Tax Notes

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Wolters Kluwer

NRT TAX TRAPS AND THE NON-SPECIALIST ADVISOR[1]

— Michael Goldberg, Tax Partner, Minden Gross LLP, MERITAS law firms worldwide and founder of "Tax Talk with Michael Goldberg", a quarterly conference call about current, relevant and real-life tax situations for professional advisors who serve high net worth clients.

This article is the second instalment in a four-part series that will appear in Tax Notes over the next few months.

Hopefully the first instalment of this Series of articles grabbed your attention and made you interested (scared) enough to keep on reading! As promised, the second instalment of the Series will begin the arduous task of providing a high-level review of the Section 94 NRT Rules, including providing some context as to just how expansive these rules are. Ready or not. . .

Policy — Application of the Section 94 NRT Rules

From a policy perspective Parliament has made its intentions quite clear: it wants to restrict the ability of trusts to qualify as Pure NRTs. To that end, the Section 94 NRT Rules have been drafted to broadly expand Canada's right to tax otherwise Pure NRTs by deeming them to be Section 94 NRTs that are tax residents of Canada for most purposes of the *Income Tax Act* including making Section 94 NRTs taxable on their worldwide income.[2]

The Section 94 NRT Rules will apply whenever there is either a:

(1) "resident contributor", or

(2) "resident beneficiary",

at the end of any relevant period, which is generally, but not always, the end of a trust's fiscal period.[3]

Before reviewing *when* a trust will have a resident contributor or a resident beneficiary, it is worth reviewing the "contributor" and "contribution" definitions, which are key building blocks to the resident contributor and resident beneficiary definitions.

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[1] Unless otherwise noted, defined terms in this article have the meaning designated in the first instalment of the Series.

[2] Because a Section 94 NRT is still factually non-resident, Canadian persons making distributions to such trusts will be obligated to withhold without treaty relief. Pursuant to the provisions in paragraph 94(2)(*g*), the Section 94 NRT will be entitled to treat amounts withheld as a credit against its Canadian tax liability. Complex rules are applicable where Section 94 NRTs make distributions to non-resident beneficiaries. For more on this topic, see the articles by Harris et al. and Schweitzer and Brodlieb, both of which were referred to in the first instalment of the Series.

[3] See subsection 94(1) "specified time" definition (when a trust ceases to exist, the specified time will be the time immediately before the trust ceased to exist).

Contributor and Contribution Definitions

Most of the key definitions in section 94, including the contributor and contribution definitions, are found in subsection 94(1).[4]

A contributor is any person, including a corporation, trust, and other entities, that has made a contribution to a trust. A person will continue to be a contributor, regardless of whether or not the person (when human) has died, or (when not human) has ceased to be in existence.

There are some modest exceptions to who will be a contributor, but the list of "exempt persons" is generally limited to government and tax exempt entities.

Clearly the contributor concept covers an extremely broad group of persons. However, since the contributor definition requires there to be a contribution, the importance of the definition does not become clear until one understands the types of acts that will constitute contributions.

Generally, a contribution will involve any direct or indirect transfer or loan of property, or an obligation to make a transfer or loan of property, to a trust. This is an extremely broad concept and is considerably broader in scope than the general process that one thinks of as necessary to establish a trust in Canada (i.e., by direct settlement of property that is provided by a settlor and that is accepted by the trustees of a trust).

It is worth mentioning that as defined in subsection 248(1), "property" is an extremely broad concept and includes property of any kind whatever, whether real or personal, immovable or movable, tangible or intangible, or corporeal or incorporeal.

Thankfully, certain loans or transfers are excluded from being contributions if they are dealt with in the interpretive provisions in subsection 94(2) or if those loans and transfers qualify as "arm's length transfers", a concept that will be discussed below.

Even though some of the subsection 94(2) interpretive rules place limitations on when a contribution will be considered to have occurred,[5] other rules in subsection 94(2) contain complex deeming rules, which make the scope of transfers and loans that will constitute contributions exceptionally wide.

For example, pursuant to paragraph 94(2)(*a*), unless the transfer is determined to be an arm's length transfer, the making of any loan or transfer of property by a person to any other person will be considered to have been a transfer to a trust if:

(1) the fair market value ("FMV") of a property or properties owned by a trust increases, or

(2) a liability or potential liability of a trust decreases,

at the time of the transfer by the person.

The rules in paragraph 94(2)(*a*) are economic based concepts. They are intended to capture loans or transfers of property that may give rise to the accretion of wealth in a jurisdiction other than Canada, by whatever means, including the reduction of liabilities.

Other key deeming rules in subsection 94(2) will deem, among other things, the issuance of shares, partnership or trust interests,[6] and the provision of services by a person[7] to be transfers by the issuer or provider of services to a trust. Due to even more complex deeming rules that are beyond the scope of the series, indirect transfers need to be reviewed carefully.

Hopefully by now it is clear that the contributor and contribution concepts cover not only an incredibly broad group of people but also a very wide group of actions by those people in respect of a trust.

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[4] Unless otherwise noted, defined terms in the Act that are used in the Series can be found in subsection 94(1).

[5] No attempt will be made to address such limitations in the Series.

[6] See paragraph 94(2)(*g*).

[7] See paragraph 94(2)(*h*).

Arm's Length Transfer

The term arm's length transfer, which is defined in subsection 94(1), is a bit misleading since the concept applies to both transfers and loans. In any case, if a loan or transfer qualifies as an arm's length transfer it will not result in a contribution having been made to a trust.

There are a number of categories of transactions that are listed in paragraph (*b*) of the definition that can be considered arm's length transfers. However, pursuant to paragraph (*a*) of the definition, in order to be an arm's length transfer, it always needs to be reasonable to conclude that none of the reasons for the loan or transfer of property is the acquisition of an interest in a non-resident trust.[8]

Still, this exception can be quite narrow. For example, the arm's length transfer exception will generally not apply in typical estate freeze situations, since such transactions tend to involve shares that will generally be "restricted property." In addition, as is the case with all arm's length matters, the determination of what transactions will qualify as arm's length is subjective.[9]

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This instalment of the Series has attempted to provide a very high level technical review of just how easy it is for a contributor to make a contribution to a trust under the Section 94 NRT Rules. The next instalment of the Series will consider the types of contributions that will engage these rules and thereby subject otherwise Pure NRTs to Canadian tax as Section 94 NRTs that are deemed to be residents of Canada.

Special thanks to Ryan Chua of Minden Gross LLP for his comments on earlier drafts of this article. All errors and omissions are the author's.

2016 CANADIAN FEDERAL BUDGET — PROMISES KEPT, PERCEIVED ABUSES ADDRESSED

— *Ron Choudhury and Neil Gurmukh, Miller Thomson LLP*

[The following article was originally published in Global Tax Weekly, Issue 178]

On March 22, 2016 ("Budget Day"), Canada's Minister of Finance, Bill Morneau, tabled the new Liberal government's first federal budget (the "Budget").

In addition to taking steps to revitalize the Canadian economy and delivering change to the middle class, the Budget included several international tax measures which (i) act on the recommendations developed by the Organisation for Economic Co-operation and Development to address base erosion and profit shifting by multinational enterprises, and (ii) strengthen Canada's international tax system by extending the application of the back-to-back loan rules to royalty arrangements and preventing unintended cross-border tax-free distributions of capital to nonresidents of Canada.

The Budget also closes many perceived loopholes related to small business planning, life insurance transactions, and debt-parking arrangements under the *Income Tax Act* (Canada) (the "Tax Act"). Another notable business tax change is the repeal of the eligible capital property regime and its replacement with a new capital cost allowance class.

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[8] Interestingly, although nearly all of the categories of transactions listed in paragraph (*b*) of the arm's length transfer definition appear to require loans or transfers to be carried out using an arm's length standard (subparagraphs (*b*)(ii) and (vi) do not explicitly contain language requiring such a standard), subparagraph (*b*)(i), dealing with payments of interest, dividends, rent, royalties, other returns, and substituted returns in respect of property, only seems to be concerned with situations that would involve returns to a trust that are designed to overcompensate a trust. As a result, provided that the terms giving rise to a particular loan or transfer were themselves carried out in an arm's length manner, then based on this interpretation it would appear the payment of non-arm's length returns that act to the detriment of a trust and that otherwise would have resulted in contributions being made to that trust would be considered arm's length transfers and therefore not contributions.

[9] For a more detailed discussion on this subject see the article by Harris et al. (cited in the first instalment of the Series).

The Budget, however, did not include measures to increase the capital gains inclusion rate and limit the preferential tax treatment of employee stock option plans, which were the subject of pre-Budget rumors.

A summary of many of the international tax measures contained in the Budget is provided below. The Budget also included various personal tax, business tax, and sales tax measures which are not discussed in this article.

International Tax Measures

Base Erosion and Profit Shifting

Base erosion and profit shifting ("BEPS") refers to tax planning arrangements undertaken by multinational enterprises ("MNEs") that exploit the interaction between domestic and international tax rules to minimize taxes. Typically, BEPS involves an effective transfer of income from a higher tax jurisdiction to low- or no-tax jurisdictions.

The Organisation for Economic Co-operation and Development (the "OECD") has developed guidelines for countering BEPS and released an initial BEPS report in 2013 at the request of the governments of The Group of Twenty (the "G20"). On October 5, 2015, the OECD presented a final package of the OECD/G20 BEPS project's 15-point action plan ("BEPS Project"), which includes finalized guidance on transfer pricing, neutralizing the effects of hybrid mismatch arrangements, preventing the granting of treaty benefits in inappropriate circumstances, and developing a multilateral instrument to modify bilateral tax treaties.

The Budget includes a number of these counter-BEPS initiatives, as set out below.

Transfer pricing documentation — country-by-country reporting: Transfer pricing refers to the pricing of goods, services, and intangibles that are traded across international borders between persons who do not deal with each other at arm's length. In order to ensure that taxable income in each jurisdiction reflects the market value of the relevant activity, many countries' tax rules generally require MNEs' transfer pricing to be on an arm's length basis. These rules also typically require MNEs to prepare transfer pricing documentation to describe their intra-group transactions and the methodologies they applied to determine the transfer pricing.

The BEPS Project recommends new standards for transfer pricing documentation and for the interpretation of the arm's length principle.

Recommendations for transfer pricing documentation aim to help tax administrations to have better information in administering tax compliance. These recommendations include a country-by-country report, which large MNEs will generally be required to file with the tax administration of the country in which the MNE's ultimate parent entity resides. A country-by-country report will include a country-by-country allocation of the key variables for the MNE, including its revenue, profit, tax paid, stated capital, accumulated earnings, number of employees, tangible assets, and the main activities of each of its subsidiaries.

Pursuant to the new country-by-country reporting requirements, a jurisdiction that receives a country-by-country report from a member of an MNE will automatically exchange the report with other jurisdictions in which the MNE operates, provided that, in each case, the other jurisdiction has implemented country-by-country reporting requirements, the two jurisdictions have a legal framework in place for automatic exchange of information, and they have entered into a competent authority agreement relating to country-by-country reporting.

The Budget proposes to implement country-by-country reporting in Canada. Notably, this measure will apply only to MNEs with total annual consolidated group revenue of EUR750m (approximately USD853m/CAD1.1bn) or more. Where such an MNE has an ultimate parent or subsidiary entity that is resident in Canada, it will be required to file a country-by-country report with the Canada Revenue Agency within one year of the end of the fiscal year to which the report relates.

First exchanges between jurisdictions of country-by-country reports are expected to occur by June 2018. Before any exchange with another jurisdiction, the Canada Revenue Agency will formalize an exchange arrangement with the other applicable jurisdiction and will ensure that it has appropriate safeguards in place to protect the confidentiality of the reports.

Country-by-country reporting will be required for the applicable MNEs for taxation years that begin after 2015.

Revised transfer pricing guidelines: Transfer pricing requirements are generally legislated in many countries' domestic tax legislation and/or bilateral tax treaties. In Canada, the arm's length principle is primarily governed by Section 247 of the Tax Act. The OECD's Transfer Pricing Guidelines are not expressly incorporated into Canada's legislation; however, they are used by the Canada Revenue Agency and the courts for interpreting and applying Section 247.

The BEPS project's revisions of the OECD's Transfer Pricing Guidelines aim to provide an improved interpretation of the arm's length principle and a better alignment of the economic activities and profits of MNEs for tax purposes. According to the Budget materials, these revisions generally support the Canada Revenue Agency's current interpretation and application of the arm's length principle, which is reflected in its audit and assessment practices. These revisions are therefore being applied by the Canada Revenue Agency, as they are said to be consistent with current practices.

The Canada Revenue Agency, however, will not be adjusting its administrative practices with respect to certain measures until the OECD's work on them is more complete. Notably, the BEPS project is finalizing its work on the threshold of low value-added services and the definition of risk-free and risk-adjusted returns for minimally functional entities (often referred to as "cash boxes"). The Canada Revenue Agency will not be adjusting its administrative practices with respect to these measures.

Treaty abuse: Treaty abuse, in particular treaty shopping, is identified in the BEPS project as one of the most important sources of concern. Treaty shopping occurs, for example, where a third-country resident creates an intermediary holding company in a treaty country, which effectively extends tax treaty benefits that were not intended and without any reciprocal benefits accruing to Canadian investors or to Canada.

The BEPS treaty abuse minimum standard requires countries to include in their tax treaties an express statement that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements.

The treaty abuse minimum standard also requires countries to implement this common intention by adopting in their tax treaties either of the following approaches to treaty anti-abuse rules: (i) a principal purpose test — which is a general anti-abuse rule that uses the criterion of whether one of the principal purposes of an arrangement or transaction was to obtain treaty benefits in a way that is not in accordance with the object and purpose of the relevant treaty provisions; and (ii) a limitation-on-benefits rule — which is a more mechanical and specific anti-abuse rule that requires satisfaction of a series of tests in order to qualify for treaty benefits.

The Budget confirms the Federal Government's commitment to address treaty abuse in accordance with the BEPS treaty abuse minimum standard. Canada currently has one treaty that has adopted a limitation-on-benefits approach (the Canada-US tax treaty) and several treaties that have adopted a limited principal purpose test.

Going forward, Canada will consider either minimum standard approach, depending on the particular circumstances and discussions with Canada's tax treaty partners. Amendments to Canada's tax treaties to include a treaty anti-abuse rule could be achieved through bilateral negotiations, a multilateral instrument recommended by the OECD that will be developed in 2016, or a combination of the two.

Spontaneous exchange of tax rulings: Another area of concern identified by the BEPS Project was a lack of transparency in connection with certain tax rulings provided by tax administrations. This lack of transparency can give rise to mismatches in cross-border tax treatment and instances of double non-taxation.

The BEPS Project recommends a framework for the spontaneous exchange of certain tax rulings that could give rise to BEPS concerns in the absence of such exchanges. The framework covers six categories of rulings: (i) rulings related to preferential regimes; (ii) cross-border unilateral advance pricing arrangements; (iii) rulings giving a downward adjustment to profits; (iv) permanent establishment rulings; (v) conduit rulings; and (vi) any other type of ruling agreed to in the future.

Canada already has an established exchange of information program through its tax treaties, tax information exchange agreements, and the multilateral Convention on Mutual Administrative Assistance in Tax Matters.

The Budget confirms the Federal Government's commitment to the OECD's BEPS-related recommendations for the spontaneous exchange of certain tax rulings. The Canada Revenue Agency will commence the exchange of tax rulings with other jurisdictions that have committed to these OECD recommendations in 2016.

Cross-Border Surplus Stripping

The paid-up capital ("PUC") of the shares of a Canadian corporation generally represents the amount of capital contributed to the corporation by its shareholders, which can be returned to shareholders free of tax, even in the cross-border setting. Retained earnings in excess of PUC that are distributed to shareholders are normally treated as taxable dividends. For non-resident shareholders, such dividends are subject to a 25 percent withholding tax (unless reduced under an applicable tax treaty).

The Tax Act contains an "anti-surplus-stripping" rule in Section 212.1 that is intended to prevent a non-resident shareholder from entering into a transaction to extract free of tax (or "strip") a Canadian corporation's retained earnings (or "surplus") in excess of the PUC of its shares or to artificially increase the PUC of the shares. When applicable, the anti-surplus-stripping rule results in a deemed dividend to the non-resident or a suppression of the PUC of the shares that would otherwise have been increased as a result of the transaction.

An exception to this anti-surplus-stripping rule is found in Subsection 212.1(4), which, if met, disables the rule in Section 212.1. The exception in Subsection 212.1(4) applies where a Canadian corporation holds shares of a non-resident corporation that itself owns shares of a Canadian corporation (i.e., the non-resident is "sandwiched" between the two Canadian corporations) and the non-resident disposes of shares of the lower-tier Canadian corporation to the Canadian parent corporation ("Canadian purchaser corporation") in order to unwind the sandwich structure. According to the Budget materials, some non-resident corporations with Canadian subsidiaries have misused this exception by reorganizing the group into a sandwich structure with a view to artificially increasing the PUC of shares of their Canadian subsidiaries.

The Budget proposes to amend the exception in Subsection 212.1(4). In particular, it will be clarified that, consistent with the policy of the anti-surplus-stripping rule, the exception does not apply where a non-resident both (i) owns, directly or indirectly, shares of the Canadian purchaser corporation, and (ii) does not deal at arm's length with the Canadian purchaser corporation.

To address the possibility of situations where it may be uncertain whether consideration has been received by a non-resident from the Canadian purchaser corporation in respect of the disposition by the non-resident of shares of the lower-tier Canadian corporation, the Budget also proposes a specific rule to deem the non-resident to receive non-share consideration from the Canadian purchaser corporation in such situations. The amount of this deemed consideration will be determined by reference to the fair market value of the shares of the lower-tier Canadian corporation received by the Canadian purchaser corporation.

This change to Subsection 212.1(4), which will apply in respect of dispositions occurring on or after Budget Day, should be considered in relation to cross-border acquisitions and reorganizations to ensure that the adverse application of this proposal is not inadvertently triggered.

Extension of the Back-to-Back Rules

The Tax Act currently contains back-to-back rules that can apply to interest payments for withholding tax purposes. These rules apply when an intermediary is interposed between a Canadian resident debtor and a foreign creditor in an attempt to reduce the withholding tax rate that would otherwise apply if interest were paid directly. There are also similar back-to-back rules for the thin capitalization rules in the Tax Act.

When the existing back-to-back withholding tax rules apply, the Canadian resident debtor is deemed to have paid a specified amount of interest to the ultimate foreign creditor. The result is that the Canadian withholding tax rate is determined based on the country of residence and status of the ultimate foreign creditor rather than the intermediary (assuming that withholding tax rate is higher).

The Budget introduces similar back-to-back rules for rents, royalties, and similar payments. This is a significant and important change. Canada has an increasing number of double tax treaties that provide a complete withholding tax exemption for payments for the use or right to use certain intellectual property, including software in some cases. If a Canadian resident were to make such a payment to a resident of a country with which Canada does not have a double tax treaty, the Canadian withholding tax rate would be 25 percent. Under some of Canada's double tax treaties, the withholding tax rate is reduced but there is no exemption.

Some taxpayers may be motivated to establish an intermediary in a country where the double tax treaty has a complete withholding tax exemption and license the intellectual property into Canada from that jurisdiction. The back-to-back rules proposed by the Budget target this type of arrangement.

Canada's tax treaties generally provide that the treaty reduced withholding tax rate is only available where the recipient of the royalty is a resident of the other treaty country and is the beneficial owner of the royalty in question. The Canada Revenue Agency has challenged beneficial ownership for treaty purposes in the Canadian tax courts, but has to date been unsuccessful. See, for example, *Velcro Canada Inc. v. The Queen*, 2012 TCC 57. The proposed back-to-back rules may, in part, be a legislative response to these court decisions.

Where they apply, the proposed back-to-back rules for royalties deem the Canadian-resident payor to have made a royalty payment directly to the ultimate non-resident recipient. The Canadian withholding tax will be payable on the deemed royalty based on the country of residence of the ultimate non-resident recipient rather than the intermediary (assuming that withholding tax rate is higher).

The proposed rules deem connected arrangements to be a back-to-back royalty arrangement if:

(1) A Canadian-resident person makes a royalty payment in respect of a particular lease, license, or similar agreement (the "Canadian Leg") to a person or entity resident in a country with which Canada has a tax treaty (the "Intermediary");

(2) The Intermediary (or a person or partnership that does not deal at arm's length with the intermediary) has an obligation to pay an amount to another non-resident person in respect of a lease, license or similar agreement, an assignment or an installment sale (the "Second Leg"); and

(3) One of the following conditions is met:

(a) The amount the Intermediary is obliged to pay under the Second Leg is established, in whole or in part, by reference to the royalty payment made by, or the royalty payment obligation of, the Canadian-resident person in the Canadian Leg or the fair market value of property, any revenue, profits, income, or cash flow from property or any other similar criteria in respect of property, where a right to use the property is granted under the Canadian Leg; or

(b) It can reasonably be concluded based upon all the facts and circumstances that the Canadian Leg was entered into or permitted to remain in effect because the Second Leg was, or was anticipated to be, entered into. In this regard, the fact that the Canadian Leg and the Second Leg are in respect of the same property will generally not be considered sufficient on its own to conclude that this condition has been met.

The proposed rules for royalties will apply to a back-to-back arrangement where the withholding tax that is payable on a royalty payment to the Intermediary is less than the withholding tax that would be payable on a direct payment by the Canadian resident payor to the ultimate non-resident recipient.

These proposed back-to-back royalty rules will apply to royalty payments made after 2016.

Character substitution rules: The Budget proposes to supplement the existing withholding back-to-back rules for interest and the proposed withholding back-to-back rules for royalties to prevent their avoidance through the substitution of economically similar arrangements where the payment from the intermediary to the ultimate non-resident recipient has a different character than the payment from the Canadian resident to the intermediary.

The proposed character substitution rules could apply where:

- Interest is paid by a Canadian-resident to an intermediary and the intermediary pays royalties to another non-resident;
- Royalties are paid by a Canadian-resident to an intermediary and the intermediary pays interest to another non-resident; or
- Interest or royalties are paid by a Canadian-resident to an intermediary and a non-resident person holds shares of the intermediary that include certain obligations to pay dividends or that satisfy certain other conditions (e.g., they are redeemable or cancellable).

Where character substitution rules apply, the Canadian resident will be deemed to have made a payment to the ultimate non-resident recipient with the same character (i.e., interest or royalty) as the payment from the Canadian resident to the intermediary.

The Budget states that the proposed character substitution rules will apply where a sufficient connection is established between the arrangement under which a Canadian resident pays interest or royalty to the intermediary and the arrangement between the intermediary and the other non-resident. Whether such a connection exists will be determined by applying tests similar to those used for back-to-back loans and back-to-back royalty arrangements. Further detail is not provided in the Budget materials.

Presumably, the legislation, when enacted, will say that a sufficient connection will exist where the amount of the payment from the intermediary to the other non-resident is determined by reference to the payment from the Canadian resident to the intermediary or it can reasonably be concluded that the arrangement between the Canadian resident and the intermediary was entered into or was permitted to remain in effect because the arrangement between the intermediary and the other non-resident was, or was anticipated to be, entered into.

The proposed character substitution rules will apply to interest and royalty payments made after 2016.

Multiple intermediary structures: The existing withholding back-to-back rules for interest as written appear to address financing structures that involve a single intermediary.

The Budget proposes to clarify the application of the existing withholding back-to-back rules for interest and the proposed withholding back-to-back rules for royalties to arrangements involving multiple intermediaries. Under this proposal, the back-to-back rules will apply to all arrangements that are sufficiently connected to the arrangement under which a Canadian resident makes a cross-border payment of interest or royalties to an intermediary (using similar criteria as with single intermediary arrangements). Where the back-to-back rules apply to multiple intermediary arrangements, the Canadian resident payor will be deemed to have made a payment to the ultimate non-resident recipient in the chain of connected arrangements of the same character as the payment to the first intermediary.

The Budget also proposes to include rules addressing multiple-intermediary arrangements within the proposed back-to-back shareholder loan rules.

This proposal will apply to payments of interest or royalties made after 2016 and to shareholder debts as of January 1, 2017.

CURRENT ITEMS OF INTEREST

Bill C-15 Receives First Reading in House of Commons

On April 20, 2016, Bill C-15, *An Act to implement certain provisions of the budget tabled in Parliament on March 22, 2016 and other measures,* was read for the first time in the House of Commons. It contains certain tax measures from the 2016 federal Budget and some of the measures from the 2015 Budget that have yet to be enacted. Some notable measures include:

- the Canada Child Benefit;
- the Teacher and Early Childhood Educator School Supply tax credit;
- repealing the Family Tax Cut and tuition and textbook amounts;
- consequential amendments relating to the increase in the top personal tax rate;
- maintaining the small business tax rate;
- various GST/HST and excise tax amendments proposed by Budget 2016;
- investments in partnerships by registered charities;
- amendments to section 55;
- withholding for non-resident employers;
- synthetic equity arrangements; and
- captive insurance.

CRA Updates Information Circular for Rulings and Technical Interpretations

IC70-6R6, *Advance Income Tax Rulings and Technical Interpretations,* was replaced on April 22, 2016, by the updated IC70-6R7. This version has been significantly updated to reflect recent changes affecting interactions with the Income Tax Rulings Directorate. First, several paragraphs have been added to reflect the pre-ruling consultation process that is available to taxpayers. These include information about:

- the purpose of the process;
- how the consultation is conducted;
- what information should be included in a pre-ruling consultation request;
- the new Appendix G that is submitted to make a request; and
- fees and deposits applicable to a pre-ruling consultation.

Second, the circular includes new information related to the sharing of information. It explains that information given to the Directorate may be shared with the Department of Finance or other branches of the CRA. A section has also been added which discusses the exchange of ruling information as a result of Canada committing to BEPS Action 5. This section describes the types of rulings that are likely to be exchanged with participating jurisdictions and confirms that certain information will be required of taxpayers when rulings in these categories are requested.

Provincial Budget — Newfoundland and Labrador

Newfoundland and Labrador's 2016 Budget, which was presented on April 14, 2016, contained extensive tax increases. Effective July 1, 2016, the HST rate will increase from 13% to 15%, personal income tax rates will increase for all tax brackets, and a new deficit reduction levy will be imposed on all individuals with taxable income in excess of $20,000. The Budget also announced increases in tobacco tax, fuel tax, and fees for 350 government services, as well as the re-introduction of the former 15% sales tax on insurance premiums.

Corporate tax rates will also increase, retroactive to January 1, 2016. Specifically, the general rate will increase from 14% to 15%, the reduced rate for manufacturing and processing profits will be eliminated, and the financial corporations capital tax rate will increase from 5% to 6%. The insurance companies tax will also increase from 4% to 5% on July 1, 2016.

Provincial Budget — Alberta

Alberta's 2016 Budget was tabled on April 14, 2016, and contained a handful of new tax measures. The small business corporate tax rate will be reduced from 3% to 2%, effective January 1, 2017. Consequently, the dividend tax credit for non-eligible dividends will be reduced after 2016. The graduated income tax brackets that come into effect in 2016 will be indexed to inflation beginning in 2017. The Budget also announced a carbon levy which will apply to fuel that is consumed for combustion purposes.

Provincial Budget — Nova Scotia

Nova Scotia's 2016-2017 Budget was presented on April 19, 2016. It contained only two tax changes — an increase in tobacco tax rates, and a new 25% non-refundable income tax credit for farmers and farm corporations that donate agricultural products to registered charities such as food banks.

Provincial Budget — Prince Edward Island

Prince Edward Island's 2016-2017 Budget was presented on April 19, 2016. It announced that the HST rate would increase from 14% to 15% on October 1, 2016, and that the Real Property Transfer Tax will be eliminated for all first-time home buyers on the same date. The Budget also proposed small increases to the following personal income tax credits for 2016 and subsequent years: PEI sales tax credit, low income tax reduction, basic personal exemption, spousal credit, and eligible dependant credit.

Draft Legislation to Implement OECD Common Reporting Standard Released

On April 15, 2016, the Department of Finance released draft legislation that proposes to implement the Common Reporting Standard ("CRS") as proposed by the Organisation for Economic Co-operation and Development ("OECD"). New Part XIX of the *Income Tax Act* will require Canadian financial institutions to identify non-resident held accounts and report account holder information to the CRA. The reporting requirements are expected to come into effect on July 1, 2017. The proposals were released for consultation and comments are due by July 15, 2016. Both the draft legislation and accompanying explanatory notes are available on the Department of Finance website.

CRA Releases New Moving Expenses Folio

Effective April 5, 2016, the CRA introduced the new Income Tax Folio S1-F3-C4, Moving Expenses. This folio replaces IT-178R3, which was last updated in March 2001. The folio contains many changes that can be found in the chapter history page. Many of these changes relate to legislative amendments that have been enacted since the last publication of the interpretation bulletin. Several paragraphs have been added to clarify rules in specific scenarios. Two examples have also been added with respect to the treatment of moving expenses where multiple moves have occurred.

Monthly Prescribed Interest Rates for Leasing Rules

The CRA announced that the prescribed rate for the month of May with respect to the leasing rules is 2.86%. A compilation of all of these monthly prescribed rates can be found in the official release.

FOCUS ON CURRENT CASES

This is a regular feature examining recent cases of special interest, coordinated by *John C. Yuan* and *Christopher L.T. Falk* of McCarthy Tétrault LLP. The contributors to this feature are from McCarthy Tétrault LLP, Montreal, Toronto, Calgary, and Vancouver.

Minister's administrative practice treated as a subsection 220(2.1) waiver

***Leith v. The Queen*, 2016 DTC 1002 (Tax Court of Canada)**

The taxpayer appealed the Minister's reassessment denying the taxpayer's deduction of employment-related expenses and farming losses. The subject expenses were purportedly incurred in connection with the taxpayer's employment as an investment advisor during the 2006 and 2007 tax years. The Tax Court (*per* Graham J.) dismissed the taxpayer's appeal in its entirety.

The decision involved both procedural and evidentiary elements. Procedurally, the sole issue was whether or not the taxpayer was entitled to claim deductions in respect of his employment expenses because he had not, in either 2006 or 2007, "filed with the taxpayer's return of income for the year" the completed prescribed form (Form T2200) as required under subsection 8(10) of the *Income Tax Act* (the "Act").

The Court concluded that the taxpayer's failure to file the Form T2200 with his return did not *per se* bar his entitlement because the CRA's instructions on the form expressly state: "The employee does not have to file this form with his or her return, but must keep it in case [the CRA] ask[s] to see it." Subsection 220(2.1) of the Act allows the Minister to "waive the requirement" for a person to file a prescribed form. In this regard, the Court held that the Minister should be considered to have waived the filing requirement by issuing instructions for the Form T2200 that allowed for a different practice.

While the taxpayer prevailed on the procedural issue, he ultimately could not show that his expenses were for the purpose of earning income from employment. The taxpayer had entered into evidence versions of the Forms T2200 for the reassessed years that differed from the versions his accountant had provided to a CRA auditor when the audit first began in 2010. The taxpayer had made hand-written alterations to the trial versions that were different from his hand-written alterations to the audit versions; yet both versions bore the same employer signature. The Court concluded that these discrepancies damaged the taxpayer's credibility, since at least one of the altered Forms T2200 (if not both) would have been changed *after* the employer had signed it. The taxpayer offered inconsistent explanations of the discrepancies, which caused the Court to find that, in his testimony, he "was drowning in his own deceits and was desperately grasping at anything that he thought might save him."

As well, the Court found that, following the initial conversation between the taxpayer's accountant and the CRA auditor in May 2010, the taxpayer prepared, two days later, backdated calendars for 2006 and 2007 purporting to corroborate the mileage he had driven for employment purposes on the relevant days. The Court noted that, at the bottom of these calendars, there was a date stamp from May 2010. Again, the Court concluded that this damaged the taxpayer's credibility.

The *Leith* decision is significant for the Court's confirmation that employment-related expenses are not ineligible for a deduction solely because a taxpayer has not filed a Form T2200 with his or her corresponding tax return (consistent with the form's own instructions). Otherwise, the Court's holding with respect to the evidentiary issue is not surprising, although what may be surprising is the degree to which the taxpayer entered into evidence clearly altered or backdated documents.

— *Mark Firman*

How much scope does the Minister have to reassess a statute-barred year that is the subject of objection proceedings?

***Glenn Foster v. The Queen*, 2016 DTC 1010 (Tax Court of Canada)**

In *Foster*, the Tax Court considered the interaction of subsection 165(3) of the *Income Tax Act* ("the Act"), which the Minister relied on to issue or vary a reassessment in response to a taxpayer's notice of objection, and subsection 152(5), which precludes the Minister from including in a reassessment made after the normal reassessment period for a taxation year any amount that was not included in computing the taxpayer's income in an assessment made before the end of such period. The issue arose in this case because the taxpayer sought and obtained a rectification order that

affected some of the key facts underlying the technical basis for reassessment under objection; the Minster sought to dispose of the objection by issuing a new reassessment based on a different reassessment theory.

The nature of the transaction that the Minister reassessed in this case was a shareholder benefit arising in 2007 from the arm's length purchase of a business by the taxpayer and a corporation he controlled. The taxpayer personally entered into a purchase agreement with the vendor to buy the vendor's business assets (consisting of fishing-related equipment and fishing licenses) for $415,000. The taxpayer had set-up a wholly-owned corporation to operate the business and, on closing, the business assets were transferred to the taxpayer's corporation with the corporation paying $200,000 of the $415,000 total purchase price to the vendor. (The balance of the purchase price appears to have been funded by a loan from a third party to the taxpayer but it is unclear from the decision how the borrowed funds ultimately flowed to the vendor.)

Notwithstanding that the purchase agreement was between the taxpayer and the vendor, the taxpayer and the corporation filed their respective tax returns for the 2007 taxation year on the basis that the corporation acquired the business assets for $415,000, with $200,000 allocated towards the equipment and $215,000 toward the licences.

In 2012, the Minister reassessed the taxpayer's 2007 taxation year to assess a shareholder benefit based on the following characterization of the facts: (i) the value of the fishing-related equipment at the time of the 2007 transaction was $130,000, (ii) the equipment was beneficially owned by the taxpayer (and not the vendor) immediately before it was transferred to the corporation, and (iii) the $200,000 amount that the corporation paid to the vendor at closing should be treated as consideration that the taxpayer received from the corporation for the transfer of the fishing-related equipment. Based on this construction of the facts, the Minister assessed a shareholder benefit of $70,000, representing the difference between the $200,000 amount that the corporation was alleged to have paid the taxpayer and the $130,000 value that the Minister assigned to the transferred equipment. Essentially, the Minister's reassessment revolved around an assumed sale transaction between the taxpayer and the corporation he controlled.

The taxpayer objected to the reassessment. In the meantime, the taxpayer and his corporation initiated legal proceedings in the New Brunswick Court of Queen's Bench to obtain a rectification order to substitute the corporation (for the taxpayer) as (i) the purchaser under the purchase agreement with the arm's length vendor, and (ii) the borrower under the agreement for the acquisition loan from the third party. The Minister did not oppose the application and the rectification order was granted in 2012. One of the implications of the rectification order was that it effectively removed the taxpayer as a party to the purchase of the business from the arm's length vendor in 2007 and caused it to be a direct transaction between the corporation and the vendor.

Even though the objection was filed and the rectification order was issued in 2012, the Minister did not dispose of the objection until 2014. Despite the fact that the 2007 transactions had been rectified in a way that made the Minister's original reassessment theory untenable (i.e.,there was no longer a transfer of the business assets by the taxpayer to the corporation), the Minister still believed that a shareholder benefit of a lesser amount could be supported on the basis of the transaction as rectified. The Minister's new theory in support of a shareholder benefit was based on the following characterization of the facts: (i) the value of the fishing-related equipment at the time of the 2007 transaction was $150,000, (ii) $150,000 of the $200,000 that the corporation paid to the third party vendor was as consideration for the equipment, and (iii) the remaining $50,000 of the $200,000 that the corporation paid to the vendor was a payment on behalf of the taxpayer as partial consideration for the taxpayer's purchase of the fishing licenses from the vendor. It is unclear from the reported decision how the Minister came to the view that the taxpayer purchased the fishing licenses in light of the way in which the agreements for the 2007 transaction were rectified. In any event, under this fact pattern, the Minister considered the taxpayer to have received a $50,000 shareholder benefit from the corporation and disposed of the objection by varying the reassessment to reduce the shareholder benefit from $70,000 to $50,000.

As the normal reassessment period for the taxpayer's 2007 taxation year had expired by the time the reassessment reflecting the $50,000 shareholder benefit was issued, the Minister's sole statutory basis for issuing that reassessment was the authority to do so under subsection 165(3) in the course of disposing of an objection to an earlier reassessment.

The taxpayer presumably filed an appeal of the latest reassessment with the Tax Court of Canada and, pursuant to the rules of procedure in the Tax Court, brought a motion to have the Court answer the following as a threshold question concerning the reassessment under appeal:

> Did the [Minister] have the statutory authority to issue the May 23, 2014 reassessment of tax for Mr. Foster's 2007 taxation year pursuant to subsection 152(5) of the [Act]?

As mentioned earlier, subsection 152(5) precludes the Minister from including in a reassessment made after the normal reassessment period any "amount" that was not included in computing the taxpayer's income in an assessment made before the end of such period. Although subsection 165(3) of the Act allows the Minister to reassess outside the normal reassessment period on receipt of a notice of objection, the taxpayer contended that any such reassessment is still subject to the restriction in subsection 152(5) and that "the amount included in income by the May 23, 2014 reassessment is a different amount than the amount included in income by the January 5, 2012 reassessment because those amounts arose out of different alleged transactions between different parties". The shareholder benefit under the earlier reassessment was derived from an assumed transfer of assets (i.e., the equipment) from the taxpayer to the corporation whereas the shareholder benefit under the reassessment under appeal was a contribution by the corporation towards the shareholder's purchase of different assets (i.e., the fishing licenses).

In response, the Crown put forth three alternative arguments:

> (1) subsection 152(5) is not applicable to a reassessment made pursuant to subsection 165(3) subsequent to receipt of a notice of objection;
>
> (2) subsection 152(5) only limits the *amount* for which the Minister may reassess a taxpayer after the expiry of the normal limitation period, and the 2014 reassessment is consistent with such limitation since the $50,000 included in the taxpayer's income is part of the $70,000 that had already been included in his income by the 2012 reassessment; or
>
> (3) if the 2014 reassessment is found to be invalid, the 2012 reassessment is valid and the taxpayer is liable for tax on the $70,000 shareholder benefit that was included in that reassessment.

The Tax Court (*per* Paris J.) concluded that the Minister indeed had the statutory authority to issue the 2014 reassessment notwithstanding that the normal reassessment period had lapsed and such reassessment was based upon (due to the rectification order) transactions that had (arguably) not been the subject of assessing activities of the Minister within such period.

In so finding, the Court confirmed that reassessments made pursuant to subsection 165(3) are indeed subject to the limitation on reassessing found in subsection 152(5). The rationale for this finding was that subsection 165(5) specifically provides that subsections 152(4) and 152(4.01) of the Act are not applicable to reassessments made pursuant to subsection 165(3) and "[s]ince subsection 152(5) is not referred to in subsection 165(5), it must be inferred that it is applicable to a reassessment made under subsection 165(3)".

As noted by the Court, this finding is consistent with the decision of the Federal Court of Appeal in *Canada v. Anchor Pointe Energy Ltd.* (2003 DTC 5512). However, Paris J. builds upon the general proposition set out in *Anchor Pointe*, holding as follows:

> [35] I also agree with the Appellant that in making a reassessment pursuant to subsection 165(3) after the expiry of the normal reassessment period, the Minister may not change the basis of the reassessment against the taxpayer. The Federal Court of Appeal in *Walsh v. The Queen*, 2007 FCA 222 held that after the expiry of the normal reassessment period the Minister cannot rely on a new argument that includes transactions which did not form the basis of the taxpayer's reassessment. While that case dealt with the application of subsection 152(9) of the *Act*, I find that the same principle applies to subsection 165(3) reassessments made after the expiry of the normal reassessment period.

> [36] The reference in subsection 152(5) to "amounts" in the phrase "amounts that were not included in an assessment or reassessment made within the normal reassessment period" must be taken to mean not just dollar amounts but amounts as they relate to particular transactions undertaken by the taxpayer. Therefore, the Minister is not permitted after the expiry of the normal reassessment period to include amounts that arise from transactions other than those that underlie an assessment or reassessment made within the normal reassessment period even if the dollar amount of the reassessment would be unchanged. [emphasis added]

In applying these principles to the facts of the case at hand, the Court concluded that the transactions underlying the 2014 reassessment were the same as those on which the 2012 reassessment was based. Although the reasons for decision do not go into great detail on this point, the Court seems to have been persuaded by the following factors:

- Both reassessments involved the acquisition of equipment and licences from the arm's length vendor and the payment of $200,000 by the corporation to the vendor. All that changed between the two reassessments was the Minister's understanding (due to the intervening rectification order) of the role of the taxpayer and the taxpayer's corporation in those transactions.
- The crux of the two reassessments was identical: the taxpayer's corporation overpaid for the equipment and the amount of the overpayment constitutes a shareholder benefit to the taxpayer.

While the taxpayer brought the motion to have the Tax Court answer the question on the scope of the Minister's reassessment authority as a preliminary matter, it appears that the Court's response to the question was dispositive of the whole matter, as the taxpayer has since discontinued his Tax Court appeal of the 2014 reassessment.

While the facts in *Foster* are rather unique, the decision is useful in that it confirms the following:

> (1) the limitation on reassessing found in subsection 152(5) does indeed apply when the Minister seeks to issue or vary a reassessment pursuant to subsection 165(3) in response to an objection;
>
> (2) the meaning of the word "amount" in subsection 152(5) is not limited to dollar amounts, but also includes amounts as they relate to particular transactions undertaken by the taxpayer, meaning that the Minister cannot, following the expiration of the normal reassessment period in respect of a taxation year, include amounts that arise from transactions other than those that underlie an assessment or reassessment made within that period even if the dollar amount of the reassessment would be unchanged;
>
> (3) in addition to barring the Minister from including any amounts in computing the income of a taxpayer for a taxation year after the normal reassessment period has ended, subsection 165(3), like subsection 152(9), does not permit the Minister to rely on a new argument that includes transactions that did not form the basis of the assessment under objection (see the Federal Court of Appeal's decision in *Walsh v. Canada (National Revenue)* (2007 DTC 5441), which was cited in *Foster*); and
>
> (4) the Minister may be within the confines of the principles outlined in (2) and (3) above if the "crux" of the assessment objected to and the reassessment made pursuant to subsection 165(3) is identical (as was found to be the case in respect of the 2012 and 2014 reassessments pertaining to Mr. Foster).

— *Brian O'Neill*

RECENT CASES

Small business deduction properly denied — management services provided were a personal services business

The taxpayer was appealing reassessments that denied its claim for a small business deduction and limited expenses claimed on the basis that it was providing services as a "personal services business" ("PSB"). The taxpayer, ICL, was incorporated by Ivan Cassell in 1983 to operate a home comfort centre for Imperial Oil. After several years, he went to work for Ultramar for about six years as a supervisor, looking after all the independent retail agents of Ultramar located on the west coast of Newfoundland and southern Labrador. In 1990 he left Ultramar and bought an area of retail business from them outside the major urban centres of Newfoundland. Cassell began growing ICL's retail oil and gas business by acquiring several gas stations in areas that the major oil companies were leaving. The retail oil and gas business of ICL was carried on under the business name Western Petroleum ("WP"). In 2005 WPNL was incorporated and ICL transferred its WP business to WPNL and the business expanded throughout Newfoundland. Cassell was the president and director of WPNL. At issue were the services provided by Cassell to WPNL in his capacity as president of

ICL. The services were provided under an oral agreement and included banking, negotiating contracts, and dealing with suppliers.

The appeal was dismissed. If Cassell would reasonably be regarded as an employee but for the existence of ICL, the small business deduction is not available to ICL and the PSB provisions would apply. The PSB provisions are designed to deny tax advantages that may be obtained by providing services through a corporation rather than personally. There is no one conclusive test or determinative factor but issues of control, risk of loss, and opportunity for profit or risk of loss are to be considered. The stated objective of Cassell providing services to WPNL was to grow its business with no mention of ICL's business. There was no written agreement between ICL and WPNL, no HST was charged on fees paid by WPNL, and ICL did not advertise its services. ICL leased gas stations to third parties, distinct from their providing management services, which generated income for WPNL. When the tenants were delinquent in paying rent, they were not pursued for the rent so that WPNL would continue to gain revenue. The profitability of WPNL took precedence over the earning of rent by ICL, confirming that Cassell's focus was solely on the profitability of WPNL's business. Someone in business on his own account would not have such a focus. The functions performed by Cassell after the transfer to WPNL were the same as those performed by him as a senior employee of ICL. Any opportunity for profit was tied to the success of WPNL and there was limited exposure to risk of loss. Cassell had the use of a company car and had a makeshift desk to work at when he went into the office. Although there was no direct control of Cassel's activities he had weekly meetings at WPNL which is consistent with what one would expect in terms of control for a senior employee. There was no evidence to support a conclusion that Cassell was providing services as a person in business on his own account. But for the existence of ICL, Cassell would reasonably be regarded as an employee and the services provided to WPNL were those of a PSB. The small business deduction was properly denied.

Ivan Cassell Limited v. The Queen

2016 DTC 1048

Minister not bound by foreign judgments where such judgments not reviewed by Canadian court

During the 2004, 2005, and 2006 taxation years, the corporate taxpayer's foreign affiliates transferred amounts to it and declared such transfers to be dividends. The taxpayer obtained rectification orders from courts in Barbados and Cyprus which re-characterized those amounts as transfers from the foreign affiliates resulting in indebtedness of the taxpayer. The Minister of National Revenue nonetheless assessed the taxpayer on the basis that the transferred amounts were dividends. The taxpayer appealed from that assessment and sought a determination by the Court of whether the Minister was required, by virtue of the foreign rectification orders, to treat the transferred amounts as indebtedness rather than dividends.

The Court determined that the minister was not bound by the foreign rectification orders. The Court held that rectification orders requested by the parties to a transaction in order to rectify the tax consequences of that transaction are not automatically granted. Rather, it is open to the courts to intervene to find that the amendments made by the parties to the acts at issue are legitimate and necessary, and judicial recognition of the validity of such amendments in the context of tax planning is to be approached cautiously. The Court held that in the present case a domestic court would have to consider relevant factors so as to ensure that the foreign judgments did not disturb the structure and integrity of the Canadian legal system or conflict with domestic law. A careful review of the foreign judgments would be required in order to ensure that a Canadian court did not extend judicial assistance if the Canadian justice system would be used in a manner not available in strictly domestic litigation. The Court concluded, therefore, that the foreign judgments would have be homologated by a competent tribunal in the province of Quebec in order to bind the Minister. The Court noted as well that, although it did not have jurisdiction to grant the equitable remedy of rectification, it was open to the appellant to rely on the foreign judgments in presenting its evidence at trial, where the presiding judge could determine the weight to be given such judgments in ruling on the validity of the assessment. The Court concluded that the Minister was not bound by the foreign judgments in issuing the assessment.

Canadian Forest v. The Queen

2016 DTC 1041

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