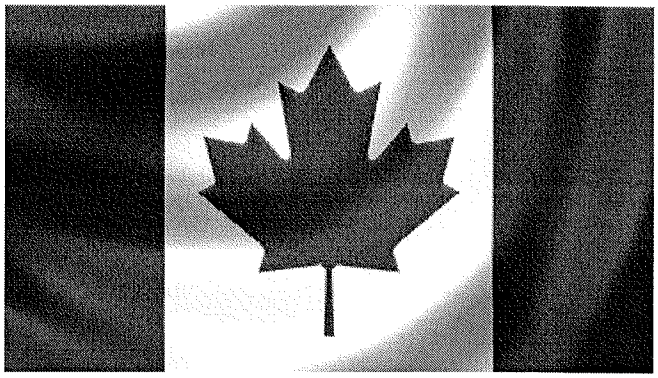
Canadian Tax Developments In 2013

by Steve Suarez and Stephanie Wong, Borden Ladner Gervais LLP



2013 brought significant Canadian tax developments in a number of areas. This article takes a brief look at the most significant Canadian tax developments in 2013 of interest to international businesses, tax practitioners and executives.

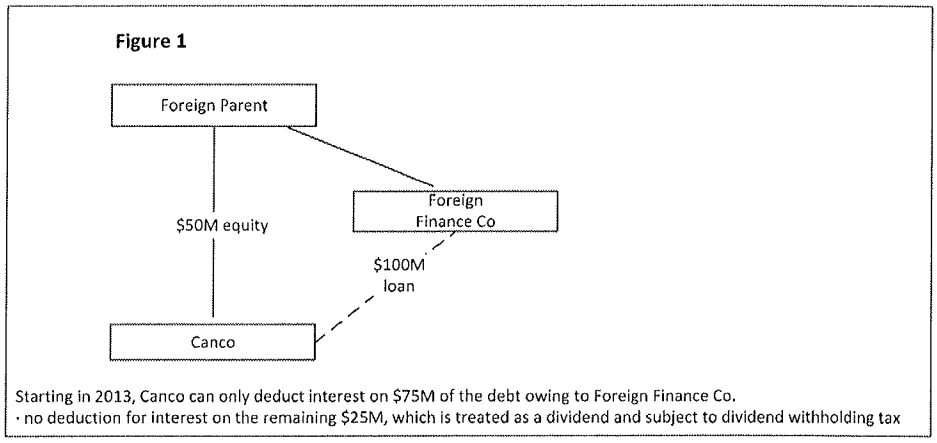
Part I: Canadian Legislative Developments

Thin Capitalization Rules Extended

As a result of the Canadian government's 2013 federal budget, the scope of Canada's thin capitalization rules will be extended. The thin capitalization rules in subsections 18(4)-(8) of the *Income Tax Act* (Canada) (the "ITA") currently apply to limit the amount of debt owing to related non-residents that a Canadian resident corporation ("Canco"), or a partnership of which Canco is a member, can deduct interest expense on for tax purposes. The debt to which these rules apply is debt owing by Canco to "specified non-residents": non-residents who either are 25 percent plus shareholders (by votes or value) of Canco or do not deal at arm's-length with such shareholders. Under changes that took effect in 2013 (see Figure 1), Canco cannot deduct interest on any such debt to the extent that it exceeds 150 percent of Canco's "equity" (which is essentially the total of Canco's unconsolidated retained earnings and the paid-up capital of Canco shares held by non-resident group members). Interest on the excess debt is non-deductible for Canadian tax purposes and is recharacterized as a dividend to which Canadian non-resident dividend withholding tax applies at a 25 percent rate, subject to reduction under an applicable tax treaty.

The existing thin capitalization rules will be extended, with appropriate modifications, to apply to Canadian-resident trusts, to non-resident corporations and trusts carrying on business in Canada or electing to

Figure 1:



be taxed as a Canadian resident under section 216 of the ITA, and to partnerships of which such a corporation or trust is a member. These amendments will take effect for taxation years beginning after 2013.[1]

Foreign Affiliate Dumping Rules – Proposed Amendments

On August 16, 2013 Canada's Department of Finance released for public comment proposed changes to the foreign affiliate dumping ("FAD") rules. First proposed in the 2012 federal budget, the FAD rules were enacted as section 212.3 of the ITA on December 14, 2012.[2]

The FAD rules target perceived tax avoidance by foreign-controlled Canadian corporations acquiring or making investments in foreign corporations that are (or become) foreign affiliates. If the FAD rules apply, they effectively treat a payment by a foreign-controlled Canadian corporation "down" the chain in respect of a foreign subsidiary (*e.g.*, acquiring its shares or making a loan to it) as if it were a distribution by the Canadian corporation "up" the chain to its foreign parent, by (1) reducing the paid-up capital of the Canadian corporation's shares and/or (2) deeming the Canadian corporation to have paid a dividend to which non-resident dividend withholding tax may apply. The FAD rules are complex and overbroad, and can catch transactions that are not offensive from a tax policy perspective. Although the 2013 proposed amendments do not significantly change the scope of the FAD rules, they introduce several technical changes that modestly narrow the scope of the rules in circumstances where the Canadian tax authorities appear satisfied that no material abuse is likely to arise. They also make the application of the FAD rules somewhat less punitive. The proposed amendments generally take effect from March 28, 2012 (the date on which the FAD rules were originally announced), unless a taxpayer elects to have them take effect on August 14, 2012 (the date on which draft legislation to implement the FAD rules was released).

Upstream Loan Rules Enacted

First announced in the 2011 federal budget, the "upstream loan" rules in subsection 90(6) of the ITA were enacted on June 26, 2013. These rules discourage a foreign affiliate of a Canadian corporation[3] from making interest-free loans to its Canadian parent ("Canco") as a means of repatriating foreign profits to Canada on a tax-free basis, instead of the foreign affiliate paying a dividend to Canco (which could be subject to Canadian tax depending on the circumstances).

The rules generally require Canco to include in income an amount owed to a foreign affiliate of Canco (or a partnership of which a Canco foreign affiliate is a member) by "specified debtors", *i.e.*, Canco and anyone not dealing at arm's-length with Canco (other than a controlled foreign affiliate of Canco). Any amount included in Canco's income under this rule and later repaid to the creditor foreign affiliate can generally be deducted in the year of repayment.

The rules apply to debts arising after August 19, 2011.[4] Anti-avoidance rules also catch back-to-back loan arrangements. Certain debts are excluded from the application of the upstream loan rules, including (1) debt repaid within two years of the date the debt arose (provided such repayment is not part of a series of loans or indebtedness and repayments); and (2) debt arising in the ordinary course of the creditor's business or a loan made in the ordinary course of the creditor's ordinary business of lending money where there are *bona fide* arrangements for repayment within a reasonable time made at the outset.

If the rules apply to include an amount in Canco's income, Canco may be able to claim a reserve[5] to fully or partially offset the income inclusion for a taxation year if it satisfies specified conditions which assess whether, at the time the debt was incurred and continuously thereafter, Canco had sufficient tax attributes relating to the relevant foreign affiliate such that some or all of the amount owing to the foreign affiliate could have been paid to Canco as a dividend from the foreign affiliate without attracting Canadian tax.

Mining Sector Changes

Taxable Canadian corporations that undertake certain mining sector activities relating to qualifying minerals in Canada are entitled to claim an investment tax credit ("ITC") equal to a percentage (originally 10 percent) of the amount of qualifying expenditures incurred before the mine is producing in reasonable commercial quantities on "grass roots" exploration to determine the existence, location, extent or quality of a mineral deposit in Canada, or activities undertaken in order to bring a new mine in Canada into production.

The 2012 federal budget announced the phasing-out of the preproduction mining expenditures ITC starting in 2013. The 10 percent ITC for preproduction *exploration* mining expenditures was reduced to 5 percent for qualifying expenditures incurred in 2013, and will be eliminated for expenditures incurred after 2013. The 10 percent ITC for preproduction *development* expenditures was maintained for qualifying expenditures made in 2013, but will be reduced to 7 percent for qualifying expenditures made in 2014, to 4 percent for qualifying expenditures made in 2015, and then eliminated for expenditures after 2015, subject to limited grandfathering.

In addition, the 2013 federal budget announced phased-in changes (over the 2015-2017 tax years) to the tax treatment of pre-production mine development expenses incurred after March 20, 2013. The treatment of such expenses will change from Canadian exploration expense ("CEE") which is deductible in full in the year incurred or can be carried forward indefinitely for use in future years, to Canadian development expense ("CDE"), which is deductible at a rate of 30 percent per year on a declining-balance basis. The existing CEE treatment for pre-production mine development expenses will be maintained for expenses incurred before March 20, 2013, and will also apply in certain cases for expenses incurred before 2017.

Also announced in the 2013 federal budget is the phasing-out (over the 2017-2020 calendar years) of the accelerated capital cost allowance ("CCA") for mining expenses incurred after March 20, 2013 (except for bituminous sands and oil shale, which will be fully phased out in 2015). The accelerated CCA rate will be maintained for eligible assets acquired before March 20, 2013, and will also apply for such assets acquired before 2018 in certain circumstances.

Scientific Research And Experimental Development Changes

Several changes to Canada's tax incentive program for scientific research and experimental development ("SR&ED") announced in the 2012 federal budget took effect in 2013. Under the SR&ED program, an ITC can be claimed for qualifying SR&ED expenditures incurred in a taxation year, while an enhanced ITC may be claimed for a limited amount of qualifying expenditures incurred in a taxation year by a Canadian-controlled private corporation ("CCPC"). For taxpayers using the simplified proxy method to determine the amount of qualifying SR&ED expenditures eligible for an ITC, the original 65 percent inclusion allowance for overhead expenditures directly attributable to SR&ED activities was reduced to 60 percent for 2013. For taxpayers making payments under arm's-length SR&ED contracts, the expenditure inclusion rate dropped from 100 percent to 80 percent in 2013 (the reduction was intended as a way of excluding the profit element of such contracts).

Further changes to the SR&ED program were announced in the 2013 federal budget and will take effect in 2014. Claimants will have to give more detailed information on SR&ED claim forms about third-party tax preparers and billing arrangements, and will be subject to a new penalty of USD1,000 per claim (with any third-party preparer being jointly and severally liable with the claimant to pay such penalty) where that information is missing, incomplete or inaccurate.

Acquisition Of Control Loss Restriction Rules Extended

The rules in subsections 111(4) and (5) of the ITA that restrict the use of a corporation's losses and certain other tax attributes following the acquisition of control of the corporation have been supplemented by the 2013 federal budget's introduction of a new anti-avoidance rule applicable to shares of a corporation acquired after March 20, 2013.

The acquisition of control rules generally apply where a person (or group of persons) acquires sufficient voting shares of a corporation such that the person (or group) has the power to elect a majority of the corporation's board of directors. The acquisition of control of a Canadian resident corporation results in a number of tax consequences, including:

- the triggering of a taxation-year end for the corporation;
- the extinguishment of any unused capital losses and non-capital property losses of the corporation realized before the acquisition of control (and no ability to apply post-acquisition of control

capital losses and non-capital property losses to pre-acquisition of control years); and

- the application of restrictions on the use of pre-acquisition of control non-capital *business* losses of the corporation to post-acquisition of control taxation years (and *vice versa*); these restrictions generally require that the corporation carry on the business that gave rise to the loss with a reasonable expectation of profit, and that the corporation only deduct such losses against its income from that business or a similar business.

The new anti-avoidance rule deems an acquisition of control (and thus a triggering of the restrictions) to occur where a person or group of persons acquires shares of a corporation representing more than 75 percent of the fair market value of all the shares of the corporation without otherwise acquiring voting control of the corporation. This anti-avoidance rule applies only in circumstances where it is reasonable to conclude that one of the main reasons that the person or group does not control the corporation is to avoid specified provisions of the ITA, including the restrictions on the trading of losses and other tax attributes.

Tax Avoidance Transaction Reporting Regime Enacted

The mandatory tax avoidance transaction reporting regime in section 237.3 of the ITA applies to certain tax avoidance transactions ("reportable transactions") if the transaction is either entered into after 2010, or part of a series of transactions completed after 2010. Legislation implementing the mandatory reporting regime, which was first proposed in 2010, was enacted on June 26, 2013.

To be a "reportable transaction", a transaction must be an "avoidance transaction" for purposes of the general anti-avoidance rule ("GAAR") in the ITA,[6] *i.e.*, it must be a transaction that would result, or is part of a series of transactions which would result, in a tax benefit (a reduction, avoidance or deferral of tax), unless the transaction has been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit. The transaction must also satisfy at least two of the following three criteria:

- contingency, performance or transaction based fees are paid to an advisor or a promoter (or a person not at arm's-length with either of them);
- an advisor or a promoter obtains in respect of the transaction or series any confidential protection (*i.e.*, anything that prohibits the disclosure of the details or structure of the transaction or series under which a tax benefit results (or would result but for the GAAR); or
- a taxpayer, a person who entered into the transaction for the benefit of a taxpayer, an advisor or a promoter (or a person who does not deal at arm's-length with any of them) has in respect of the transaction or series certain "contractual protection" (*e.g.*, an indemnity, compensation or guarantee which protects against a failure of the transaction or series to achieve a tax benefit).

Among the persons required to file an information return relating to a reportable transaction (or

relevant series of transactions) are those obtaining a tax benefit, and advisors and promoters entitled to a fee from the transaction or series of transactions. For reportable transactions that arose in 2010, 2011 or 2012, the filing due date for the information return was October 23, 2013. For reportable transactions arising in 2013, the information return must be filed by June 30, 2014. Persons who fail to report as required are subject to penalties, the denial of tax benefits and the extension of the period during which the Canada Revenue Agency ("CRA") can reassess the taxpayer.

Government Consultation On Treaty Shopping Measures

In recent years the Canadian government has lost a number of court cases involving alleged treaty shopping.[7] The government considers treaty shopping to arise when a non-resident who is not entitled to the benefits of a tax treaty with Canada seeks to obtain treaty benefits by using an entity resident in a country with which Canada has concluded a tax treaty to earn, through that entity, Canadian-source income. In the 2013 federal budget, the government announced its intention to consult on possible measures to "protect the integrity of Canada's tax treaties while preserving a business tax environment that is conducive to foreign investment." In August 2013, the Department of Finance released for public comment a consultation paper outlining possible approaches to prevent treaty shopping.[8] The deadline for submitting comments on the consultation paper is December 13, 2013.

Examination Of Consolidation Tax System Completed

Canada does not have a consolidation or group-relief tax system. In the 2010 federal budget, the Canadian government announced its intention to examine potential new rules to permit taxation on the basis of corporate groups rather than individual corporations. Following the receipt of feedback from consultations with the provinces, the territories and the business community, the government announced in the 2013 federal budget that it had completed its examination, that no consensus had been achieved on how a corporate group taxation system could be introduced that would improve the tax system and address the concerns raised by the various parties, and that moving to a formal system of corporate group taxation is not a current priority.

Other Legislative Changes

On July 12, 2013, the Department of Finance released for public comment a package of proposed technical amendments to the ITA,[9] which include a number of proposals relating to the taxation of Canadian corporations with foreign affiliates. Some of the proposals reflect changes referred to in Department of Finance comfort letters issued over a number of years. The proposals include changes to ensure that various foreign affiliate rules in the ITA apply appropriately to structures involving partnerships, changes that narrow the scope of certain base erosion rules, and new rules to ensure an appropriate income inclusion for stub-year foreign accrual property income on dispositions of foreign affiliate shares.

On October 18, 2013, the Department of Finance released draft legislation to implement a number of the 2013 federal budget measures described above.[10] In addition, the draft legislation includes revised versions of December 21, 2012 proposed changes to the corporate divisive reorganization rules in section 55 of the ITA and the tax cost bump rules in subsection 88(1) of the ITA, and the rules eliminating the tax advantages of "stapled securities" (debt and equity that trade as a unit) in certain circumstances, which were originally released on July 25, 2012.[11]

New Tax Treaties, Protocols And Tax Information Exchange Agreement[12]

The Canada-Colombia tax treaty (signed on November 21, 2008) took effect on January 1, 2013. The Canada-Serbia tax treaty (signed on April 27, 2012) entered into force in 2013 and will take effect in both Canada and Serbia on January 1, 2014. The Canada-Hong Kong tax treaty (signed on November 11, 2012) also entered into force in 2013 and will generally take effect in Canada on January 1, 2014 and in Hong Kong on April 1, 2014.[13] On the effective date of the relevant tax treaty, treaty-reduced rates of non-resident withholding tax on interest, dividends and royalties will apply to amounts paid or credited by residents of Canada to residents of the other treaty country (and *vice versa*).

The 1987 Canada-Poland tax treaty has been replaced by a new tax treaty (signed on May 14, 2012), which entered into force in 2013 and will take effect in both Canada and Poland on January 1, 2014. The new treaty generally either lowers or maintains the withholding tax rates in the 1987 treaty; however, it increases (from 0 percent to 5 percent) the withholding tax rate on copyright royalties in respect of the production or reproduction of literary, dramatic, musical or artistic work (other than motion picture films or works on film, videotape or other means of reproduction for use in connection with television broadcasting).

The second protocol amending the exchange of information provisions of the Canada-Austria tax treaty (signed on March 9, 2012) entered into force in 2013 and will take effect on January 1, 2014. The agreement regarding the interpretation of the exchange of information provisions of the Canada-Switzerland tax treaty (as amended by the October 2010 protocol) also entered into force, with retroactive effect from December 16, 2011.

Canada also signed tax information exchange agreements with Bahrain, the British Virgin Islands, Brunei, Liechtenstein, Panama and Uruguay in 2013.

On November 21, 2013, Canada ratified the Convention on Mutual Administrative Assistance in Tax Matters (signed on April 28, 2004), as amended by the Protocol made on May 27, 2010. The Convention will enter into force in Canada on March 1, 2014 in accordance with the terms of Article 28. Canada ratified the Convention with the reservations that it will not be obligated to collect taxes on behalf of another country, or provide assistance in the service of related documents. Canada will instead continue to negotiate assistance in the collection of taxes on a bilateral basis.

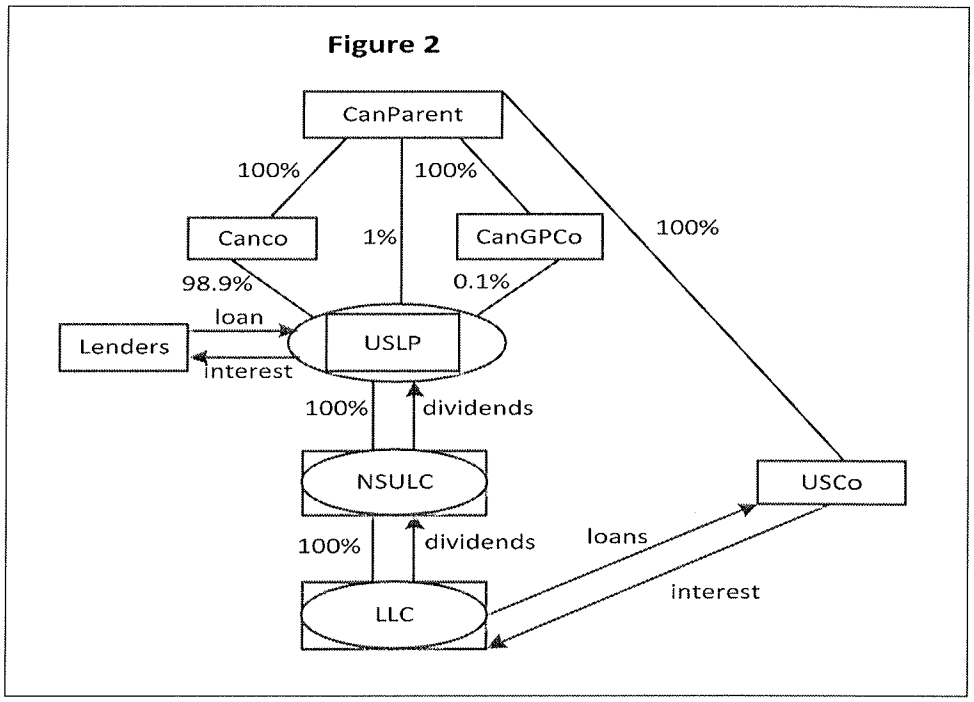
Part II: Canadian Judicial Developments

The Canadian courts decided a number of tax cases in 2013 that may be relevant to international businesses and tax executives.

Cross-Border Financing Structures

In *FL Smidth Ltd. v. The Queen*,[14] the Federal Court of Appeal ("FCA") upheld the decision of the Tax Court of Canada ("TCC") that the taxpayer ("Canco") could not deduct, under subsection 20(12) of the ITA, US taxes paid by a US hybrid entity involved in a cross-border financing arrangement commonly known as a "tower structure". In a typical tower structure, an arm's-length borrowing is structured to generate expense deductions in both Canada and the US (*i.e.*, a "double dip"). Three hybrid entities were involved: a US limited partnership ("USLP") formed by Canco and its Canadian resident parent corporation ("CanParent"); a Nova Scotia unlimited liability company ("NSULC") incorporated and wholly owned by USLP; and a US limited liability company ("LLC") incorporated and wholly owned by NSULC. USLP was treated as a corporation for US tax purposes and as a partnership (flow-through) for Canadian tax purposes, while NSULC and LLC were each treated as a disregarded entity for US tax purposes and a corporation for Canadian tax purposes.

Figure 2:



USLP borrowed money and subscribed for shares of NSULC, NSULC used its subscription proceeds to subscribe for shares of LLC, LLC used its subscription proceeds to make interest bearing loans to a US company ("USCo") in Canco's corporate group, and USCo used the borrowed money to fund indirect purchases of other US companies. On an ongoing basis under this structure, USCo paid interest to LLC, LLC paid dividends to NSULC, NSULC paid dividends to USLP, and USLP paid interest on the money it borrowed (see Figure 2).

From a US tax perspective, USLP was treated as having made the LLC loans directly to USCo (since LLC and NSULC were disregarded entities), with the result that USLP was taxed on the net interest income received on the LLC loans (after deducting interest payments on the money borrowed to

subscribe for the NSULC shares). The LLC and NSULC dividends were disregarded for US tax purposes.

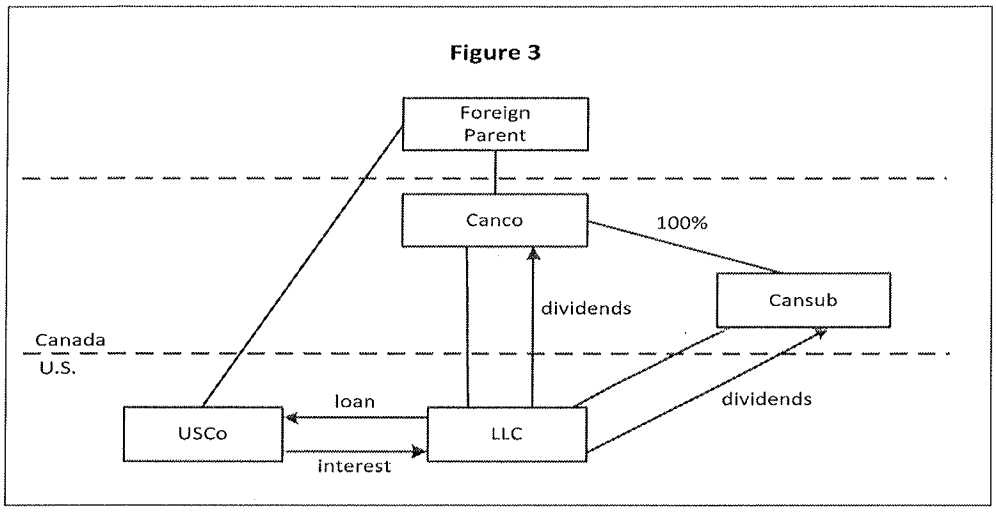
From a Canadian tax perspective, the intended results were as follows:

- Since LLC was a foreign affiliate of both NSULC and Canco, interest income earned by LLC from USCo was included in LLC's exempt surplus under the recharacterization rule in paragraph 95(2)(a) of the ITA, which meant that dividends received by NSULC from LLC were not subject to Canadian tax;[15]
- USLP included the NSULC dividends in its income and deducted the interest expense it paid on the funds it had borrowed; USLP also deducted the US taxes it paid on its net interest income from the LLC loans (which was the deduction in dispute in Canada); and
- Canco included its share of the NSULC dividends received by USLP in its income and claimed the domestic intercorporate dividend deduction, which meant that the dividends were not subject to Canadian tax; Canco also included in income its share of USLP's income and claimed a deduction under subsection 20(12) of the ITA for its proportionate share of the US taxes paid by USLP on the net interest income from the LLC loans. The CRA denied the subsection 20(12) deduction.

Subsection 20(12) of the ITA permits a Canadian resident taxpayer to deduct, in computing its income for a taxation year, foreign non-business income taxes paid by the taxpayer for the year that (1) are paid in respect of a property or business source of income, and (2) cannot reasonably be regarded as having been paid by a corporation "*in respect of*" income from shares of a foreign affiliate of the corporation. The TCC found that the second condition was not satisfied in this case: the US tax was related to or connected with (*i.e.*, paid in respect of) the dividends received by NSULC from LLC (a foreign affiliate of the taxpayer) since both were part of the flow of funds that originated with USCo and ended with USLP. Accordingly, the taxpayer could not deduct its share of the US taxes paid by USLP under subsection 20(12). The TCC also held that the result was not inconsistent with the Canada-US tax treaty, since it did not subject the income earned by USLP to double taxation. On appeal, the FCA affirmed the TCC's decision that subsection 20(12) did not apply, but very importantly did not endorse the TCC's view that subsection 20(12) cannot apply in any case where the foreign affiliate regime provides relief from double taxation of dividends received from a foreign affiliate. The taxpayer did not seek leave to appeal this decision to the Supreme Court of Canada ("SCC").

In *Lehigh Cement Limited v. The Queen*,[16] a Canadian resident corporation ("Canco") and its wholly owned Canadian subsidiary ("Cansub") were members of a multinational corporate group. In the course of a complex corporate refinancing, Canco and Cansub incorporated a US LLC ("LLC") as their foreign affiliate. LLC loaned money to a US corporation ("USCo") that was related to LLC, Canco and Cansub (see Figure 3).

Figure 3:



USCo paid interest income to LLC that was included in LLC's exempt surplus under the recharacterization rule in paragraph 95(2)(a) of the ITA as it read at that time, with the result that Canco and Cansub received dividends from LLC free of Canadian tax. The CRA reassessed Canco and Cansub to include the LLC dividends in their income on the basis that they had acquired the LLC shares principally to avoid tax and, therefore, the anti-avoidance rule in paragraph 95(6)(b) of the ITA applied to deem Canco and Cansub not to have acquired the LLC shares. Absent the acquisition of the LLC shares, LLC would not qualify as a foreign affiliate of, and the dividends would be taxable to, Canco and Cansub.

In general terms, paragraph 95(6)(b) of the ITA is an anti-avoidance rule for purposes of the foreign affiliate regime that provides that where a person acquires or disposes of shares of a corporation and it can reasonably be considered that the principal purpose of the acquisition or disposition is to permit a person to avoid, reduce or defer the payment of tax or any other amount that would otherwise be payable under the ITA, the acquisition or disposition is deemed not to have occurred. Despite the provision's broad wording, it is generally accepted not to apply to various structures clearly contemplated (and encouraged) under Canada's foreign affiliate rules.

Although the TCC interpreted paragraph 95(6)(b) broadly, it held that the provision did not apply on the specific facts. The TCC concluded that in determining the purpose of the share acquisition or disposition, the fact that the acquisition or disposition is part of a series of transactions and the overall purpose of the series of transactions may be relevant in determining the purpose of the share acquisition or disposition. Furthermore, since paragraph 95(6)(b) does not explicitly include a misuse or abuse test (in contrast to the GAAR[17]), the TCC rejected the argument that the provision was not intended to apply to non-abusive tax-motivated reorganizations that rely on the foreign affiliate rules.

The TCC reasoned that in order to determine whether paragraph 95(6)(b) applies on the facts, the court must (1) identify the tax otherwise payable under the ITA that is alleged to have been avoided, reduced or deferred, (2) determine whether

the share acquisition or disposition permitted this avoidance, reduction or deferral and (3) assess the taxpayer's purpose in acquiring or disposing of the shares. Moreover, the reference in paragraph 95(6)(b) to tax "otherwise payable" invites a comparison with an alternative arrangement that Canco might reasonably have carried out (and in which the particular share acquisition or disposition did not occur). The TCC accepted the argument that the reasonable alternative arrangement in this case was Canco borrowing funds to subscribe directly for shares of USCo. Based on that alternative arrangement, the TCC concluded that no tax was avoided and therefore paragraph 95(6)(b) did not apply. The Crown has appealed the TCC's decision to the FCA, which hopefully will lead to a more detailed analysis of the scope of this important anti-avoidance rule.

Transfer Pricing: Request For Foreign-Based Information

In *Soft-Moc Inc. v. MNR*,[18] the Federal Court rejected the taxpayer's challenge of the CRA's demand to provide foreign-based information pursuant to subsection 231.6(2) of the ITA. The CRA had issued the request as part of its audit of the taxpayer's transfer pricing arrangements. Subsection 231.6(2) gives the CRA broad powers to require a Canadian resident person or a non-resident person carrying on business in Canada to provide any "foreign-based information or document", *i.e.*, any information or document that is available or located outside Canada and that may be relevant to the administration or enforcement of the ITA.

The taxpayer, a Canadian footwear retailer, was 90 percent owned by a Canadian who had established residence in the Bahamas and had incorporated four wholly-owned Bahamian companies, to which the taxpayer paid substantial amounts for merchandising and business development services, information technology consulting and software licensing. The CRA's request sought detailed information on the services provided by the Bahamian companies to the taxpayer. The taxpayer challenged the CRA's request as being unreasonable, arguing that it was overbroad (*i.e.*, a fishing expedition), the information was confidential and proprietary (or non-existent), and the disclosure of confidential information would destroy the value of the Bahamian companies' services.

The Court concluded that while the documents requested under subsection 231.6(2) need to be both relevant and reasonable, the case law sets a low threshold and the CRA's powers are wide-ranging. The requirement had been issued for specific audit purposes, and the link between the information requested and the purposes of the audit was both obvious and reasonable, given that the taxpayer and the four Bahamian corporations were owned and controlled by one person, and the taxpayer was the only client of three of the Bahamian corporations. The Court also found that the taxpayer had failed to prove that the information sought by the CRA was confidential, proprietary or sensitive. Based on an earlier case, the Court in any event noted that the confidential, proprietary or sensitive character of information is not a reason for finding a CRA

request for information unreasonable. The taxpayer has appealed the decision to the FCA.

Assets Sold With Embedded vs. Severable Liabilities

In *Daishowa-Marubeni International Ltd. v. The Queen*,[19] the SCC considered the fundamental issue of the tax treatment to an asset vendor of liabilities and obligations assumed by the asset buyer that related to the assets being sold. The SCC unanimously overturned the majority decision of the FCA and held in favor of the taxpayer that it was not required to add to its proceeds of disposition any amount in respect of reforestation obligations attached to timber harvest rights that it sold. The SCC found that the reforestation obligations were by law embedded in (and inseparable from) the harvest rights, which had the effect of depressing the value of the harvest rights to the taxpayer. The SCC's decision shows the importance of distinguishing between such embedded liabilities (which are effectively a feature of the property being sold) and severable liabilities such as debts secured by a mortgage on the property being sold (which may be borne by someone other than the owner of the property). It also underscores the necessity of obtaining tax input at the earliest stage of a transaction to ensure that it is characterized correctly for Canadian tax purposes.

CCPC Status

In *The Queen v. Bioartificial Gel Technologies (Bagtech) Inc.*,[20] the FCA confirmed that careful drafting of a unanimous shareholders' agreement can preserve a corporation's status as a CCPC even though non-residents acquire significant investments in shares of the corporation. CCPC status is required in order for a corporation to take advantage of certain Canadian tax benefits, including a lower tax rate on the corporation's first CAD500,000 of active business income and an enhanced refundable tax credit for qualifying SR&ED expenditures. Generally, a corporation will be a CCPC as long as (1) its shares are not listed on a stock exchange and (2) it is not controlled either legally (*i.e.*, through the power to elect a majority of the corporation's board of directors) or factually by one or more non-residents or public corporations (or any combination of them). In *Bagtech*, non-resident shareholders held more than 50 percent of the corporation's issued voting shares, but the corporation's unanimous shareholders' agreement gave the corporation's Canadian resident shareholders the power to elect a majority of the corporation's board of directors. The FCA affirmed the TCC's decision that the unanimous shareholders' agreement ought to be considered in determining whether the corporation was a CCPC, and that it resulted in the corporation qualifying as a CCPC even though non-residents owned a majority of its issued voting shares.

GAAR Decisions

The SCC refused the taxpayer's application for leave to appeal the FCA's decision applying the GAAR in *Global Equity Fund Ltd. v. the Queen*.[21] This was one of three "manufactured loss" cases in which a series of transactions was carried out that shifted value from one class of corporate shares with a relatively high tax cost to another class of

shares, in order to generate a loss on a sale of the first class of shares that would offset a previously realized gain. In all three cases, the FCA applied the GAAR to deny the taxpayer's loss resulting from the series of transactions. Two of the cases, *Triad Gestco Ltd. v. The Queen*[22] and *1207192 Ontario Ltd. v. The Queen*,[23] concerned capital loss claims. In those cases, the FCA concluded that while the capital loss provisions in the ITA do not expressly state that a taxpayer must suffer an economic loss in order to deduct a capital loss, that requirement must be read into the provisions since the purpose of the provisions is to tax the net realized increase in the value of capital assets.

In contrast, *Global Equity Fund Ltd. v. The Queen* concerned a business loss claim, and in that case the FCA was not prepared to accept the argument that only an actual reduction in wealth or an actual economic loss should be recognized under the general provisions of the ITA relating to business losses. However, the FCA concluded that, properly interpreted, the ITA provisions relevant to the computation of business income and losses require that in order for a business loss to be recognized for tax purposes, there must be an air of economic or business reality associated with that loss. Further, the FCA found (at paragraph 67) that the transactions were "nothing more than a paper shuffle carried out with the purpose of creating an artificial business loss for the purpose of avoiding the payment of taxes otherwise owed on the profits resulting from the real-world business operations of (the taxpayer)." Since there was no economic or business reality associated with the loss, the transactions creating the loss defeated the underlying rationale of the general provisions of the ITA relating to business losses.

The SCC also refused the Canadian government's application for leave to appeal the Alberta Court of Appeal's decision in *The Queen v. Husky Energy Inc.*[24] In that and a similar case, *The Queen v. Canada Safeway Limited*,[25] the provincial version of the GAAR was held not to apply to interprovincial tax planning that exploited differences (now eliminated) between Ontario and Alberta's corporate tax rules. However, an Ontario Court denied the taxpayer's intended tax results with respect to a similar inter-provincial tax planning arrangement (without relying on the provincial GAAR) in *Inter-Leasing Inc. v. Ontario (Minister of Revenue)*.[26]

Limits Imposed on CRA's Audit And Enforcement Powers

In several recent cases, the Courts have protected taxpayers by imposing reasonable limits on the CRA's broad administrative and enforcement powers under the ITA.

The TCC's decision in *Birchcliff Energy Ltd. v. The Queen*[27] sets an important precedent compelling the CRA to provide greater disclosure in the pleadings it files when litigating a case under the GAAR. Most GAAR litigation focuses on two issues: whether the tax policy that the CRA alleges to have been abused exists, and if so, whether it was in fact abused by the taxpayer's transactions.

However, the CRA's historical practice in GAAR cases was not to identify the relevant tax policy in its pleadings filed with the court. The TCC ruled in favor of the taxpayer that the CRA must set out as a material fact the relevant tax policy underlying the legislative provisions that the CRA assessor relied upon in reassessing the taxpayer under the GAAR. While the TCC acknowledged that it is open to the CRA to allege before the court the existence of a different tax policy than that relied upon by it in issuing the reassessment, the taxpayer is entitled in the pleadings to know what the basis of the CRA's reassessment was at the time it was made.

In *MNR v. RBC Life Insurance Company et al.*,[28] the FCA held that the Minister of National Revenue could not use her authority under the *Income Tax Act* to demand information for the primary purpose of "chilling" a business. The Minister's demand directed RBC to disclose records that would identify clients who had a specific insurance product that had been under review by the CRA's GAAR Committee. As the Minister's demand concerned records that would identify unnamed persons, the Minister was required to (and did) obtain court authorization before serving the demand. On review of the court authorization, the FCA held that the Minister acted improperly by using her audit powers primarily for the purpose of "sending a message to the industry" rather than for a valid audit purpose. The CRA also failed to provide full and frank disclosure in obtaining the court authorization because it did not disclose material information and documents that could have affected the Court's decision whether to grant the authorization. As a result, the FCA has set some reasonable limits on the Minister's substantial statutory authority to demand information.

Ficek v. The Queen[29] was another case in which the CRA did not succeed in using its powers to chill taxpayers' participation in transactions of which it did not approve. The TCC took the CRA to task for delaying assessments against taxpayers who had participated in a tax shelter scheme. There was evidence of internal CRA communications indicating that the CRA felt that it had the relevant taxpayers "over a barrel" by withholding assessments and refunds in order to deter further participation in the tax shelter. The Federal Court concluded that this was an improper reason to delay assessment and held that the CRA had failed to comply with its duty to assess taxpayers within a reasonable time.

Part III: Commodity Tax Developments

2013 was a year of transition for Canada's commodity taxes. The federal goods and services tax (GST) is a value-added tax imposed across the country. In addition to the GST, Canada's provinces may impose a retail sales tax. The federal government has encouraged the provinces to harmonize their retail sales tax with the federally administered GST. In provinces that have harmonized, the federally administered tax is generally referred to as the "harmonized sales tax," which is collected at a rate determined individually for each harmonized province.

In 2013, Prince Edward Island harmonized its provincial retail sales tax with the federal GST. Conversely, British Columbia ceased its harmonization with the federal GST and reintroduced a provincial retail sales tax. As a result, Canada now has three provinces that impose a traditional retail sales tax (British Columbia, Manitoba and Saskatchewan). The province of Alberta and the territories of Nunavut, Yukon and the Northwest Territories do not impose a retail sales tax, only the federal GST.

The province of Quebec imposes a provincial tax, known as the Quebec Sales Tax (QST), which is a value-added tax similar to the GST. While maintaining its separate tax administration, Quebec agreed to harmonize by taking steps to make the QST consistent with the GST. These changes to the QST, which took effect on January 1, 2013, include treating financial services as QST-exempt rather than zero-rated. As a result, persons providing financial services are no longer able to recover QST paid in the course of providing those services.

Endnotes

1 For more information on the changes to the thin capitalization rules, please see BLG's tax law bulletin at http://www.blg.com/en/newsandpublications/publication_3576.

2 To learn more about the FAD rules, please see BLG's tax law bulletins discussing the FAD rules (http://www.blg.com/en/NewsAndPublications/Documents/Publication_3223.pdf) and the proposed changes (http://www.blg.com/en/newsandpublications/publication_3498).

3 Generally, a corporation resident outside of Canada will be a "foreign affiliate" of a Canadian resident taxpayer if (1) the Canadian resident taxpayer owns at least 1 percent of the foreign corporation's shares (directly or indirectly), and (2) the Canadian resident taxpayer and all persons related to that taxpayer collectively own at least 10 percent of the foreign corporation's shares (directly or indirectly).

4 Debts outstanding on that date are effectively grandfathered until August 19, 2016.

5 A reserve permits a deduction to be claimed for a taxation year if the required conditions are met, with the amount being added back into income the following year.

6 The GAAR in section 245 of the ITA applies where there is an "avoidance transaction", unless it may reasonably be considered that the transaction would not result directly or indirectly in a misuse of the provisions of the ITA, the *Income Tax Regulations* or a tax treaty or an abuse of such legislation having regard to the provisions of the legislation as a whole. If the GAAR applies, the taxpayer's tax benefit from the avoidance transaction will be denied.

7 *MIL (Investments) S.A. v. The Queen*, 2007 FCA 236, affirming 2006 TCC 460; *Prévost Car Inc. v. The Queen*, 2009 FCA 57, affirming 2008 TCC 231; *Velcro Canada v. The Queen*, 2012 TCC 57. Court decisions are generally available to view on the relevant court's website: for Supreme Court of Canada decisions, see http://scc-csc.lexum.com/decisia-scc-csc/scc-csc/scc-csc/en/nav_date.do; for Federal Court of Appeal decisions, see http://decisions.fca-caf.gc.ca/site/fca-caf/decisions/en/nav_date.do; for Tax Court of Canada decisions,

see http://decision.tcc-cci.gc.ca/site/tcc-cci/decisions/en/nav_date.do.

8 The consultation paper can be viewed on the Department of Finance's website at http://www.fin.gc.ca/activty/consult/ts-cf-eng.asp.

9 *See* the Department of Finance's website at http://www.fin.gc.ca/drleg-apl/ltedst-irdatv-0713-eng.asp.

10 *See* the Department of Finance's website at http://www.fin.gc.ca/drleg-apl/nwmm-amvm-1013-eng.asp.

11 For further discussion of the stapled security rules, please see BLG's tax law bulletin at http://www.blg.com/en/NewsAndPublications/Documents/Publication_3139.pdf.

12 For notices of Canadian tax treaty developments and copies of Canadian tax treaties, see the Department of Finance's website at http://www.fin.gc.ca/treaties-conventions/treatystatus_-eng.asp.

13 The withholding tax provisions of the Canada-Hong Kong tax treaty will take effect in Canada on January 1, 2014, and most other Canadian tax provisions will have effect for taxation years beginning on or after January 1, 2014. In respect of Hong Kong taxes, the treaty will generally take effect for taxation years beginning on or after April 1, 2014. However, the capital gains and shipping and air transport provisions of the treaty are effective in both countries from October 29, 2013 (the date the treaty entered into force).

14 2013 FCA 160, affirming 2012 TCC 3.

15 *See* footnote 3, which describes the test for foreign affiliate status. Distributions from a foreign affiliate are subject to an exemption/credit system. Earnings of a foreign affiliate that are included in exempt surplus (*e.g.,* from an active business carried on by the foreign affiliate in a country with which Canada has a tax treaty or tax information exchange agreement) can be repatriated back to the Canadian parent corporation free of Canadian tax. (For more on the types of "surplus" earned by a foreign affiliate of a Canadian corporation and their implications, see http://mining-taxcanada.com/investment-outside-of-canada/).

16 2013 TCC 176 (under appeal to FCA).

17 *See* footnote 6.

18 2013 FC 291 (under appeal to FCA).

19 2013 SCC 29. To read more about this case, please see BLG's tax law bulletin at http://www.blg.com/en/newsandpublications/publication_3377.

20 2013 FCA 164.

21 2012 FCA 272, reversing 2011 TCC 507.

22 2012 FCA 258, affirming 2011 TCC 259.

23 2012 FCA 259, affirming 2011 TCC 383.

24 2012 ABCA 231, affirming 2011 ABQB 268.

25 2012 ABCA 232, affirming 2011 ABQB 329.

26 2013 ONSC 2927.

27 2012 CarswellNat 5540 (TCC). To read more about this case, please see BLG's tax law bulletin at http://www.blg.com/en/NewsAndPublications/Documents/Publication_3249.pdf.

28 2013 FCA 50. For further discussion of this decision, please see BLG's tax law bulletin at http://www.blg.com/en/NewsAndPublications/Documents/Publication_3302.pdf.

29 2013 FC 502. To learn more about the case, see BLG's tax law bulletin at http://www.blg.com/en/newsandpublications/publication_3379.