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2013 CANADIAN TAX FOUNDATION ROUNDTABLE — PART I

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On November 26, 2013, the Canada Revenue Agency ("CRA") participated in the annual Roundtable session at the 65th Annual Tax Conference of the Canadian Tax Foundation held in Toronto, Ontario.

The CRA was represented by Randy Hewlett, Director of Income Tax Rulings; Mark Symes, Director of Income Tax Rulings; and Jeff Sadrian, Director of Compliance Programs Branch. The Roundtable was chaired by Elio Luongo of KPMG LLP and John Tobin of Torys LLP.

Although the discussion this year covered a range of topics, there was a significant focus on international issues, including questions on foreign affiliates and foreign property reporting requirements. There were also numerous references to comments made by CRA representatives at the 2013 International Fiscal Association ("IFA") Conference held in Denmark, Copenhagen earlier this year.

The Roundtable session was presented in a question and answer format. The summary below is based on notes taken by attendees during the session and a PowerPoint presentation prepared by the panellists and released by the Canadian Tax Foundation ("CTF") which sets out the questions. Written answers from the CRA are to be provided at a later date. Any references to the Act are references to the *Income Tax Act* unless otherwise indicated.

Due to its length, this summary is divided into two parts. Part I includes summaries of answers to questions 1–7; Part II includes summaries of answers to questions 8–16. Part II will be published in a subsequent edition of *Tax Topics*.

Question 1: Pre-Ruling Consultations

The CRA announced a new pilot project launched by the Income Tax Rulings Directorate ("ITRD") to provide pre-ruling consultation services. Taxpayers may now approach the ITRD on a formal, written basis to obtain a preliminary "pre-ruling" on a particular issue in order to determine whether the ITRD will issue a full ruling on the same issue in the future. A fee will be charged for taxpayers who use this service similar to the manner in which "Advance Rulings" are obtained. The objective of this service is to prevent situations where taxpayers have incurred costs to obtain a ruling which the ITRD cannot provide.

Additional information on the service is available on the CRA website (http://www.cra-arc.gc.ca/tx/txprfssnls/srvcs/prcnsltns/pltprjctprcnsltnts-eng.html).

Question 2(a): Repayment of Upstream Loans

The CRA was asked to comment on the repayment of upstream loans. The upstream loan rules generally require Canadian-resident taxpayers to include a "specified amount" of an upstream loan made by a foreign affiliate of the taxpayer to a "specified debtor" if the loan is outstanding for more than two years. The specified amount to be included in income is calculated under subsection 90(15) of the Act. The specified debtor includes a person with whom the taxpayer does not deal at arm's length or a partnership which includes the taxpayer or non-arm's length persons.

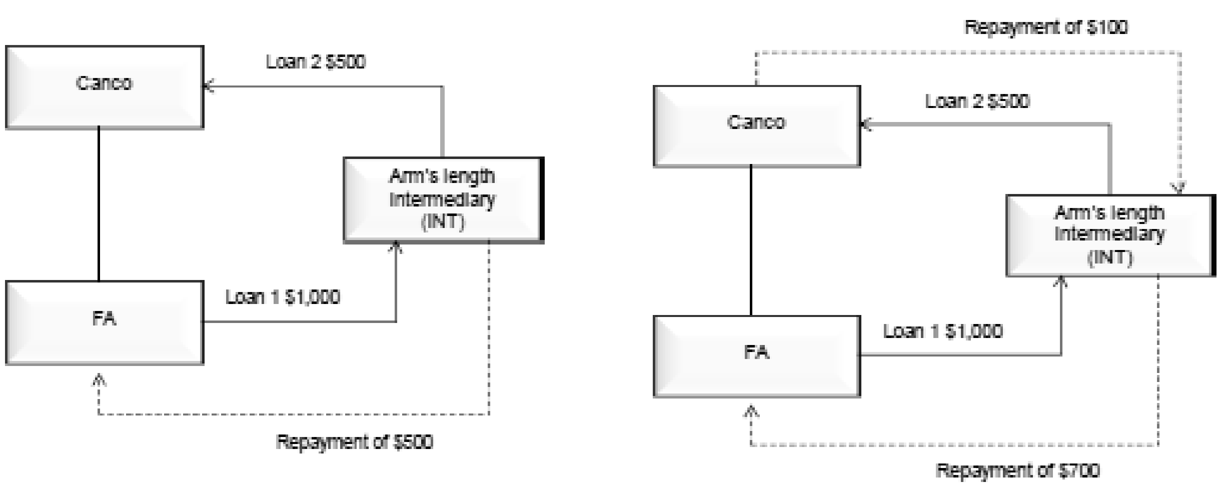
As per paragraph 90(8)(*a*) of the Act, there is no inclusion of an upstream loan in a taxpayer's income if the upstream loan is repaid within two years of the day the loan is made (other than as a series of loans or other transactions and repayments) or if the loan is made in the ordinary course of a creditor's business and reasonable arrangements were made to repay the loan within a period of time. The CRA was asked under what circumstances it would consider a loan or indebtedness to have been repaid.

The panellists commented that the CRA is generally guided by its policies under subsection 15(2) of the Act. This position was previously stated at the 2013 IFA Conference. The panellists noted that they will make a factual determination based on the intention of the parties, the provisions of any relevant agreements, and accounting records to determine whether a repayment of the loan has been made. Loans or indebtedness that have been "set off" against receivables are considered to have been repaid by the CRA.

The CRA further stated that it would be difficult to comment on cash pooling arrangements in the context of upstream loans, as such arrangements have varying parties, attributes, and legal relationships. However, the panellists did note that cash pooling has been considered in the context of subsection 15(2) loans and analogous principles would likely apply.

Question 2(b): Back-to-Back Upstream Loans

The CRA provided two examples to further demonstrate when, in its view, an upstream loan may have been repaid. In both examples there were three parties: a foreign affiliate, a Canadian-resident corporation, and an arm's length intermediary.



In the first example, the foreign affiliate loans $1,000 to the intermediary lender (Loan 1), which then loans $500 to Canco (Loan 2). If the intermediary repays $500 of Loan 1, the CRA would not consider any portion of the upstream loan to be repaid.

In the second example, if Canco repays $100 of Loan 2 and the intermediary repays $700 from Loan 1, then $200 of the upstream loan would be considered by the CRA to be repaid.

The CRA panellists reiterated that a factual determination is required to determine when back-to-back loans are considered to have been repaid in an upstream loan situation.

Question 3: *CAE Inc. v. The Queen*

The CRA provided its views on the Federal Court of Appeal's ("FCA's") decision in *CAE Inc. v. The Queen* (2013 DTC 5084) with regards to the change-in-use rules in the Act outlined in subsections 13(7) and 45(1).

In this case, the taxpayer sold certain flight simulators and leased other flight simulators to entities that provide flight training services. One of the issues raised in the case was whether the taxpayer could claim capital cost allowance ("CCA") on simulators that were initially leased to customers and sold at a later date or on simulators leased to customers who held options to purchase. Under subsections 13(7) and 45(1) of the Act, there is a deemed disposition at fair market value upon a change in use of depreciable or non-depreciable capital property to (or from) an income-earning property. The FCA held that these two subsections could also apply on a conversion of property from inventory to capital property and vice versa.

At the conference, the CRA stated that it considers the FCA's comments on the application and interpretation of subsections 13(7) and 45(1) to be *obiter dicta*. The CRA maintains its position outlined in Interpretation Bulletin IT-102R2, "Conversion of Property, other than Real Property, from or to Inventory" (July 22, 1985) and Interpretation Bulletin IT-218R, "Profit, Capital Gains, and Losses from the Sale of Real Estate, Including Farmland and Inherited Land and Conversion of Real Estate from Capital Property to Inventory and Vice Versa" (September 16, 1986), namely that these change-in-use provisions will only apply when property is converted from an income-producing purpose to a non-income-producing purpose and not when property is converted from inventory to capital property where the property continues to be used to produce income. The panellists stated that the FCA's interpretation of the change-in-use provisions would result in "untenable results" and would create a significant administrative burden for both the CRA and taxpayers.

The CRA's position is that the change-in-use rules should only apply where there is a change from a personal use to an income-earning use and vice versa (not to changes between inventory use and income-generating use as capital property). As such, despite the Court's comments in *CAE*, the panellists noted it was "business as usual" at the CRA with respect to this issue.

The panellists concluded that the CRA will likely issue an update on this issue in the future.

Question 4(a): T3 and T5 Exemptions for T1135 Reporting Purposes

The panellists were asked for administrative guidance on the practical application of the T3/T5 exemption for T1135 purposes.

Under section 233.3 of the Act, if the cost of foreign property exceeds $100,000 at any time in the year, Canadian taxpayers are obligated to report these holdings in form T1135, "Foreign Income Verification Statement". Form T1135 applies on a property-by-property and year-by-year basis. The T1135 requirements have recently been revised to require, for each property, the country in which the property is located, maximum cost amount, and other details. Form T1135 now states that "where the reporting taxpayer has received a T3 or T5 from a Canadian issuer in respect of a specified foreign property for a taxation year, that specified foreign property is excluded from the T1135 reporting requirement for that taxation year".

The panellists stated that, in their view, the underlying T1135 criteria have not necessarily changed and the process remains the same; despite the revisions made to the forms, all that is required is additional information and detail. The CRA noted that any errors on the T1135 form could result in an extension of three years to the normal reassessment period which, as per subsections 152(3.1) and (4), is generally three years from the date of the original notice of assessment.

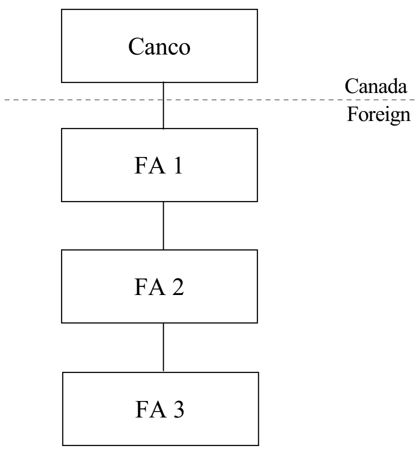
The panellists noted that the reporting requirements will continue to be subject to ongoing consultations with various stakeholders.

Question 4(b): Electronic Filing of T1134/T1135

There is no electronic filing for these forms and they must be paper filed. An electronic option may be made available shortly.

Question 4(c): T1134 Reporting

In 2013, a new T1134 return entitled "Information Return Relating to Controlled and Non-Controlled Foreign Affiliates (2011 and Later Years)" was released to consolidate forms T1134A, "Information Return Relating to Foreign Affiliates That Are not Controlled Foreign Affiliates", and T1134B, "Information Return Relating to Controlled Foreign Affiliates".



At the Roundtable, the CRA panellists were asked to comment on duplicate reporting requirements in the new T1134. The panellists noted that the issue of repetitive reporting was discussed earlier at the 2013 IFA Conference. The CRA panellists stated that the CRA will no longer require repetitive reporting on T1134 tiered structures. Only direct equity interests in foreign affiliates should be reported and not indirect interests.

In the example provided by the CRA, the form will no longer require FA 3 to be reported twice by FA 1 and FA 2, as these are indirect equity interests.

Question 5(a): Article XXIX-A of the Canada-US Tax Treaty

Article XXIX-A of the Canada-US Tax Treaty contains several tests to determine which persons are entitled to treaty benefits. Under Article XXIX-A(2)(*c*), a "qualifying person" includes a company whose principal class of shares is primarily and regularly traded on a recognized stock exchange. The CRA was asked what issues have been considered with respect to this provision.

The panellists noted that the CRA evaluates each class of shares separately to determine if it qualifies and satisfies the "regularly traded" requirements in Article XXIX-A(2)(*c*). The panellists noted that in one situation the CRA refused to rule that "super-voting shares" closely held by a corporation satisfied the test and were "regularly traded". In CRA Document No. 2011-0429261R3, "Article IV(7)(*b*) Loan Restructuring" (2011), a Canadian subsidiary of a US corporation with one class of traded shares was given a favourable ruling with the qualification that the parent company had to maintain its listing and trading.

Question 5(b): Article XXIX-A Active Trade or Business

The CRA was also asked to comment on paragraph 3 of Article XXIX-A, which allows non-qualifying persons to obtain treaty benefits for income derived from the other contracting state if the "active trade or business" test is satisfied. The CRA considers the relative size of assets, number of employees, and other factors to determine if this test is met. For views on Article XXIX-A paragraph 3, see, for example, CRA Document Nos. 2012-0458361R3, "Cross-Border Financing" (2012); 2009-0317941E4, "Canada-US Tax Convention Art XXIX-A" (April 12, 2010); and 2009-0345881C6, "Article XXIX-A:3 of the Canada US Tax Treaty" (November 2, 2009).

The CRA has also given favourable rulings in the context of bankruptcies. For example, see CRA Document No. 2012-0435211R3, "Article XXIX-A(3) of the Canada-US Tax Convention" (2012).

Question 5(c): Article XXIX-A Derivative Benefits

Paragraph 4 of Article XXIX-A of the Canada-US Tax Treaty provides an exception where a company resident in a contracting state is entitled to treaty benefits even if the company is not a "qualifying person" and does not satisfy the active trade or business test. This "derivative benefits test" is met if two sub-tests, namely an ownership test in Article XXIX-A(4)(*a*) and a base erosion test in Article XXIX-A(4)(*b*), are satisfied.

The CRA was asked to provide an overview of recent ruling requests related to paragraph 4. The panellists commented on a recently released ruling, CRA Document No. 2012-0471921R3, "Deemed Dividend on Return of Capital" (2013), wherein the CRA was unable to rule on the base erosion test but the ownership test was satisfied. In the ruling, the CRA stated that the "derivative benefits" test was met so long as the base erosion test was satisfied in the present year.

Question 6: *Daishowa-Marubeni International Ltd. v. Canada*

In *Daishowa-Marubeni International Ltd. v. Canada* (2013 DTC 5085), the Supreme Court of Canada considered whether the vendor of forest tenures was required to include the cost of reforestation obligations in its "proceeds of disposition". The Supreme Court held that these obligations were not a separate liability but were "embedded" and related to the value of the property in question. As a result, the Court held that the value of the embedded obligation did not give rise to a separate amount that should be included in the vendor's proceeds of disposition.

The panellists confirmed that the CRA accepts the holding in this case. The panellists stated that a directive was issued to CRA field auditors to treat reclamation obligations in mining, oil and gas, and forestry services in a manner consistent with this case. The panellists implied that this directive only applied to the resources sector.

Question 7: Amendment of Prior Year Discretionary Deductions

The CRA was asked to clarify its position that amending returns in prior years and reversing claims of capital cost allowance to reduce reporting non-capital losses is not permissible.

The panellists stated that amending prior year returns in order to reduce reported non-capital losses by reversing claims of capital cost allowance is not permitted if it would enable taxpayers to create new non-capital losses that would have otherwise expired. Subsection 111(5.1) contains specific rules, applicable on an acquisition of control of a corporation by a person or groups of persons, that limit the carry forward of specific losses for depreciable capital property to discourage trading in loss corporations.

The panellists noted that guidance provided in Information Circular IC84-1, "Revision of Capital Cost Allowance Claims and Other Permissive Deductions" (July 9, 1984), regarding requests to amend prior year capital cost allowance claims in taxable and non-taxable years is discretionary and should be applied to "resuscitate" losses but not "resurrect" losses that are completely "dead".

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TAX AGREEMENT BETWEEN CANADA AND PANAMA ENTERS INTO FORCE

On December 6, 2013, the "Agreement between Canada and the Republic of Panama for Tax Cooperation and the Exchange of Information Relating to Taxes" entered into force. Signed on March 17, 2013, the Agreement has effect in accordance with the provisions of its Article 11.

RECENT CASES

Solicitor-client privilege did not protect taxpayer from disclosing financials from his law practice

This appeal was to consider the solicitor-client privilege asserted by the taxpayer, who was the subject of enforcement proceedings by the Canada Revenue Agency ("CRA") under a compliance order issued by the Federal Court. He argued that his accounts receivable accounts, inclusive of client names and amounts, were protected by solicitor-client privilege. Moreover, the taxpayer raised section 8 of the *Canadian Charter of Rights and Freedoms*, arguing the CRA's requirement for information was akin to an unreasonable search or seizure.

The taxpayer's appeal was allowed in part. The threshold for protection of the taxpayer's business financials was low to ensure compliance with the *Income Tax Act*. Moreover, such privilege is afforded to the client, not to the solicitor, and there was no evidence that clients were consulted on seeking such protection. Accordingly, the lower court did not err in finding that the information requested was not subject to solicitor-client privilege. The taxpayer did not point to any palpable error in the lower court's decision as to the Charter questions that would justify intervention. However, the appeal was partly allowed, as the lower court should have taken the appropriate steps to verify whether solicitor-client privilege protected any of the taxpayer's clients individually.

¶48,586, *Thompson*, 2013 DTC 5146

Tax appeal process was proper forum to determine residency of trust

The applicant brought an originating application to the Court for a declaration that a trust settled for the benefit of the spouse of N (also the sole trustee of the trust) was a validly settled trust. The Canada Revenue Agency ("CRA"), as agent of the Province of Ontario, took the position that the trust was a sham and, alternatively, if it was validly settled, it was liable to pay Ontario and not Alberta provincial taxes. The applicant argued that the Court had jurisdiction to rule on the validity of the trust, while the respondent argued that the Court should not exercise its discretion and defer to the tax appeal process. The trust held shares in Gypsum Technologies Inc. ("GTI"), which were later sold and realized profits to the trust. The respondent argued that if the trust was valid, any income would be attributed to the settlor under subsection 75(2). If it was valid, it was properly resident in Ontario where management and control were exercised.

The applicant's motion was dismissed. The Court declined to rule on the validity of the trust in favour of the tax appeal process. This was a tax dispute for which Parliament established a specific process that should not be circumvented by incidental litigation. Moreover, there was no evidence that the trustee would be prejudiced by the issues being determined by the Tax Court compared to the Alberta courts.

¶48,588, *Nerland*, 2013 DTC 5148

Minister's original *ex parte* compliance order set aside

The taxpayer promoted cruises for its customers. In July 2009, the Canada Revenue Agency ("CRA") commenced an employer compliance audit and asked for detailed information in relation to each cruise the taxpayer provided during 2007 and 2009 (the "Cruises"), much of which the taxpayer provided. However, the taxpayer did not provide registration forms, the list of the attendees on the Cruises, or the companies each individual on the Cruises represented. On February 1, 2011, on the Minister's *ex parte* application, the Federal Court ordered the taxpayer to provide this information (2011 DTC 5035). The taxpayer subsequently applied to have this order cancelled on the grounds that on the *ex parte* application the Minister failed to make full and frank disclosure and a number of the assertions in the supporting affidavits were erroneous. The Minister argued that, since the two statutory conditions in paragraphs 231.2(3)(*a*) and (*b*) had been satisfied, the judge hearing the *ex parte* application had no discretion but to grant the application. Paragraphs 231.2(3)(*a*) and (*b*) stipulate that, to justify the issuance of an *ex parte* order, the judge must be satisfied that the unnamed person or group to which the Minister's requirement applies is ascertainable and that the requirement is being made to verify the person's or group's compliance with the *Income Tax Act*.

The application was granted. The Minister's argument based on paragraphs 231.2(3)(*a*) and (*b*) was rejected in *MNR v. Derakhshani* (2010 DTC 5043). In *ex parte* proceedings, moreover, the applicant must exercise the utmost good faith and make full and frank disclosure. In the taxpayer's case, the judge was told during the *ex parte* hearing by the CRA auditor that the CRA could not identify the individuals who attended the Cruises because the taxpayer did not issue T4A slips. This was inaccurate and misleading, inasmuch as the taxpayer had provided the CRA with the names of all the companies that nominated employees to attend the Cruises, and the CRA could have contacted these companies for the information being sought. The judge should have been told about this. Admittedly an *ex parte* order will only be disturbed where the non-disclosure is material, and where, if the non-disclosure had not occurred, the *ex parte* judge's exercise of his/her discretion would have been affected. In this case, however, there was material non-disclosure that could have affected the outcome, even though there was no suggestion of malicious intent on the CRA's part. The original *ex parte* order was therefore cancelled.

¶48,589, *Lordco Parts Ltd.*, 2013 DTC 5149

Taxpayer convicted on one charge of tax evasion and other related charges stayed

Although not an accountant, and although he had no formal qualifications, the taxpayer operated an accounting firm as a sole proprietor. He was charged in the Provincial Court of Saskatchewan with tax evasion and with filing false tax returns. Although he admitted failing to report the income in issue, he argued, in part, that he lacked *mens rea,* in that he had filed the returns in issue using income estimates and had made this clear to the Canada Revenue Agency ("CRA").

The taxpayer was convicted. The taxpayer's explanations for filing returns reporting income amounts that fell far short of his actual professional income earned lacked credibility, as did his insistence that he had always intended to file amended returns showing the correct amounts. The taxpayer, therefore, had the requisite *mens rea* to justify being convicted on the tax evasion and filing false returns charges. Following the principle in *R. v. Kienapple* (SCC), however, it was inappropriate to convict the taxpayer of both tax evasion and filing false returns on the same evidence. The taxpayer was therefore convicted on one count of tax evasion, and a judicial stay against all other charges was imposed at the expiration of all applicable appeal periods.

¶48,590, *Tiffin*, 2013 DTC 5150

Taxpayer did not have requisite intent to evade taxes

The accused taxpayer was a directional drilling consultant for a company called Newsco. During an audit of Newsco, it was determined that it had made payments to the taxpayer in 2001 to 2005 and that he had not filed personal returns for 2002 to 2005. For 2004 and 2005, he was accused of making false and deceptive statements by understating his taxable income and of evading taxes. At issue was $340,000 of income received from Newsco that was not reported in his personal returns. The taxpayer had a corporation he used as a consulting business and to receive payments from Newsco. Newsco provided the Canada Revenue Agency with copies of invoices submitted to it by the taxpayer in 2004 and 2005 and cheques sent to the taxpayer. The taxpayer hired an accountant to prepare his corporate and personal tax returns. The personal returns were filed by October 2006 and it was unclear when the outstanding corporate returns were filed.

The Crown failed to prove that the taxpayer made false or deceptive statements in understating his income taxes or that he wilfully evaded paying taxes for 2004 and 2005. To find the taxpayer guilty it must be proven beyond a reasonable doubt that he wilfully made false statements and wilfully evaded payment of taxes. While it was clear that the Newsco payments were not reported in the taxpayer's returns, there was reasonable doubt as to whether that was the fault of the taxpayer. The accountant was not a credible witness. He held himself out as a professional accountant and there was no reason for the taxpayer to doubt his expertise. The accountant failed to provide documentation of his meetings with the taxpayer, offered no documentation in support of his tax return preparation, and was unable to prove that he had ever sent the taxpayer the returns before or after they were filed. The accountant also had the wrong address for the taxpayer, which was another reason to doubt that the taxpayer had ever seen the returns. It was highly unlikely that the accountant did not see the invoices issued by the taxpayer to Newsco, the cheques received, or the taxpayer's banks statements. The taxpayer testified that he did not know what the accountant had filed, giving rise to reasonable doubt that he had knowledge of the contents of his tax returns.

¶48,591, *McMahon*, 2013 DTC 5151

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