Tax Topics

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THE LOSSES THAT FLOW?

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Introduction

In a business structure whereby you have a limited partnership (the "bottom-tier partnership") of which one or more partners is itself a partnership (the "top-tier partnership"), the question of the ability to use losses allocated by the bottom-tier partnership to the top-tier partnership is a complicated one and one that has, until recently, been somewhat unclear. The Canada Revenue Agency's (the "CRA's") long-standing published administrative position[1] states that losses allocated by the bottom-tier partnership to a top-tier partnership in excess of that partner's at-risk amount are deemed to be limited partnership losses by virtue of paragraph 96(2.1)(*e*) of the *Income Tax Act*[2] (the "Act"). The limited partnership losses cannot be used by the top-tier partnership because a partnership is not a taxpayer for purposes of paragraph 111(1)(*e*) of the Act and the allocation of limited partnership losses are not contemplated in Subdivision j of the Act.[3] In the CRA's view, these losses are essentially trapped in the top-tier partnership with no ability to use them against income allocated by the bottom-tier partnership in the future or to allocate them to its partners.

This position results in a different treatment of limited partnership losses for members of a limited partnership which are partnerships themselves as compared to an individual, trust, or corporation that is a member of a limited partnership.

In *Her Majesty the Queen v. Green et al.*[4] ("Green"), the Federal Court of Appeal looked at the issues of the ability of a top-tier partnership to use losses in a tiered limited partnership structure, and the ability of those losses to retain their character as business losses as opposed to being limited partnership losses. The Federal Court of Appeal affirmed the decision of the Tax Court of Canada,[5] which went against the CRA's long-standing published position. This article discusses the case and its impact.

Background

Subsection 96(1) of the Act sets out the general rules for the computation of the income of a member of a partnership from a partnership. While a partnership is not a separate

[1] See CRA documents no.: 2004-0062801E5, May 14, 2004; 2004-0107981E5, February 25, 2005; and 2012-043652IE5, May 31, 2012.

[2] R.S.C. 1985 (5th Supp.), c.1.

[3] *Supra* note 1.

[4] 2017 DTC 5068 (FCA)

[5] *The Queen v. Green et al.*, 2016 DTC 1018 (TCC)

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legal entity for tax purposes, subsection 96(1) of the Act requires that the income of a partner from a partnership be computed as if the partnership were a separate legal person and as if each partnership activity were carried on by the partnership as a separate person. The partnership then calculates each taxable capital gain and allowable capital loss from the disposition of partnership property and the income and loss of the partnership from each of its sources of income for each taxation year of the partnership. The income or loss is then allocated among the partners to the extent of each partner's interest in the partnership and any applicable terms set out in the relevant partnership agreement.

Tiered partnerships are contemplated by subsection 102(2) of the Act, which provides that, for purposes of Subdivision j of Division B of Part I of the Act (which are the provisions related only to partnerships and their members), "a reference to a person or a taxpayer who is a member of a particular partnership shall include a reference to another partnership that is a member of the particular partnership".[6]

Subsection 96(2.1) is part of the at-risk rules found in the Act. In general, subsection 96(2.1) of the Act provides that, notwithstanding section 96(1), any losses of the limited partner will be deductible only to the extent of the partner's at-risk amount. To the extent that the loss is not deductible by the limited partner in the taxation year in which it is incurred, it is deemed by paragraph 96(2.1)(*e*) of the Act to be a limited partnership loss, and can be carried forward and deducted to the extent of the limited partner's at risk amount at the end of any subsequent taxation year pursuant to paragraph 111(1)(*e*) of the Act.

In *Green*, during the period 1996 to 2009, the taxpayers in question (the "Appellants") were limited partners of the Monarch Entertainment 1994 Master Limited Partnership (the "MLP") and, during the same period, the MLP was a limited partner in 31 limited partnerships (the "PSLPs"). Each PSLP incurred annual business losses from 1996 to 2009. Pursuant to the relevant PSLP partnership agreements, 99.999% of the losses of each of the PSLPs were allocated to the MLP at the end of each fiscal period (December 31) of the PSLPs. Pursuant to the MLP partnership agreement, 99.999% of the losses of the MLP were allocated to the Appellants and the other limited partners of the MLP at the end of each fiscal period (December 31) of the MLP. At the end of each of the PSLPs' fiscal periods from 1996 to 2008 the at-risk amount of the MLP in each of the PSLPs was nil, and at the end of each of the MLP's fiscal periods from 1996 to 2008 the at-risk amount of the Appellants in the MLP was nil.

At the end of 2009, the Appellants' at-risk amounts in the MLP were increased by an allocation of capital gains from the MLP to each of them as partners of the MLP. In their respective tax returns for the 2009 taxation year, each of the Appellants claimed, as a deduction in computing taxable income, accumulated limited partnership losses of prior years in respect of the MLP.

The CRA reassessed each of the Appellants to deny the deduction of the accumulated limited partnership losses.

Tax Court of Canada

At the Tax Court of Canada (the "TCC"), the issue was whether, for tax purposes, where the top-tier partnership had no at-risk amount in respect of the lower-tier partnership at the end of a particular fiscal period, business losses realized by the lower-tier partnership in the particular fiscal period retained their character as business losses of the top-tier partnership, and were therefore available to be allocated to the partners of the top-tier partnership as business losses (which would then be subject to the application of the at-risk rules in the hands of the partners of the top-tier partnership).

The Crown argued that since the top-tier limited partnership has no at-risk amount, the top-tier partnership's share of the business losses of the bottom-tier partnership is deemed to be a limited partnership loss of the top-tier partnership pursuant to paragraph 96(2.1)(*e*) of the Act and ceases to be a business loss. Further, they argued that the deemed limited partnership loss would not flow up to the partners of the top-tier partnership because there is no provision for allocating the top-tier partnership's limited partnership loss to the partners of the top-tier partnership.

[6] Subsection 102(2) of the Act.

The TCC applied a textual, contextual, and purposive analysis of the relevant provisions of the Act and rejected the Crown's arguments, finding in favor of the Appellants. The TCC found that the text, context, and purpose of subsection 96(2.1) all supported the Appellants' position that the business losses of the bottom-tier partnership flowed out to the top-tier partnership and to the partners of the top-tier partnership, and retain their character as business losses at each step.

The Crown appealed the TCC's decision.

Federal Court of Appeal

On appeal to the Federal Court of Appeal ("FCA"), the issue was whether the TCC was correct in determining that business losses could be flowed through from one limited partnership to another limited partnership and then to the partners of that second limited partnership, retaining their character as business losses throughout.

The FCA started by stating:

> As noted above, partnerships (including limited partnerships) are not persons and, except as provided in subsection 102(2) of the ITA, are not taxpayers for purposes of the ITA. Subsection 102(2) of the ITA only applies for the purposes of Subdivision j of Division B of Part I (sections 96 to 102 inclusive).[7]

The FCA agreed with the TCC in discussing the analysis to be conducted as follows:

> As noted by the Tax Court Judge, the provisions of the ITA are to be interpreted based on a textual, contextual and purposive analysis (*Canada Trustco*, at para. 10). In this case, in my view, the text of the provision should not be read in isolation. Rather the context and purpose are important in interpreting the words that are used.[8]

In conducting its analysis the FCA stated:

> Since a partnership does not pay tax, the purpose of section 96 of the ITA is not to determine the income of a partnership for the purposes of determining the amount of tax payable by that partnership. The purpose of section 96 is to ensure that any income or loss realized by the partnership is allocated to its partners and that the source of that income or loss is maintained to allow the members of that partnership to identify the source of income or loss for the purposes of section 3 of the ITA.[9]

In the FCA's view:

> When the instructions in computing income and non-capital loss contained in paragraphs 96(2.1)(*c*) and (*d*) of the ITA are read in context, in my view, they again are only intended to apply to taxpayers who are required to compute those amounts under sections 3 and 111, respectively. Since partnerships are not taxpayers for the purposes of sections 3 and 111, these sections do not apply to partnerships.[10]

Further, the FCA stated:

> It should also be noted that generally the ITA provides that limited partnership losses will be deductible in the future if the at-risk amount of the partner in the limited partnership increases. However, the provision allowing the future deduction is paragraph 111(1)(*e*) of the ITA which does not apply to partnerships since this deduction is only available "for the purpose of computing the taxable income of a taxpayer for a taxation year . . .". It does not seem to me that Parliament would have intended to apply the restriction on limited partnership losses to partnerships (MLP) as members of another limited partnership (PSLP) but deny such partnerships (MLP) the benefit of the deduction in the future if the limited partnership (PSLP) should earn income resulting in an increase in the at-risk amount of that partnership (MLP) in the limited partnership

[7] *Supra*, note 4 at para 12.

[8] *Supra*, note 4 at para 17.

[9] *Supra*, note 4 at para 18.

[10] *Supra*, note 4 at para 22.

> (PSLP). Therefore, in my view, paragraph 96(2.1)(*e*) of the ITA would also not apply to a partnership that is a member of a limited partnership.[11]

The FCA went on to comment that Parliament intended that either the computation of income would be done for all partnerships who are members of other partnerships, or none at all.[12] However, if the former was intended, the FCA noted that the computation of income for a partnership that is a member of another partnership would cause problems when that top-tier partnership attempts to allocate its income on a source-by-source basis to its partners. As such, in the FCA's view:

> . . .Parliament did not intend for a partnership that is a member of another partnership to compute income. Rather, Parliament intended for the sources of income (or loss) to be kept separate and retain their identity as income (or loss) from a particular source as they are allocated from one partnership to another partnership and then to the partners of that second partnership (and so on as the case may be). This would mean that losses from a business incurred by a particular PSLP would still be losses from a business in MLP and then allocated by MLP to its partners as losses from that business.[13]

Accordingly, the Crown's appeal was dismissed and it appears that the limited partnership at-risk rules in subsection 96(2.1) do not apply to top-tier partnerships in their capacity as members of a bottom-tier partnership.

In dismissing the appeal the FCA commented on the Crown's concerns:

> The Crown argued that if the losses incurred by a particular partnership (PSLP) retain their character as business losses when flowed through another partnership (MLP), there could be a possibility that losses incurred by one limited partnership could be claimed against income from another limited partnership. The Crown also submitted that the at-risk rules could be avoided entirely if the top-tier partnership (MLP) were a general partnership. However, in my view, these concerns do not outweigh the concerns that arise based on the Crown's interpretation.[14]

The FCA went on to say that Parliament could deal with the Crown's concerns by amending the Act, if it so wished, and depending on the particular facts of another case, the CRA could try to apply the general anti-avoidance rule (the "GAAR") in section 245 of the Act.[15]

What's Next?

Based on the FCA's decision in *Green*, it appears that the limited partnership at-risk rules in subsection 96(2.1) of the Act do not apply to top-tier partnerships in their capacity as members of a bottom-tier partnership.

While the FCA's sympathies toward the Appellants are understandable, the result in *Green* appears to have been motivated by the unfair result that could flow from the "trapping" of losses in a top-tier partnership. In the Court's eyes, accepting the Crown's argument could result in top-tier partnerships accumulating limited partnership losses which could never be used to reduce income allocated to those partnerships in subsequent taxation years.

This case is an example whereby the plain text of the legislation was not sufficient to determine the result. In the Court's view, a textual, contextual, and purposive analysis was required to determine the proper treatment of the losses.

While the Crown has not appealed the FCA's decision in *Green*, it remains to be seen whether Parliament will take any steps to amend the legislation to restrict the flow-through of losses in a tiered partnership structure involving limited partnerships. It is also unclear whether the CRA will attempt to apply the GAAR in similar cases. For now, however, this decision represents a significant victory for tiered-partnerships and their partners.

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[11] *Supra*, note 4 at para 23.

[12] *Supra*, note 4 at para 28.

[13] *Supra*, note 4 at para 29.

[14] *Supra*, note 4 at para 31.

[15] *Supra*, note 4 at para 31.

A number of tax lawyers from Dentons Canada LLP write commentary for Wolters Kluwer's Canadian Tax Reporter *and sit on its Editorial Board as well as on the Editorial Board for Wolters Kluwer's* Income Tax Act with Regulations, Annotated. *Dentons Canada lawyers also write the commentary for Wolters Kluwer's* Federal Tax Practice *reporter and the summaries for Wolters Kluwer's* Window on Canadian Tax. *Dentons Canada lawyers wrote the commentary for* Canada–U.S. Tax Treaty: A Practical Interpretation *and have authored other books published by Wolters Kluwer:* Canadian Transfer Pricing *(2nd Edition, 2011);* Federal Tax Practice*;* Charities, Non-Profits, and Philanthropy under the Income Tax Act*; and* Corporation Capital Tax in Canada. *Tony Schweitzer, a Tax Partner with the Toronto office of Dentons Canada LLP and a member of the Editorial Board of Wolters Kluwer's* Canadian Tax Reporter, *is the editor of the firm's regular monthly feature articles appearing in* Tax Topics.

RECENT INCOME TAX INTERPRETATIONS

Deductibility of Social Media Expenses

The CRA was asked if expenses incurred to advertise on social media were deductible business expenses for tax purposes. The CRA confirmed that those advertising expenses were deductible, provided all the following conditions were met:

- they were incurred for the purpose of earning business income (s. 18(1)(*a*) of the *Income Tax Act* (the "Act"));
- they were not capital expenses (s. 18(1)(*b*) of the Act);
- they were not personal or living expenses (s. 18(1)(*h*) of the Act); and
- they were reasonable (s. 67 of the Act).

The CRA noted that advertising expenses incurred in TV broadcasts, newspapers, and periodicals not meeting certain Canadian content or ownership requirements were not deductible, but noted that those rules did not apply to foreign advertising expenses on foreign social media websites.

— *External Technical Interpretation, ¶13,889*

Exemption for Volunteer Emergency Services

The CRA confirmed that individuals employed by a government, municipality, or public authority, and providing volunteer emergency services as an ambulance technician, a firefighter, or otherwise, could claim an exemption of up to $1,000 from the amounts received from an employer for those services. The exemption is available for each employer to whom the services are rendered during the year (e.g., if the employee works for two municipalities during the year and receives at least $1,000 from each for his services, he can claim the exemption twice on his income tax return). This interpretation is consistent with the wording of s. 81(4) of the *Income Tax Act* and related technical notes.

— *Internal Technical Interpretation, ¶13,887*

Tax-Free Savings Account Restrictions

The CRA was asked to consider a situation where an uncle would have lent money to his nephew at a 3% interest rate to enable him to contribute to his Tax-Free Savings Account ("TFSA"). The broker would have included restrictions in the TFSA contract requiring the nephew to keep a minimum amount as a loan guarantee, preventing him from liquidating the assets in the TFSA without telling his uncle.

The CRA was asked if a contract including the above restrictions would remain a valid TFSA.

The CRA did not specifically confirm that the above contract would continue to qualify as a TFSA, but noted that a valid TFSA would have to continue to meet the following conditions:

- A valid TFSA must be maintained for the exclusive benefit of the account holder.
- No one else must have rights in the distribution or investment of the TFSA assets.
- Only the TFSA holder may contribute to the TFSA.
- The TFSA holder may instruct the issuer to transfer the assets to another TFSA.
- If the TFSA is a trust, the trust cannot borrow money for the purpose of the TFSA.

If any of those conditions is not met, the arrangement ceases to be a TFSA.

The CRA noted that a TFSA holder could use his right in the plan as a loan guarantee, but only if the following conditions were met:

- The terms of the loan are similar to those agreed upon between unrelated parties.
- It is reasonable to conclude that none of the main objectives of the use of the right were to allow a person or partnership to take advantage of the TFSA tax exemption.

Therefore, provided that those conditions are met, an individual may borrow to contribute to his TFSA.

— External Technical Interpretation, ¶13,867

2017 STEP — Q15 — Registration of Tax Preparers

On January 17, 2014, the Minister released a proposal to introduce the Registration of Tax Preparers Program ("RTPP"), which is a registration system for tax preparers who prepare tax returns for a fee, and requested input from taxpayers, tax preparers, and other stakeholders. Can the CRA comment on the input it has received, and the status of this proposal?

CRA Response: CRA analysis has shown that to be effective the program as originally proposed would require significant investments that no longer align with CRA priorities. The CRA is now considering other options that would serve to implement the objectives of the proposed RTPP through existing CRA programs and initiatives at lower costs. These options include leveraging programs like the Liaison Officer Initiative, the upcoming pilot of the Dedicated Telephone Service for Income Tax Service Providers, and utilizing its current partnerships with various associations and other stakeholders, as well as a continued commitment to an expanded suite of electronic services.

— STEP CRA Roundtable — Question 15, June 13, 2017, ¶13,884

2017 STEP — Q14 — Dedicated Telephone Service

The Income Tax Rulings Directorate recently confirmed at the 2017 CPA-BC and CRA Roundtable its plan to introduce a new dedicated telephone service ("DTS") for income tax service providers, which was originally announced in Budget 2016. Under a three-year pilot project beginning in July 2017, the DTS will initially be offered to certain Chartered Professional Accountants in Ontario and Quebec. Can the CRA provide an update on this pilot project?

CRA Response: On June 5, Rulings Officers assigned to the DTS began to accept calls from 500 registrants who were provided access under an early "soft" launch of the new service. In the coming weeks, access to the service will be gradually expanded until 3,000 participants are registered under the pilot project. The response to date from initial DTS registrants has been very positive. If the pilot is successful, the DTS may be expanded nationwide and to more income tax service providers on a permanent basis. The service is not intended to be a problem resolution line for dealing with specific taxpayer issues. Also, the DTS is not intended for specialized tax professionals whose services focus on complex tax planning.

— STEP CRA Roundtable — Question 14, June 13, 2017, ¶13,882

RECENT CASES

Appeal from assessment for director's liability dismissed

The taxpayer was the director of a company which had failed to remit both payroll withholdings and goods and services tax amounts as required. The minister issued assessments against the taxpayer as a director of that company, under both the *Income Tax Act* and the *Excise Tax Act*, and the taxpayer appealed. He acknowledged that the company had failed to make remittances as required and that the amounts were owed, and he did not put forward a due diligence defence. Rather, the taxpayer argued that the preconditions for a director's liability assessment under both statutes had not been met, in that the minister had not, as required, made a good faith attempt to determine and seize corporate assessments to satisfy the liability. The taxpayer argued that there were corporate assets available to seize and that he had so informed the minister, who failed to act on that information.

The appeal was dismissed. The Court held that the good faith test set out in the jurisprudence imposed an obligation on the minister to act without any ulterior or improper motive and that the onus was on the respondent to show that such obligation had been met. The Tax Court reviewed the steps undertaken by the Canada Revenue Agency in connection with the corporation's outstanding remittances and concluded that the respondent had met that onus. The Court held that, while it was possible that the Canada Revenue Agency could have done more to ensure collection from the corporation, the Court's role was not to look at what the CRA could have done or whether the steps taken were reasonable. Rather, the Court was required to determine whether the CRA acted in good faith, and the evidence before the Court supported the conclusion that the CRA did so, based on the information available to it at the time.

¶49,791, *Tjelta v. The Queen*, 2017 DTC 1114

Appeal from denial of R&D expenses allowed in part

The individual appellant was an actor and sole owner of the corporate appellant. In assessments issued for the individual taxpayer for the 2009, 2010, and 2011 taxation years, the minister disallowed approximately one-half of expenses claimed, and also assessed him as having received a shareholder benefit during the 2010 taxation year. The minister also assessed the corporate appellant for its 2010 taxation year to deny expense deduction claims. Both taxpayers appealed from those assessments.

The appeals were allowed in part. The Court held that a taxpayer who claims business expenses must show both that the expenses were incurred and also that they were made for the purpose of producing income in the business and were not personal or living expenses. It noted that the dispute in the case before it related to whether the expenses claimed were business or personal in nature. The Court reviewed the specific expenses claimed in each category, including wardrobe costs, automobile expenses, entertainment expenses, business promotion, and research and development and determined, for each category, the portion of expenses which could be characterized as deductible business expenses. It then considered the assessment for shareholder benefits and held that such benefits could only be reduced to the extent that there were reductions in any of the disallowed amounts which were included in those benefits. The Court held that the company was entitled to an additional deduction of $452 in research and development expenses, and that such additional deduction should be reflected in an equivalent reduction in the shareholder benefit assessed. Both appeals were therefore allowed to a limited extent, without costs, and the assessments were referred back to the minister for reconsideration and reassessment in accordance with the Court's reasons.

¶49,792, *Shenanigans Media et al. v. The Queen*, 2017 DTC 1115

Appeal from section 160 assessment dismissed where no consideration provided for transfers

Two assessments were issued against the appellant under section 160 of the *Income Tax Act*, on the basis that transfers of property had been made to her from her husband at the time he was a tax debtor. The taxpayer appealed from those assessments. She did not dispute the underlying tax liability of her husband, or the fact of the transfers, but argued that she had provided consideration for those transfers in the form of her payment of the preponderance of family living expenses during the relevant taxation years.

The appeal was dismissed. The Tax Court concluded that while the evidence showed that the appellant had made significant contributions to family expenses, it could not agree that such contributions constituted consideration for the transfers made to her by her husband. Appellate jurisprudence with respect to section 160 is clear that the nature of expenses incurred with transferred funds, such as household or family expenses, are irrelevant to the determination of whether there was a transfer, and also that allowing a husband to live in the family residence is not considered the provision of consideration at fair market value. The Court held that there must be proof at the time of each transfer that consideration was given. In the Court's view, no such proof was provided by the appellant, and merely agreeing in advance to pay the majority of the family living expenses did not constitute giving fair market value consideration at the time of each transfer.

¶49,793, *Elander v. The Queen*, 2017 DTC 1116

Appeal from denial of dependent and child tax credits dismissed

The taxpayer and his former spouse separated in 2010. Their child's primary residence was with the former spouse, and the taxpayer paid support amounts to that former spouse. In June 2013, the parties agreed that the child's primary residence would change to be with the taxpayer and that, with that change in residence, support payments would cease. One year later, a Court order was issued reflecting that agreement and that order also provided that the taxpayer would be entitled to claim the child for tax purposes from 2014 onward. The taxpayer claimed both the dependent tax credit and the child tax credit for the 2013 tax year and his claims were denied on assessment. The taxpayer appealed from that denial.

The appeal was dismissed. The Tax Court of Canada held that it was first required to determine whether the appellant paid support to his former spouse for any months during the 2013 taxation year. The Court reviewed the evidence with respect to payments made before concluding that monthly payment of support amounts did continue for some period of time during 2013, and ceased sometime between April and September. The question for determination was therefore whether there could be a proration of the disputed tax credits. The Court considered the relevant statutory language before holding that no statutory language used in or in connection with subsection 118 indicated that the deductions at issue could be prorated for a taxation year. The Court noted in particular that such statutory language contrasted with other provisions in the *Income Tax Act* which explicitly provided for proration. The jurisprudence also supported the Court's conclusion that the subsection 118 deductions could not be shared for the same taxation year and that since the appellant was required to pay support for part of that year, only the appellant's former spouse could make such claim. The Court concluded that the minister's reassessment was correct, and the appeal was dismissed.

¶49,790, *Cook v. The Queen*, 2017 DTC 1113

INTERNATIONAL NEWS

EU Council Behind Digital Tax Push, Despite OECD Appeal

This article originally appeared in Wolters Kluwer's Global Tax Weekly Issue 260.

EU leaders appear to still favor developing an EU-level response to the direct-tax challenges of the digital economy, despite a call from the OECD Director-General that countries should work together to develop a coherent global tax response.

Following the EU Council meeting on October 19, EU leaders attending agreed to a post-meeting communiqué that said: "It is important to ensure that all companies pay their fair share of taxes and to ensure a global level-playing field in line with the work currently underway at the OECD. The European Council invites the Council to pursue its examination of the [European] Commission communication on this issue and looks forward to appropriate Commission proposals by early 2018."

The comments voice support for the Commission's new agenda, launched on September 21, to ensure the digital economy is taxed "in a fair and growth-friendly way". It had announced proposals for short-term measures that could be considered while discussions on implementing a common corporate tax base — a uniform set of rules on the calculation of corporation tax in particular for entities operating across EU, and non-EU, states — continue. These included:

- An equalization tax on the turnover of digitalized companies. This would apply to all "untaxed or insufficiently taxed" income generated from internet-based business activities, creditable against corporate tax or as a separate tax;
- A withholding tax on digital transactions. This would operate as a standalone gross-basis final withholding tax on certain payments made to non-resident providers of goods and services ordered online; or
- A levy on revenues generated from the provision of digital services or advertising activity. This could be applied to all transactions concluded remotely with in-country customers where a non-resident entity has a significant economic presence.

The Commission had said it could announce concrete proposals by the spring of 2018.

Prior to the EU Council meeting, in an address to G20 leaders and Central Bank Governors on October 13, 2017, OECD Secretary-General Angel Gurría appealed to countries to engage only in a collective effort on the design of temporary, short-term measures to tackle the international tax challenges of the digital economy. Gurría said: "There is now a very high public pressure on governments to act and calls to move quickly to ensure that there is fair taxation of digitalized businesses. Thus, the risk of unilateral measures is increasing, and with it, the potential for negative spillover impacts. Unilateral measures would undermine the collective efforts undertaken, as well as the results achieved so far, collectively, in the G20. To make progress, we must continue to work together, to move collectively."

"The BEPS project has been a success because we worked together. We need to maintain this momentum for international tax cooperation, and call on you to affirm your support for this roadmap towards a consensus-based approach to the taxation of a digitalized economy," he added.

Gurría said that in April 2018 the OECD will deliver a report containing concrete proposals on the issue, and a meeting with stakeholders will be held in November to prepare the draft of the report.

The EU Council's message would suggest that the EU will proceed with new digital tax options regardless of whether the OECD concludes that the introduction of such as part of a global response to BEPS is the best option. Gurría's warnings against unilateral action may not have fallen entirely on deaf ears, but EU leaders appear keen to continue to lead the charge on digital tax reform, having earlier led the way in developing an improved value-added tax regime covering cross-border supplies of electronic services, which the OECD is now recommending other states should mirror.

EU Launches State Aid Probe Into UK's Group Financing Exemption

This article originally appeared in Wolters Kluwer's Global Tax Weekly Issue 260.

The European Commission has opened an in-depth probe into the UK's Group Financing Exemption, which exempts certain transactions by multinational groups from the application of UK rules targeting tax avoidance.

The probe will investigate if the scheme allows these multinationals to pay less UK tax in a selective manner, which would be in breach of EU state aid rules.

The Exemption is an element of the UK's controlled foreign company ("CFC") rules, which are intended to prevent UK companies from using a subsidiary, based in a low- or no-tax jurisdiction, to avoid taxation in the UK. In particular, they allow the UK tax authorities to reallocate all profits artificially shifted to an offshore subsidiary back to the UK parent company, where they can be taxed accordingly.

In a statement announcing the launch of its investigation, the Commission noted that, since 2013, the UK's CFC rules have included the Group Financing Exemption for certain financing income of multinational groups active in the UK. On the reason for announcing an investigation, the Commission stated:

> Generally speaking, financing income is often used as a channel for profit shifting by multinationals, given the mobility of capital. The UK's Group Financing Exemption exempts from reallocation to the UK, and hence UK taxation, financing income received by the offshore subsidiary from another foreign group company. Thus, a multinational active in the UK can provide financing to a foreign group company via an offshore subsidiary. Due to the exemption, it pays little or even no tax on the profits from these transactions, because:
>
> - The offshore subsidiary pays little or no tax on the financing income in the country where it is based; and
> - The offshore subsidiary's financing income is also not (or only partially) reallocated to the UK for taxation due to the exemption.
>
> On the other hand, the CFC rules reallocate other income artificially shifted to offshore subsidiaries of UK parent companies to the UK for taxation.

The Commission confirmed that its investigation is not intended to call into question the UK's right to introduce CFC rules or determine an appropriate level of taxation; instead the EU's probe is intended to determine whether the country is providing selective tax advantages — i.e., that the UK is providing similarly situated companies with different levels of taxation in breach of EU rules. "The role of EU state aid control is to ensure member states do not give some companies a better tax treatment than others," the Commission said. "The case law of the EU Courts makes clear that an exemption from an anti-avoidance provision can amount to such a selective advantage."

Margrethe Vestager, the Commissioner in charge of competition policy, said:

> All companies must pay their fair share of tax. Anti-tax avoidance rules play an important role to achieve this goal. But rules targeting tax avoidance cannot go against their purpose and treat some companies better than others. This is why we will carefully look at an exemption to the UK's anti-tax avoidance rules for certain transactions by multinationals, to make sure it does not breach EU state aid rules.

Swiss ' Tax Spy' Confesses in German Court

This article originally appeared in Wolters Kluwer's Global Tax Weekly Issue 260.

The man accused of spying on the tax authority in the German state of North Rhine-Westphalia ("NRW") on behalf of Switzerland has appeared in court in Frankfurt.

The suspect, an ex-member of the Swiss police force and referred to in court as Daniel M., told the court that he had been paid €28,000 (US$32,550) by the Swiss authorities to obtain details about tax investigators working at the NRW tax authority.

However, he denied acting with criminal intent, telling the court via a statement read out by his lawyer that he acted out of a combination of "patriotism, a desire for adventure, a pursuit of profit, and outrage".

It is believed the suspect, who was arrested in Frankfurt in April 2017, was tasked with gathering information on NRW tax office personnel because the authority had on numerous occasions received electronic media containing information of clients of Swiss banks, which had been obtained from financial institutions in defiance of Switzerland's laws on privacy and data protection.

According to broadcaster Deutsche Welle, NRW has paid €17.9 million to acquire information on potential tax evaders since 2010, collecting in excess of €7 billion in unpaid taxes and penalties as a result.

Daniel M. could face a jail sentence of up to five years after being charged with espionage. The judge, however, said the punishment could be reduced to a suspended sentence and a fine of around €50,000 if the suspect provides credible information on his activities in Germany.

TAX TOPICS

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