

Tax Topics

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BUDGET 2017 — SHOTS ACROSS THE BOW — AND SOME DIRECT HITS. . .

— Michael Goldberg, partner through a professional corporation at Minden Gross LLP¹

The lead-up to the March 22, 2017 Federal Budget (“Budget”) was filled with fear and trepidation that the Trudeau Liberal Government (“Government”) would use the Budget to grab more taxes from Canadians to pay for their platform promises. In particular, in advance of the Budget, there was concern that capital gains inclusion rates were likely to increase significantly, from the 50% inclusion rate to 75% or possibly even more.

The good news for taxpayers — at least for now — is that the Budget did not make any particularly significant *tax rate* changes at all.² Unfortunately, that is not to say that the Budget was a tax non-event.

Shots Across the Bow

Tax professionals are always worried about something. It seems to be an occupational hazard, or perhaps a deeply-ingrained socialized character flaw. Perhaps it is that we’ve adopted Bruce Cockburn’s song “The Trouble with Normal (is it always gets worse)” as our theme song — or maybe that’s just me. In any case, it appears this Budget has left us with reason to be worried.

Contained deep in the Budget papers,³ under the heading “A Tax System That’s Fair for Middle Class Canadians”, is a discussion about “Tax Planning Using Private Corporations”, setting out the theme that high-income individuals are using corporations to avoid paying their fair share of taxes. Some of the variety of strategies that the government notes it is concerned about *include* using private corporations to:

- (1) allow high-income individuals to shift income to lower-income family members or other non-arm’s length persons that can reduce (or even eliminate) overall taxes in a non-arm’s length group;
- (2) cause passive income to be taxed at *much* lower tax rates than if the income had been earned personally; and
- (3) convert regular income into capital gains, which because of the high tax rates on dividend income can significantly reduce the integrated tax rate in connection with earning income through a corporation as opposed to if such income had been earned personally.

¹ Michael Goldberg, partner through a professional corporation at 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.

² The Budget does contain significant tinkering with various credits and other tax attributes that will impact individuals and corporations. In addition, although for now services such as Netflix have dodged the bullet, a new Uber tax has scored a direct hit by extending GST/HST to ride-hailing services so that they are treated in a manner similar to traditional taxi services.

³ See page 199 of the Budget Plan.

In short, the Government is not amused. Stay tuned for more developments — which may be coming in the form of a report in the next few months.

Some other shots fired in the Budget include commitments made to collaborate with the provinces to ensure transparency regarding beneficial ownership, which is in keeping with broader anti-money laundering initiatives carried on by the Government. In addition, as if taxpayers didn't have enough to worry about, the Budget proposes investments of more than half a billion dollars in the Canada Revenue Agency — which the Budget projects will result in revenue of \$2.5 billion over five years.

Direct Hits

Some of the direct hits fired in the Budget, while disappointing, were at least foreseeable.

A number of strategies used by taxpayers to manage their tax situations and/or to benefit from certain fact patterns took direct hits in the Budget. For example, the use of straddle transactions (or "straddles", colloquially)⁴ to manage a taxpayer's taxable income appear to have been effectively eliminated in respect of straddles entered into on or after the date of the Budget. Also, the "*de facto* control" test, a test that is critical to causing a number of provisions in the *Income Tax Act* (Canada) ("Act") to become applicable, including the association rules,⁵ is proposed to be broadened significantly. The change to this test is intended to legislatively override recent case law that the Government obviously did not agree with.⁶

On the other hand, I don't know any advisors who foresaw the elimination of the so-called "billed-basis accounting" exclusion available to professionals who elect to defer the value of their work-in-process ("WIP"). Assuming that this proposal is enacted, professionals will be required to determine the lesser of the cost and fair market value of their WIP each year ("WIP Amount") and, beginning in the taxation year ending after the particular professional's current taxation year, the professional will be required to take 50% of the WIP Amount at year-end into income for that taxation year (for professionals with calendar year-ends, the relevant period for this first inclusion will be the taxation year ended December 31, 2018). Thereafter, the professional will be required to include the full year-end WIP Amount in income, subject to claiming deductions for the WIP Amount included in the preceding year.⁷

The government has touted this change as being capable of raising nearly half a billion dollars of tax revenues over the next three years.⁸ Sadly, I can't imagine that in the current political/class warfare environment the general public will have much sympathy for the professionals being forced to pay these additional taxes.

While the elimination of billed-basis accounting is likely to impact all professionals to a certain degree, it would appear to especially hurt lawyers and accountants, who often carry large WIP balances at year-ends. This is particularly the case for any professionals who work on a contingency basis.

Assuming the billed-basis accounting proposals are enacted, the future battleground for professionals seeking to defer taxation of their WIP will shift to the valuation of WIP, since it is the lesser of the cost and fair market value of the WIP that will be taxable. However, that is an article that can be written⁹ on another day.

⁴ Straddles generally involve a taxpayer taking opposing positions (short and long positions) and managing them in a manner that will result in one position being in a gain position and the other in a nearly identical loss position. The taxpayer can then choose to time the realization of losses in a manner that would allow those losses to offset current year income and move the gain position into a subsequent taxation year. Similar transactions can be put in place year after year. The proposed changes are intended to defer the ability to realize the loss position to the extent that the gain remains unrealized.

⁵ Association has a number of consequences, including causing associated corporations to have to share certain Canadian controlled private corporation benefits such as access to the \$500,000 small business deduction limit and SR&ED benefits. The association rules are found in section 256 of the Act.

⁶ *McGillivray Restaurant Ltd. v. R.*, 2016 DTC 5048

⁷ Assuming WIP Amounts are constant over the first two post-Budget taxation years of the professional, effectively 50% of the WIP Amount will be included in income in each year. Subsequent increases or decreases in year-end WIP Amounts will give rise to net income inclusions or deductions, as the case may be.

⁸ It has been noted that this change may lead to many more professionals incorporating their practices, which generally appears to be sound advice. However, given the potential for ongoing changes to the taxation of corporations (not just corporations earning passive income — we tax advisors worry about there being further changes to the taxation of professional corporations too!), it is unclear whether such a strategy will be appropriate for all professionals in the long run.

⁹ By someone else.

CURRENT ITEMS OF INTEREST

Notice of Ways and Means Motion for 2017 Federal Budget

On April 7, 2017, the Department of Finance released a Notice of Ways and Means Motion and related explanatory notes to implement certain, but not all, provisions of the Federal Budget tabled in Parliament on March 22, 2017.

2017 Newfoundland and Labrador Budget

On April 6, 2017, the government of Newfoundland and Labrador introduced its 2017 Budget. The Budget contained no new taxes or tax increases except for gasoline tax changes.

2017 Prince Edward Island Budget

On April 7, 2017, the government of Prince Edward Island introduced its 2017 Budget. The Budget contained no new taxes or tax increases, but it did contain the following two changes:

- A 2% increase of the basic personal amount, spouse or common-law partner amount, and eligible dependant amount to claim a non-refundable tax credit.
- A change to protect the provincial education tax credit which would otherwise have been eliminated following the recent elimination of the federal education tax credit.

RECENT CASES

Appeal from Rule 58 determination of Tax Court judge allowed

The appellant had obtained court orders from two foreign jurisdictions which provided a rectification remedy re-characterizing dividend payments made as loans, but the Minister of National Revenue refused to accept such re-characterization for Canadian tax purposes. The taxpayer appealed to the Tax Court of Canada which held, on a Rule 58 application, that the foreign orders did not bind the minister. That decision was based on a finding that, under the Civil Code, homologation was required to render the foreign judgment enforceable in the province of Quebec and to bind the minister. The taxpayer appealed further to the Federal Court of Appeal.

The appeal was allowed. The appellate Court held, in agreement with the appellant, that foreign judgments must be taken as fact, even in the absence of homologation. The Civil Code provides that "an act purporting to be issued by a competent foreign public officer makes proof of its content against all persons. . ." The Court concluded that, as such, factual findings contained within those judgments were facts that could not be disregarded by a Court and that the foreign judgments in question were proof that the corporate resolutions had been rectified to authorize the dividend payments and to transform them into indebtedness. The Court held as well that as the minister was not a party to the foreign proceedings, there was nothing to enforce against the Minister and homologation was therefore a non-issue. On the question of the effect of the foreign orders with respect to the minister, the Court held that the resolution of that question would necessarily depend on the evidence adduced by the parties and the weight ascribed to the foreign orders as facts, pursuant to the provisions of the Civil Code. In the Court's view, such determination was to be made not on a Rule 58 application, but by the Tax Court judge on the basis of the full evidentiary record at his or her disposal. The appellate Court concluded, therefore, that it would allow the appeal, set aside the judgment of the Tax Court and decline to answer the question under Rule 58, and that it would also dismiss the Rule 58 motion before the Tax Court.

Corporate taxpayer's application for judicial review of CRA's fairness decision denied

The corporate taxpayer applied for relief (under sections 281.1 of the *Excise Tax Act* and 220(3.1) of the *Income Tax Act*) from penalties and interest for payroll and GST/HST accounts for 2009-2014, and from penalties and interest related to income tax arrears for 2004 and 2005. In denying this relief a CRA Team Leader concluded, in essence, that: (a) the taxpayer admittedly provided information that did not show a positive financial situation for some tax years; (b) the taxpayer's directors did not exercise the reasonable care expected to ensure proper filing and remittance compliance; (c) the taxpayer was not prevented from meeting its filing obligations due to circumstances beyond its control; and (d) source remittance deductions should be held in trust and remitted, and not used to fund business operations. The taxpayer applied to the Federal Court for judicial review of the CRA Team Leader's decision.

The taxpayer's application was dismissed. The Team Leader's decision that there was no conclusive evidence of financial hardship or extraordinary circumstances facing the taxpayer in this case was reasonable, based on the record before her. Nor was there any evidence to support the taxpayer's submission that the Team Leader conducted only a bare review of the evidence before her, or that she failed to understand the basis for the taxpayer's fairness request. Her decision therefore met the "reasonableness" criterion set out in *Canada Revenue Agency v. Telfer*, 2009 DTC 5046 (FCA). Her decision also fell within the range of possible and acceptable outcomes, and was rendered in a transparent, justifiable, and intelligible manner, in accordance with the criteria set out in *Dunsmuir v. New Brunswick*, 2008 UDT 101 (SCC).

¶49,615, *Donald Coley et al. v. MNR*, 2017 DTC 5025

INTERNATIONAL NEWS

Topical News Briefing: European Disunion?

by the *Global Tax Weekly* Editorial Team

This article originally appeared in Wolters Kluwer's Global Tax Weekly Issue 230.

At a time when the EU is pushing for greater harmonization of its member states' laws, harmony is not the first word that one might use to describe some attitudes to EU policy at national level at present, including in the area of taxation.

Generally, the EU has managed to rally widespread support among member states for its various recent anti-tax avoidance initiatives, such as the administrative cooperation and anti-avoidance directives, which feed into global efforts to crack down on base erosion and profit shifting. However, the European Commission's probe into national tax rulings, sometimes referred to as "comfort letters", appears to have crossed a line for some members of the bloc.

As reported in this week's issue of *Global Tax Weekly*, Luxembourg is particularly unhappy about the campaign to clamp down on private tax rulings issued to mainly multinational taxpayers by member states' tax authorities, and is preparing to support Ireland in its appeal against the controversial order from the Commission to recover €13 billion (US\$13.9 billion) in state aid from Apple.

Indeed, there has been a great deal of unease about the Commission's recent policy of challenging individual tax rulings using the state aid laws, which have not been used in such a systematic way before. Not only are questions being raised about the legitimacy of the Commission's approach, but there are also objections to the highly retrospective nature of some of the claims, especially in the Apple case, which has created waves on both sides of the Atlantic, with some members of the US Congress having fiercely criticized the Commission's actions.

There is also a palpable lack of enthusiasm for ideas that could encroach on member states' tax sovereignty. A prominent example is the proposed common consolidated corporate tax base ("CCCTB"), which the Commission recently repackaged as both an anti-BEPS and a pro-simplification initiative. However, with analyses of the CCCTB showing that small member states in particular could lose out as multinationals apportion more profits in large countries, some are hostile to the idea, notably Ireland.

The Commission has also struggled to sell the idea of an EU financial transactions tax ("FTT"). With no chance that all 28 member states were going to agree to its original proposals, released in 2011, a core group of just 11 member states forged ahead under the rarely used enhanced cooperation mechanism. However, as was reported recently, even this core group is struggling to come to an agreement on a final version of the tax, and there is a very real possibility that the proposals will have to be abandoned if fewer than the minimum of nine member states needed to invoke enhanced cooperation are left at the end of the next round of talks.

Ultimately, with the EU now up to 28 member states (although this will of course be reduced by one when, as is expected, the UK exits the bloc), it is now becoming harder for the EU to achieve a consensus on new initiatives at European level. And this fact has led the EU to conclude in a recent White Paper on the bloc's future that a two-speed Europe might be more effective at bringing about policy changes, split between a "coalition of the willing," and, one might say, a coalition of the not-so-willing. This is something we saw with the introduction of the single currency, and could be a trend that multinational investors in Europe may encounter more and more in the area of taxation.

Commerce Secretary Discusses NAFTA Agenda

This article originally appeared in Wolters Kluwer's Global Tax Weekly Issue 230.

US Commerce Secretary Wilbur Ross has discussed the amendments the US will be seeking to the North American Free Trade Agreement ("NAFTA").

Ross told CNBC the US will update NAFTA to ensure there are no "back doors" for non-NAFTA countries to access its provisions through lacking rules of origin.

He said rules of origin are "a loophole that allows material from outside [NAFTA states] to come in and yet be counted as though it was NAFTA-produced, up to certain limits."

Moving on to discuss trade in general, he noted that the US has three times sought to level the playing field for US businesses concerning foreign countries' value-added tax systems, which permit refunds for exported goods. He said: "We in the US do not have a value-added tax but the World Trade Organization three times has turned down legislation three times drafted by our Congress to per cent the rebate of our equivalent, namely corporate income taxes, on our exports. It's totally unfair to let our competitors get a rebate, sometimes as high as 20 per cent, on their exports. And, yet, we can't get a rebate of our taxes. That's a problem that has to be solved in one way or another, and we will be using NAFTA as a partial means of addressing VAT."

"It would be a nation-to-nation solution, not a solution particular to any one individual company", he told CNBC.

He said the Trump Administration is undecided on the issue of the Border Adjustment Tax, saying that although the Administration is "studying it very, very carefully . . . [it] has taken no position on it as of yet."

Ross confirmed that he hopes to initiate the 90-day consultation period for NAFTA renegotiation prior to the spring recess.

Irish Business Concerned By US Tax Reform

This article originally appeared in Wolters Kluwer's Global Tax Weekly Issue 230.

The introduction by the US of a Border Adjustment Tax ("BAT") would "present by far the greatest challenge for Irish business", according to Fergal O'Brien, Director of Policy and Public Affairs at business association Ibec.

Ibec has published its Q1 Quarterly Economic Outlook. It forecasts growth of 3.1 per cent for 2017, and 2.8 per cent for 2018. Employment is expected to grow by 2.4 per cent in 2017, creating almost 50,000 jobs.

In spite of these positive figures, O'Brien said that "the economic impact of changes to our trading relations with the US . . . are still unknown and are a cause of concern for Irish businesses."

The US accounted for 24 per cent of Irish exports in 2015, up from 16 per cent in 2002. According to Ibec, the BAT "has the most potential to seriously undermine Irish exports to the US."

It explained: "The scheme would be equivalent to imposing tariffs (equal to the corporation tax rate) on imports while subsidizing exports. If this proposal were introduced, it could have a significant impact on Irish exports to the US depending on its impact on the dollar."

Professional services firm PwC has published a briefing on US tax reform and considerations for Irish businesses. It said that, in attempting to encourage the location of intangibles and manufacturing in the US, a BAT could provide a significant challenge to foreign direct investment and other investment in Ireland.

However, PwC noted that it is far from certain that a BAT will be implemented, and pointed out the political difficulties of implementing a value-added tax style system. "It is an attempt to adopt a consumption tax, like a VAT with its border adjustable feature, in place of an income tax, and would be a radical departure from the traditional corporate tax system. Implementing it in this fashion would be much more complex than simply enacting a VAT", it said.

Nonetheless, PwC warned that were the US to move to a system of this kind, "the EU and other trading partners could seek to introduce in their income tax systems similar restrictions for US companies seeking to import into those jurisdictions."



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For Wolters Kluwer Canada Limited

TARA ISARD, Senior Manager, Content
Tax & Accounting Canada
(416) 224-2224 ext. 6408
email: Tara.Isard@wolterskluwer.com

NATASHA MENON, Senior Research Product Manager
Tax & Accounting Canada
(416) 224-2224 ext. 6360
email: Natasha.Menon@wolterskluwer.com

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Wolters Kluwer Canada Limited
300-90 Sheppard Avenue East
Toronto ON M2N 6X1
1 800 268 4522 tel
1 800 461 4131 fax
www.wolterskluwer.ca

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email: circdept@publisher.com

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