances.

Assuming that the proposed rules on loss transfer restrict the retroactive application of the transfer rules, losses carried forward from pre-transition will not be eligible for application against income occurring pre-transition. Therefore, the maximum amount of losses carried forward that can be applied in the year subsequent to transition is the amount of taxable income occurring in that year and which would not otherwise have been reduced for losses occurring in that year.

For example, based on Chart 2, 2008 taxable income was \$208.9 billion. Non-Capital Losses and Capital Losses occurring in 2008 were \$103.8 billion and \$27.7 billion, respectively. Therefore, were the conversion to have occurred in 2008 there would have been approximately \$91.2 billion of taxable income available to saturate loss carry forward balances. See Chart 1, below, for the calculation.

Chart 1: Calculation of Annual Unsaturated Income

Taxable Income	208.9
Non-Capital Losses Incurred	(103.8)
Capital Losses Incurred*	(13.9)

	\$91.2 billion

**(Net of non taxable component: 27.7 x 50% rate in 2013)*

The limitation on current year income effectively sets a limit on the amount of lost tax revenue in a single year. Based on these figures the maximum effect on tax revenue in a single year is approximately \$14.1 to 40.74 billionⁱ.

Chart 2: (In billions)

Statistics on Canadian Taxpayers					
Calendar year 2006 - 2008					
		2008	2007	2006	2005
Taxable Income	(1)	208.9	203.1	190.6	165.0
<u>Non-Capital Losses</u>					
Non-Capital Losses Incurred	(1)	103.8	66.2	50.1	42.5
Non-Capital Losses Pools End of Year	(1)	206.0	175.0	157.1	150.4
Current Year non-utilized dollars		31.0	17.9	6.7	
Current Year non-utilized as percentage of losses		30%	27%	13%	
Current Year non-utilized as percentage of income		15%	9%	4%	
Current Year utilized as percentage of income		35%	24%	23%	
<u>Impact of full recognition in 2014 - New Brunswick</u>					
	Offset against Income Subject to the Small Business Deduction Income	31.9	15.5%		
	Offset against Active income taxed at the General Rate or Manufacturing Income	51.5	25.0%		
	Offset against Investment Income	92.0	44.7%		
<u>Capital Losses</u>					
Capital Losses Incurred	(1)	27.7	30.5	12.3	12.7
Capital Losses Pools End of Year	(1)	77.8	82.6	72.0	73.8
Current Year non-utilized dollars		(4.8)	10.6	(1.8)	
Current Year non-utilized as percentage of losses		-17%	35%	-15%	
Current Year non-utilized as percentage of income		-2%	5%	-1%	
Current Year utilized as percentage of income		16%	10%	7%	
<u>Impact of full recognition in 2014 - New Brunswick</u>					
	Offset against Investment Income	17.4	44.67% x 50% inclusion		
(1)	These figures obtained from: Department of Finance: Canada. (2010). <i>The Taxation of Corporate Groups</i> . Ottawa: Government of Canada.				

The expected time period after which loss utilization should stabilize is 3 yearsⁱⁱ, after which tax arbitrage will have resulted in the application of losses wherever able to reduce taxable income. Losses occurring on a go forward basis after three years will be applied against income in a manner that can be expected to continue into the foreseeable future. Fluctuations will need to be tracked to determine whether this new system creates additional variability to the Canadian system of taxation.

These calculations all assume that the current unutilized balances of losses belong to organizations that will be eligible for the revised tax loss transfer system. However, only 19% of all Canadian corporations would qualify for the program if restricted to a 90% ownership threshold. These corporate groups tend to produce a disproportionately large share of the annual taxable income of Canadian taxpayers and would account for approximately 63% of all taxable income (Department of Finance, 2010). This reduction in eligibility will impact the ability of the losses to be utilized.

4.2 Recognition of Previously Expiring Losses

In addition to the accelerated recognition of losses which would have been utilized under old methods of loss transfer, there is the potential for the previously unutilized 25% of tax losses to now be capable of being absorbed by taxable income in other entities. Although it is unlikely that all of the previously unutilized losses will be capable of being absorbed, this scenario is presented below as an illustration of a worst case scenario for the Government of Canada's fiscal position. Chart 2 presents annual non-capital losses occurring of \$103.8 billion. Because of the dramatic increase in losses in 2008 and the

unpredictable economic climate at that time, a more accurate prediction of annual losses occurring is likely to be a four year average based on available data. Therefore, I will use \$65.65 billion as the average annual non-capital losses occurringⁱⁱⁱ. Based on the Department of Finance's estimate of 25% of these losses being unrecognizable previous to the implementation of a new tax transfer system, approximately \$16.41 billion in annual losses expire without being recognized against taxable income. Assuming an annual rate of growth of 3%, the present value of not recognizing these losses in perpetuity is between \$84.73 and \$244.19^{iv} billion in lost tax revenues to Canadian Federal and Provincial governments depending on the tax rate on the income reduced.

4.3 Interprovincial Planning

Another key issue surrounding the implementation of a loss transfer filing system is the impact it will have on the distribution of provincial tax revenues. All provinces, and Ontario in particular, are concerned over the erosion of their tax revenues if losses occurring in other provinces were to be applied against taxable income in their province. What would ordinarily be a source of tax revenue would be eliminated.

Currently, 55% of income and 60% of losses are created by corporations liable for tax in only one province (Department of Finance, 2010). It is difficult to determine whether any reliable conclusions can be drawn from this statistic. If provincial arbitrage is undertaken within a corporate group, losses may already be applied to reduce tax at the highest rate possible (and so achieve a greater savings across the group). It is also reasonable to consider that corporations situate their operations based on optimal tax

rates. International and intra-national competitiveness is one of the primary motivators behind tax rates and competes with the monetary demand for social services in order to reach a reasonable rate. Alberta is widely regarded as an onshore tax 'haven' for its low tax rates compared to other locations within Canada. Physically locating to Alberta, or artificially creating residency in Alberta, are planning techniques that have been used to lower tax rates of a taxpayer. This problem was so prevalent that the trust residency rules were required to be changed through case law in order to prevent unreasonable planning opportunities^v. Given the existence of these planning opportunities, the impact of intra-provincial planning may not be of significant concern.

As can be seen in Chart 3, below, the average provincial tax rate on general rate active business income is 12.7%. The optimum planning arrangement for a taxpayer would be to shift losses they have incurred in low rate jurisdictions against income they have incurred in high rate jurisdictions. Therefore, provinces with the most to lose from a tax loss consolidation include Nova Scotia and Prince Edward Island since their tax rate of 16% is the highest in the country. Taxpayers will be biased to want to reduce a tax burden calculated on a high ratio.

Ontario, which has raised the loudest outcry around this issue, is actually below the national average rate of tax at 11.5%. It would be reasonable to conclude that losses incurred within Ontario would be applied elsewhere in order to take advantage of taxes payable to Ontario at a rate below the national average. Ontario would stand to gain from this initiative from a purely rate based theory.

The provinces who would achieve the greatest benefits would include Alberta and British Columbia as their tax rates are the lowest in the country at 10% and 11%, respectively. Both of these provinces are financially very sound. Their low corporate tax rates are possible because of high tax bases on which to calculate these rates. Their economic prosperity can be shared with the residents of their province and also encourages new entrants which furthers the cycle of prosperity. These benefits may detract these provinces from consideration of rate adjustments in order to better implement a new method of loss transfers. It is likely, however, that were the rates of taxation in these provinces more evenly distributed with the remainder of Canada, the provinces would continue to attract investment because of their infrastructure and economies of scale which have already been established.

The consideration of a loss transfer system identifies a pervasive rift within our national tax system that has inherently motivated, rewarded, and disadvantaged many taxpayers and the provinces themselves since its inception. It would be encouraging if the debate on this proposal was able to elicit discussion on whether the Canadian provincial tax system is achieving the results that it was designed to. After all, taxation is one of government's primary tools for influencing taxpayer behaviour. Economic issues have brought 'have' and 'have not' provincial discord to a forefront. Industrious minds attuned to the problem may be able to develop a system that eliminates bias and creates more equal footing so that any province can achieve financial success.

Chart 3
Canadian Provincial Tax Rates (%)
2014 Calendar Year

	NB	NS	PEI	NFLD	QC	ONT	MAN	SASK	ALB	BC	YUK	NWT	NUN
Small Business Deduction Rate	4.5	3.5	4.5	4.0	8.0	4.5	0.0	2.0	2.0	2.5	4.0	4.0	4.0
General Rate Income	12.0	16.0	16.0	14.0	11.9	11.5	12.0	12.0	10.0	11.0	15.0	11.5	12.0
High Rate Non-Active Income	12.0	16.0	16.0	14.0	11.9	11.5	12.0	12.0	10.0	11.0	15.0	11.5	12.0

Average General Rate: 12.7
Highest Differentials:
Nova Scotia/PEI 3.3
Alberta -2.7

Source: KPMG LLP (2013). *Tax Facts 2013-2014*. Toronto

5.0 International Models

5.1 Introduction

One method of determining the optimum structure of a tax loss transfer system is to make comparisons to systems already in use around the world. Currently, two thirds of OECD countries employ some method of tax loss transfer systems (Department of Finance: Canada, 2010). A sample of countries who employ or who do not employ a tax loss transfer system is Chart 4, below.

Chart 4: Countries Which Employ or do Not Employ a Tax Loss Transfer System	
Countries Providing a System of Group Tax Consolidation or Relief	Countries with No Statutory System of Group Taxation
Australia	Belgium
Austria	Canada
Cyprus	China
Denmark	Czech Republic
France	Greece
Germany	Hong Kong
Ireland	Hungary
Italy	Korea
Japan	Switzerland
Latvia	Turkey
Luxembourg	
Malaysia	
Malta	
Netherlands	
Portugal	
Singapore	
Spain	
Sweden	
United Kingdom	
United States	
<i>Source (Laurin, 2009)</i>	

Statistics can be obtained on the various methods used by each country employing these systems. However, as you will note from the analysis below, the methods and thresholds used vary wildly. It becomes important given this diversity to consider what factors would give weight to using one country's methods over another. How can we determine which countries we should imitate? I do not give a definitive answer to this puzzle since my logic can be debated, but several factors I have considered are outlined below.

One option might be to choose countries which have experienced fiscal prosperity based on the rationale that an economically sound country must make consistent intelligent decisions. Therefore, if they were to adopt a system which did not give rise to positive repercussions we could safely assume they would act to remove it. The reasoning leads to the conclusion that a fiscally prosperous country has a reasonably effective system of tax loss consolidation or transfer. This criteria may be a difficult one to determine, given that all countries experience periods of economic prosperity and difficulty.

A second option might be to choose countries with personal and corporate taxation rates (as a percentage of income) which are similar to our own. A country which relies on a similar ratio of tax revenues in order to fund their operations would be expected to have similar outcomes from the transition to a tax loss transfer system as Canada would expect to incur. Other statistics that could be used for this type of comparison might be deficit levels, population, or annual taxable income or losses per person.

Given the proposed tax loss regime's issues around Provincial revenue allocation, a comparative system that is Federal as opposed to Unitary might be most advantageous.

A system that functions well for a Unitary government may not have the fundamental requirements Canada will need to account for Provincial revenue allocation.

It might be considered that countries with similar historical backgrounds and who have relied on similar principles as Canada in developing a tax regime will have the most in common with us. Given these considerations, Commonwealth countries may be the most practical comparative.

The United States is our most influential trade partner. Aligning our taxation systems with theirs may create an added incentive for US companies to do business in Canada, creating an additional benefit from the transition.

In addition, I think it important to consider countries which have recently transitioned to a tax loss transfer system or those who have made dramatic changes in their legislation around this system. The underlying reasons behind their choice to convert as well as the perceived impacts of the conversion will help Canada in managing the conversion if it were to occur here.

5.2 Country Comparisons

Consolidation or Loss Transfer

The distribution of countries using either a tax loss consolidation system, where figures are aggregated at a group level, or using a loss transfer system, where only balances are transferred, appears to be fairly evenly split. Listed in Chart 5, below, are the countries studied who use variations of the two types of systems.

Chart 5: Countries Which Use a Loss Consolidation or Loss Transfer System	
Consolidation System	Transfer System
Australia	Finland
Denmark	Germany
France	Ireland
Italy	Norway
Japan	Singapore
Netherlands	Sweden
United States	United Kingdom
<i>Source</i> (Department of Finance: Canada, 2010) (Laurin, 2009) (Vance, 2011)	

When comparing what I would consider “tax loss transfer systems” it is interesting to note that the mechanics of how individual balances are transferred can differ between the various countries. Germany, Sweden, Finland and Norway, for example, use profit-transfer systems (Laurin, 2009). The net profit of each corporation in an eligible group is calculated and those companies having positive net profit can transfer them to loss making corporations or the parent corporation in order to equalize income.

Ireland, Singapore, and the United Kingdom also use the same balance transfer type of system. However in their case it is the losses that are transferred from loss making companies into income earning companies (Laurin, 2009).

Both an income and loss transfer system results in the same tax impact regardless of whether a country is provincially divided. Therefore, the main reason behind the difference is likely the ease with which it can be implemented and reported.

France and the United States are both countries which use a consolidation type approach to loss planning. In the United States, each State maintains its own corporate tax returns however balances are computed at a group level. Each corporation is also jointly and

individually liable for their tax liability with the group as a whole (Vance, 2011). French companies must each file their own tax return, but they are not liable for the individual tax balances calculated (Laurin, 2009). The overall balance owing is calculated at the group level only.

In contrast to systems where individual corporate identities are maintained, where an eligible group uses Australia's consolidation system, a single filing is performed and the individual companies lose their separate identity for tax purposes (Vance, 2011).

Eligibility

There are also various thresholds at which corporations in each country are eligible to participate in their tax loss regime. The level of required ownership will dictate the number of corporate groups which are eligible for the regime. Therefore, restricting this option to corporations with high ownership interests or wholly owned corporations will also help to restrict the impact on government revenues. Requiring a high ownership interest will also minimize the financial impact of accounting for the interest of non-controlling shareholders.

Conversely, using an ownership threshold which is the minimum required to give a controlling interest will allow the desired benefits of a tax loss regime to be available to as many corporations as possible. An example of this minimum threshold is an ownership of greater than 50% of the voting shares of a corporation.

Chart 6: Ownership Threshold for Eligibility	
Country	Eligibility Threshold
Australia*	100% share ownership
Denmark*	50% share votes
Finland	90% share ownership
France*	95% share votes and value
Germany	50% shares ownership
Italy	50% share ownership
Japan	100% share ownership
Netherlands	95% share ownership
United Kingdom*	75% share ownership
United States*	80% share votes & value
<i>*These countries confirmed to require a common corporate parent</i>	
<i>Source (Department of Finance: Canada, 2010) (Laurin, 2009) (Vance, 2011)</i>	

As can be seen from Chart 6, above, the majority of countries reviewed appear to use a high threshold of ownership interest as their test for eligibility. In most cases, where specifically mentioned, a combination of votes and value are considered in meeting this test. The 'votes' test indicates that only share capital which have voting privileges attributable to them will be eligible for consideration in meeting this test, whereas the 'value' test is based on what outstanding share capital has the greatest fair market value attributable to it. Using a 'value' test can result in a non-decision making shareholder being eligible for consolidation because of the high value of the shares they hold. In Canada, it is common for structures to exist where the voting control is maintained by a single family patriarch or matriarch while the majority of share value resides elsewhere (these are called 'skinny shares'). Using both votes and value prevent the artificial creation of an eligible parent through share terms, who would otherwise not share in the economic interest (through growth in fair value of shares held) of the corporation in question.

The eligibility for a tax loss regime can also be determined by issues other than ownership. In the United States, for example, only a domestic corporation can be the parent of a consolidated group (Laurin, 2009). A domestic corporation is one created in the United States and controlled by individual residents of the United States. In France, permanent establishments of foreign companies can be the head of a consolidated group (Public Finances General Directorate, 2011). This rule would open eligibility to any company who establishes a base of operations in France that is sufficient to be considered a permanent establishment including a sales office or a manufacturing plant. Denmark's tax loss regime is mandatory for Danish corporations, but international companies are able to voluntarily participate if they are eligible (Vance, 2011). This gives the country a measure of reliability over tax revenues arising from the treatment of Danish corporations and reduces the variability to include only international participation.

All corporations which were reviewed for the nature of the parent entity (corporate vs. individual) were found to require a common corporate parent in order to be eligible for their tax loss regime. This is contrary to my original expectation, given that a common individual shareholder would result in subsidiaries having a common economic goal very similar to where a corporate parent is present. If this requirement were instituted in Canada it might have significant consequences on a company's ability to meet the lifetime capital gains exemption tests for private companies, and would also give rise to required planning for most corporate groups to create eligibility without preventing the intended goals of current corporate structures.

Participation Decision

Whether an eligible corporation is required to participate, may elect for a defined period, or may annually elect to participate will impact some of the important benefits desired to be achieved using a tax loss regime. The greater the flexibility a corporation has to determine participation on a short term basis, the less predictable a government's tax base will be. The ability to annually elect will also encourage increased planning compared to a mandatory system. This planning will counteract the desired outcomes of simplicity and reduced cost of adhering to the tax system.

Chart 7: Participation Requirement Levels	
Participation requirement levels	
Country	Flexibility in Participation
Australia	Elective by parent, non-retractable and subsidiaries must all participate once elected.
Finland	Voluntary participation
France	Annually elective, each subsidiary has own choice to participate
Germany	Voluntary and each subsidiary may decide, but once elected must participate for five years
Italy	Voluntary and each subsidiary may decide, but once elected must participate for three years
Netherlands	Annually elective, each subsidiary has own choice to participate
United Kingdom	Annually elective
United States	Voluntary by parent, mandatory for all subsidiaries once elected
<i>Source</i> (Laurin, 2009) (Vance, 2011)	

Regardless of the increased planning costs and the increased variability of government revenues, based on Chart 7, above, it appears that voluntary and annually elective participation are the most popular amongst countries which were reviewed. This may have arisen because of taxpayers' access to this level of choice using the current methods of loss transfer. Implementing a tax loss regime that was more restrictive than what is currently available would infer that the current ability to utilize intra-group losses was not desired. A mid-way decision to give taxpayers the ability to plan but also increased revenue stability would be the voluntary participation but with multi-year elections such as Italy and German employ.

Provincial Considerations

Many provinces are wary of a tax loss regime because of issues around inter-provincial income shifting in order to take advantage of low provincial tax rates compared with other jurisdictions. Provinces are concerned that their tax base will be further eroded by income shifting within corporate groups. As the United States operates State and Federal levels of taxation it is a useful comparison in how to combat this issue. In the United States, the system has increased complexity because each State administers its own tax code. While this is also done Provincially and Territorially in Canada, in most cases Provincial and Territorial tax codes mimic Federal law. This is not the case in the United States. For example, in some States losses arising in that State are only permitted to be applied to reduce income of corporate group members within that same State (Vance, 2011). This restriction would help to ease the concerns of participating Provinces, but only universal application by all Provinces would result in equity. If a restriction of this

nature were considered in the Canadian transition, it should likely be mandated at the Federal level.

Non-Controlling Interests

Ensuring the appropriate compensation of non-controlling interests will ensure that this tax loss regime is considered fair by all involved shareholders. Not providing a method for compensation for lost tax attributes would likely lead to a reduced willingness of investors to become involved in business ventures where they did not maintain majority control. One country which has devised a method of compensating their non-controlling shareholders is Denmark. In Denmark, the taxable income or loss of a subsidiary is included 100% in the income of the group's consolidated income, regardless of the actual ownership interest the group holds in it (Bech-Bruun, 2013). When a loss is transferred to offset income of a profitable company within the group, the company which receives the loss must financially compensate the loss making company for it. Effectively, the non-controlling interests are not paid directly for the loss of attributes, but the value of their investment remains stable because of this offset. The future value of reduced taxes arising because of the losses are offset by an increase in cash received by the profit company.

5.3 Recent Conversions

Australia adopted their system of consolidation in 2003 (Vance, 2011). That they are also a Commonwealth and English speaking country makes them a useful comparative. Their theories on social equity are similar to our own, and their legislation is easy to

obtain in a useable form without the need for translation; which may give rise to discrepancies in interpretation.

In 2011 a review of the consolidation regime was completed by Australia's Board of Taxation in order to gauge the effectiveness of the regime in meeting the objectives initially set for it. The report's overall conclusion was that the regime had "delivered substantial efficiency and integrity improvements to the Australian tax system when compared with the income tax grouping rules which wholly-owned groups previously had to apply" (The Board of Taxation, 2012). Cited benefits obtained include better transparency of overall tax liability for large corporate groups and increased transparency, operational efficiency from the reduced planning needs around intra-group transactions, and reduced compliance costs. Reduction in compliance costs were triggered by no longer requiring election forms or valuations for intra-group transactions. However, the review did identify that the transition to the new system resulted in an increase in complexity to the tax system and was not without substantial cost

Some of the benefits hoped to be achieved by the Australian system were similar to our own such as reducing the high costs of reporting intra-group transactions and loss transfer strategies (The Board of Taxation, 2012). It was also hoped that the new system would reduce the administrative costs of overseeing the tax system. However, several of the benefits were quite different. Australia moved towards a full tax consolidation system where individual corporate identities are ignored, thus having the additional benefits of avoiding double taxation on deemed disposition and wind-up of corporations, and avoiding the practice of staggering corporate year ends to defer taxation. Unless a full consolidation system was undertaken, Canada's transition would not target these issues.

The downside to full consolidation is the loss of corporate identity and the difficulty for individual corporations in joining and leaving groups.

Studies found that 83% of small to medium wholly-owned groups elected to use the consolidation regime and 93% of large businesses (The Board of Taxation, 2012). The conclusion was that the complexity of the rules discouraged small businesses to participate compared with their larger counterparts. This may detract from a tax loss consolidation regime's ability to create one of the benefits attributed to these plans; that of allowing small businesses access to the same loss consolidation planning as large businesses. When discussing one of the benefits to be gained from these systems, it was considered that large businesses were better able to afford the planning advice in order to perform loss consolidation under Canada's current system. It was hoped that a new system would create a level playing field for all, but this finding by Australia's Board of Taxation does not support that conclusion.

One interesting component of Australia's system of taxation is called the "tax cost setting rules". Because corporate identity is eliminated on entry into a corporate group, the assets and liabilities of a subsidiary must be combined with those of their parent corporation. An issue arose around determining what value to use for those net assets in doing that combination. Typically, on the purchase of shares of a corporation the net assets acquired are valued at their tax basis as they existed prior to the acquisition. However, because these values did not reflect the tax cost paid to acquire those assets, Australia's tax consolidation regime requires the net assets to be consolidated at the value they were purchased for (The Board of Taxation, 2012). This, in effect, appears to result in the same tax basis for assets under a share purchase as would ordinarily occur under an

asset purchase. There would be no disadvantage under this system on a share purchase, as the tax cost available to depreciate over time (Capital Cost Allowance) will be the same as in an asset purchase. A similar rule applies on the exit of a corporation from a consolidated group.

One of the benefits said to have been obtained from the transaction was the decreased need for valuations to undertake intra-group transactions. However, these 'tax cost setting rules' would require valuations and complex calculations in order to determine the value of assets on entering or leaving the corporate group. There may be efficiencies and cost savings from transactions within a group, but it appears that changes to the corporate structure will give rise to more costs than under Canada's current system.

The complexity of the tax cost setting rules are cited as one of the key concerns the Board of Taxation had with the consolidation regime (The Board of Taxation, 2012). The Board of Taxation also allowed that additional compliance costs to update reporting software, accounting systems, and to hire advisors to give assistance on understanding the new rules were high. The interaction of the tax consolidation rules with other aspects of the income tax act have also given rise to unexpected consequences or uncertainty over outcomes that were not a desired part of the regime. In the eight years between implementation and the publishing of the review report, the Board of Taxation believes that several of these issues have been corrected through legislation but not all.

Canada's consultation participants, in particular the Department of Finance, appeared concerned about the impact these changes would have on tax revenues. The Board of Taxation report does comment that the consolidation regime's complexity makes it very

difficult to predict government revenues. It also appears difficult to calculate the financial impact of minute changes to the rules, leading to some hesitancy to do so (The Board of Taxation, 2012).

This review of high level comments on the Australian tax loss consolidation regime has identified previously unconsidered issues arising from how the rules are implemented. The overall feedback appears positive, but these comments illustrate that care must be taken in devising the underlying rules for this proposal given the magnitude of its implementation.

Another recent transition was Denmark, whose current system was adopted in 2004 but previously had a loss transfer system with different rules. The current system is mandatory and requires a 50% ownership threshold, whereas the previous system was voluntary but required a 100% ownership threshold (Vance, 2011). Further research on the reasons for the transition and the effects pre-loss system, mid-loss system, and with the newest revised loss system would give a gradient scale of the effectiveness of these options.

6.0 Conclusions & Areas of Future Research

6.1 Conclusions

This report reviewed the proposal to implement a tax loss regime in Canada that would allow eligible corporate groups to either file a single consolidated corporate tax return, or to transfer income or losses amongst members of the corporate group in order to facilitate taxation based on economic entities instead of legal entities. Various stakeholder opinions were compiled including government, oversight organizations, and practicing tax professionals.

Benefits of the proposed tax loss regime include increased fairness and neutrality of tax outcome across structures as well as increased economic prosperity through international investment and increased cash-flow for businesses. Issues arising out of the proposed tax loss regime include the accelerated use of loss pools leading to decreased government tax revenues as well as indecision on how provinces are to be allocated tax revenues on inter-provincial transfers of income or losses.

Comparable foreign systems of tax loss transfers and consolidation were reviewed to determine whether best practices exist and wide variation was found between the tax loss regimes currently in use around the world. Finally, Australia's recent post-implementation review of their tax loss consolidation system is discussed in order to benefit from their reflections on the success of their tax loss regime and potential areas for future improvement.

The Canadian Federal government's 2013 budget, released March 21, 2013, identified the Federal government's intentions not to pursue implementing a tax loss regime in the near

future because of the inability to gain a consensus on key issues with stakeholders and provincial and territorial officials. The variety of systems that exist, and the lack of conformity on key issues of design, make it difficult to determine if a best practice exists which Canada can emulate. There is a multitude of information available on options but very little in the way of conclusions at this time.

The budget also made reference to the significant up-front costs of converting to a new tax loss regime. Given the decline in business profitability and resulting decline in government tax revenues for the period of 2008-2012, it may not be the optimum time to commit to a substantial renovation of the Income Tax Act.

However, it seems likely that this topic will re-emerge in the future when circumstances are more economically prosperous. The history of discourse on this topic continues to make it one to watch as we move forward.

6.2 Areas of Future Research

In regards to comparable loss transfer systems, Denmark previously employed a tax loss transfer system and subsequently revised it in 2004 to be both mandatory and to include a great array of corporations (Vance, 2011). A review of the impacts of the pre-loss system, the mid-way loss system, and the currently employed tax loss system would provide a gradient scale of effectiveness of these system characteristics.

As Canada has currently decided not to pursue this legislation at the current time, it may be optimal to disregard further research in this area and instead focus on alternative

international structures which may benefit Canadian taxpayers, the Canadian government and the Canadian economy. During review of Australia's transition to the tax loss consolidation system, it was observed that their pre-transition rules were very similar to Canada's in all but one case. For example, Australia allowed losses to be transferred between group members using planning techniques, dividends were permitted to be paid tax free to another member of a group, and capital losses were rolled-over when assets were transferred between group members (The Board of Taxation, 2012). The one exception was that Australia also permitted capital gains to be rolled-over when assets were transferred between group members. It is possible to affect this sort of tax deferral under the Canadian system however the consideration received must include share capital. A review of Australia's system to determine whether there are benefits to permitted different forms of gain roll-overs may give rise to increased efficiencies if implemented in Canada.

The area of focus in tax law is continually shifting. As corporate loss planning has been thoroughly researched and set aside for the moment, other emerging concepts in tax may benefit from further research as opposed to focusing resources on a currently tabled topic.

Similar to the call for stakeholder input on loss transfer systems, the Department of Finance has now called for stakeholder input on possible measures to prevent international treaty shopping (Department of Finance, 2013). However, the difficulty around tax consultations in an academic environment is the short turnaround times for completion. The current deadline for stakeholder input is December 13, 2013. If this short deadline were obtainable, this topic is a current and intriguing one. Currently, residents of a country may choose to create a taxable entity in another country and do

business through that country in order to gain favorable treaty provisions. For example, take a Canadian corporation who wishes to do business in the United States (US) but is aware of favorable treaty provisions through Belgium which would result in lower overall taxes after the cost of the planning. Sales that would ordinarily be made by the Canadian corporation to the US are instead sold by the Canadian Corporation through the Belgian corporation and subsequently on to the US, despite the economic reality of the sale being from the Canadian corporation to the US. This is depicted in Figure 6, below.

Figure 6: Example of Treaty Shopping

Before Treaty Shopping



After Treaty Shopping



The benefits provided by treaty shopping are unintended and encourage transactions for other than economic purposes in order to obtain favorable tax treatment. From a

layperson's standpoint, this form of tax planning is an unfavorable one and garners significant negative media attention for corporations who undertake it and for tax advisors who perform it.

This issue also blends well into another emerging tax discussion topic; tax morality and transparency. It can be challenging as a tax advisor in adhering to the rule based nature of the tax environment, and considering clients' desires for optimum tax reduction, to also be cognizant of the concept of a "fair" tax system. The ability for tax practitioners to use current systems to achieve an advantageous position can be perceived as abusive and not in accordance with the principle that all participants of an economic ecosystem pay their share of taxes. The discussion of whether tax obligations are based on fairness is an interesting one that delves deeply into the underlying principles of the tax code and government's intentions in all countries around the world. This debate is not restricted to Canada, and media attention has been focused on multi-national American companies taking advantage of foreign tax regimes; Google, Amazon, and Apple to name a few (Gray, 2013). This issue may be of prime importance at this time because of the economic hardships being experienced globally by many foreign governments.

Research into tax morality would involve not just a profile of common tax avoidance culprits, who may not be whom you expect, but should also include an economic and philosophic discussion on what taxation is intended to achieve and why regulations leading to abuse are maintained. First person research into public perception on tax morality would paint an interesting comparison between how individuals perceive corporate tax planning compared to their own efforts to minimize their annual tax bill.

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ⁱ \$91.2 billion in losses utilized x 15.5% small business deduction rate in New Brunswick = \$14.1 billion, \$91.2 billion in losses utilized x 44.67% non-active investment income rate in New Brunswick = \$40.7 billion.

ⁱⁱ \$208.9 estimated annual taxable income from Chart 2 / \$91.2 taxable income available for absorption of losses carried forward before transition from Chart 1 = 2.29 years. As partial years do not exist in taxation, it will take 3 years before the impact of losses carried from transition are able to be absorbed.

ⁱⁱⁱ 103.8 2008 losses + 66.2 2007 losses + 50.1 2006 losses + 42.5 2005 losses = 262.60 combined losses over 4 years / 4 years = \$65.65 billion average annual losses.

^{iv} \$16.41 billion in annual losses / 0.03 annual rate of return = \$546.66. \$546.66 present value of annual losses x 15.5% small business deduction rate in New Brunswick = \$84.73 billion, \$546.66 present value of annual losses x 44.67% non-active investment income rate in New Brunswick = \$244.19 billion.

^v *St. Michael Trust Corp. v. Her Majesty the Queen* (2010 FCA 309)

**Curriculum Vitae
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Education

University of New Brunswick	Master of Business Administration – 2013 (Expected) Current cumulative GPA – 4.0
University of New Brunswick	Diploma in University Teaching – 2012
Canadian Institute Of Chartered Accountants	In-Depth Tax Course – 2009-2011 Parts I & II Group study & In-Residence
Canadian Institute Of Chartered Accountants	Chartered Accountant Designation – September 2010
Atlantic School of Chartered Accountancy	Uniform Final Evaluation - 2009 David Hope Honour Roll
University of New Brunswick	Bachelor of Business Administration - 2008 First Class Honours in Accounting Minor in Economics, Concentration in Finance Dean's list 2006/07 and 2007/08

Work Experience

KPMG LLP Manager	August 2011 – Present Tax Services Department
University of New Brunswick Contract Professor	September 2012 - Present Economics Department Principles of Personal Taxation Principles of Corporation Taxation Trusts and Estates
Chartered Professional Accountants (CPA) Canada In-Residence Tutor	July 2013 In-Depth Tax Course Part I Facilitate learning by leading discussion groups and Guiding students through problem sets on various In-depth tax matters
Atlantic School of Chartered Accountancy	August 2010 – August 2012 Tutor & Course Marker for the Uniform Final Evaluation (CA designation final exam)

Grant Thornton LLP October 2009 – July 2011
Senior Analyst/Analyst Tax Services Department

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Accountant Assurance & Business Advisory Services Department

Awards & Honours

Rotarian of the Year – Fredericton North Rotary Club 2012
Community Leader Award – KPMG LLP 2012
Difference Maker (nominee) – Grant Thornton LLP 2011
David Hope Honour Roll – Atlantic School of Chartered Accountancy 2009
Alumnae Undergraduate Scholarship – University of New Brunswick 2007
Jennifer A. Douglass Memorial Bursary – University of New Brunswick 2007
College Hill Social Club Bursary – University of New Brunswick 2006
Governor Thomas Carleton Scholarship – University of New Brunswick 2005

Publications

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Speaking Engagements

C. Sears, “Off-shoring profitability and Qualitative Review”, KPMG LLP Provincial Legislation Update, May 2013.

C. Sears, “Toast to the Graduates”, New Brunswick Institute of Chartered Accountants Convocation Ceremonies, January 2012.

C. Sears, “Canada-US Tax Convention: New Limitation of Benefits Provision”, KPMG LLP Provincial Legislation Update, January 2012.

C. Sears, “Accelerating Capital Cost Allowance on Major Capital Projects”, KPMG LLP Provincial Legislation Update, December 2011.

C. Sears, “Tax Regulatory Update”, KPMG LLP Seminar for Not-For-Profit Organizations, November 2011.

C. Sears, “Countdown to Summer”, ACOA Speakers Toastmaster Club, May 2011.

C. Sears, “Achieving your Professional Goals”, Golden Toastmasters Club, April 2011.

C. Sears, “Impending Doom – Preparing for Tax Season”, Golden Toastmasters Club, March 2011.

Activities

<i>New Brunswick Institute Of Chartered Accountants</i>	2012-2013 CPA Unification – Atlantic School of Chartered Accountants Repurposing Sub Committee
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<i>Rotary International</i>	2011-Present Fredericton North Rotary Club Youth Exchange Coordinator
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<i>Toastmasters International</i>	2010-Present Competent Leader & Competent Communicator Manuals Treasurer
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