

Canada

by Steve Suarez and Stephanie Wong

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The year 2012 brought significant Canadian tax developments in several areas.

Legislation

The 2012 federal budget strengthened Canada's thin capitalization rules by reducing the 2-1 debt-to-equity limit to 1.5 to 1, effective January 1, 2013; including debt incurred by a partnership of which a Canadian corporation is a member; and treating disallowed interest as a dividend for Canadian withholding tax purposes. New foreign affiliate dumping rules apply to investments by foreign-controlled Canadian corporations in foreign group members that are or become foreign affiliates. Secondary transfer pricing adjustments affecting a non-arm's-length nonresident are now deemed dividends (triggering nonresident withholding tax). Starting in 2013, reduced benefits under the scientific research and experimental development regime will be phased in, while some resource sector investment tax credits will be phased out (subject to transitional relief). (For prior coverage, see *Tax Notes Int'l*, Apr. 16, 2012, p. 247, *Doc 2012-6875*, or *2012 WTD 73-17*; for a discussion of Canadian year-end tax planning deadlines for 2012, including those related to the 2012 budget changes, see *Tax Notes Int'l*, Nov. 19, 2012, p. 747, *Doc 2012-22478*, or *2012 WTD 223-18*.)

Draft legislation was released to deny the deduction of amounts paid by the issuer of a stapled security (debt and equity that trade as a unit) in some circumstances. (For prior coverage, see *Tax Notes Int'l*, Sept. 17, 2012, p. 1098, *Doc 2012-18928*, or *2012 WTD 177-8*.)

The nonresident withholding tax rules were amended so that trust income made payable (but not paid or credited) to a nonresident beneficiary is deemed paid or credited for withholding tax purposes before a trust's emigration from Canada.

A comprehensive technical bill introduced on October 24 implements (and, in many cases, revises) several outstanding legislative proposals going back many years, including:

- long-awaited amendments to Canada's foreign affiliate regime (including upstream loan rules);
- amended rules regarding nonresident trusts, offshore investment fund property, real estate investment trusts, foreign tax credit generators, aggressive tax avoidance transaction reporting, and restrictive covenant rules;
- expanded shareholder benefit and debt rules addressing partnerships and issues arising from foreign spinoffs; and
- amended rules regarding the treatment of nonresidents with Canadian service providers.

Canada signed tax treaties with Serbia and Hong Kong, updated its treaties with New Zealand and Poland, and signed protocols with Austria and Luxembourg. Canada's treaty with Colombia and the protocol to the Canada-Singapore treaty entered into force. Canada's tax information exchange agreements with Costa Rica, Dominica, the Netherlands (in respect of Aruba), and Saint Lucia entered into force. Canada also began negotiating an information exchange agreement with the United States.

Jurisprudence

General Antiavoidance Rule

The Supreme Court of Canada dismissed the taxpayer's appeal in *Cophthorne Holdings Ltd. v. The Queen*. An internal reorganization carried out before a horizontal amalgamation in order to preserve the paid-up capital of both amalgamating corporations' shares on the amalgamation was subject to the general antiavoidance rule. (For prior coverage, see *Tax Notes Int'l*, Jan. 2, 2012, p. 14, *Doc 2011-26678*, or *2011 WTD 245-1*.)

The government has sought leave from the Supreme Court of Canada to appeal the Alberta Court of Appeal's decision in *The Queen v. Husky Energy Inc.* In that

and a similar case, *The Queen v. Canada Safeway Limited*, the provincial version of the GAAR was not applied to interprovincial tax planning that exploited differences (now eliminated) between Ontario and Alberta's corporate tax rules.

The Federal Court of Appeal applied the GAAR in *Triad Gestco Ltd. v. The Queen*, *Ontario Ltd. v. The Queen*, and *Global Equity Fund Ltd. v. The Queen*, in which a loss was manufactured through a series of transactions to offset a previously realized gain. (For prior coverage, see *Tax Notes Int'l*, Oct. 29, 2012, p. 446, *Doc 2012-21522*, or *2012 WTD 203-5*.)

Other SCC Cases

The Supreme Court of Canada dismissed the taxpayer's appeal in *Garron Family Trust (Trustee of) v. The Queen*, upholding the use of a central management and control test to determine that a Barbadian trust was resident in Canada for tax purposes. (For prior coverage, see *Tax Notes Int'l*, Apr. 23, 2012, p. 315, *Doc 2012-7851*, or *2012 WTD 73-2*.)

The Supreme Court of Canada dismissed the government's appeal and the taxpayer's cross-appeal in *The Queen v. GlaxoSmithKline Inc.* The Tax Court of Canada must now reconsider, based on a related license agreement, whether the taxpayer paid a reasonable price to a related nonresident for the supply of an active ingredient in a brand-name medication manufactured and sold in Canada. (For prior coverage, see *Tax Notes Int'l*, Oct. 29, 2012, p. 433, *Doc 2012-21849*, or *2012 WTD 209-7*.)

The taxpayer was granted leave to appeal the decision in *Daishowa-Marubeni International Ltd. v. The Queen* requiring it to include in its taxable sale proceeds the noncash consideration it derived from transferring a reforestation obligation attached to the timber property it sold. (For prior coverage, see *Tax Notes Int'l*, June 11, 2012, p. 1006, *Doc 2012-12160*, or *2012 WTD 110-6*.)

The taxpayer in *Envision Credit Union v. The Queen* was granted leave to appeal the decision that the amalgamating corporations' tax attributes flowed through to the amalgamated corporation on a non-tax-deferred amalgamation. (For prior coverage, see *Tax Notes Int'l*, July 2, 2012, p. 20, *Doc 2012-13303*, or *2012 WTD 121-4*.)

Other Decisions

In *FLSmith v. The Queen*, the Tax Court of Canada held that the taxpayer could not deduct taxes paid by a U.S. hybrid entity involved in a cross-border financing structure. (For prior coverage, see *Tax Notes Int'l*, Feb. 6, 2012, p. 455, *Doc 2012-1261*, or *2012 WTD 24-13*.)

The Tax Court in *Velcro Canada Inc. v. The Queen* held that a Dutch intermediary holding company was en-

titled to a treaty-reduced rate of Canadian royalty withholding tax, because it beneficially owned the royalties and was not a conduit. (For prior coverage, see *Tax Notes Int'l*, Mar. 5, 2012, p. 725, *Doc 2012-4168*, or *2012 WTD 40-2*.)

In *Sommerer v. The Queen*, the Federal Court of Appeals held that a nonresident trust's gains from a sale of property could not be attributed to the person who sold the property to the trust and that the gains were exempt from Canadian taxation under the Austria-Canada tax treaty. (For prior coverage, see *Tax Notes Int'l*, Aug. 6, 2012, p. 500, *Doc 2012-16126*, or *2012 WTD 148-3*.)

In *McPeake v. Canada (Attorney General)*, the British Columbia Supreme Court rectified a trust deed to reflect the taxpayer's tax avoidance intent. In *Twomey v. The Queen*, the Tax Court of Canada held that the taxpayer could correct clerical errors in corporate share transactions without a court-ordered rectification.

Commodity Tax

Persons doing business in Canada were busy preparing for significant commodity tax changes in 2013. The federal goods and services tax is a VAT levied in Alberta, Saskatchewan, Manitoba, Nunavut, the Northwest Territories, Quebec, and Prince Edward Island. Saskatchewan, Manitoba, and Prince Edward Island levy an additional provincial sales tax (PST) that is not a VAT. British Columbia, Ontario, Nova Scotia, New Brunswick, and Newfoundland and Labrador levy an HST (PST harmonized with the GST). Effective April 1, 2013, British Columbia will cease to levy HST and reintroduce a PST, while Prince Edward Island will implement an HST. Quebec also levies a PST — the Quebec sales tax (QST) — that is mostly harmonized with the GST.

Effective January 1, 2013, Quebec will fully harmonize its QST with the GST:

- the QST rate will increase to 9.975 percent and will be calculated on a base that does not include GST;
- suppliers of financial services can no longer claim input tax refunds;
- nonresidents can no longer register for QST to avoid the drop shipment rules; and
- registered nonresidents must cancel their registrations.

Much of the implementing legislation has not been released yet, adding to businesses' difficulties in preparing for the changes. ◆

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