INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÉRES

Barbara Amsden
Director, Capital Markets
Tel: 416) 687-5476
E-mail: bamsden@iiac.ca

September 28, 2006

Mr. Robert Hamilton
Assistant Deputy Minister, Tax Policy Branch
Department of Finance
140 O'Connor Street
Ottawa, ON K1A 0G5
Tel: (613) 992-1646
E-mail: hamilton.bob@fin.gc.ca

Dear Bob:

Re: Draft Changes to Eliminate the Double Taxation of Large Corporation Dividends

The Investment Industry Association of Canada (IIAC) welcomes the opportunity to comment on the government's proposed legislation to eliminate the double taxation of large corporation dividends. As the professional association for Canada's 200 investment dealers, which collectively administer approximately $1 trillion in client investments, we understand the importance of this draft legislation and want to work with your department to ensure it is structured in an equitable and efficient manner.

IIAC is supportive of the government's plan to eliminate the double taxation of large corporate dividends. In recent weeks, however, we have submitted correspondence to your Department and Canada Revenue Agency officials expressing specific areas of concern with respect to this draft legislation and here we include a number of additional issues.

Implementation

Our submission dated August 8th, attached for your reference, outlines the insurmountable operational issues our members will face if required to implement the legislation as currently drafted given that the details of the proposal's application are not yet finalized and thus technology development cannot reasonably begin. Accordingly, we recommend in that submission that 2006, as a minimum, be considered a transition year and that all dividends declared from publicly listed corporations in 2006 be recognized as "eligible" for tax reporting purposes. This will also avoid investor confusion and irritation arising from delays in issuance of or inaccurate T5 slips that they need in order to complete their tax returns.

Technology development requirements apart, the coming-into-force provisions entitling corporations to up to 90 days following Royal Assent to inform investors of their dividend designation makes the

legislation more unworkable as, given that we are now approaching September's end, many corporations may not make a designation until 2007. This will make it impossible for financial institutions to prepare 2006 T5 tax slips for their clients that accurately differentiate between "eligible" and "ineligible" dividends. This year-end problem could also potentially re-occur each year going forward. While corporations need time to obtain a qualified opinion from tax and legal counsel as to the nature of their dividends, for the sake of simplicity, we reiterate the need to treat 2006 dividends from at least publicly listed corporations as "eligible" for tax purposes, and suggest that it is desirable for the legislation to be simplified if necessary to allow corporations, in the future, to announce the tax status with their dividend announcements.

Securities Lending

More recently, in our September 15th submission, also attached, we expressed concerns stemming from the fact that the draft legislation does not address the special treatment of dividend compensation payments for listed public securities under securities lending arrangements. In that submission, we recommended that the proposed legislation be amended to provide that the dividend compensation payments from borrowers to lenders of securities, where the security is deemed to pay "eligible" dividends, also be treated as "eligible" dividends in the hands of taxable security lenders for tax reporting purposes.

We now take the opportunity to touch upon a few other technical areas in the draft legislation that we believe need to be revisited.

Inconsistency with Marketplace Operations/Administrative Simplicity

Requiring corporations to inform their investors *directly* of their dividend designation is not in line with the market practices of today. Most investors who hold individual equities do so through a nominee account held with a brokerage firm. Little or no contact is made by issuers directly to their investors. While informal discussions with Finance staff indicated practical ways, such as published dividend notices, of informing investors, most efficient for all parties – and therefore our preference – would be the designation of a central filing location(s) that financial institutions can access and use for client tax reporting purposes. This could include, for example, an existing site hosted by a regulated widely-held industry utility such as The Canadian Depository for Securities Limited (CDS) (such as the existing CDS website, to which we have requested that Finance mandate issuer reporting of T3s and T5013s or, assuming issuers must include the dividend designation in dividend notices filed with the exchanges and/or www.sedar.com). As a minimum, issuers must directly inform all brokerage firms, which are also responsible for preparing investors' T5 slips, of their company's dividend designation.

Penalty Tax

IIAC is of the view that the penalty tax proposed in the draft legislation is at too high a level. Given that the low rate income pool (LRIP) is intended to be a combination of active business income from a Canadian-controlled private corporation (CCPC), which may be taxed at as low a rate as 18 per cent, and CCPC-source investment income that would have a higher tax content, the LRIP should have a minimum tax content of 18 per cent. However, applying a tax rate of 20 per cent to the remaining 82 per cent generates tax at 34.4 per cent – already high, given that the general tax rate before the federal abatement is intended to be 29 percent, even before the 10 percent second penalty tax and any provincial tax.

It is also unclear whether or not the provinces will implement additional penalty taxes, further compounding the situation. We encourage the government to discourage provinces from administering any additional penalty tax or that any penalty taxes be shared.

Provincial Harmonization

For the draft legislation to be administered efficiently and cause the least amount of confusion for investors, it is imperative that the provincial, territorial and federal governments harmonize their dividend legislation to the greatest extent possible. Items such as implementation date and definitions need to be standardized across the country. We encourage the Department of Finance to engage in discussions with their counterparts in the various provinces and territories to achieve this and are writing to your provincial and territorial counterparts in this regard.

"Eligible Dividend" Redefined

The definition of "eligible dividend," as outlined in the draft legislation, needs to be re-examined. Consistent with our September 15th submission, we believe that a dividend deemed by subsection 260(5) would be added to the LRIP because it was not paid directly by the corporation, regardless of the nature of the dividend in the hands of the payor. This proposal may have the effect of denying the benefit of the enhanced dividend tax credit to a significant number of public shareholders, for example, those who hold their shares through margin accounts that typically allow their shares to be lent by their broker. As a result, these shareholders will receive deemed dividends rather than direct ones. The definition should therefore be amended to include dividend compensation payments stemming from the loan of a security that has been deemed to pay "eligible" dividends.

Additionally, while we understand that Finance may see the complexity of the draft legislation provisions as necessary for small closely held companies, we believe that it is neither necessary nor practical when applied to large corporations listed on stock exchanges. For publicly listed corporations, we think that the potential loss of tax revenues would be small. We therefore ask that the proposed legislation be amended in a manner that still allows the government to achieve its intended objective while simplifying administration for market participants. More specifically, we recommend that the definition of "eligible dividend" be redrafted in a manner that deems that all dividends paid by a publicly listed company are "eligible" for tax purposes unless the corporation has issued any public statement to the contrary. We are of the view that this recommendation makes sense given that it would be relatively unusual for dividends from public corporations to be deemed "ineligible" and it places responsibility on the entities in the only position to be aware of eligibility status. As a minimum, we recommend an exemption for a set period until Canada Revenue Agency officials can confirm that the LRIP does not exceed dividends that are likely to be paid to non-resident or non-taxable shareholders during the term of the approval.

We thank the Government for its efforts in working towards a more equitable tax treatment of corporate dividends. We would pleased to meet with you or your officials to discuss our recommendations further.

Sincerely,

Cc: Brian Ernewein (ernewein.brian@fin.gc.ca)
Ryan Hall (ryan.hall@fin.gc.ca)

Barbara Amsden
DIRECTOR, CAPITAL MARKETS
Tel: 416) 687-5476
Fax: (416) 364-4861
E-mail: bamsden@iiac.ca

August 8, 2006

Mr. Paul Fuoco
Policy Analyst
Canada Revenue Agency
Place de Ville, 22nd Floor
320 Queen Street,
Ottawa, Ontario K1A OL5
Tel: (613) 957-2056
Fax: (613) 941-5932
E-mail: paul.fuoco@cra-arc.gc.ca

Mr. Ryan Hall
Policy Officer
Tax Policy Branch
Department of Finance
140 O'Connor Street
Ottawa, Ontario K1A 0G5
Tel: (613) 996-5155
Fax: (613) 992-4450
E-mail: ryan.hall@fin.gc.ca

Dear Sirs:

Re: Draft Changes to Eliminate Double Taxation of Large Corporate Dividends

On behalf of the Investment Industry Association of Canada (IIAC),[2] I would like to thank you both for taking the time to speak to the IIAC recently regarding the promised changes to eliminate double taxation of large corporate dividends. Our industry supports the changes from a tax policy/fairness perspective, thus these comments relate solely to practical compliance matters and are aimed at successfully implementing the measures during 2006 and in 2007 forward. In this regard, we question whether many firms will be able to comply with the legislation in 2006 because of serious systems constraints and other reasons as the legislation will only be in place three-quarters of the way through the reportable year. As

[2] On April 1, 2006, the Investment Dealers Association of Canada (IDA) legally divided into a self-regulatory organization (SRO) and IIAC – the industry association. The Association represents the position of the Canadian investment industry on regulatory and public policy issues. Its mandate is to promote efficient, fair and competitive capital markets for Canada while helping its member firms succeed in the industry.

well, there will be challenges for 2007 unless the technical amendments receive Royal Assent by the end of September, as explained in the attached.

We appreciate your willingness to discuss some of the issues that dealers and probably other tax reporters in the investment industry more broadly will be facing. While we intend to formally respond to the draft technical amendments released on June 29, we hope our preliminary comments here may be of assistance to the Canada Revenue Agency (CRA) and Finance Canada in your review of how to effectively implement the tax measures from the government's, investors', issuers' and intermediaries' perspectives. We continue to evaluate the impacts of the proposed measures and will advise of any additional concerns as soon as possible.

We would be pleased to discuss these issues with you further at your convenience. Members of our staff expect to be in Ottawa in the next few weeks and could meet with you at that time to answer any questions that you may have.

Yours truly,

cc: Brian Ernewein
Keith Evans, Merv Lye, The Canadian Depository for Securities Limited

IMPLEMENTATION ISSUES OF CONCERN

There are two key issues for substantially all if not all dealers (and others) in 2006: systems/ procedural problems and differentiation between large corporation and other dividends.

1. *Systems/procedural issues*

While many may believe that technology should simplify implementation of changes, given legacy systems and the volumes of transactions affected by the proposed change, this is not the case:

- First, the system changes that will be required (often to legacy systems) usually take at the very minimum three months from beginning to end for even a small change. The change must be analyzed for the required systems and procedural enhancements (e.g., to identify a dividend payment as eligible or ineligible, to change the T5 tax reporting software to add an additional field), sized, funded and resourced, programmed, extensively tested to avoid customer complaints, proceduralized, translated and communicated internally and externally.

- Second, most institutions and all large ones will have to change both their payments and their tax reporting systems – different institutions may have, in fact, more than one payment and tax reporting system due to the diversification of their business units. The steps to systems and procedural changes were noted above; also, because at least two systems are affected, additional systems integration testing will be required.

- Third, many institutions rely fully or in part on service providers such as IBM, ADP, ADP Dataphile, clearing brokers or others to help manage their securities processing. These entities, some operating out of the U.S., typically undertake, from a practical and cost-effective perspective, little functional analysis and no detailed analysis or programming until the final details of the measure are confirmed, the legislative proposals are passed and Royal Assent is received.

2. *Information issues*

In the final quarter of 2006, it is unlikely that all issuers will have informed the necessary parties into which category their dividends fall. Moreover, as issuers will have 90 days following Royal Assent to notify recipients (frequently being dealers that act as nominee holders for security holders), this easily may not happen until well into the first quarter of calendar 2007.[3]

We also surmise that a good many taxpayers will expect that all their dividends will fall into the eligible category and they will have little understanding or sympathy if an issuer that technically issues eligible dividends has inadvertently not informed them or their nominee holder.

Clear and unambiguous answers to the above challenges, which differ for the 2006 and 2007 calendar years, are of immediate importance for the reasons noted below.

---

[3] This is problematic as, after a brokerage firm receives the necessary data from issuers and other parties, it then typically needs several weeks to carry out the computer runs necessary to produce the required CRA information slips. This is followed by time required to print and mail the CRA information slips to clients by the end of February.

Issues relating to 2006

Systems and procedural issues for 2007 and forward alone will be a significant challenge for the reasons noted above because the dividend payments must be captured as eligible or ineligible at inception in the dealers' and their service providers' systems. This is impossible systems- and procedures-wise for the 2006 tax year for many if not most of our members.

We believe that 2006 must be seen as a transition year due to the fact that we will likely not have final details of requirements until the final quarter of this year at best and likely some answers may not be available until 2007. This is further complicated by the fact that, in order to meet the February 28th reporting deadlines, most dealers will have closed their T5 production file by the end of the first week of January 2007.

Each year, our members deal with dividend payments from thousands of issuers. The Canadian Depository for Securities Limited (CDS), which houses trillions of dollars of securities on deposit for the dealers and bank financial groups that hold securities on behalf of their customers, reported 25,000 dividend payments received from issuers in 2005. These are distributed to investors, but mainly to nominee holders to pay onward to their millions of customers/investors in aggregate, in multiple millions of individual dividend payments. The millions of dividends already paid this year are likely to be, in the overwhelming majority, large corporation dividends.

It would be extremely costly and almost certainly a virtually entirely manual process to review all the millions of dividend payments already made to millions of customers to determine: (1) which are eligible/ineligible, (2) whether any changed from ineligible to eligible (or the reverse) during 2006 and, if so, when, and (3) which payments are affected by such a change. Because as unpaid agents of the government, the dealers and other tax reporters will already be paying substantial amounts for implementation of changes for 2007 and beyond, we request relief for the 2006 year.

Issues relating to 2007 and future years

As explained above, dealers and other tax reporters, with their service providers, need absolutely clear direction on what are eligible and ineligible dividend payments made after December 31, 2006 as this must be captured from the first day of the new year.

Other

While not expected to present additional challenges at present, at least two provinces to date have announced their intention to mirror the federal tax measure. This may add operational and informational complexities if there is any difference at all between federal and provincial measures.

Recommendations and questions

1. For 2006, assuming:
   - a relatively small revenue impact for the federal government
   - certain communications challenges from government to issuers to tax reporters to investors
   - a desire to minimize issuer, investor and intermediary concerns

   we request the government to consider accepting that for 2006 all dividends receive the eligible dividend treatment.

2. For both 2006 and 2007 and beyond, we urge you to consider a requirement for issuers to file the eligibility/ineligibility status with CDS in advance of payment (see 5. below) – given that there are thousands of issuers, we believe that requiring them only to post eligibility on their own websites will

not be of as much benefit as we may have thought. As well, we urge you to consider having eligibility or ineligibility status apply for a full calendar year to simplify matters for the issuer, investor, intermediary and, we believe, CRA.

3. For 2007, we urge the government to issue the final technical amendments as soon after the House of Commons resumes sitting in September, ensuring to the extent this is possible, priority passage and Royal Assent by the end of September 2006.

4. We understand that listed trusts will be able to flow through eligible dividends to beneficiaries and assume that this will be made clear in the amendments. We do not know how this will impact T3 reporting and trust future communications will clarify this.

5. Communications efforts should be initiated in the immediate term. Our industry will work with issuers where possible regarding this issue, but in the strongest possible terms we encourage the government, if it has not already done so, to work with issuer groups and use CRA contacts to ensure issuers are immediately able to inform recipients. In this regard, we are working with Brian Ernewein of the Tax Policy Branch of Finance Canada regarding issuer filing of T3 slips with copies to CDS as a regulated central location that virtually all issuers, large and small, already know and deal with directly or through agents. We would like to discuss having issuers dealing with nominee holders required to provide information regarding the eligibility of their dividends to CDS, as depository for an estimated 95 to 98 per cent of securities held in this country. This will streamline reporting for all parties and reduce errors and re-filings.

Ian C.W. Russell, FCSI
President and CEO

September 15, 2006

The Honourable James M. Flaherty
Department of Finance
140 O'Connor Street
Ottawa, ON
K1A 0GF

Dear Minister:

Re: Securities Lending and Proposed Legislation to Eliminate the Double Taxation of Large Corporation Dividends

The Investment Industry Association of Canada[1] (the "IIAC") urgently brings to your attention an issue with respect to the proposed legislation, released by the Department of Finance on June 29, 2006, to eliminate the double taxation of large corporation dividends (the "Proposed Legislation"). While the IIAC will be submitting under separate cover general comments on the Budget 2006 Income Tax Measures document released on August 31, we write today because the draft legislation fails to recognize the special treatment of listed public securities under securities lending arrangements in its application to dividends for lenders of such securities. This could seriously interfere with short-selling in the marketplace and damage the liquidity and efficiency of the capital markets in Canada.

Background

A prerequisite for liquid and efficient capital markets is the ability of buyers of stock to find sellers in almost all circumstances. While the sellers of stock are often the actual owners of such stock there are also, as you know, many short-sellers (i.e. so-called "market makers"). In this circumstance, they need to be able to borrow the shorted stock from an actual owner.

[1] On April 1, 2006, the Investment Dealers Association of Canada (IDA) legally divided into a self-regulatory organization (SRO) and IIAC – the industry association. The Association represents the position of the Canadian investment industry on regulatory and public policy issues. Its mandate is to promote efficient, fair and competitive capital markets for Canada while helping its member firms succeed in the industry.

11 King Street West, Suite 1600, Toronto, ON Canada M5H 4C7 ❖ T. (416) 364-2754 ❖ F. (416) 364-4861 ❖ www.iiac.ca

If, when a stock is borrowed or during the term of the securities loan, a dividend is declared on the stock, the borrower is typically required to pay a dividend compensation payment to the lender. Under subsection 260(5) of the *Income Tax Act* (Canada), a taxable lender is normally entitled to treat the dividend compensation payment as an actual dividend. However, under the proposed draft legislation, if the actual dividend would otherwise be an "eligible dividend" (i.e., a dividend entitled to the preferred dividend tax credit treatment), the Proposed Legislation precludes the dividend compensation payment from being treated as an "eligible dividend". This occurs because the dividend will not have been paid by the issuer and therefore the corporation cannot designate such a payment as an eligible dividend.

Concerns

The fee payable to a lender for a loan of stock typically ranges between 10 and 25 basis points on an annualized basis. However, if a taxable lender is not entitled to treat a dividend compensation payment as an eligible dividend, the added cost to the taxable lender will discourage taxable owners from lending stock in the future.

There are very large amounts of stock currently in the hands of taxable owners that are then, in many cases, lent out. The three major categories of such owners are financial institutions (i.e., banks and securities dealers), mutual funds, and individuals (including the tens of thousands of individual retail investors who maintain margin investment accounts at our member firms[2]). If these persons are unwilling to lend stock in the future due to the tax consequences of the Proposed Legislation, the volatility and bid-offer spreads in the Canadian capital markets can be expected to increase. More importantly, the liquidity and efficiency of the Canadian capital markets will decrease.

Recommendation

IIAC notes that the Department of Finance made no disclosure at the time of the announcement of the Proposed Legislation in November 2005 that dividend compensation payments might be treated different than actual dividends. IIAC recommends that there be the earliest possible announcement that the Proposed Legislation will be modified to provide that dividend compensation payments from borrowers to lenders of securities will be treated as “eligible” dividends in the hands of taxable lenders for tax reporting purposes. The early notice is needed because shares in margin accounts and elsewhere have been regularly loaned to borrowers during the preceding months of 2006. Unless the Proposed Legislation is remedied as recommended, these investors whose stock is borrowed will not receive the benefit of the more favourable tax treatment on “eligible dividends”. Furthermore, these investors will likely only become aware of these circumstances when they receive their 2006 tax reporting information in early 2007.

---

[2] Typically, margin investors grant access to their portfolio holdings to their dealers for lending purposes. These investors therefore also may be in receipt of dividend compensation payments from their dealers. Margin investing is an important strategy for many investors in Canada trying to maximize returns and retirement savings. There is over $12 billion in margin debt outstanding in margin accounts which provide a valuable source of capital and liquidity to the Canadian capital markets.

We trust that the intention was not to treat dividend compensation payments differently and we urge you to clarify this matter at the earliest opportunity. The IIAC would be pleased to further elaborate on the technical aspects of this issue with your officials at their convenience. Thank you for your consideration of our request

Yours very sincerely,

cc: Mark Carney
Bob Hamilton
Brian Ernewein
Joseph Lam