PRACTITIONERS' CORNER

Ten Essential Elements of Canada's Tax System

by Steve Suarez and Susan Wooles

Because so many business transactions today are international, tax professionals increasingly find themselves dealing with more than one tax system. Even when local advisers are retained to assist in a particular jurisdiction, it is still necessary for those working with advisers to have some basic understanding of that jurisdiction's tax regime, since without that it is very difficult to make the advice from different countries fit into a comprehensive and logical plan. This article selects 10 elements of the Canadian tax system that a nonresident with some business connection to Canada might find relevant and describes them in sufficient detail to give the reader a sense of how they work.

I. Legal Form vs. Economic Substance

In general, the Canadian tax consequences of a transaction are determined based on the legal form rather than the economic substance of the transaction. The legal form of a transaction is essentially the true legal relationship created by the transaction, that is, how the law characterizes it irrespective of whether its economic substance is more similar to some other form of legal relationship. The parties cannot create a particular legal relationship simply by calling it such; a court may determine that the legal rights created by the parties are different than the legal label the parties have put on them (for example, calling something a partnership does not make it so if the underlying legal requirements for a partnership are not met).[1] However, the courts will generally respect the legal relationships that the parties do create. (For an example of this principle, see Section VIII below.)

In general, Canadian courts will not look to the economic substance of a transaction in determining its tax consequences, and will not attempt to recharacterize a legal relationship the parties have created merely because the economic results (or economic substance) look more like those of some other form of legal relationship. In *Shell Canada Ltd. v. The Queen*, the Supreme Court of Canada stated:

> This Court has never held that the economic realities of a situation can be used to recharacterize a taxpayer's bona fide legal relationships. To the contrary, we have held that, absent a specific provision of the Act to the contrary or a finding that they are a sham, the taxpayer's legal relationships must be respected in tax cases. Recharacterization is only permissible when the label attached by the taxpayer to the particular transaction does not properly reflect its actual legal effect.[2]

The unwillingness of Canadian courts to characterize transactions based on their economic substance may be tempered somewhat in the case of transactions to which the general antiavoidance rule in section 245

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[1] *See, e.g., Continental Bank of Canada and Continental Bank Leasing Corporation v. The Queen*, 94 DTC 1858 at 1871 (TCC), upheld by [1998] 2 SCR 298 ("The essential nature of a transaction cannot be altered for income tax purposes by calling it by a different name. It is the true legal relationship, not the nomenclature that governs"); *CCLI (1994) Inc. v. The Queen*, 2006 DTC 2695 at para. 26 (TCC).

(Footnote continued in next column.)

[2] [1999] 3 SCR 622 at para. 39.

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of the Income Tax Act (Canada) may be applicable.[3] In *Canada Trustco Mortgage Co. v. The Queen*, the Supreme Court of Canada recognized that economic substance may be relevant in interpreting specific provisions of the ITA as part of the determination of whether the GAAR will apply, although the Court did not elaborate on the proper meaning or application of economic substance for purposes of the GAAR analysis.[4] It remains to be seen to what extent economic substance may inform the analysis of Canadian courts in determining whether the GAAR can be applied to deny a tax benefit resulting from a transaction.

The Canadian characterization of a transaction in accordance with its legal form should be contrasted with the U.S. judicial substance-over-form doctrine. This doctrine permits U.S. courts to characterize a transaction in accordance with the economic realities of the transaction, as opposed to the form of the transaction.[5] For example, even if an instrument is labeled as ''debt'' and treated as debt for commercial law purposes, the U.S. tax characterization of that instrument may be that the instrument in substance is equity if the instrument has sufficient equity-like characteristics, that is, the nontax characterization of the instrument is only one of a number of factors to be taken into account. As a result, the issuer would not be entitled to a deduction for U.S. tax purposes on payments of ''interest'' on that instrument (since in substance the payments would be dividends and treated as such for U.S. tax purposes).[6] In contrast, an instrument that is treated as debt for commercial law purposes generally would be treated as debt for Canadian tax purposes since the legal relationship created between the parties is one of debtor-creditor.

Because the Canadian tax treatment of a transaction depends on its legal form whereas the U.S. tax treatment of a transaction depends on its economic substance, the two countries may view the same transactions very differently. For example, a repo transaction, in which a taxpayer sells property and agrees to repurchase the property at a future date, is generally viewed for Canadian tax purposes as the sale and subsequent repurchase of property — the legal form is respected. In contrast, for U.S. tax purposes a repo is generally treated as a secured financing with the borrower retaining ownership of the underlying property, since the economic substance of a repo transaction is that the incidents of ownership remain with the ''selling'' taxpayer and thus the taxpayer has not disposed of the property. This interplay of legal form and economic substance creates both pitfalls and opportunities, and is often used in enhancing the tax efficiency of financing structures.

II. Interest Deductibility

The deductibility of interest expense on debt is an important area of the Canadian tax system and one that has received quite a bit of attention from tax authorities in the past several years. The essential test for interest deductibility on borrowed money is whether the borrowed money has been used for the purpose of gaining or producing income from a business or property.[7] Without this income-earning purpose, the interest is not deductible. The earning of income need not be the primary purpose of the borrowing and can be one of multiple purposes, but it must be a genuine purpose. The actual use of the borrowed money is the determining factor (not whatever was originally intended when the money was borrowed), and if the debtor ceases to use borrowed money for one purpose and starts to use it for another, continued interest deductibility will depend on whether the new use meets the income-earning purpose test.

The income-earning purpose test is generally a direct use test: Look to the particular money that was borrowed, and see whether what it was spent on is for an income-earning use. Since money is fungible, this is not always easy to do. Indeed, in some cases taxpayers engage in ''cash damming,'' for example, segregating borrowed money from other funds to be able to show that the borrowed money was used directly for purposes that meet the income-earning test, or making a point of clearly using nonborrowed funds (for example, retained earnings) for applications that do not meet this test. This also means that when a taxpayer has both eligible and ineligible expenditures, the potential exists for the taxpayer to reorder his affairs to make a point of directing borrowed money toward an eligible use (thereby meeting the direct tracing test) and other funds to an ineligible

[3] The GAAR operates to deny a tax benefit resulting from an avoidance transaction if the transaction would result in a misuse or abuse of the provisions of the ITA.

[4] [2005] 2 SCR 601 at paras. 56-60.

[5] *See, e.g., Frank Lyon Co. v. U.S.*, 435 US 561 at 573 (1978). A U.S. commentator has described the term ''form'' as meaning the ''non-tax legal attributes of the transaction'' and ''substance'' as the ''non-tax economic relationships between the parties created, and commercial goals achieved, by virtue of the transaction.'' *See* Lewis R. Steinberg, ''Form, Substance and Directionality in Subchapter C,'' (1999) 52 *Tax Law.* 457.

[6] *See Laidlaw Transportation Inc., et al., v. C.I.R.*, T.C. Memo. 1998-232 for an example of a case when the court found that an instrument labeled as debt should be characterized as equity for U.S. tax purposes.

[7] For example, borrowed money used to buy shares of a corporation would generally be deductible on the basis that there was some possibility of earning dividend income on the shares. In the case of debt that is the unpaid purchase price for property, the test is whether the property was acquired by the debtor to gain or produce income from the property or from a business.

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use.[8] In situations when borrowed money has been commingled with other funds, the Canada Revenue Agency is generally willing to allow taxpayers to employ positive ordering to treat borrowed money as having been applied to eligible uses to the extent of such uses, that is, interest deductibility will only be denied to the extent that the amount of borrowed money exceeds the amount of the taxpayer's expenditures that meet the income-earning purpose test.[9]

The deductibility of interest expense on debt is an important area of the Canadian tax system and has received attention from tax authorities.

In exceptional circumstances the courts and the CRA are willing to depart from the direct tracing rule and allow interest deductibility on money that is clearly traced to an ineligible use, if the borrowed money can be said to ''fill the hole'' that would otherwise have been left had the taxpayer used other available (nonborrowed) funds for the ineligible use. For example, the CRA accepts that a corporation can borrow money to pay dividends (clearly a non-income-producing use) to the extent that it has unconsolidated retained earnings, on the basis that in theory it could have sold business assets, used the proceeds to pay the dividend, and then borrowed money to repurchase the business assets (clearly an eligible use).[10] Similarly, when money is borrowed and used to repurchase or redeem shares (also a non-income-earning purpose), interest deductibility is permitted to the extent of the corporation's retained earnings plus the amount of share capital for the relevant class of shares.

The ITA contains various other limitations on the deductibility of interest in specific circumstances. These include:

- *Reasonable amount*: Interest is only deductible to the extent that the amount of the interest is ''reasonable'' in the circumstances, which is generally interpreted as meaning an amount not exceeding an arm's-length or market rate of interest.
- *Thin capitalization*: Since nonresidents are generally taxable on Canadian-source interest income only on a withholding tax basis (and sometimes not even that),[11] there are thin capitalization rules in place that limit the extent to which a nonresident can debt-finance its Canadian subsidiaries and have the resulting interest expense reduce their taxable income. Essentially, a Canadian corporation cannot deduct interest expense on debt owing to specified nonresidents[12] that exceeds two times the sum of the corporation's retained earnings and the paid-up capital of any shares of the corporation held by such nonresidents. These rules are relatively straightforward, unlike the more complicated U.S. earnings stripping rules. There is no thin capitalization rule on debt owing to Canadian lenders or arm's-length nonresidents.
- *Unpaid interest*: When accrued interest owing to a non-arm's-length creditor remains unpaid at the end of the second tax year following the year in which the interest accrued, it is added back to the debtor's income for the following tax year.[13]
- *Foreign affiliate double-dip interest*: Recently enacted legislation will limit or deny interest expense on money borrowed by a Canadian corporation, if (1) those borrowed funds are linked in some manner to a second loan made by a foreign affiliate of the Canadian corporation (for example, if the Canadian borrower uses the money to acquire shares of the foreign affiliate, which then uses the money to make the second loan), and (2) the interest earned by the foreign affiliate on the second loan is effectively exempted from the Canadian tax system.[14] Essentially the regime assumes that the corporate

[8]This principle was upheld by the Supreme Court of Canada in *Singleton v. The Queen*, 2001 DTC 5533, in which a taxpayer withdrew capital from a business, used it for an ineligible purpose, and then borrowed replacement funds to put back into the business.

[9]*See* Interpretation Bulletin IT-533, ''Interest Deductibility and Related Issues,'' dated Oct. 31, 2003, para. 20.

[10]*Id.*, at para. 23.

[11]For example, Canada is removing withholding tax on cross-border interest payments to arm's-length lenders, and under the new protocol to the Canada-U.S. treaty (awaiting ratification), withholding tax on Canada-U.S. cross-border interest is being phased out altogether; *see* Canadian Department of Finance press release, ''Canada Enacts Important Updates to the Canada-U.S. Tax Treaty,'' *Doc 2007-27499* or *2007 WTD 243-13*.

[12]Defined as a nonresident who either (alone or together with non-arm's-length persons) owns 25 percent or more of the corporation's shares (by votes or value) or who does not deal at arm's length with such a shareholder.

[13]Alternatively, the parties can elect for the creditor to be deemed to have been paid and to have reloaned the money back to the debtor.

[14]That is, because the foreign affiliate's income is treated as ''exempt surplus'' and therefore not subject to Canadian tax when the foreign affiliate pays the income as a dividend to the Canadian parent. *See* Steve Suarez, ''Canada Makes Major Revisions to Interest Proposal,'' *Tax Notes Int'l*, May 21, 2007, p. 763, *Doc 2007-11796*, or *2007 WTD 94-1*.

group has already received the benefit of one interest expense deduction (by whoever borrowed the second loan from the foreign affiliate) outside of Canada, and decrees that the Canadian parent corporation should not get a second deduction in Canada on its borrowing. In contrast, the United States generally would allow an interest deduction on a similar fact pattern;[15] however, a portion of the interest expense would be allocated to foreign-source income using a worldwide apportionment formula (thereby reducing foreign-source income), which could limit the U.S. parent's ability to claim a foreign tax credit on any dividends later paid by the foreign subsidiary to the U.S. parent.

III. Capital Gains

All taxpayers (both individuals and corporations) include only one-half of capital gains (''taxable capital gains'') in income, without regard to any holding period. As such, capital gains are effectively taxed at only half the rate of tax applicable to most other forms of income. One-half of capital losses can be offset against taxable capital gains (but not other forms of income), and any unused capital losses can be carried back for three years and carried forward indefinitely. (See Section IV below.) The ITA does not provide a rule to distinguish capital property (the disposition of which results in a capital gain or loss) from property that is held on income account (that is, the profits from the sale of which are treated as ordinary income, for example, inventory). Whether a particular property is capital property is determined based on common-law principles such as the purpose for which the property was acquired or the length of time it was held. These rules are thus significantly different from those in the United States, where only individuals are entitled to a preferential capital gains rate, holding period rules apply, and corporate capital losses can only be carried forward for five years.

Nonresidents of Canada not carrying on business in Canada are subject to Canadian tax on capital gains from the disposition of taxable Canadian property, which includes real property situated in Canada and shares of a Canadian-resident corporation that are not listed on a designated stock exchange (listed shares are taxable Canadian property only when the nonresident and its affiliates hold 25 percent or more of any class of the issuer's shares any time in the preceding five years). The same 50 percent income inclusion rate described above applies to such capital gains. However, most Canadian tax treaties (including the Canada-U.S. treaty) limit the property on which Canada may tax capital gains realized by a resident of the other jurisdiction to (1) Canadian real property (and interests in entities that derive their value principally from Canadian real property), and (2) property forming part of a Canadian permanent establishment through which the nonresident carries on business. Hence, tax treaties (which take precedence over the ITA) significantly restrict Canada's ability to tax capital gains of nonresidents.

A nonresident disposing of most forms of taxable Canadian property is generally required to notify the CRA of the disposition, whether or not a gain exists and whether or not any such gain is treaty exempt. Unless the nonresident obtains a certificate (a section 116 certificate) from the CRA stating otherwise, the purchaser must withhold a portion (usually 25 percent) of the purchase price and remit it to the CRA, as a prepayment of the nonresident's Canadian tax.[16] Legislative changes arising from the 2008 federal budget restrict the scope of this reporting and withholding regime in some circumstances starting in 2009 (in particular when gains on the disposed-of property are treaty exempt), although it remains to be seen whether in practice these changes will actually achieve this.[17]

In contrast, the United States generally does not tax nonresidents on gains from the disposition of capital assets (to the extent the gains are not effectively connected with the conduct of a U.S. trade or business), except as provided under the 1980 Foreign Investment in Real Property Tax Act (and other limited exceptions).[18] The FIRPTA rules generally provide that nonresident individuals and foreign corporations will be taxed on gains on the sale of a U.S. real property interest as if the gains were effectively connected with the conduct of a U.S. trade or business. A U.S. real property interest generally includes any interest in real property in the United States (other than solely as a creditor) and any interest in a corporation (other than solely as a creditor) in which the fair market value of the corporation's U.S. real property interests equals or

[15]Subject to the possible application of the dual consolidated loss rules of section 1503(d) of the Internal Revenue Code.

[16]For a discussion of section 116 certificates and associated problems, see Jack Bernstein, ''Section 116 Certificates: A Canadian Nightmare,'' *Tax Notes Int'l*, Oct. 15, 2007, p. 285, *Doc 2007-21714*, or *2007 WTD 203-6*.

[17]*See* Steve Suarez, ''Canada's 2008 Budget Is Light on Business Tax Measures,'' *Doc 2008-4180* or *2008 WTD 40-2*.

[18]The FIRPTA rules are found in IRC section 897.

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exceeds 50 percent of the fair market value of all of its real estate interests and other business assets.[19]

IV. Losses

The ITA contains detailed rules governing the classification, computation, recognition, and use of losses.[20] Unlike the U.S. tax system, the Canadian tax system does not include a group consolidation concept whereby an affiliated group of corporations can apply losses of one group member against income and gains of another simply by filing a consolidated tax return, although there are loss utilization planning strategies that can achieve comparable results.[21]

Losses generally fall into one of two categories: capital losses and losses from a business or investment (noncapital losses). Capital losses usually arise on a disposition of a capital property when the taxpayer's cost of the property exceeds the proceeds of disposition (net of any selling expenses), whereas noncapital losses generally arise when the expenses associated with the business or investment exceed the income generated from that business or investment (typically, operating losses). Capital losses can only be used against capital gains, whereas noncapital losses can be used against any income or gains (making them more valuable). Noncapital losses from a particular year can be carried forward and used up to 20 years later (there is no carryforward limit for capital losses). Both types of losses may be carried back and applied in the three most recent taxation years.

Subject to limited exceptions, losses on property are realized only when the property is disposed of (for example, on a sale). A number of stop-loss rules deny the current recognition of a loss when a taxpayer disposes of property and postdisposition the same property (or an identical property) is still owned by the taxpayer or an affiliated person. Usually the result of a stop-loss rule applying is that the seller's loss will be suspended until the relevant property is not owned by either the taxpayer or an affiliate; less frequently, the seller's accrued loss will be denied and added to the purchaser's basis in the disposed-of property, to be realized by the purchaser on a subsequent disposition.

The scheme of the Canadian tax system generally operates to prevent a taxpayer's losses from being utilized by or transferred to *unaffiliated* persons. For example, antiavoidance rules prevent a disposition of property on a nonrecognition basis as part of a series of transactions if one of the main purposes of the series is to use an unaffiliated person's deductions or losses on a subsequent disposition of that property (or a substituted property). Moreover, when control of a corporation has been acquired, significant restrictions exist on the use of the corporation's losses. (See below.) Conversely, Canadian tax authorities normally accept planning designed to allow members of an *affiliated* group to match income and losses realized within the group.[22] Indeed, it is common for taxpayers to seek to transfer losses within an affiliated corporate group to achieve de facto consolidation, and the CRA has issued many favorable private rulings regarding the shifting of income from a profitable company to an affiliated loss company to allow the loss company to absorb the additional income with its losses. Rules also exist to facilitate the ongoing use of losses when Canadian corporations consolidate (either by merging to form a single entity or when one winds up into the other) in situations when no acquisition of control occurs.

The scheme of the Canadian tax system generally operates to prevent losses from being utilized by or transferred to unaffiliated persons.

A purchaser's ability to use the losses of a corporation it has acquired control of is severely constrained. An acquisition of control of a corporation generally occurs when there is a change in the shareholdings of the corporation such that a different person or group of persons has de jure control of the corporation (that is, the ability to elect the majority of the corporation's board of directors).[23] If control of a corporation is acquired, its tax year is deemed to end, and any accrued but unrealized losses on its property are deemed to be realized immediately before that year-end. To the extent that the corporation has noncapital losses from an investment (as opposed to a business) or capital losses

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[19]*See* IRC sections 897(a) and 897(c). There is an exception for stock of a corporation regularly traded on an established securities market to the extent that the nonresident does not hold more than 5 percent of the stock.

[20]For a detailed discussion of these rules, see Steve Suarez, "Tax Planning With Losses in Canada," *Tax Notes Int'l*, Aug. 1, 2005, p. 451, *Doc 2005-11065*, or *2005 WTD 148-12*.

[21]The U.S. consolidated return regulations contain some limitations on the ability to apply losses of one group member against income and gains of another, *e.g.,* the separate return limitation year rules.

[22]Loss utilization techniques designed to extend the carryforward periods of losses that are about to expire or import losses into Canada from outside the Canadian tax system are considered unacceptable.

[23]In general, no acquisition of control occurs if the new controller is related to the previous controller (if any), or was already related to the subject corporation.

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at the time control is acquired, they are prohibited from being carried forward into any postacquisition of control tax years, and vice versa. However, noncapital losses from a business arising in preacquisition of control tax years *can* be carried forward to postacquisition of control tax years (and vice versa) if both: (1) the corporation carries on the loss business with a reasonable expectation of profit throughout the year in which it seeks to use the loss, and (2) the income against which the loss is used arises from carrying on either the business that generated the loss or a business of selling similar properties or rendering similar services as were sold or rendered in the loss business. Thus, for example, a mining company cannot acquire control of a software company and expect to be able to use the target's preacquisition of control losses against future mining income. These rules are conceptually similar to (but significantly less complicated than) the limitation of losses rules found in IRC section 382.

V. Paid-Up Capital

Paid-up capital (PUC) is essentially the tax version of the corporate law concept of stated capital or the accounting concept of share capital, subject to adjustments set out in the ITA. When a Canadian corporation creates and issues new shares from treasury, the amount paid by the subscriber to the corporation for the shares is generally added to the PUC of the relevant class of the corporation's shares. Each separate class of shares has its own PUC, and within each class of a corporation's shares the PUC is pooled so that no matter what amount each shareholder paid for their shares (that is, his basis), the PUC of each share of any particular class will be the same (total PUC of the class divided by the number of shares in the class). Since shares may be purchased and sold among shareholders many times without the corporation issuing new shares, in most cases a shareholder's basis in his shares is higher than the shares' PUC.

For Canadian tax purposes, distributions by a Canadian corporation to its shareholders are generally treated as dividends. However, dividends generally do not include amounts received on a return or reduction of PUC, which typically occurs when the corporation reduces its share capital account by distributing cash or property to its shareholders. Because such amounts are essentially a return of invested capital rather than profits, they are not treated as dividends (other than some PUC reductions by public corporations) and are not included in income. Instead, they reduce the holder's basis in the shares, with a gain being realized to the extent (if any) that the amount distributed exceeds the holder's basis in the shares on which the PUC reduction is made. Since PUC represents the ability of a corporation to make distributions to its shareholders as a tax-free return of capital, it is a valuable tax attribute.

Under Canadian tax law, a corporation can generally choose to make distributions to shareholders as a return of share capital (to the extent of PUC) or distribution of profits (as dividends). There is no requirement to distribute profits as dividends before returning PUC, unlike the U.S. mechanical tax rule in which any corporate distribution is treated as a dividend, to the extent of the corporation's earnings and profits (that is, earnings and profits are required to be distributed first). Therefore, an important difference exists between the treatment of corporate distributions for Canadian and U.S. tax purposes: In Canada, there is some measure of electivity to treat some corporate distributions as a tax-free return of capital even when the corporation has accumulated profits, whereas in the United States there is no choice to treat a corporate distribution as a tax-free return of capital if a corporation has earnings and profits.

Under Canadian tax law, there is no requirement to distribute profits as dividends before returning paid-up capital.

Any distribution that a Canadian corporation makes to a nonresident shareholder other than a reduction of PUC will generally be treated as a dividend, and will give rise to Canadian dividend withholding tax. This makes maximizing cross-border PUC particularly important for a nonresident shareholder of a Canadian corporation (especially a controlling shareholder), since if the nonresident has high basis in the shares of that Canadian corporation but low PUC, it can only realize on the difference without triggering Canadian dividend withholding tax by selling those shares to a third party: Distributions from the Canadian corporation in excess of PUC will be treated as dividends. Consider the example of a foreign Acquirer purchasing a Canadian corporation (Canco):

Fair market value of shares of Canco: $10 million

PUC of shares of Canco: $2 million

If Acquirer were to acquire the shares of Canco directly for $10 million, it would have the ability to receive only up to $2 million in distributions from Canco free of Canadian tax. Any distribution from Canco in excess of the $2 million PUC would be deemed to be a dividend, triggering Canadian dividend withholding tax. Effectively, the extra $8 million of basis over PUC would be trapped in the cost of the shares, tax recognition for which could be obtained only on a sale of those shares to a third party.

Alternatively, if Acquirer were to create a new Canadian subsidiary (Offerer) and subscribe for new Offerer shares for $10 million (that is, the acquisition

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funds), and have Offerer use the funds to buy Canco, the basis *and* the PUC of those newly issued Offerer shares held by Acquirer would be $10 million: $10 million of PUC is created on the issuance of the new Offerer shares. As a result, Acquirer would be able to repatriate its entire $10 million investment from Offerer free of Canadian dividend withholding tax.[24] Thus, the maximization of cross-border PUC is an important benefit of using a Canadian holding corporation to acquire the shares of a Canadian corporation. (Maximizing cross-border PUC is also important in debt-financing Canadian subsidiaries of nonresidents, as the thin capitalization rules limiting interest deductibility on debt owing to related nonresidents are based on cross-border PUC; see Section II above.) Once Acquirer has acquired the Canco shares directly, it is generally not possible to transfer them to Offerer for Offerer shares with a PUC in excess of the PUC of the Canco shares — the original acquisition must be effected by Offerer to achieve the desired result.

VI. Section 85 Rollovers

Section 85 of the ITA provides a mechanism by which taxpayers can transfer eligible property (which includes most property) to a taxable Canadian corporation on a tax-deferred (or rollover) basis. For section 85 to apply, the transferor must receive consideration for the transferred property that includes at least one share of the transferee corporation (consideration other than shares of the transferee corporation (boot) may also be received), and the transferor and the transferee corporation must jointly elect to have section 85 apply.

The transferor and transferee mutually choose an amount that will be deemed to be the transferor's proceeds of disposition of the property and the transferee corporation's cost of the property. There are limitations on this elected amount:

- it cannot be greater than the fair market value of the transferred property;
- it cannot be less than the fair market value of any boot received by the transferor; and
- it cannot be less than the lesser of the transferred property's fair market value and its cost (that is, basis) to the transferor for tax purposes.

Typically the result of these rules is that the parties can elect anywhere between the transferor's cost of the transferred property and its fair market value. If the parties elect an amount equal to the transferor's cost of the transferred property, no gain will be realized on the transfer, since the transferor's disposition proceeds will equal the property's cost. Since the elected amount cannot be less than the amount of any boot received, if the transferor does not want to realize any gain then she cannot receive boot in excess of her cost of the transferred property. In computing the transferor's cost of the consideration received, boot is acquired at a cost equal to its fair market value. To the extent that the elected amount exceeds the cost of any boot, the excess is deemed to be the transferor's cost of the transferee corporation shares received by the transferor — the elected amount is allocated first to the boot, and any excess to the shares.

The result of these rules is that it is possible to extract ''boot to basis.'' For example, assume that a transferor has a property with a fair market value of $100 and a cost of $60. If that property is transferred to a Canadian corporation in exchange for cash and transferee shares under section 85, it is possible for the transferor to receive up to $60 of cash (and $40 worth of transferee shares) without realizing any gain — there is no requirement to realize a proportionate amount of the $40 accrued gain. This flexibility to extract boot up to the amount of the transferor's basis on a full-deferral basis makes section 85 elections very useful.

In contrast, IRC section 351 is considerably more limited. Section 351 generally provides that if property is transferred to a corporation *solely* in exchange for stock of the transferee corporation, gain or loss is not recognized if the transferors are in control of the transferee corporation immediately after the exchange.[25] Therefore only a limited range of transferors are able to take advantage of section 351. If the transfer would otherwise qualify under section 351(a) except for the fact that the transferors receive boot in addition to stock of the transferee corporation, any gain (but not any loss) is recognized to the extent of the amount of money received plus the fair market value of the other property received. Therefore, it is not possible to extract boot to basis. Moreover, whereas section 85 is an elective provision that the parties can choose to have apply (and can choose the elected amount within a range), section 351 is nonelective. If the section 351 requirements are met regarding a transfer of property to a corporation, the transferor and transferee will be bound by that provision (although if taxpayers do not want to be bound by section 351, it is generally possible to plan around section 351 to avoid its application).

[24]While the Canco shares that Offerer would purchase for $10 million would still have their original $2 million PUC, these low-PUC shares could be eliminated without Canadian tax consequences on an amalgamation of Offerer and Canco. It is possible that the PUC of the existing Canco shares might *exceed* their fair market value, in which case Acquirer may be better off acquiring the Canco shares directly rather than through a Canadian acquisition vehicle.

[25]Control is defined as stock possessing at least 80 percent of the voting power of all voting stock and at least 80 percent of the total number of shares of all other classes of stock of the transferee corporation; *see* IRC section 368(c).

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VII. Paragraph 88(1)(d) Step-Up

When an acquirer purchases shares of a corporation, the only tax recognition that the acquirer receives for the purchase price is in the basis of the shares of the target corporation. If that target corporation is later wound up or merged into the acquirer (as often occurs), these shares disappear, and with them the acquirer's tax recognition of the purchase price. Paragraph 88(l)(d) is a relieving provision designed to mitigate some of the harshness of this result. Essentially, this provision allows a Canadian corporate acquirer to increase the basis (adjusted cost base, or ACB) of nondepreciable capital property it acquires when a target Canadian corporation is wound up or merged into the Canadian corporate acquirer. For example, if the acquirer (Offerer) pays $100 to acquire all the shares of a Canadian corporation (Canco) that has $70 of basis in nondepreciable capital property worth $100, paragraph 88(1)(d) allows Offerer to wind up Canco on a tax-deferred basis, acquire its property, and potentially increase the basis in that property from $70 to $100.

This provision is complex, and has a number of key elements:[26]

- Both Offerer and Canco must be taxable Canadian corporations (that is, Canadian incorporated and resident).
- The only property eligible for this step-up in ACB is Canco's nondepreciable capital property. In most cases, this means land and interests in other entities (for example, shares of subsidiaries or partnership interests) but not buildings, equipment, or inventory.
- Only property owned by Canco at the time that Offerer acquired control of it is eligible for this increase in ACB.
- The ACB of any eligible property cannot be increased above its fair market value.
- The total amount by which the ACB of all eligible assets may be increased is limited to:

ACB of Offerer's Canco shares	–	ACB of Canco's assets (net of Canco's liabilities and some reserves)	–	dividends paid by Canco to Offerer

- There are a number of complex provisions designed to prevent Offerer from selling Canco property back to former Canco shareholders, directly or indirectly.

[26]For a detailed discussion of the paragraph 88(1)(d) step-up, see Steve Suarez, ''Canada's Tax Cost Step-Up: What Foreign Purchasers Should Know,'' *Tax Notes Int'l*, Dec. 4, 2006, p. 779, *Doc 2006-21865*, or *2006 WTD 237-7*.

If Offerer paid $10 million for all of the shares of Canco and if Canco's assets had a fair market value of $10 million and an ACB to Canco of $4 million, then on a wind-up of Canco into Offerer, Offerer's post-wind-up ACB of the assets it acquires from Canco could be as high as $10 million if all of Canco's assets qualified for the paragraph 88(1)(d) step-up.

The paragraph 88(1)(d) step-up is particularly useful when Offerer intends to dispose of some Canco assets (elsewhere within its own corporate group or to a third-party buyer) following the acquisition of Canco. If the assets to be sold do not qualify for the paragraph 88(1)(d) step-up (for example, buildings or equipment), it could be advantageous to have Canco transfer these assets to a newly formed, wholly owned Canadian subsidiary of Canco in exchange for the subsidiary's shares. (This can be done on a tax-deferred basis in Canada; see Section VI above.) After Offerer acquires Canco, it winds up Canco and in so doing acquires the shares of the new subsidiary at a stepped-up ACB, which are then sold to the third party. Canco's drop-down of assets to the subsidiary has the effect of changing what Canco holds from ineligible assets to eligible assets (shares of a subsidiary). Note that since only property held by Canco *at the time* Offerer acquires control of it is eligible for the step-up, it is essential that Canco complete the drop-down of the assets to the new subsidiary *before* Offerer acquires control of Canco.

IRC section 338 contains a rule that also allows a purchaser of stock to increase the basis of assets in a target company for U.S. purposes, but that rule operates quite differently from paragraph 88(1)(d). Section 338 allows a purchaser to elect (under section 338(g)) to treat a qualified stock purchase as an asset purchase, which results in the step-up of the basis of the target's assets by deeming the target to have sold all of its assets and treating the target as a new corporation that purchases the old target's assets based on the price for which the target's stock was purchased. The effect of a section 338(g) election is that there will be two layers of tax: The seller will be taxed on the sale of shares and the target will be taxed on its deemed sale of assets. This result can be mitigated if a section 338(h)(10) election is made, which treats the qualified stock purchase as a sale of the assets of the old target followed by a liquidation of the old target.[27] Because of the two layers of tax that result from a section 338(g) election, these elections generally are not used in a domestic context; only section 338(h)(10) elections tend to be made in domestic acquisitions. Section 338(g) elections tend to be used in international acquisitions in which there will not be any corporate-level U.S. tax (because the target corporation that is deemed to have sold its assets is not a U.S. taxpayer).

[27]A section 338(h)(10) election is not available in all circumstances.

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The key differences between paragraph 88(1)(d) ITA and IRC section 338 are:

- the target must be wound up or merged into the acquirer in order for paragraph 88(1)(d) to apply, whereas the target will stay in existence (albeit treated as a new entity for U.S. tax purposes) if a section 338(g) election is made;
- the disposition of target assets that occurs on a paragraph 88(1)(d) wind-up is tax deferred (accrued gains are not realized), whereas the asset sale deemed to occur under IRC section 338 occurs on a full-recognition basis;
- unlike paragraph 88(1)(d), all of the target's assets will be eligible for a section 338 election;
- there is no double layer of tax if paragraph 88(1)(d) applies, unlike with section 338 (in the absence of a section 338(h)(10) election); and
- paragraph 88(1)(d) only applies when Offerer and Canco are taxable Canadian corporations, whereas section 338 can apply to the purchase by a U.S. corporation of shares of a foreign target.

In some circumstances a U.S. acquirer may use both a paragraph 88(1)(d) step-up and section 338 election on the acquisition of a Canadian target through a Canadian acquisition company. The effect of a section 338 election in this situation would generally be to step up the basis of the Canadian target's assets for U.S. purposes (with no adverse U.S. tax consequences, assuming the Canadian target is not subject to U.S. tax) and to reset the earnings and profits of the Canadian target to zero.

VIII. Exchangeable Shares

Exchangeable shares are an interesting alternative for a foreign acquirer using its own equity as part or all of the purchase price to acquire a Canadian target company. Exchangeable shares are shares of a Canadian corporation (a subsidiary of the foreign acquirer) that are exchangeable for shares of the foreign acquirer, and (with some ancillary rights) replicate as closely as possible the economics of shares of the foreign acquirer. An exchangeable share structure allows a foreign acquirer to use shares that are economically equivalent to its own shares as consideration for the acquisition while also offering Canadian target shareholders the opportunity for tax deferral, because for Canadian tax purposes the legal form of the structure should be respected and the exchangeable shares would thus be treated as those of a Canadian corporation.[28] As such, it is an excellent example of Canada's emphasis on form over economic substance, discussed in Section I above.

The Canadian income tax system does not allow for nonrecognition (or rollover) treatment when shares of a Canadian corporation are exchanged for shares of a foreign corporation: Only shares of a Canadian corporation can be received for other Canadian shares on a nonrecognition basis. Therefore, on an exchange of Canadian shares for foreign shares, a Canadian-resident shareholder generally will realize any accrued gains on the Canadian shares based on the difference between the fair market value of the foreign corporation shares received and the holder's basis in the Canadian corporation shares exchanged. However, the Canadian income tax system generally does allow for rollover treatment when shares of a Canadian corporation are exchanged for shares of another Canadian corporation. (See, for example, Section VI above.) Also, Canadian residents receive more favorable tax treatment for dividends received from Canadian corporations than dividends received from foreign corporations. Therefore, if the foreign acquirer intends to acquire a Canadian target using share consideration, Canadian shareholders of the target may well prefer to receive shares in a Canadian corporation (that is, exchangeable shares) instead of shares of the foreign acquirer. As a general rule, the use of an exchangeable share structure is most desirable in a cross-border acquisition when there are existing accrued gains to be deferred or future dividends to be paid and there is a significant Canadian shareholder base that would benefit from these advantages.

In a typical exchangeable share structure, the foreign acquirer (Foreign Parent) will own all of the common shares of a Canadian corporation (Exchangeco) that will issue the exchangeable shares. Under Foreign Parent's acquisition of the Canadian target company (Canco), shareholders of Canco will exchange their shares of Canco either for common shares of Foreign Parent or (in the case of Canadian residents who so wish) for exchangeable shares issued by Exchangeco. Shareholders of Canco that exchange their Canco shares for exchangeable shares of Exchangeco generally would be able to obtain rollover treatment and thereby defer recognizing any gain on the exchange, since the legal form of the transaction is an exchange of shares of one Canadian corporation for shares in another Canadian corporation. The fact that the exchangeable shares are intended to replicate the economics of a common share of Foreign Parent generally is not relevant for Canadian tax purposes since legal form (and not economic substance) prevails for Canadian tax purposes.

The basic concept is that the terms of Exchangeco's exchangeable shares entitle the holder at any time and on demand to deliver her exchangeable shares and receive a corresponding number of Foreign Parent shares (which will cause any accrued gains to be realized and

[28]For a detailed discussion of exchangeable shares, see Steve Suarez and Pooja Samtani, ''Using Exchangeable Shares in Inbound Canadian Transactions,'' *Tax Notes Int'l*, Dec. 24, 2007, p. 1281, *Doc 2007-25892*, or *2007 WTD 248-9*.

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taxed). In the event of Exchangeco's liquidation, holders of exchangeable shares receive a common share of Foreign Parent for each exchangeable share and would not be entitled to any other property. To the extent that dividends are paid on the common shares of Foreign Parent, Exchangeco will pay a corresponding dividend on the exchangeable shares. The exchangeable shares are thus a proxy for Foreign Parent shares. For as long as the shareholder continues to hold exchangeable shares, Canadian taxation of accrued gains will be deferred and any dividends that will be paid by Exchangeco are considered Canadian source and taxed advantageously in Canada. Under the terms of the exchangeable shares, some events may trigger the automatic exchange of exchangeable shares, and in most cases all exchangeable shares must be exchanged for Foreign Parent shares within an agreed-on time period. Holders of exchangeable shares can be given the ability to vote on matters that Foreign Parent shareholders vote on, and (to the extent legally possible) are precluded from voting on matters regarding Exchangeco.

IX. Transfer Pricing

The Canadian transfer pricing system is, in general terms, based on the arm's-length principle described in the OECD transfer pricing guidelines.[29] When a taxpayer and a non-arm's-length nonresident participate in a transaction or series of transactions the terms of which are different from what arm's-length parties would have agreed to (or which arm's-length parties would not have entered into at all), section 247 ITA allows the CRA to adjust any amounts relevant to the computation of the taxpayer's income to correspond to what arm's-length parties would have done.

More particularly, subsection 247(2) provides that if the terms or conditions in a non-arm's-length transaction differ from those that would have been made between persons dealing at arm's length, the CRA may adjust the quantum or nature of the amounts that would otherwise be determined regarding the taxpayer to those that would have been determined if the terms or conditions of the transaction had been those that would have been made between persons dealing at arm's length. In the case of a transaction that would not have been entered into by persons dealing at arm's length and that could not reasonably be considered to have been entered into primarily for bona fide purposes other than to obtain a tax benefit, the CRA can determine the quantum or nature of amounts based on the transaction that would have been entered into by arm's-length persons. Notably, nothing in the ITA expressly incorporates the OECD transfer pricing guidelines into Canadian law.[30]

Section 247 provides for the application of a 10 percent penalty on transfer pricing adjustments if the transfer pricing adjustments exceed the lesser of 10 percent of the taxpayer's gross revenue for the year and $5 million. When the penalty threshold test has been met, the penalty is on 10 percent of the full amount of the transfer pricing adjustment, rather than on the tax payable as a result of the adjustments. A taxpayer may avoid the penalty if (1) it has made reasonable efforts to establish and apply arm's-length transfer pricing or an arm's-length allocation regarding the transaction and (2) it produces and maintains contemporaneous documentation meeting the specified statutory requirements for non-arm's-length transactions and produces that documentation within three months of receiving a request from the CRA.

No detailed legislative guidance on the appropriate transfer pricing of non-arm's-length transactions has been provided in the ITA or by regulation. In particular, under the Canadian system, there is no counterpart to the detailed rules set out in the regulations issued under section 482 IRC. Rather, as noted above, section 247 briefly sets out the arm's-length principle and enacts the penalty regime, including the contemporaneous documentation requirements. The CRA has issued Information Circular 87-2R, ''International Transfer Pricing,''[31] which provides administrative guidance on the application of section 247, including transfer pricing methodologies to be used by taxpayers based in large part on the OECD transfer pricing guidelines. If there is sufficient information available about comparable arm's-length transactions, taxpayers generally are required to use the comparable uncontrolled price method, which compares the price charged in a non-arm's-length transaction to the price charged in a comparable arm's-length transaction. The CRA has also published numerous transfer pricing memorandums

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[29]OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, Paris, 1995.

[30]The Tax Court of Canada gave significant weight to the OECD transfer pricing guidelines in its recent transfer pricing decision, *GlaxoSmithKline v. The Queen*, 2008 DTC 3957 (TCC). For a discussion of *GlaxoSmithKline*, see Elinore J. Richardson and Stephanie Wong, ''Canadian Court Endorses OECD Transfer Pricing Guidelines,'' *Tax Notes Int'l*, July 14, 2008, p. 143, *Doc 2008-15027*, or *2008 WTD 133-1*.

[31]An information circular is similar in concept to an IRS revenue procedure — it represents the CRA's administrative position but is not binding on a court, taxpayers, or the government.

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that generally describe CRA policies and guidelines regarding specific transfer pricing issues.

To date, no transfer pricing cases have been decided under section 247.[32] Thus, transfer pricing in Canada is based to a large extent on the CRA's administrative policy and the OECD transfer pricing guidelines, instead of legislation or case law.

X. Privilege

There are two main types of privilege in Canada that apply to communications between a solicitor and client: solicitor-client privilege and litigation privilege. Solicitor-client privilege (similar to attorney-client privilege in the U.S.) generally protects confidential communications between a lawyer and a client that directly relate to the seeking, formulating, or giving of legal advice. Litigation privilege (similar to the attorney work product doctrine in the United States), however, applies only when litigation is contemplated, anticipated, or ongoing, and applies not only to communications between a lawyer and client but also to communications between a lawyer and third parties, and a client and third parties, and to materials other than communications. For litigation privilege to attach to a communication or document, the communication must be made or the document must be created for the dominant purpose of preparing for actual or reasonably anticipated litigation.

Unlike in the United States, there is no statutory privilege in Canada that protects communications between a client and an accountant regarding tax advice. Canadian courts have also declined to recognize such a privilege.[33] Therefore, to the extent that a taxpayer retains an accountant to provide tax advice, prima facie communications between the taxpayer and that accountant will not be privileged. However, if an accountant acts as agent for a client in obtaining legal advice from a lawyer, communications between a lawyer and the accountant, and communications between the accountant and the client regarding that advice, should be privileged. Also, if a lawyer retains an accountant to assist in providing legal advice to the client, communications between the lawyer and the accountant may be privileged. Finally, to the extent that an accountant prepares communications or other materials in connection with litigation, those communications or materials should be covered by the litigation privilege (if the factors for litigation privilege are otherwise met). Accordingly, with the participation of legal counsel there is some ability to bring an accountant within the scope of privileged communications.

Privilege that is successfully established can be lost when it has been waived. Canadian courts have recognized a doctrine of limited waiver when a corporation is compelled to disclose otherwise privileged documents to its external auditor under applicable corporate law, finding that in such a situation privilege generally is waived only for the external auditor and preserved against the rest of the world.[34] In contrast, U.S. courts have not recognized a doctrine of limited waiver, although a recent case held that tax accrual workpapers disclosed to an external auditor retained their privilege under the work product doctrine, even though the attorney-client privilege and accountant-client privilege were found to be waived.[35]

The subject of accountants' working papers is a difficult one, as prima facie no privilege exists for them. There is no clear CRA policy on the issue of whether CRA auditors should request accountants' working papers. The CRA has been examining this issue for many years as a result of concerns that some CRA auditors had been requesting such working papers as a matter of routine, with no uniform policy. In contrast, the IRS has adopted a policy of restraint in terms of requests for tax accrual workpapers and generally requests those workpapers only in unusual circumstances (such as when the taxpayer has participated in a listed transaction).[36] ◆

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[32] *GlaxoSmithKline* dealt with the transfer pricing rules under former subsection 69(2), which was the predecessor to section 247.

[33] *See, e.g., M.N.R. v. Tower*, 2003 DTC 5540 (FCA).

[34] *See, e.g., Interprovincial Pipe Line v. M.N.R.*, 95 DTC 5642 (FCTD), and *Philip Services Corp. (Receiver of) and O.S.C.*, (2005) 77 O.R. (3d) 209 (Ont. Div. Ct.).

[35] *See U.S. v. Textron Inc.*, 100 AFTR 2d 2007-5848 (DC RI). *Textron* is currently under appeal; *see also Regions Financial Corp. v. U.S.*, 101 AFTR 2d 2008-2179 (DC AL), for a similar case when the work product privilege was found to apply.

[36] Announcement 2002-63, 2002-27 IRB 1.

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