



Consultation sur les planifications fiscales agressives

Titre du mémoire : Deloitte's Comments on the Working Paper "Aggressive Tax Planning"

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We have reviewed the Working Paper titled "Aggressive Tax Planning" released by the Minister of Finance (the "Minister") on January 30, 2009 (the "Working Paper") and are pleased to have the opportunity to provide our comments and recommendations. We believe that it is important for the government to receive feedback on major tax policy and administrative initiatives before they are brought into force and congratulate the Minister for releasing the Working Paper and providing an opportunity for the tax community and others to provide comments.

As the largest tax firm in Quebec and Canada with almost 1,500 tax professionals in Canada, including over 300 in Quebec, we understand the difficulties and costs that businesses face in order to comply with complex tax legislative and administrative requirements. We note that the Working Paper recognizes that it is important to limit the complexity of Quebec's tax system and to streamline the system's administrative rules. We agree that this is an extremely important objective and believe that our recommendations will assist the government in striking the appropriate balance in protecting its revenue base without adding unnecessary administrative complexity.

OUR PRACTICE

In order to provide context for our recommendations, we briefly describe our practice below.

Types of Services

Our services to clients are principally divided into two groups (1) recurring compliance work (e.g., income tax return preparation services and related compliance) and (2) tax advisory services.

Our compliance services involve helping our clients deal with the increased responsibilities resulting from tax laws that continue to become more complex. In addition to assisting clients with tax filings, our work includes support to clients in claiming available tax incentives; assistance in complying with obligations for employees who transfer temporarily or permanently to other jurisdictions; testing client processes to identify overpayments of taxes made because of errors; and providing documentation reports to support intercompany transfer pricing. Our compliance related services also include providing tax support in financial statement audits and assisting clients with their tax accounting.

Our tax advisory services include assistance with evaluating the tax risks in merger and acquisition transactions and in structuring these transactions; assistance in planning for business expansion and reorganizations, and advice related to international expansion; family succession planning; and compensation arrangements. Although clients often face similar issues and we encourage and support our tax professionals to share the knowledge that they gain in serving clients, our tax advice is tailored to specific client situations or circumstances.

We invest significantly in professional development, knowledge sharing and quality assurance processes and testing. This investment is designed to ensure that the advice which we provide and the positions

taken by our clients in tax filings are well researched, well documented and well supported by the law. In order to manage the reputational risks inherent in our practice, we have established national opinion committees to provide a forum where our client service teams consult in order to ensure that our advice reflects a high level of quality and consistency. Moreover, our organization and management structure includes a Quality and Reputation Leader for the tax practice who oversees our quality, risk and reputation initiatives and programs.

Fee Arrangements with Clients

In the vast majority of cases, we charge for our services based on pre-agreed hourly fee or based on quoted fixed fees established by our estimate of time to be spent. For certain types of work, we may provide our clients with the option of choosing a fee which is based on the tax outcome achieved (referred to as a “contingent fee arrangement”). These contingent fee arrangements are generally limited to two types of services that we provide.

Assisting clients in making scientific research and experimental development (“R&D”) claims is one of two types of services where contingent fee arrangements may be used. Identifying the activities that qualify for R&D incentives is complex and time consuming. It requires our professionals, many of whom are engineers, to gain a clear understanding of the technology or process advancements that our clients are making and then to help them translate that understanding into claims that the tax authorities will review and accept. This work is virtually always reviewed by the tax authorities. We believe that we have developed an excellent reputation with the tax authorities based on the quality of our work; and, as a result, the tax authorities make relatively few adjustments to the claims that our clients make. Our clients may choose a traditional fee arrangement based on an estimate of the time that we will spend or a contingent fee arrangement for this work. Many clients choose a contingent fee arrangement so that they are more able to control their costs in relation to the benefits they receive.

We may also provide certain indirect tax services to clients pursuant to a contingent fee arrangement. Our indirect tax practitioners provide advice to clients on indirect tax matters and on the processes that they should use to collect and recover such taxes. By their nature, indirect taxes are incurred on a very large number of transactions. Our clients rely on having adequate systems and processes in place to capture these taxes. Inevitably, either through human error or process deficiencies, clients make mistakes in computing the amount of indirect taxes which they recover. Our indirect tax recovery practitioners use sophisticated data mining techniques to review client data and determine where errors have been made. We then assist clients in making refund claims and in adjusting their processes to reduce the chance of error in the future. Again, this work is often reviewed by tax authorities. Similar to R&D claims, many of our clients choose a contingent fee arrangement to reduce the risk of spending money on a review where the cost exceeds the benefit of doing so.

WORKING PAPER BACKGROUND AND CONTEXT

The Background chapter of the Working Paper provides the context to set the stage for the actions under consideration. We have a number of observations on the statements made in this section as well as some general comments related to the background material.

Aggressive Tax Planning (“ATP”)

The Working Paper defines and describes ATP as “a tax avoidance transaction that complies with the letter but abuses the spirit of the law”; “a result obtained in circumstances other than those provided by the fiscal policy and not sought by the latter”; and “a tax avoidance transaction that consists in reducing

the effective tax rate of a particular income to a level below the one sought by fiscal policy for such income”¹.

The notion that a tax result may abuse “the spirit of the law” or is not one sought by fiscal policy is a vague and ambiguous concept. The Working Paper² cites the following passage from the Supreme Court of Canada decision in *Canada Trustco*:

To send the courts on the search for some overarching policy and then to use such a policy to override the wording of the provisions of the *Income Tax Act* would inappropriately place the formulation of taxation policy in the hands of the judiciary, requiring judges to perform a task to which they are unaccustomed and for which they are not equipped. Did Parliament intend judges to formulate taxation policies that are not grounded in the provisions of the Act and to apply them to override the specific provisions of the Act? Notwithstanding the interpretative challenges that the GAAR presents, we cannot find a basis for concluding that such a marked departure from judicial and interpretative norms was Parliament’s intent³.

Taxpayers, tax advisors, and tax authorities are even less able than the judiciary to identify overarching tax policy. A recent example which illustrates the challenges in determining whether a particular tax planning arrangement might be considered to provide a result that is not in accord with tax policy can be found in the recent reversal by the federal Minister of Finance of section 18.2 of the federal *Income Tax Act*⁴. In defending the initial introduction of section 18.2, the Minister of Finance stated that the affected “double-dip” structures are “inherently unfair” and “hard-working Canadians” should not be asked to subsidize them⁵. On further reflection, after receiving a report from an Advisory Panel formed to make recommendations on Canada’s international tax system⁶, the measures were reversed in the most recent federal budget.

Although the concept of ATP is not directly relevant to the actions under consideration, the inference or overtone throughout the Working Paper is that the ambiguous administrative concept described as ATP, in and of itself, is an inappropriate practice. Taxpayers are entitled to organize their affairs in order to minimize their tax within the law, albeit significantly tempered by the GAAR as discussed below. Taxpayers are also entitled to the relative certainty and predictability that the rule of law seeks to provide. Taxpayers who in good faith believe that they have a realistic possibility of sustaining a tax position on its merits in a court ought not to be penalized based on an ambiguous administrative concept.

A penalty or reporting regime should not be based on such an ambiguous administrative concept as the one set out in the Background section.

The GAAR as a Substantive Tool and a General Deterrent

The Working Paper states that there has been a proliferation of ATP and, therefore, there is a need for new statutory provisions to counteract this trend. The Working Paper expresses concern that the effect

¹ Section 1.1 of the Working Paper.

² In section 1.2.2.

³ *Canada Trustco Mortgage Co. v. R.*, [2005] 2 S.C.R. 601, paragraph 41.

⁴ *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp), as amended.

⁵ See Canada, Department of Finance, “Canada’s New Government Improves Tax Fairness with Anti-Tax-Haven Initiative,” *News Release* 2007-041, May 14, 2007, and accompanying Background; and “Notes for Remarks by the Honourable Jim Flaherty, Minister of Finance, to the Toronto Board of Trade.”

⁶ Advisory Panel on Canada’s System of International Taxation, “Final Report: Enhancing Canada’s International Tax Advantage” (December 2008).

of ATP “on such fundamentals as taxpayers’ feelings of fairness and justice, poses a real threat to Québec’s tax base.”

As a result of the introduction of the GAAR, tax authorities have a powerful tool which they can and have used to curb ATP. We believe that the Working Paper understates the effectiveness of the GAAR both as a substantive tool and as a general deterrent. The recent decisions in *Lipson*⁷ and *OGT Holdings Ltd*⁸ are good examples of the use of the GAAR as a substantive tool available to governments in countering ATP.

Although perhaps less apparent to the tax authorities, our experience is that the deterrent effect of the GAAR is also significant. The inherent uncertainties associated with the application of the GAAR in many cases, together with developments in financial reporting for taxes and the existence of large case (continuous) audits (both discussed below), provide a significant deterrent to ATP. We observe many taxpayers, particularly large corporations and public companies, choosing not to proceed with tax planning transactions in the absence of professional tax advice providing assurance that the planning meets either a “more likely than not” or “should” standard⁹.

Lastly, the Working Paper points out that the GAAR Committee¹⁰ applies the GAAR very cautiously since the Committee’s intention is to ensure that the GAAR is applied consistently and evenly within the tax administration¹¹. We support the existence of the Committee as well as the efforts to apply the GAAR with caution. This is consistent with the judicial observation that the GAAR is an extreme sanction. However, the inference in the Working Paper is that the caution applied by the Committee undermines the effectiveness of the GAAR as a tool to combat ATP. In our experience, we have not observed that the existence of a review Committee has impeded the use of the GAAR as a tool to combat ATP. Our experience seems consistent with the data on the use of the GAAR. In a presentation on the GAAR at the 2008 Canadian Tax Foundation annual conference, it was reported that the GAAR was applied in 69% of the 806 cases referred to the federal Committee¹².

Financial Reporting for Taxes and Large Case Tax Audits

A complete discussion of developments in the area of financial reporting for taxes is beyond the scope of this letter. Suffice it to say that the level of refinement and rigour now being brought to bear around financial reporting for taxes has been enhanced. Not surprisingly, many public entities will only entertain tax planning transactions that meet a “more likely than not” or “should” level standard based on an analysis of the law so that the tax benefits can be recognized for financial statement purposes. At the same time, most large corporate taxpayers are subject to regular audits by the tax authorities. These factors, coupled with the onerous cost of non-deductible interest on tax reassessments, means that these taxpayers are likely only to engage in tax planning that is supportable in law and has a high probability of success.

⁷ *Lipson v. R.*, 2009 SCC 1, 2009 D.T.C. 5015 (Eng.), 2009 D.T.C. 5016 (Fr.), [2009] 1 C.T.C. 314.

⁸ *OGT Holdings Ltd. c. Québec*, 2009 QCCA 191.

⁹ The use of the terms “more likely than not” and “should” in tax opinion is an evolving practice in Canada, with the “more likely than not” standard required in order to recognize a tax benefit under U.S. Financial Accounting Standards Board (“FASB”) *Interpretation No. 48*, “Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109” (June 2006).

¹⁰ There are GAAR committees at both the Quebec and the federal levels.

¹¹ Section 2.2.2, at page 41.

¹² Ed Kroft and Deen C. Olsen, “The GAAR - Where Are We? Part II” - see the slides used in the presentation at the sixtieth annual Canadian Tax Foundation conference.

Risk/Reward Ratio

The Working Paper states that “the virtual absence of negative financial consequences regarding ATP is one of the most important endogenous factors in the proliferation of these schemes because it ensures a very attractive risk/reward ratio for the taxpayer”.

We submit that there are negative financial consequences for taxpayers that take aggressive tax positions. When taxpayers take unsustainable tax positions, whether aggressive or not, they face considerable penalties in the form of non-deductible interest. The interest rates in Quebec on unpaid taxes from 2006 through 2008 averaged 8.67% and this interest is non-deductible for tax purposes. Assuming an average corporate tax rate of 33% for these years, this is the equivalent of 12.94% pretax. During this period, bank prime rates averaged 5.55%; consequently, corporations that are reassessed for taxes arising in prior periods face an interest differential of 7.39% as compared to the prime rate. Since it is not uncommon for reassessments to occur 3 years or longer after the year in which the tax arises, the interest differential creates a substantial non-deductible “penalty”. In contrast, while the United States and the United Kingdom both have penalty regimes, both countries also have lower interest rates for unpaid taxes and the interest is deductible.

New Business Model for Tax Intermediaries

The Working Paper attributes the proliferation of ATP schemes, in part, to the emergence of new business models for tax intermediaries. In particular, the Working Paper describes the new business model as the development and marketing of “off-the-shelf tax products”, often on a contingent fee basis.

As discussed above, our tax service lines share knowledge widely through training and the use of databases and we invest heavily in these initiatives. As such, it is conceivable, particularly given our size, that multiple clients may adopt similar tax planning where the facts and circumstances of the clients’ situations are also similar.

Our clients will continue to seek ways to minimize their tax costs as long as such minimization is within the law. We believe these clients have a right to undertake tax planning, including what the tax authorities might consider ATP, provided they have a reasonable basis for tax positions taken. We do not advocate that clients take tax positions without substantial authority in support of the position; and we will not be associated with tax positions that have no reasonable basis in law. As a result of the changes in financial reporting, the “interest penalty” for unsustainable tax positions, and the evolution of judicial developments in the GAAR, our clients are generally only interested in tax planning that has a high probability of success on its merits.

For the reasons noted above, we believe that the Working Paper overstates the impact of the “new business model” on the proliferation of ATP.

Coordinate Legislation, Rates, and Tax Base

The recent steps taken by the Minister to eliminate the differences between the tax rules in Quebec and those federally and in other provinces, along with the movement of the tax rates in each of the provinces to within a very close range of each other, ideally to the 10% rate recommended by the federal government, and the harmonization of the tax base, should eliminate most, if not all, of the interprovincial planning arrangements that are discussed in the Working Paper.

RECOMMENDATIONS

We believe that as a result of the items noted above – the evolution of the GAAR through judicial interpretation, changes in financial reporting, the tax penalty resulting from non-deductible interest, and recent legislative amendments introduced in Quebec – the risks faced by the Quebec tax authorities from the types of ATP outlined in the Working Paper have been substantially diminished. Accordingly, our first two recommendations, *Further Consultation* and *Adopt a Coordinated Approach*, suggest that the Minister take the time for additional consultation before any action is taken so that the appropriate balance is struck between protecting the revenue base and not overburdening taxpayers with unnecessary administrative requirements. Our other recommendations deal with the details of a disclosure and penalty regime.

Further Consultation

The Working Paper proposals would have far-reaching consequences for both the Quebec tax authorities and for business. The depth of analysis in the Working Paper demonstrates that considerable thought has been put into the proposed actions. However, we expect that the Minister will receive a number of submissions making substantive recommendations for modifications to the proposed actions.

We believe that the Minister would be well served by entering into a dialogue with business, tax advisors, and other interested parties to discuss recommended modifications before introducing legislation. Such a dialogue would help the Minister to achieve a proper balance by considering the complexity and costs associated with any new administrative requirements.

Adopt a Coordinated Approach

We do not believe that it is advisable for the Minister to adopt a new reporting and penalty regime solely applicable in Quebec without first engaging in a discussion with the Canada Revenue Agency and the federal Department of Finance (and possibly the Alberta Ministry of Revenue) in order to try to agree on a regime that could be applied throughout Canada.

As the Working Paper acknowledges, Canadian fiscal federalism results in a system that differs from most other countries in that the provinces impose and collect a substantial portion of corporate tax revenue. In many other major industrial countries (and certainly the ones used as examples in the Working Paper), all or substantially all of the corporate tax revenue is collected by the national government. Canada also differs from many other major industrial countries in not having a system to allow for consolidated tax filings or similar forms of group relief. As the Working Paper also notes, the potential disadvantage that the imposition of separate federal and provincial corporate taxes could have on Canadian business has been mitigated to a substantial degree by the coordinated approach to tax law development and administration.

Businesses operating in Quebec already face the added complexity of a different (although largely coordinated) tax system and a separate tax administration which includes a separate audit function. The introduction of a separate reporting, penalty and statutory reassessment period regime is inconsistent with the government's stated objective of maintaining a business climate that fosters competitiveness.

We strongly urge the Minister to take the time to explore a coordinated approach with the other Canadian jurisdictions rather than having Quebec strike out on its own to introduce a new reporting and penalty regime.

Reconcile Reporting and Penalty Regimes

The Working Paper comments on the various reporting and penalty regimes which already exist in Quebec tax legislation and then goes on to consider a completely new regime without attempting to reconcile them. We recommend that any new proposals that are implemented be incorporated into the current tax regime so that they build on and do not overlap with existing provisions. If this requires some modification to be made to the existing tax shelter rules and preparer penalties¹³, we believe that such modification is preferable to adding a completely new set of rules that may overlap with existing provisions.

Mandatory Disclosure – Confidentiality Agreements

Confidentiality agreements have been used in the context of tax planning created by one firm that was believed not to be known to other tax advisors. The business purpose of these agreements was to protect the idea from becoming generally known so as to maintain the advisor's competitive advantage in regard to the planning. Their purpose was not to prevent the taxpayer from speaking about or explaining the planning when asked by the tax authorities, and such agreements were often specific on that point.

The use of confidentiality agreements became prevalent in the late 1990s and early 2000s. In step with the changed business environment in Canada over the last number of years, we doubt that many providers of tax services are entering into confidentiality agreements with taxpayers. If a disclosure regime is introduced, it should be streamlined and efficient and should involve only a single annual filing.

We recommend that any disclosure requirements recognize that statements in engagement letters, advice, work product, valuations and other communications (“work product”) between a tax advisor and his or her client which prohibit parties other than the client from relying on the advisor's work product without the advisor's consent should not be considered confidentiality agreements. These statements are required in order to protect an advisor against claims by third parties who are not in legal privity with the advisor and who are not meant to be relying on the advice or work product. Similarly, requirements that a client indemnify an advisor against all claims asserted against the advisor related to a third party's inappropriate reliance on advice provided to the client, should not constitute a confidentiality agreement. Also, warnings on spreadsheets and emails with regard to reliance and disposition by unauthorized recipients should not constitute confidentiality agreements.

Mandatory Disclosure – Contingent Fee Arrangements

As we have indicated, contingent fee arrangements are used by our tax practice in assisting clients with R&D tax credit claims and indirect tax reviews. Many of our clients may also use other service providers to assist them in determining whether they have made tax overpayments in a number of areas (such as employment taxes, worker compensation payments, and many other specialized taxes) and many of these services may be provided on a contingent fee basis.

We do not believe that these are the types of tax services that the Working Paper is directed towards. In most cases, the claims for tax refunds or tax credits which result from such work is already subject to a careful review by the relevant tax authorities. Nevertheless, if a disclosure regime is introduced for all contingent fee arrangements, clients that select this type of arrangement would be required to make

¹³ As the Working Paper notes, the preparer penalties can apply to any person, whether or not he or she is a preparer.

disclosure. For large clients with decentralized operations, it may very difficult to put processes in place to identify and report all of the various arrangements that may be required to be disclosed. Furthermore, if each arrangement must be disclosed separately, there will be a significant and unnecessary compliance burden placed on taxpayers. The volume of disclosures may also make it difficult for the tax authorities to identify those situations which are the most relevant and which they should review.

We recommend that the disclosure regime be limited to contingent fee arrangements involving tax planning positions taken by a taxpayer in filing an income or other tax return, as this seems to be the focus of the concerns discussed in the Working Paper. We do not believe that disclosure of contingent fee arrangements for claims for tax incentives and claims for tax refunds is required. We understand that the U.K. disclosure regime does not apply to claims for tax incentives or for refunds based on errors even when these services are provided on a contingent fee basis.

Disclosure – Additional Recommendations

We recommend that the disclosure be a single disclosure form that is part of the annual filing made with the annual income tax return. We also believe that the penalties for failure to file the required disclosure on a timely basis, which can reach \$100,000 and which are unrelated to the tax liability at issue, seem to be disproportionately high, particularly for small and medium size businesses¹⁴.

Taxpayer Penalties Linked to the GAAR

The Working Paper calls for a penalty for any reassessment resulting from a successful challenge of a tax position based on the GAAR equal to 25% of the tax reassessed. Although the Working Paper is aimed at ATP, the penalty proposal would apply to any reassessment that was a result of the application of the GAAR. We do not believe that a penalty linked to a GAAR reassessment as some form of proxy for an ATP penalty regime is the appropriate test. As noted in the *Copthorne*¹⁵ case “a penalty should not be imposed as a consequence of the successful application of GAAR by the Minister, since a taxpayer can never file or pay anything on the basis that GAAR applies, without the Minister first initiating the application of GAAR.”

The Working Paper indicates that the penalty could be avoided with a “successful defense of due diligence”, without describing what the test would be for such a defense.

The Working Paper justifies the need for a penalty on the basis that there is a need to change the risk/reward ratio for ATP because there is a “virtual absence of negative financial consequences” regarding ATP. As noted above, the rate of interest charged by Quebec for underpaid taxes, the fact that the interest is non-deductible for tax purposes and the impact that underpaid taxes may have on tax instalments means that there is a significant financial penalty for a taxpayer that is reassessed for taking any tax position that cannot be sustained.

The penalty should not be linked to reassessments that are sustained using the GAAR. Instead, any penalty should only apply to tax positions which do not meet the test of having “substantial authority”¹⁶ under the law and only if positions that do not have this level of authority are not disclosed.

¹⁴ For comparison, we note that the U.K. disclosure penalty is £6000.

¹⁵ *Copthorne Holdings Ltd. v. R.*, 2005 TCC 491 at paragraph 78.

¹⁶ In the United States, the test is generally whether the taxpayer’s position has “substantial authority”. We believe that a similar test would be appropriate for any penalty or disclosure regime that might be introduced. We recognize that it may be necessary to provide administrative guidance related to the determination of when such a test is met.

Further, the current penalty which is inherent in the non-deductibility of interest should be eliminated by making interest on tax underpayments which result from tax reassessments deductible.

Promoter Penalty

The Working Paper also calls for a penalty on a “promoter” of any tax arrangement which is successfully challenged under the GAAR. For the reasons noted above, we do not believe that any penalty should be linked to reassessments under the GAAR. In addition, as the Working Paper notes, Quebec already has a penalty regime for tax “preparers”. We note that the Working Paper seems to indicate that the definition for “promoter” is meant to be based on the Australian regime definition and should not apply to a tax advisor who develops a planning arrangement at the request of a client. However, the suggested definition of the term “promoter” would seem to be broad enough to include such advisors.

We recommend that the definition of promoter be clarified to ensure that it does not apply to an advisor who provides tax advice or tax planning at the request of a client. In addition, if a penalty regime is introduced, it should provide for an exemption for tax planning and advice which is supported by the requisite level of authority¹⁷, independent of the taxpayer’s due diligence defence.

Preventive Disclosure

As discussed above, our recommended approach would limit the application of penalties to tax positions taken by taxpayers that do not meet the “substantial authority” level and that are not disclosed. We believe that disclosure of tax positions taken that do not meet such a test is appropriate so that taxpayers can avoid penalties on such positions and so the tax authorities are aware of any positions that are not supported by the requisite level of authority. However, we do not believe that the detailed disclosure described on page 94 of the Working Paper is necessary.

We understand that the disclosure regimes in both the United States and the United Kingdom are far less burdensome than the approach outlined in the Working Paper. We believe that a simple disclosure of the issue should be sufficient to alert the tax authorities. This would simplify initial compliance while still informing tax authorities of the issue so that they can request relevant information during the audit process.

Extended Limitation Period Linked to the GAAR

We do not believe that it is either necessary or appropriate to extend the limitation period in the statute for reassessments based on the GAAR. As we have noted above, we do not believe that penalties should be linked to the GAAR. Similarly, we do not believe that the statute should be extended for reassessments based on the GAAR.

We note that most, if not all, large taxpayers are subject to regular audits. The audit process is very time consuming for both tax authorities and taxpayers. It becomes even more time consuming and difficult as the time between the filing of a tax return and the completion of a tax audit lengthens. We believe that with the disclosure regime that we are recommending, that tax authorities should be able to develop and implement audit plans for businesses that deal with the issues within the current statutory time frame.

¹⁷ Similar to the test for the taxpayer penalty and disclosure regime, we believe that the U.S. “substantial authority” test is a reasonable model.

We believe that both tax authorities and taxpayers would be better served if tax audits are completed as close as possible to when the tax returns are filed and if issues which are identified as part of the audit are dealt with quickly.

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We would be pleased to discuss our recommendations or to provide clarifying comments. Please feel free to contact Pierre Baraby at 514-393-5480 or at pbaraby@deloitte.ca or Andrew W. Dunn at 416-601-6227 or at adunn@deloitte.ca.



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