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In This Issue

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The *Income Tax Technical News* can be found on the Canada Revenue Agency Internet site at **www.cra.gc.ca**.

This issue contains topics of current interest that were discussed at the annual **Canadian Tax Foundation** conference held in Toronto from November 22 to November 24, 2009. Members of the panel were Mr. Phil Jolie, Director of the International and Trusts Division, and Mr. Mark Symes, Director of the Financial Sector and Exempt Entities Division, both of the Income Tax Rulings Directorate at the Canada Revenue Agency, Mr. Andrew W. Dunn of Deloitte & Touche LLP, Toronto and Mr. Ron Durand of Stikeman Elliott LLP, Toronto.

Unless otherwise stated, all statutory references throughout this Income Tax Technical News are to the Income Tax Act (the "Act").

Valuation of Special Voting Shares

Question

At the Canadian Tax Foundation's 2007 annual conference, the Canada Revenue Agency (CRA) said that, to value different classes of shares in a company, it generally determines the en bloc fair market value (FMV) and then allocates the value to each class of shares in isolation. The CRA said that the FMV of each class of shares must be determined on its own merits according to the individual rights and restrictions of each class. The CRA's opinion is that a hypothetical purchaser would be willing to pay some amount for the voting control of a company, and therefore the FMV of voting non-participating shares is more than nominal.

The CRA conceded that the value of the pure voting right may be difficult to ascertain.[1]

At the Canadian Tax Foundation's 2007 British Columbia conference, a practitioner reported that the CRA was attributing 30 to 50 percent of the value of a company to voting non-participating shares.[2] At the 2009 British Columbia conference, the CRA stated that

> "non-participating controlling shares have some value and may therefore bear a premium. However, in the context of an estate freeze of a Canadian-controlled private corporation, where the freezor, as part of the estate freeze, keeps controlling non-participating preference shares in order to protect his economic interest in the corporation, the CRA generally accepts not to take into account any premium that could be attributable to such shares for purposes of subsection 70(5) of the Income Tax Act at the freezor's death."[3]

Dustan v. The Queen[4] involved the allocation of purchase price on a sale to third parties. The CRA's position, as expressed in the pleadings, is that shareholders owning voting, non-participating shares have control over the amount and timing of any economic benefit received by other shareholders and therefore the voting shares have an FMV much greater than a nominal amount.

Can the CRA explain the methodology used to arrive at the FMV of such shares? Does it make a difference if the voting shares control only the timing of payments on the non-voting shares and do not control the value accruing on those shares? Does it follow that, to the extent that the voting shares have value, any separate class of frozen shares will have a value less than its retraction amount? Does the same logic apply in determining the value of being a trustee of a discretionary trust that owns shares?

Response

The question arises in the context of estate freezes of private corporations, where the freezor desires additional security for the value of the freeze shares taken back. Provided that the owners of all the shares of the corporation act in a manner consistent with the assumption that no value attaches to the voting rights, and the rights are eventually extinguished for no consideration, the CRA will generally not attribute value to the rights. If the holder of the rights uses them to run the corporation in conflict with the common shareholders or seeks or is offered consideration for them, it would be difficult for the CRA to ignore this evidence of value.

Key Employee Tax-Free Savings Account

Question

In a recent internal technical interpretation,[5] the CRA indicated that where common shares of a company are issued to a tax-free savings account (TFSA) of a key employee as part of a freeze, the CRA considers the shares' FMV increase to be an "advantage" as defined in subsection 207.01(1) of the *Income Tax Act*[6]—that is, a benefit taxable to the employee.

What is the basis for this position, and how should the value of this advantage be determined? Can the CRA clarify whether it would attempt to put a value on the new common shares at the time of the transfer, or whether the value must be determined annually on the basis of the future FMV growth? Does it matter whether the issuer is a public company or a private company?

Response

Section 207.05 imposes a special tax if an advantage is extended to the holder of a TFSA, the TFSA itself, or any other person not dealing at arm's length with the holder. "Advantage" is defined in subsection 207.01(1) to include any increase in the total FMV of property held in connection with a TFSA that can reasonably be considered to be attributable, directly or indirectly, to

- a transaction or event (or a series of transactions or events) that would not have occurred in an open market between arm's-length parties acting prudently, knowledgeably, and willingly, and one of the main purposes of which is to benefit from the tax-exempt status of the TFSA; or
- a payment received in substitution for either (1) a payment for services rendered by the holder or non-arm's-length person, or (2) a payment of a return on investment or proceeds of disposition in respect of property held outside the TFSA by the holder or non-arm's-length person.

In the case of an advantage described above, the amount of tax payable is equal to 100 percent of the increase in FMV of the TFSA property. A separate tax is payable for each advantage, and the liability to pay the tax generally lies with the holder of the TFSA.

We confirm that it remains the CRA's view that the transactions described in the question would be considered an advantage.

The CRA is also of the view that the words "directly or indirectly" in the definition encompass not only the increase in the FMV of the TFSA resulting from the share issuance, but also all future increases in FMV that are reasonably attributable to the initial advantage. These increases include, for example, any increase in FMV of the TFSA or any other TFSA of the holder that is reasonably attributable to any dividends paid on the shares, any capital appreciation in value on the shares or on any substituted property (whether realized or not), and any income earned on income. Because the advantage tax is required to be remitted annually, it would be necessary to determine the total increases in FMV annually.

The fact that the company might be a public company would not be a relevant factor in determining whether shares issued to a key employee's TFSA as part of a freeze are subject to the TFSA advantage rules.

We would also like to take this opportunity to discuss several tax-planning schemes involving TFSAs that have come to our attention. These schemes purportedly enable taxpayers to effectively avoid the statutory limit on TFSA contributions and, in some cases, to avoid paying tax on withdrawals from registered retirement savings plans (RRSPs) and other registered plans or on otherwise taxable income.

The Department of Finance announced on October 16, 2009[7] several measures to address these schemes. Briefly, the proposed measures include a ban on trading activities between a TFSA and the taxpayer's registered or non-registered accounts. It is also proposed that any income earned on deliberate TFSA overcontributions or prohibited investments will be treated as an advantage and thus as subject to a 100 percent tax.

While these proposed amendments apply on a prospective basis only, the CRA intends to closely review any unusual TFSA transactions that took place before the announcement (as well as those that occur after the announcement) and, in appropriate circumstances, to apply existing anti-avoidance rules to challenge the purported tax benefits being claimed.

The TFSA advantage rules give the CRA significant scope to challenge schemes that are designed to avoid the TFSA statutory contribution limit or to shift taxable income away from a taxpayer and into the shelter of a TFSA. Schemes that rely on unfairly valued transactions, artificial transactions, or transactions that would not reasonably be expected to occur between arm's-length parties dealing in an open market are clearly caught by the advantage rules and will be challenged by the CRA where appropriate.

The CRA may also challenge the valuation of the transaction or assert that the transaction is not legally effective. In such circumstances, the transaction may be treated as a contribution to the TFSA and thus taken into account in determining the 1 percent per month tax on TFSA overcontributions. Where the transaction involved an RRSP or other registered plan, it may be treated as a taxable withdrawal from the registered plan. The CRA may also, in appropriate circumstances, hold the financial institution that administers the registered plan liable for any unremitted withholding tax and associated penalties.

In addition to tax consequences that may be present under the TFSA-specific rules, the CRA may, in appropriate circumstances, apply the general anti-avoidance rule (GAAR) to deny the tax benefit that was obtained by virtue of the transaction or assess third-party penalties or gross negligence penalties.

We wish to remind taxpayers and their advisers that the CRA has a number of compliance tools at its disposal to challenge TFSA schemes, up to and including criminal prosecution for the most egregious cases. We encourage any taxpayers who were involved in these schemes to avail themselves of the CRA's voluntary disclosure program.

Corporate-Held Life Insurance

Question

Private corporations sometimes acquire life insurance policies to provide funds in the event of a significant shareholder's death. A situation similar to the following is often encountered. An individual shareholder (A) holds 100 percent of the voting shares of a given corporation (Parentco). Parentco holds 100 percent of the voting shares of another corporation (Subco). Subco is the holder of a life insurance policy on the life of A and pays the premiums relating thereto. The beneficiary of the life insurance policy is Parentco.

Can the CRA confirm that subsection 15(1) would not apply to the situation described above, as indicated in CRA documents nos. 2004-0065461C6 and 9824645?[8]

Response

The question of whether a corporation has conferred a benefit on a shareholder for the purposes of subsection 15(1) is generally one of fact.

Generally speaking, the CRA considers that subsection 15(1) applies where a transaction or a series of transactions gives rise to an impoverishment of the corporation and an enrichment of the shareholder. In *Del Grande v. The Queen*,[9] the court stated the following:

> "Paragraph 15(1)(*c*) contemplates the conferral of a genuine economic benefit upon the shareholder. The word "confer" implies the bestowal of bounty or largesse, to the economic benefit of the conferee and a corresponding economic detriment of the corporation."

We are of the view that Subco would have conferred a benefit on its shareholder, Parentco, in paying the premiums relating to the life insurance policy of which Parentco is the beneficiary. As a result, subsection 15(1) would apply, such that Parentco, in computing its income for the year, would have to include the amount of the benefit conferred on it by Subco. This amount would generally be included as income from property.

This interpretation represents a change of position from what was stated in document nos. 2004-0065461C6 and 9824645 and will apply as of the 2010 calendar year. In cases of life insurance policies already issued, the amount of the benefit conferred will be included in the shareholder's income as of the 2011 calendar year.

Also, as stated in document no. 9824645, subsection 245(2) could, depending on the circumstances, apply to adjust the calculation of the amount to be included by Parentco in its capital dividend account upon receipt of the proceeds of the life insurance policy.

Paid-Up Capital Increase by an Unlimited Liability Company

Question

The policy underlying Article IV(7)(*b*) of the Canada-US income tax convention[10] is not obvious. The US Joint Committee on Taxation's explanation to the US Senate's Foreign Relations Committee states that

> "[t]he rules of paragraph 7(*b*) are aimed largely at curtailing the use of certain legal entity structures that include hybrid fiscally transparent entities, which, when combined with the selective use of debt and equity, may facilitate the allowance of either (1) duplicated interest deductions in the United States and Canada, or (2) a single, internally generated interest deduction. . . . As a general matter, it is a legitimate objective for Canada and the United States, separately or jointly, to attack these or other types of structures that give rise to double deductions (or to single deductions with no income offsets). Commentators have noted, however, that many U.S. companies utilize Canadian ULCs to structure their Canadian investments and businesses, without engaging in such potentially abusive transactions, for a variety of legitimate reasons."[11]

Consider a situation where a fully taxable US C corporation ("USco") wholly owns a Canadian unlimited liability company (ULC) that carries on business in Canada. ULC is a hybrid entity in that it is treated as a corporation for Canadian tax purposes but is viewed as "fiscally transparent" or "disregarded" under US tax law. As of January 1, 2010, under Article IV(7)(*b*) of the treaty, payments by ULC to USco in this circumstance will be ineligible for treaty relief to the extent that the payment is treated differently in the hands of the recipient depending on whether or not the payer is a hybrid entity.

Therefore, a dividend paid by ULC to USco seems to fall squarely within the wording of Article IV(7)(*b*) and would be ineligible for treaty relief because the dividend is treated differently in the hands of the recipient depending on whether or not ULC is fiscally transparent.

Consider a situation where ULC increased its paid-up capital (PUC) by capitalizing its retained earnings and then made a cross-border payment in reduction of that capital. The increase in PUC would create a deemed dividend for Canadian tax purposes, but would have no relevance for US tax purposes, whether or not ULC is fiscally transparent. As a result, because the treatment of the deemed dividend under the taxation laws of the United States would be no different than it would have been if ULC were not disregarded by the United States, the deemed dividend triggered on the increase in PUC should be eligible for treaty relief. A subsequent distribution on the reduction of the newly created capital would not be subject to Canadian domestic withholding tax, so the treaty would not need to be applied.

What is the CRA's view of such arrangements?

Response

Provided that the deemed dividend resulting from the increase in the PUC of the shares of ULC is disregarded under the taxation laws of the United States, and would be similarly disregarded if ULC were not fiscally transparent, Article IV(7)(*b*) would not apply.

The application of GAAR would depend on all the facts and circumstances. However, we would not normally expect GAAR to apply if ULC is used by USco to carry on an active branch operation in Canada and USco and ULC enter into the above-noted arrangement so as to continue to qualify for the 5 percent withholding tax on the distribution of ULC's after-tax earnings to USco.

Luxembourg Intermediary

Question

Assume that in the question entitled "Paid-up Capital Increase by an Unlimited Liability Company" on page 4, a Luxembourg société à responsabilité limitée (Luxco) is inserted between USco and ULC. Luxco is considered to be a resident of Luxembourg for Canadian tax purposes and is therefore eligible for treaty relief under the Canada-Luxembourg treaty,[12] but is disregarded for US tax purposes.

Would the 5 percent withholding tax rate under the Canada-Luxembourg treaty generally apply to dividends paid by ULC to Luxco?

Response

The 5 percent withholding rate will normally apply if Luxco is the beneficial owner of the dividends. Our recent views on the meaning of "beneficial owner" in the light of *Canada v. Prévost Car Inc.*[13] are set out in document no. 2009-0321451C6.[14]

Our comments concerning the application of GAAR to a deemed dividend would generally be applicable here.

Payments by ULC

Question

Assume that, in the situation described in the question entitled "Paid-Up Capital Increase by an Unlimited Liability Company" on page 4, ULC owes interest to USco. Payment of such interest would be denied treaty benefits under Article IV(7)(*b*), since the payment would be disregarded for US tax purposes, but it would not be disregarded if ULC were not fiscally transparent for US tax purposes.

What if the debt were rearranged so that instead of being payable to USco (ULC's US parent corporation), it was payable to ULC's US grandparent? For US tax purposes, the grandparent would be regarded as having received interest from the Canadian branch of its US subsidiary. For Canadian purposes, the interest would be treated as having been paid to the US grandparent directly from the Canadian ULC. In this case, the treatment would not be identical because of the US consolidated rules, but is likely essentially equivalent. Would the CRA generally regard the payment of interest by ULC to its US grandparent as satisfying the "same treatment" requirement in Article IV(7)(*b*)?

Response

Assuming that the interest is subject to the same treatment in the United States in the hands of the US grandparent as it would be if ULC were not fiscally transparent, we would agree that Article IV(7)(*b*) does not apply.

It is not possible to make any categorical statements regarding the application of GAAR to the restructuring of cross-border interest payments.

GAAR may apply if the ULC is part of a financing arrangement that results in, among other things, duplicated interest deductions or an internally generated interest deduction in one country without offsetting interest income in the other country.

Payments by a ULC to an LLC in 2009

Question

Before the fifth protocol was signed in the fall of 2007, it was widely expected that it would apply to provide treaty benefits to US-owned limited liability companies (LLCs). With this expectation in mind, some US parties structured their investments in Canada through an LLC owning a ULC. As expected, Article IV(6) was included in the protocol to provide treaty benefits to the owners of fiscally transparent entities, including LLCs.

However, in a recent technical interpretation,[15] the CRA was asked whether treaty benefits would be available before 2010 (when Article IV(7)(*b*) comes into effect) on payments by a ULC (Canco) to an S corporation. The CRA stated the following:

> "In the case of the payment of a dividend to an S-corporation, which is considered a fiscally transparent entity for United States income tax purposes, Article IV(6) may apply to treat an amount of the dividend income allocated to a shareholder of the S-corporation to be dividend income derived by the shareholder. However, in light of Canco's fiscal transparency and the resulting United States income tax treatment of the

> payment of dividends by Canco to USco, it is our view that Article IV(6) will not apply to treat a dividend paid by Canco to USco to be derived by the shareholder of USco because, for United States income tax purposes, the shareholder will not be considered to have derived a dividend (i.e., an amount of income) through USco."[16]

The concern is that on the same logic, Article IV(6) would not apply to a dividend from a ULC to an LLC paid after Article IV(6) came into effect and before 2010 (or after 2010 in circumstances where Article IV(7)(*b*) would not apply). There is also a concern in respect of other circumstances where income of a fiscally transparent entity such as an LLC exists for Canadian tax purposes (for example, a deemed dividend under section 84 or 212.1 of the Act) but does not exist for US tax purposes.

In the CRA's opinion, would treaty benefits be available with respect to payments such as dividends or interest made by ULC to LLC after January 31, 2009 and before January 1, 2010? Does Article IV(6) not apply where an amount of income profit or gain does not exist for US tax purposes?

Response

Article IV(6) of the treaty is effective, in respect of taxes withheld at source, for amounts paid or credited on or after February 1, 2009. Conversely, Article IV(7) has effect from January 1, 2010. Accordingly, an amount paid or credited to a US LLC by a Canadian ULC before January 1, 2010 and after January 31, 2009 would be eligible for treaty-reduced rates to the extent that the amount is considered, by Article IV(6), to be derived by a resident of the United States who is a "qualifying person" as that term is defined in Article XXIX A(2) of the treaty.

Treaty Forms

Question

In June 2009, the CRA released for public comment the following proposed prescribed declaration forms for applying treaty benefits to income paid to non-residents:

- Form NR301, "*Declaration of Benefits Under a Tax Treaty for a Non-Resident Taxpayer.*"
- Form NR302, "*Declaration of Benefits Under a Tax Treaty for a Partnership with Non-Resident Partners.*"
- Form NR303, "*Declaration of Benefits Under a Tax Treaty for a Hybrid Entity.*"

The consultation period closed on September 30, 2009. What is the status of the CRA's review of the forms, including how the forms and filing requirements may be amended, when new forms will be issued, and when the forms will be in effect?

Response

We are currently reviewing suggestions that we have received from both internal and external stakeholders on revisions to various forms, including these. When this review is completed, the CRA will consult with various stakeholders on any proposed changes. In the meantime, the comments in *Information Circular* 76-12R6[17] are relevant as to the due diligence expected in establishing rights to treaty benefits.

US LLC with a Canadian Branch

Question

Consider a situation where US LLC carries on business in Canada through a Canadian branch or permanent establishment (PE). US LLC is treated as a corporation for Canadian tax purposes but as fiscally transparent for US tax purposes. US LLC is owned by four equal shareholders—a Bermudian-resident corporation, a US-resident C corporation, a US-tax exempt, and a US-resident individual.

Article IV(6) of the treaty appears to look through US LLC to the identity of the underlying shareholders, who are deemed to have derived the income of US LLC if they are US residents. How does the CRA determine the tax consequences of income earned by US LLC? Are the US C corporation, the US tax-exempt, and the US-resident individual taxed on the income as though they earned it directly?

Response

Under the Act, US LLC computes its taxable income earned in Canada and is subject to tax at the applicable corporate rates, and it also computes its branch tax at 25 percent under Part XIV.

A reduction of US LLC's tax under Part I and Part XIV is available under Article XXI of the treaty based on the percentage of the LLC's branch profits that are considered, by Article IV(6), to be derived by the exempt organization.

A reduction in the branch tax is also available under Article X(6) of the treaty based on the percentage of the LLC's branch profits that are considered, by Article IV(6), to be derived by the US C corporation.

Article X(6) of the treaty does not provide for any reduction in the branch tax in respect of individual shareholders.

Written guidance on how US LLC reports the reduction in tax in respect of its US-resident shareholder will be provided in the near future. In the meantime, US LLC should provide a sufficient explanation with its T2 return to allow the CRA to understand the basis and calculation of any claimed tax reductions.

Exchangeable Debentures: Paragraph 20(1)(*f*)

Question 1

At the Canadian Tax Foundation's 2008 annual conference,[18] the CRA was asked to provide its views in respect of the application of paragraph 20(1)(*f*) to exchangeable debentures in light of the Federal Court of Appeal decision in *Tembec Inc. et al. v. The Queen*.[19] The CRA was not prepared to comment at that time because the taxpayer in that case had applied for leave to appeal the decision to the Supreme Court of Canada. On January 22, 2009, the Supreme Court refused leave to appeal.

Can the CRA now provide its views in respect of the application of paragraph 20(1)(*f*) to exchangeable debentures issued with or without an original discount, considering the decision of the Federal Court of Appeal in the *Tembec* case?

Response 1

Before the decision in *Imperial Oil Ltd. and Inco Ltd. v. Canada*,[20] the CRA's position with respect to exchangeable debentures issued with or without an original discount was that a deduction was generally available under paragraph 20(1)(*f*) with respect to the original discount as well as the appreciation of the principal amount of the debenture over its face value, provided that such appreciation was inherent to the terms and conditions of the debenture.

At the Canadian Tax Foundation's 2006 annual conference,[21] we stated that the CRA would consult with its legal services advisers to determine whether its longstanding position in respect of the application of paragraph 20(1)(*f*) to exchangeable debentures was supportable at law in light of the comments in the Supreme Court's decision in *Imperial Oil*. We also stated that this position would continue to be maintained for exchangeable debentures in place at that time, and mentioned that if these consultations resulted in a change in the CRA's position, it would be announced to the public when the decision was made.

At the Canadian Tax Foundation's 2008 annual conference,[22] we stated that the CRA was awaiting the final conclusion of the *Tembec* case in order to complete the analysis announced in 2006, and that if a change of position was necessary, it would be announced and administered on a prospective basis.

In light of the decision of the Federal Court of Appeal in the *Tembec* case, we are now of the view that our abovementioned position is not supportable at law. Hence, this case limits the deduction of financing costs provided for by paragraph 20(1)(*f*) to the original discount, granted when an obligation is issued. The appreciation of the principal amount of the debenture over its face value is not deductible under paragraph 20(1)(*f*). This represents a change of position and will therefore be administered on a prospective basis to debentures issued on or after January 1, 2010. In this respect, a debenture issued prior to January 1, 2010, but modified on or after that date will be considered issued on or after January 1, 2010.

Question 2

If, considering the decision of the Federal Court of Appeal in the *Tembec* case, the CRA is of the view that paragraph 20(1)(*f*) does not apply to the appreciation of the principal amount of the debenture over its face value, can the CRA provide its views in respect of the tax consequences applicable to the issuer of exchangeable debentures upon exchange?

Response 2

There are many varieties of exchangeable securities in the market. Moreover, the fundamental characteristics of exchangeable debentures can differ significantly from one situation to another. Accordingly, it is not possible for the CRA to provide general comments or general positions concerning the tax consequences applicable to the issuer of exchangeable debentures, upon exchange, that will apply to all possible situations.

However, we are prepared to provide the following comments concerning exchangeable debentures that have, among other features, the following terms and conditions:

1) The debentures are issued for a fixed amount of money in Canadian dollars (for instance, $1,000) that represents the face value of the debentures. The debentures are issued with no original discount.

2) The debentures bear interest at a commercial fixed rate per year calculated on their face value. The interest on the debentures is paid by the issuer at least annually.

3) The debentures are exchangeable at any time at the holders' option for shares of another corporation (the target shares) prior to maturity. Some debentures have an initial non-exchange period.

4) The terms of the debentures specifically provide a fixed exchange ratio (specifying the number of the target shares that can be obtained for each debenture). In some cases, the security contract may provide for certain changes in the exchange ratio over time.

Where there is an exchange of such an exchangeable debenture by the debenture holder for the target shares, the issuer repays its debt by delivering the target shares. Consequently, the debenture issuer may repay more than the face value of the debenture if the FMV of the target shares exceeds the face value of the debenture. However, as the Supreme Court stated in *Imperial Oil* and other cases, a borrowing obtained to raise financial capital is generally on capital account and any costs related to such a borrowing are therefore payments on account of capital within the meaning of paragraph 18(1)(*b*) and, as such, are not deductible from income unless the deduction thereof is expressly permitted. It follows that the appreciation of the principal amount of a debenture over its face value is a payment on account of capital, the deduction of which is prohibited by paragraph 18(1)(*b*). Paragraph 20(1)(*e*) does not apply to such appreciation, because this would be an amount paid on account of the principal amount of the debenture, and therefore an excluded amount for the purposes of paragraph 20(1)(*e*). Because the issuer is simply repaying a debt, the issuer does not sustain a capital loss for the purposes of paragraph 39(1)(*b*) on repayment. We are not aware of any other provision of the Act that allows a deduction to the issuer in these circumstances.

Upon exchange, the issuer also disposes of the target shares for proceeds equal to their FMV, which is the amount of the issuer's obligation pursuant to the exchangeable debenture that is satisfied by their delivery.

Question 3

Can the CRA provide its views in respect of the tax consequences applicable to the holder of an exchangeable debenture, upon exchange?

Response 3

We are still of the view that when a holder of an exchangeable debenture exercises the right to exchange the debenture for the target shares, the holder would dispose of the debenture for proceeds equal to the FMV of the consideration received—that is, the FMV of the target shares. The adjusted cost base (ACB) of the target shares to the holder would equal the FMV of the debenture given up to acquire them which (ignoring interest rate fluctuations) would ordinarily equal the FMV of the target shares.

Unanimous Shareholder Agreements and the CCPC Definition

Question 1

In a technical interpretation,[23] the CRA states that a unanimous shareholder agreement is not relevant in applying the test summarized in paragraph (*b*) of the definition "Canadian-controlled private corporation" (CCPC) in subsection 125(7).

The wording in paragraph (*b*) of the definition is as follows:

> "Canadian-controlled private corporation" means a private corporation that is a Canadian corporation other than . . .
>
> (*b*) a corporation that would, if each share of the capital stock of a corporation that is owned by a non-resident person, by a public corporation (other than a prescribed venture capital corporation), or by a corporation described in paragraph (*c*) were owned by a particular person, be controlled by the particular person."

Does the CRA agree that paragraph (*b*) of the CCPC definition refers to *de jure* control (since it does not say "controlled, directly or indirectly in any manner whatever")?

Response 1

Yes.

Question 2

Why should a unanimous shareholder agreement not be considered in applying paragraph (*b*) of the CCPC definition when the Supreme Court indicated in *Duha Printers (Western) Ltd. v. The Queen*[24] that unanimous shareholder agreements are constating documents of a corporation and should thus be taken into account in determining *de jure* control?

Response 2

Paragraph (*b*) of the CCPC definition in subsection 125(7) mainly deals with situations where the shares of a corporation are held by more than one public corporation or non-resident, but no person or group of persons controls. The Department of Finance technical notes which accompanied the paragraph's introduction read as follows:

> "A corporation the voting shares of which are distributed among a large number of persons is usually not considered to be controlled by any group of its shareholders, provided the shareholders do not act together to exercise control. . . . Paragraph (*b*) requires non-residents' and public corporations' shareholdings—not only of the corporation in question, but of all corporations—to be notionally attributed to one hypothetical person. If that person would control the corporation, then the corporation is not a CCPC."[25]

In *Duha*, the Supreme Court said that

> "[t]he general test for *de jure* control is that enunciated in *Buckerfield's*, *supra*: whether the majority shareholder enjoys "effective control" over the "affairs and fortunes" of the corporation, as manifested in "ownership of such a number of shares as carries with it the right to a majority of the votes in the election of the board of directors."[26]

If the consolidation of all public corporation or non-resident shareholdings in the hands of a particular person, in accordance with paragraph (*b*) of the CCPC definition, would result in the particular person having the right to "a majority of the votes in the election of the board of directors," the particular person would control the corporation in a situation where no one else controls it.

In *Duha*, the Supreme Court said:

> "[T]o recognize the USA as affecting *de jure* control begs the question of how much power must be removed from the directors before one may safely conclude that the majority voting shareholder no longer has *de jure* control."[27]

The court also said:

> "In my view, it is possible to determine whether *de jure* control has been lost as a result of a USA by asking whether the USA leaves any way for the majority shareholder to exercise effective control over the affairs and fortunes of the corporations in a way analogous or equivalent to the power to elect the majority of the board of directors."[28]

Where Canadian residents do not own enough shares to elect the majority of the board of directors, the objective and effect of the presumption in paragraph (*b*) of the CCPC definition is to treat the hypothetical person as having the ability to exercise effective control over the affairs and fortunes of the corporation in a way analogous to the power to elect the majority of directors. That is so because the hypothetical person is not party to a unanimous shareholder agreement nor is that person deemed to be a party to it. In our view, it would be contrary to both the text and the purpose of the provision to consider that the fiction of control created by the application of paragraph (*b*) of the CCPC definition could be diluted by an agreement that restricts the powers of the directors of a corporation to allocate them to shareholders that would never include the hypothetical shareholder.

Cost of Property Acquired from a Shareholder for No Consideration

Question

The CRA previously stated that where property is transferred to a corporation by a shareholder for no consideration, the corporation will not have any cost base in the property. In a 2007 ruling,[29] the CRA ruled that the corporation obtained tax basis in cash transferred by a shareholder to the corporation for no consideration. Can you provide assurance that the position expressed in the ruling would apply regardless of the type of property transferred?

Response

In the absence of a specific provision in the Act to the contrary, it is the position of the CRA that a corporation that receives property from its shareholder for no consideration has a cost basis for that property equal to its FMV. Should the CRA not agree with the taxpayers' valuation, the conditions set out in *Interpretation Bulletin* IT-169[30] apply with such modifications as the circumstances require.

Filings Based on Proposed Changes to Law

Question

Taxpayers often face a combination of proposed law, draft legislation, and comfort letters that could affect their tax filings. Can the CRA confirm that taxpayers should file on the basis of these pending changes?

Response

It is the CRA's longstanding practice to ask taxpayers to file on the basis of proposed legislation. This practice eases both the compliance burden on taxpayers and the administrative burden on the CRA. However, where proposed legislation results in an increase in benefits (for example, Canada child tax benefit) to the taxpayer, or if a significant rebate or refund is at stake, the CRA's past practice has generally been to wait until the measure has been enacted.

A comfort letter is not considered proposed legislation and usually only reflects the Department of Finance's views on a particular issue affecting a specific taxpayer. Given that our tax system is on the basis of self-assessment, taxpayers may decide to file on the basis of a comfort letter. Generally, the CRA will not reassess taxpayers who filed on the basis of a comfort letter, provided that they did so in conformity with the comfort letter.

Generally speaking, the CRA will not reassess if the initial assessment was correct in law.[31] As a result, a taxpayer's request to amend their tax records to reflect proposed legislation will be denied. It is recommended that taxpayers file a waiver in respect of the normal reassessment period to protect their interests.

In the event that the government announces that it will not proceed with a particular amendment, any taxpayers who have filed on the basis of the proposed amendment are expected to take immediate steps to put their affairs in order and, if applicable, pay any taxes owing. Where taxpayers acted reasonably in the circumstances, took immediate steps to put their affairs in order, and paid any taxes owing, the CRA will waive penalties and/or interest as appropriate.

Assessments

Question

An assessment can create significant negative disclosure issues for a publicly traded taxpayer, notwithstanding any ultimate resolution of the issue in the taxpayer's favour. What recourse does a taxpayer have when it feels that it is being treated unfairly by, or is not receiving a proper hearing from, a Taxation Services Office (TSO)? In particular, in what circumstances does the taxpayer have a right to elevate its concerns to head office?

Response

Taxpayers should first discuss their concerns with the official raising the assessment. If taxpayers continue to have concerns, they are encouraged to raise the issue with that official's supervisor, and to move progressively to higher levels of management within the TSO as appropriate. If, after communicating with the higher levels of management in the TSO, taxpayers continue to have concerns, they can call officials in Headquarters. It is preferable that taxpayers try to resolve this issue with officials in the TSO first, since accountability for the assessing position with regard to the file rests with the TSO.

Proposed assessments frequently involve input from CRA experts, as appropriate. If the taxpayer requests it of the auditor, valuators will meet with the taxpayer or the taxpayers' representatives and provide their interpretation of the facts, consider all additional information provided, and adjust their report as required. Where advice has been received from the Department of Justice, the CRA may develop an assessment that takes that advice into consideration, and therefore the CRA auditor is the most appropriate person with whom to discuss any concerns about the assessment. In exceptional circumstances, the auditor may ask a representative from the Department of Justice to assist in addressing these concerns.

Services Provided by a US Resident to a Canadian Subsidiary of a US Customer

Question

New Article V(9) of the treaty provides that a PE can be deemed to arise in circumstances where services are provided by an enterprise with respect to the same or a connected project for customers who are either residents of the other state or who maintain a PE in the other state.

In addition, the technical explanation of the fifth protocol[32] states that the new services PE provision applies only to the provision of services, and only to services provided by an enterprise to third parties. The CRA has indicated that the term "third party" should be interpreted to mean any person other than the person operating the enterprise in question, and that a related person is considered a third party for the purposes of the provision.

Consider a situation where a US-resident service provider is engaged by a US multinational to provide services, and some modest portion of that contract is provided in Canada to a Canadian-resident subsidiary of the US multinational customer that is the primary client. The service provider conducts no other business in Canada.

Could Article V(9) of the treaty apply to give rise to a deemed PE of the US-resident service provider?

Response

Depending on the circumstances, it appears that Article V(9)(*b*) could apply to give rise to a PE for the service provider in Canada. If it does, only the profits of the service provider that are attributable to the functions performed and the risks assumed by the provision of the services in Canada would be attributed to the deemed PE.

Services Provided by a US Employee to a Canadian Subsidiary

Question

Consider a situation where a US-resident consulting company seconds one of its employees to its Canadian subsidiary for eight months to act as interim chief financial officer. The employee remains on the US payroll, but those costs are reimbursed by the Canadian company and the employee is under the supervision of the Canadian subsidiary's executive team. Could Article V(9) apply to give rise to a deemed PE?

Response

Where an enterprise of the United States is merely reimbursed for the amount of its compensation costs in respect of an employee that has been seconded to a resident of Canada and the employee is under the supervision of that resident of Canada, the enterprise of the United States would not be seen as providing services in Canada. In the case described above, the employee would be seen as performing his or her duties of employment in his or her capacity as an employee of the Canadian subsidiary only, and Article V(9) would not apply. However, the employee's remuneration would be taxable in Canada pursuant to Article XV, provided that it exceeds $10,000.

Services Provided by a US Employee to a Customer of a Canadian Subsidiary

Question

Consider a situation where the US-resident consulting company seconds one of its employees to its Canadian subsidiary for eight months to provide services in Canada to a Canadian client. The employee remains on the US payroll, but the US company charges the Canadian subsidiary 85 percent of the employee's regular per diem rate for the use of the employee's services. The employee is under the supervision of the Canadian subsidiary's executive team. Could Article V(9) apply to give rise to a deemed PE?

Response

It appears that Article V(9) could apply to give rise to a PE in Canada. However, only the profits of the parent that are attributable to the functions performed and the risks assumed by the provision of services in Canada by the parent would be attributed to the deemed PE. The employee's remuneration would be taxable in Canada pursuant to Article XV, provided that it exceeds $10,000.

IFRS and Foreign GAAP

Question

Many businesses will be adopting international financial reporting standards (IFRS) over the course of the next few years. Others use foreign generally accepted accounting principles (GAAP) because they are part of international corporate groups. What impact will this have on the computation of taxable income, and what is the CRA doing to accommodate and prepare for this change?

Response

The CRA would be prepared to accept financial statements based on current Canadian GAAP or on IFRS as the basis of profit for the purposes of section 9. Statements based on GAAP of another country with similar rules could also suffice, particularly if they were prepared for reasons other than tax returns.

In *Canderel Limited v. The Queen*,[33] the Supreme Court said that the computation of profit is a matter of law, and GAAP is an interpretive aid that is external to the legal determination of profit. Furthermore, many provisions in the Act (particularly sections 10, 12, 18, and 20) allow or require adjustments to reported profit in arriving at income for tax purposes. The impact of these adjustments eliminates for tax purposes virtually all the differences between various methods of income computation for accounting purposes. If an obscure foreign accounting rule resulted in a large tax change, the CRA might question its appropriateness.

Also, a few provisions of the Act make particular reference to accounting rules—for instance, the mark-to-market rules of section 142.2 are based on GAAP. Although a choice of GAAP could result in some timing differences, we would not expect them to be material.

Loss Consolidation

Question

Canada does not have a consolidated corporate filing system. Canada has attempted to accommodate taxpayers with diverse corporate groups by providing a great deal of latitude in intercorporate planning designed to use losses triggered through normal commercial operations within a corporate group without restricting the access to those losses in any general way.

Now that the CRA is administering some additional provincial tax regimes (for example, Ontario's), there has been more discussion about the consideration of provincial allocation changes in the course of any kind of loss-consolidation transactions. Are there any recent changes to the CRA's approach to reviewing loss-consolidation transactions? Does it matter if the provincial allocation changes in the course of the loss consolidation?

Response

The CRA's position with respect to loss-consolidation transactions within a corporate group remains essentially as stated at previous Canadian Tax Foundation conferences.

The CRA will continue to monitor the interprovincial effects of loss-consolidation transactions. If a typical loss-consolidation transaction results in an incidental shifting of income or losses between provinces, simply because the profitco and the lossco happen to have different provincial allocations, there should not be a concern from the perspective of agreeing provinces. If, on the other hand, the transactions are designed to deliberately shift income or loss between provinces, provincial concerns will have to be considered.

Foreign Currency Reporting

Question

Consider a situation where a US company owns one or more Canadian holding companies, which have no active operations themselves but which, in turn, own one or more Canadian operating subsidiaries. The Canadian holding companies maintain their accounting records in US dollars, which is in accordance with GAAP. The Canadian operating subsidiaries are not US-dollar reporting entities.

1) Is the fact that the Canadian holding company's books and records are kept in US dollars sufficient to elect pursuant to subsection 261(3)?

2) If the answer is no, what other factors would be considered? For example, does the fact that the Canadian holding company holds other assets (such as shares and loans) that are US-dollar-denominated assets in addition to the shares of the Canadian operating company change the answer?

3) In the course of reviewing the eligibility to elect under section 261, what procedures will the CRA perform? Will those procedures be different de pending on whether the company (or the ultimate parent of the company) is listed on a stock exchange or is privately owned?

Response

A Canadian-resident corporation (other than an investment corporation, a mortgage investment corporation, or a mutual fund corporation) that is required under applicable financial reporting principles to maintain all of its records and books of account in US dollars should generally be eligible to elect to report its Canadian tax results in US dollars.

The CRA may, in the course of an audit, review the eligibility requirements of a taxpayer to report its Canadian tax results in a qualifying currency. At this time, no specific procedures have been adopted to test a particular taxpayer's eligibility to report in a qualifying currency; however, any procedures that are adopted would be expected to apply equally to all corporations.

Convertible Debentures: Paragraph 20(1)(*f*)

Question 1

Over the past few years, the tax literature has indicated some confusion between the tax treatment applicable on a conversion of a convertible debenture and the tax treatment applicable on an exchange of an exchangeable debenture.

Now that the CRA has completed its analysis with respect to the impact of the *Tembec* case[34] on the application of paragraph 20(1)(*f*) to exchangeable debentures, can the CRA comment on the tax consequences applicable to the debenture issuer upon the conversion of a convertible debenture?

Response 1

There are many varieties of convertible securities in the market. Moreover, the fundamental characteristics of convertible debentures can differ significantly from one situation to another. Accordingly, it is not possible for the CRA to provide general comments or general positions concerning the tax consequences applicable upon the conversion of convertible debentures that will apply to all possible situations.

However, we are prepared to provide the following comments concerning convertible debentures that have, among other features, the following terms and conditions:

1) The debentures are issued for a fixed amount of money in Canadian dollars (for instance, $1,000) that represents the face value of the debentures. The debentures are issued with no original discount.

2) The debentures bear interest at a commercial fixed rate per year calculated on their face value. The interest on the debentures is paid by the issuer at least annually.

3) The debentures are convertible at any time at the holders' option into the common shares of the issuer prior to maturity. They may also have an initial non-conversion period.

4) The terms of the debentures specifically provide a fixed conversion ratio (specifying the number of common shares that can be obtained for each debenture). In some cases, the security contract may provide for certain changes in the conversion ratio over time.

We are generally of the view that in the case of a convertible debenture having the features described above, the principal amount of the debenture is equal to its face value. As a result, where there is a conversion of a convertible debenture by its original holder for common shares of the issuer, it is our view that in general there would be no outlay or expense for the purposes of paragraph 18(1)(*a*).

We generally consider that when shares are issued in repayment of a debt, the amount paid in satisfaction of the principal amount of the obligation depends on the agreement of the parties, which is generally reflected by the stated capital of the shares issued (pursuant to the applicable corporate law). This position is supported by a number of court cases, including *Teleglobe Inc. v. The Queen*.[35]

Since the amount payable and actually paid by the issuer upon conversion is equal to the issue price of the debenture, the issuer does not incur any expense upon conversion. This is consistent with our longstanding position and was confirmed by the comments of the Federal Court of Appeal in *Tembec*, to the effect that "the issuance of shares by the appellants from their share capital at a lower price than their actual value dilutes the shareholders' equity without anyone incurring any expenses."[36] Furthermore, the *Tembec* case stated that paragraph 20(1)(*f*) was not applicable because no original discount was granted when the convertible debentures examined were issued.

Question 2

Can the CRA comment on the tax consequences applicable to the debenture holder upon the conversion of a convertible debenture?

Response 2

As a general rule, and subject to section 51, the proceeds of a creditor who accepts shares in satisfaction of an outstanding debt is the FMV of the shares.[37] Section 51 provides a deferral of the gain that would otherwise be realized by a holder of a convertible debenture upon the exercise of the conversion rights contained in the convertible debenture, provided that the debenture was a capital property of the holder. As a result of the application of section 51, upon the exercise of the conversion rights there would be deemed to be no disposition of the debenture, and the cost of the shares so acquired by the debenture holder would be deemed to be his or her ACB of the debenture immediately before the conversion.

Convertible Debentures and Part XIII

Question 1

Despite its being the subject of questions and responses at the Canadian Tax Foundation's 2008 annual conference[38] and the May 2009 International Fiscal Association (IFA) conference,[39] the Canadian withholding tax treatment of convertible debt remains subject to considerable uncertainty. Even in the context of "traditional convertible debentures" having the terms and conditions identified in the CRA's response at the 2009 IFA conference,[40] the CRA declined to comment on status as an "excluded obligation" for the purposes of subsection 214(8) or on the application of the definition of "participating debt interest" in subsection 212(3).

While the CRA's response at the IFA conference—that conversion of a traditional convertible debenture would, in the CRA's view, not give rise to any "excess" under subsection 214(7)—is helpful, there is uncertainty about matters that the CRA declined to comment on. The practical consequence of this uncertainty is that if a traditional convertible debenture is to be issued to a non-resident on the basis that the debenture is not subject to Canadian withholding tax, in the absence of an advance income tax ruling, the traditional convertible debenture must still comply with subparagraph 212(1)(*b*)(vii) more than one and a half years after the general repeal of those requirements.

To illustrate the source of the continuing uncertainty, traditional convertible debentures, like any debentures, are typically assignable. In some cases, traditional convertible debentures may be traded in public markets. Where a non-resident subscribes for a traditional convertible debenture, the price for which the debenture is subsequently assigned or sold may exceed the price at issue. The excess may reflect appreciation in the value of the underlying shares, interest rate changes, improved credit, etc. If the assignee is a resident of Canada and the traditional convertible debenture is not an excluded obligation, the excess would generally be deemed to be interest pursuant to subsection 214(7). If the deemed interest is "participating debt interest" as defined in subsection 212(3), it would be subject to Canadian withholding tax pursuant to paragraph 212(1)(*b*). If the potential deemed interest on the traditional convertible debenture would be, or may be, participating debt interest, it is unclear whether the fixed coupon on the traditional convertible debenture is thereby also participating debt interest, having regard to the reference in the definition to any portion of interest on an obligation.

Can the CRA comment on whether a traditional convertible debenture is an excluded obligation for the purposes of paragraph 214(8)(*c*)?

Response 1

In order to be an excluded obligation under paragraph 214(8)(*c*), a debt must

1) not be an indexed debt obligation;
2) have been issued for an amount that is not less than 97 percent of its principal amount; and
3) have a yield, expressed in terms of an annual rate on its issue price, that does not exceed four-thirds of the interest stipulated to be payable on its principal amount, or the amount outstanding as or on account of its principal amount.

Whether a particular debt meets these conditions is a question of fact that must be determined according to the terms of a particular debt obligation. However, considering the *Tembec*[41] case and the similarity of the wording in paragraph 214(8)(*c*) and subparagraph 20(1)(*f*)(i), we are of the view that for the purposes of paragraph 214(8)(*c*), the principal amount must be ascertained at the time the debt is issued. In other words, in order to determine whether a particular debt has been issued for an amount that is not less than 97 percent of its principal amount for the purposes of paragraph 214(8)(*c*), we are of the view that the appreciation or depreciation of the principal amount over time must not be taken into account.

Because there are many varieties of convertible securities in the market, and as stated in CRA document no. 2009-0320231C6,[42] we still encourage the practitioner community to request advance income tax rulings if they have concerns about the application of Part XIII of the Act with respect to convertible debentures in the context of proposed transactions.

Question 2

If a traditional convertible debenture is not an excluded obligation, is any excess of the price for which the obligation is assigned or otherwise transferred over the price for which the obligation was issued "participating debt interest" for the purposes of subsection 212(3)?

Response 2

As stated at the Canadian Tax Foundation's 2008 annual conference, the CRA invites submissions from the practitioner community to develop guidance on this issue. (Subsequent to the date of the 2009 conference, the CRA received submissions from the Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants, which are being considered by the CRA.)

Question 3

If the excess would be, or may be, participating debt interest, is the fixed coupon on the traditional convertible debenture also treated as participating debt interest?

Response 3

As stated at the Canadian Tax Foundation's 2008 annual conference,[43] our initial analysis suggests that if the excess constitutes participating debt interest, the entire interest amount will be participating debt interest. However, to fully develop its position on this issue, the CRA invites submissions from the practitioner community. (Subsequent to the date of the 2009 conference, the CRA received submissions from the Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants, which are being considered by the CRA.)

Central Paymaster Rules

Question

The "central paymaster" rules in new regulation 402.1 will apply if, among other things, a service performed for a corporation "is of a type that could reasonably be expected to be performed by employees of the corporation in the ordinary course [of the business of the corporation]."[44] The wording of this test differs from the wording of the test in regulation 402(7) (which applies where the services performed "would normally be performed by employees of the corporation" and which is discussed in *Interpretation Bulletin* IT-145R).[45]

Can the CRA comment on its interpretation of the "reasonably be expected" test in new regulation 402.1 in the following circumstances?

1) The corporation that is the recipient of the services has never performed the particular services and functions itself (for example, where it has never had its own legal staff, and it receives legal services from its parent corporation).
2) The services in question are shared administrative (that is, non-operational) services where the corporation does not require the full-time services of any particular employees of the related service provider.

Can the CRA also comment on the consequences if both regulation 402(7) and new regulation 402.1 technically apply to a particular arrangement?

Response

There is no requirement for a corporation to have ever performed "particular services and functions" for regulation 402.1 to apply. The fact that the subsidiary has never had its own legal staff is irrelevant. If employees of the parent corporation (a master-servant relationship) report to a PE of a subsidiary, receive direction from the subsidiary's corporate structure, and all or substantially all of their economic activity is for the benefit of the subsidiary, then for the purposes of regulation 400 the salaries and wages of the employees would be allocated to the subsidiaries' gross salaries and wages paid in the year and deducted from the parent's gross salaries and wages paid in the year.

Generally, in a situation where the services in question are shared administrative (that is, non-operational) services, regulation 402.1 would not apply. If employees of the parent corporation report to a PE of a parent, receive direction from the parent's corporate structure, and all or substantially all of their economic activity is for the benefit of the parent, which in this case is providing a service to a subsidiary, then for the purposes of regulation 400 the salaries and wages of those employees would be that of the parent's gross salaries and wages paid in the year.

The interpretation of "normally" for regulation 402(7) has two conditions:

1) The service or function performed by the service provider must be one that is already performed by an employee of the corporation. It is the CRA's position that regulation 402(7) will not apply in situations where the corporation does not have any employees.
2) The need for the individual service provider to perform a particular service or function is short-term.

Where the corporation never had its own employees performing the legal services, those services would not be services that were previously performed by the corporation's employees, and therefore regulation 402(7) would not apply. Where the services provided (shared administrative services) are not short-term or temporary, they would not meet the definition of "normally."

Calculating LRIP for Cash-Basis Taxpayers

Question

When a corporation ceases to be a CCPC, subsection 89(8) calculates an addition to the corporation's low-rate income pool (LRIP). As part of that calculation, the corporation is required to include the total of all amounts each of which is the cost amount to the corporation of a property immediately before the end of its preceding taxation year. "Cost amount" of inventory is defined in subsection 248(1) to be "the value at that time as determined for the purpose of computing the taxpayer's income" (paragraph (*c*) of the definition).

The application of this provision to taxpayers carrying on a farming business using the cash method in section 28 is unclear. Under the cash method, income is considered to be earned when cash has been received, and expenses are considered to be incurred when they have been paid. Therefore, if a corporation pays for inventory during the year, it will be entitled to deduct that amount in calculating the corporation's income for the year. Consequently, the value of the corporation's inventory at any point during the year does not appear to be relevant for the purposes of calculating the corporation's income, except for the limited purposes of paragraph 28(1)(*b*) (which provides for additions to income in order to voluntarily income-average) or paragraph 28(1)(*c*) (which ensures that the purchase of inventory does not result in losses to the corporation). Subsection 28(1.2) applies only for the purposes of paragraph 28(1)(*c*) to deem the value of inventory to be the lesser of the cash cost and the FMV of the inventory.

In *Interpretation Bulletin* IT-427[46] (cancelled and replaced by IT-427R in 1993),[47] the CRA commented that the cost amount of farming inventory for a cash-basis taxpayer was considered to be nil on the rollover of farming inventory under section 85. Section 85 has since been amended to deem the elected amount to be a percentage of the amount included pursuant to paragraph 28(1)(*c*) (plus any additional amount designated by the parties), and IT-427R was published to reflect this change. However, it is not clear whether the analysis that led the CRA to conclude that the cost amount of farming inventory was nil would apply for other purposes of the Act, including subsection 89(8).

An analogy might be drawn to Canadian resource property. Canadian resource property acquired by a taxpayer is added to the taxpayer's resource pools. The CRA has consistently said that the cost amount of Canadian resource property is nil for the purposes of the Act and is not affected by the existence of undeducted resource pools.[48]

Can the CRA confirm that it would treat the cost amount of farming inventory of a cash-basis taxpayer as nil for the purposes of subsection 89(8)? Can the CRA also confirm that a cash-basis taxpayer's accounts receivable, prepaid expenses, accounts payable, and accrued liabilities should generally have a cost amount of nil for this purpose?

Response

For the purposes of applying subsection 89(8), and in accordance with paragraph (*c*) of the definition of "cost amount" in subsection 248(1), the cost amount of farming inventory to a cash-basis taxpayer immediately before the end of its taxation year preceding its change in status from a CCPC to a non-CCPC generally would be nil, provided that the value of such inventory at that time is not otherwise determined for the purpose of computing the taxpayer's income.

Furthermore, for the purposes of applying subsection 89(8), the cost amount of rights arising from the prepayment of expenses by a cash-basis taxpayer, immediately before the end of its taxation year preceding its change in status from a CCPC to a non-CCPC, would be determined pursuant to paragraph (*f*) of the definition of "cost amount" in subsection 248(1). Accordingly, the cost amount would generally be nil where the amount paid in respect of such prepaid expenses has been deducted in computing the taxpayer's income for any taxation year preceding the change in status.

The cost amount of accounts receivable to a cash-basis taxpayer immediately before the end of its taxation year preceding its change in status from a CCPC to a non-CCPC, for the purpose of applying subsection 89(8), would generally correspond with the face amount that the taxpayer has a right to receive, pursuant to paragraph (*e*) of the definition of "cost amount" in subsection 248(1).

On the other hand, an amount for the accounts payable of a cash-basis taxpayer should technically be included in variable D of subsection 89(8). Variable D is the total of all amounts each of which is the amount of any debt owing by the corporation, or of any other obligation of the corporation to pay any amount, that was outstanding immediately before the end of its taxation year preceding its change in status from a CCPC to a non-CCPC.

Consistency in Audit Practice

Question

What efforts are made to coordinate assessing practices across the country?

Response

The CRA ensures consistent assessing practices across the country by providing the TSOs with training material and effective audit reference tools and materials such as manuals and policies. This coordination effort is reinforced through internal conferences and regional meetings.

Update on Committees

Question

Can the CRA provide an update on the activities of the Transfer Pricing Review Committee (TPRC), the Joint International Tax Shelter Information Centre (JITSIC), and the GAAR Committee?

Response

JITSIC was established on April 23, 2004 as a means to increase collaboration and coordinate information about abusive tax transactions. Currently participating in this initiative are the tax administrations of Canada, the United States, the United Kingdom, Australia, and Japan. (China participated as an observer for a six-month term in 2008, and Korea is currently participating as an observer for a one-year term.)

The member countries exchange information about specific abusive transactions and their promoters and investors within the framework of each country's existing bilateral tax treaties. This allows each country to carry out its abusive tax transaction enforcement activities more effectively and efficiently.

JITSIC has played a significant role in addressing offshore and tax haven non-compliant activities, which have resulted in specific audit action undertaken by the CRA or one of its JITSIC partners. Examples of the types of issues involved in these audit actions include taxpayers identified as holding offshore credit cards; promoters and tax shelters; and financial products that generate large foreign tax credits for multinational corporations.

A total of 228 cases were referred to the TPRC from its inception to the fall of 2009—192 penalty referrals under subsection 247(3), 3 qualified cost contribution agreement referrals, and 33 recharacterization referrals under paragraph 247(2)(*b*). On average, the TPRC has penalized 54 percent of all referrals.

As of November 2009, the GAAR Committee had reviewed approximately 900 submissions, and had agreed that GAAR applied to 70 percent of them. Of these, GAAR was the primary assessing position half the time.

Foreign Exchange Gains and Losses

Question

Canco and its wholly-owned subsidiary, Cansub, are taxable Canadian corporations that have a Canadian-dollar tax functional currency. Cansub issues to Canco a note denominated in US dollars that is convertible into common shares of Cansub at the option of the holder. On conversion, Cansub will issue shares to Canco with an FMV equal to the outstanding principal amount of the note, and will add an amount to the stated capital of Cansub equal to the Canadian-dollar equivalent of such amount computed using the Bank of Canada noon exchange rate on the date of the conversion. Cansub uses the proceeds of the note to acquire US-dollar assets.

Will Cansub realize a foreign exchange gain (or sustain a loss) under subsection 39(2) upon conversion of the note if the amount added to the stated capital of Cansub upon conversion is less than (or greater than) the Canadian-dollar equivalent of the principal amount of the Note on the date it was issued? (CRA document no. 2004-0085081E5, September 8, 2005 suggests that the answer would be yes, although that interpretation did not address any potential loss.)

Response

Yes, the subsidiary will realize a gain or loss pursuant to subsection 39(2). The transaction appears to be somewhat artificial, and if anomalous tax results would otherwise arise, the anti-avoidance provisions of the Act may apply.

[1] Richard Montroy, Mickey Sarazin, Gabe Hayos, and Stephen S. Heller, "Canada Revenue Agency Round Table," in *Report of Proceedings of the Fifty-Ninth Tax Conference*, 2007 Conference Report (Toronto: Canadian Tax Foundation, 2008), 4:1-29, at 4:21-22.

[2] Vern Blair, "Valuation—Allocation of Value," in *2007 British Columbia Tax Conference* (Toronto: Canadian Tax Foundation, 2007), tab 9, at 10.

[3] Shane Onufrechuk, J. André Rachert, Darrell Mahoney, Terrence McAulay, and Robert Smith, "Questions and CRA Responses," in *2009 British Columbia Tax Conference* (Toronto: Canadian Tax Foundation, 2009), tab 16, at 2.

[4] Docket no. 2009-1152(IT)G (TCC) (discontinued).

[5] CRA document no. 2009-0320311I7, May 27, 2009.

[6] RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this paper are to the Act.

[7] Canada, Department of Finance, "Government of Canada Proposes Technical Changes Concerning Tax-Free Savings Accounts," *News Release* no. 2009-099, October 16, 2009.

[8] CRA document no. 2004-0065461C6, May 4, 2004, and CRA document no. 9824645, December 15, 1998.

[9] 93 DTC 133, at 137 (TCC).

[10] *The Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital*, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007 (herein referred to as "the treaty").

[11] Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Canada*, JCX-57-08 (Washington, DC: Joint Committee on Taxation, July 8, 2008), paragraph VI(B).

[12] *Convention Between Canada and the Grand Duchy of Luxembourg for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital*, signed at Luxembourg on September 10, 1999.

[13] 2009 FCA 57.

[14] CRA document no. 2009-0321451C6, May 21, 2009.

[15] CRA document no. 2009-0319481E5, June 1, 2009.

[16] Ibid.

[17] IC 76-12R6, *Applicable Rate of Part XIII Tax on Amounts Paid or Credited to Persons in Countries with Which Canada Has a Tax Convention*, November 2, 2007.

[18] Wayne Adams, Daryl Boychuk, Peter Dunn, Douglas S. Ewens, and Trent Henry, "Canada Revenue Agency Round Table," in *Report of Proceedings of the Sixtieth Tax Conference*, 2008 Conference Report (Toronto: Canadian Tax Foundation, 2009), 3:1-28, at 3:13-14.

[19] 2009 DTC 5877 (FCA); aff'g. 2008 DTC 3232 (TCC); leave to appeal to SCC refused January 22, 2009.

[20] 2006 DTC 6639 (SCC).

[21] "Canada Revenue Agency Round Table," presented at the 2006 Canadian Tax Foundation annual conference, November 26-28, 2006.

[22] Supra note 18, at 3:14.

[23] CRA document no. 2008-026590217, May 6, 2008.

[24] 98 DTC 6334 (SCC).

[25] Canada, Department of Finance, *Explanatory Notes Relating to Income Tax* (Ottawa: Department of Finance, 1997), subclause 145(2).

[26] Supra note 24, at paragraph 85.

[27] Ibid., at paragraph 72.

[28] Ibid., at paragraph 82.

[29] CRA document no. 2006-0176081R3, January 2007.

[30] IT-169, *Price Adjustment Clauses*, August 6, 1974.

[31] IC 75-7R3, *Reassessment of a Return of Income*, July 9, 1984.

[32] United States, Department of the Treasury, Technical Explanation of the Protocol Done at Chelsea on September 21, 2007, Amending the Convention Between the United States and Canada with Respect to Taxes on Income and on Capital.

[33] 98 DTC 6100 (SCC).

[34] Supra note 19.

[35] 2002 DTC 7517 (FCA).

[36] Supra note 19, at paragraph 9 (FCA).

[37] *Praxair Canada Inc. v. The Queen*, 93 DTC 5100 (FCTD).

[38] Supra note 18.

[39] Canada Revenue Agency, round table seminar at the International Fiscal Association (Canadian Branch) annual conference, Toronto, May 21-22, 2009.

[40] CRA document no. 2009-0320231C6, May 1, 2009.

[41] Supra note 19.

[42] Supra note 40.

[43] Supra note 18, at 3:15-16.

[44] Regulation 402.1(1)(b)(iii).

[45] IT-145R (Consolidated), *Canadian Manufacturing and Processing Profits—Reduced Rate of Corporate Tax*.

[46] IT-427, *Livestock of Farmers*, March 5, 1979.

[47] IT-427R, *Livestock of Farmers*, June 4, 1993.

[48] See, for example, Revenue Canada, "1992 CPTS Roundtable" (1992) vol. 5, no. 2 *Canadian Petroleum Tax Journal* 85-95, question 8.