Canadian Tax Highlights

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ECP-Related CDA Dividend "In the Course of a Winding Up" Pre-2017

The announced January 1, 2017 repeal of section 14 shifted the eligible capital property (ECP) rules to the less favourable class 14.1 of the depreciable capital property rules. This shift incentivized sales in 2016 of businesses involving significant ECP values and transactions crystallizing ECP realizations. Corporate taxpayers that were so incentivized may have elected capital dividend treatment for 2016 dividends, and may have done so before the normal fiscal year-end.

The businesses involved in these events may have failed to recognize that in order for a capital dividend account (CDA) to arise out of a cumulative ECP gain, there had to be a negative balance in the account at the year-end that included the event. Where a taxpayer elected CDA treatment before the corporation's year-end, the CRA may have been of the view that an excessive CDA election occurred, which was subject to part III tax, penalties, and interest.

The author has seen assessments and reassessments regarding these 2016 cumulative ECP gains-related CDA elections.

There are situations where an ECP sale- or ECP transaction-based CDA may be established before the normal fiscal year-end without attracting part III tax. Such a dividend can be paid before the corporate taxpayer's fiscal year-end if it is done in the course of a winding up. There are special rules referencing "in the course of the winding-up" that deem a year-end to occur specifically for CDA and other surplus determination purposes, but for only those purposes. The deemed year-end is not compliance-based: it is deemed to occur only to facilitate the identification of the CDA and other surpluses. The required facts and the provisions of the Act that are relevant are discussed below.

Winding-Up Dividend and Deemed Year-End for CDA Determination Purposes

For the purposes of the CDA calculation:

- paragraphs 88(2)(a) and (b) deem certain events to occur (no election is required for these paragraphs to be effective);
- subsection 84(2) supports the CDA dividend characterization;
- subsection 89(3) permits the taxpayer to designate the ordering of the dividends if it is determined on the facts that there is a mix of both CDA and taxable dividends arising from the deemed dividends, deemed paid and deemed received, as calculated at the deemed special purpose year-end; and
- the subparagraph 88(2)(a)(iv) deemed year-end is for CDA calculation purposes only—it is not a "compliance year-end."

Subsection 88(2) Distribution on Winding Up

Subsection 84(2) deems a dividend to be paid by the distributing corporation and received by the shareholder at the time of distribution on (among other events) the winding up of a corporation's business.

Paragraphs 88(2)(a) and (b) establish that if a business of a corporation is wound up, and at a particular time in the course of the winding up corporate property is distributed to its shareholder, then

- pursuant to paragraph 88(2)(a), for the purposes of computing the corporation's CDA, at the "time of computation" that is "immediately before the particular time," there is a special purpose deemed year-end (not a compliance year-end) for CDA determination purposes (hence the cumulative ECP CDA add-on should be there for CDA computation purposes); and
- pursuant to paragraph 88(2)(b), the CDA dividend is deemed paid for the purposes of subsection 83(2).

Therefore, it is arguable that if a capital dividend election is made prior to the normal course fiscal year-end of the corporation (but in the course of the winding up), coupled with the deemed special purpose year-end, the minister cannot assess under part III for an excessive CDA elected amount. The taxpayer's CDA amount elected should be correct, because the

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above provisions permit the timing (via the deemed year-end) required and desired by the taxpayer.

In the Course of a Winding Up

There is little jurisprudence on the phrase "in the course of the winding-up." In *Interpretation Bulletin* IT-126R2, "Meaning of 'Winding-Up,'" March 20, 1995, the CRA refers to the winding up of both a business and a corporation. The CRA says that "where any positive steps are taken towards the winding-up, discontinuance or reorganization of its business," subsection 84(2) applies. Such an event appears to begin the course of a winding up.

The author's experience includes lengthy windups, wherein protracted and staged conveyances of particular assets occurred for strategic and risk-management reasons unrelated to tax issues. *Interpretation Bulletin* IT-149R4, "Winding-Up Dividend," June 28, 1991, discusses the CRA's views regarding processes and components of a winding-up dividend.

Conclusion

Taxpayers that receive a part III proposed assessment that involves CDA out of pre-2017 cumulative ECP gain should consider whether events have occurred that place such dividends in a period in the course of a winding up. This may permit cumulative ECP-based CDA to exist within a deemed year-end, as discussed above. The sale of a business that included cumulative ECP gain should be viewed as a step in the course of a winding up of the business that was sold.

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Section 160 in a Butterfly Reorganization

In *Eyeball Networks Inc. v. The Queen* (2019 TCC 150), the TCC determined that a related-party butterfly reorganization under paragraph 55(3)(a) involved a transfer of property for less than fair market value (FMV) consideration to which section 160 could apply. If this decision is not altered on appeal, practitioners will need to exercise much greater caution in determining whether the distributing corporation has tax liabilities that it cannot pay or may not be able to pay.

For commercial reasons, the appellant (Newco) acquired approximately $30 million in IT assets and patents from a corporation (Oldco) controlled by its shareholder, Mr. Piche. In consideration for the acquired assets, Newco assumed Oldco's commercial liabilities and issued preferred shares with a redemption amount equal to the estimated FMV of the acquired assets less the assumed liabilities. Mr. Piche transferred preferred shares of Oldco with a redemption amount equivalent to that estimated FMV to Newco. Both transfers took place under section 85 and were subject to price adjustment clauses in the relevant transfer agreements.

Subsequent to the transfers, Oldco redeemed its preferred shares owned by Newco for a demand promissory note in the amount of $30 million ("the Oldco note"). Newco also redeemed its preferred shares owned by Oldco for a second promissory note in the amount of $30 million ("the Newco note"). A mutual debt cancellation agreement was then executed, pursuant to which the debts were set off against one another.

The minister later reassessed Oldco for taxation years that preceded the reorganization. By that point, Oldco's business had been substantially wound down and the minister was unable to collect the reassessed amounts. The minister then assessed the appellant under section 160 on the basis that the economic reality of the reorganization was that Oldco's business assets were transferred to Newco for no consideration. According to the minister's characterization of the facts, none of the transfers had occurred for consideration because the consideration issued was transitory—that is, because the Newco preferred shares and the Newco note disappeared in the course of the reorganization.

Newco did not contest that there was a transfer of property between parties not at arm's length at a time when Oldco was liable to pay tax under the Act. Newco contended instead that the transfer was in consideration for shares with an FMV precisely equivalent to the value of the transferred property.

Bocock J rejected the Crown's attempt to use "economic reality" to apply section 160 on a step transaction basis. The transactions were properly implemented to ensure symmetry between the preferred shares issued and the FMV of the transferred property. The court nevertheless considered it open to determine whether the "inceptive value" of the consideration provided for the acquired assets changed at some point during the transfer.

Bocock J held that the cancellation agreement resulted in a transfer of property for the purposes of section 160. The Oldco note and the Newco note were property, since they were both negotiable instruments. Furthermore, when the notes were cancelled by setoff there was a transfer of property, since a setoff obviates otherwise necessary cross-payments between mutual creditors and debtors. In other words, setoff truncates the procedures that would otherwise be necessary to satisfy the mutual debts into one transaction. These steps would have required transfers of property between the debtors and creditors to satisfy their mutual obligations. Since the setoff avoids these steps, Bocock J concluded that a setoff is a transfer of property, notwithstanding that no property was actually transferred by either party.

After determining that a setoff involved transfers of property, Bocock J then made findings of fact with respect to the value of the notes. Because the Newco note was backed by the assets acquired from Oldco, the note's FMV was $30 million. In

contrast, the value of the Oldco note was nominal at the time of the setoff. The court apparently did not consider evidence as to the value of either note in arriving at this conclusion.

Bocock J's conclusion of law that a setoff constitutes a transfer of property, and his finding of fact that the Oldco note had a nominal FMV, formed the basis for the dismissal of the appeal. The setoff of the valuable Newco note held by Oldco against the worthless Oldco note held by Newco resulted in a transfer of property from Oldco to Newco for no consideration at a time when Oldco owed tax, and the requirements of section 160 were thus satisfied.

The absence of expert evidence on valuation may limit the precedential value of this case. It is at least questionable that the Oldco note had nominal value because, at the time of setoff, Oldco was in possession of a demand promissory note backed by Newco's assets. Even if a discount were to be applied to reflect the enforcement costs of collecting the debt, a finding that the note had no value at all appears unsupportable.

The court's description of the legal effect of setoff is also tenuous. First, a setoff involves the cancellation of rights, which is distinct from acquisitions of property in satisfaction of debts. A key requirement of a transfer is that property be divested by a transferor and become vested in a transferee; the vesting of property in a transferee necessitates a recipient. The cancellation of mutual rights as a creditor by way of setoff does not result in anyone's acquiring the rights of the creditor, even if the "economic reality" of the setoff is that it eliminates the need for cross-payments (which would be transfers of property).

The practical difficulty with Bocock J's conclusions can be illustrated using a hypothetical scenario in which Newco had obtained a daylight loan in order to repay the Newco note. The result of that repayment would have been a transfer of property for FMV consideration. Oldco would then have $30 million of cash on hand to repay the Oldco note, which at that point would have been backed by $30 million of assets, such that the cash repayment would have been a transfer of property for FMV consideration. With respect, it should not be the case that a needless cash cycle would not have resulted in the application of section 160, while a cash-free setoff results in a transfer for inadequate consideration.

The time to appeal this decision to the FCA has not yet expired, so it remains possible that the FCA will have the last word on all of these points.

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No Late-Filing Penalty for Cautious Taxpayer

In *Moore v. The Queen* (2019 TCC 141), the TCC found that a taxpayer should not be subject to a $2,500 CRA penalty for late-filing a form T1135 to report his ownership of US shares, because he took appropriate steps to inform the CRA and correct the error. The TCC noted that the taxpayer had acted in good faith, reported all related income, and voluntarily disclosed his late filing to the CRA as soon as he discovered his obligation. In allowing the taxpayer's appeal, the TCC applied the "judge-made due diligence defence" and acknowledged that, while this defence should be used sparingly, it was appropriate in this case. Note that since this decision was made under a TCC informal procedure, it does not set precedent.

In this case, the taxpayer (Mr. M) owned shares that he acquired through an employer-sponsored share purchase plan. Although this plan was offered by his employer (Canco) and administered by a Canadian financial institution for Canco's employees, the purchased shares were shares of Canco's parent company (Parentco), a publicly traded US corporation.

In 2016, another company acquired Canco, and the employer-sponsored share purchase plan was no longer available. As a result, Mr. M transferred his Parentco shares to a Canadian brokerage account. Although Mr. M reported all related income appropriately in his personal tax returns, he realized that he should have begun filing form T1135, "Foreign Income Verification Statement," starting in 2015, when the aggregate cost of his Parentco shares in the plan first exceeded $100,000.

Mr. M completed form T1135 for both 2015 and 2016 shortly after his 2016 return filing-due date, and informed the CRA about his mistake. The CRA assessed Mr. M a $2,500 penalty for not filing his 2015 form on a timely basis.

Under subsection 233.3(3), a Canadian-resident individual must file a form T1135 for the taxation year if he or she owns "specified foreign property" with a total cost amount that exceeds $100,000 at any time in the year (other than a time when the individual is a non-resident).

A "specified foreign property" is defined in subsection 233.3(1) and includes various types of foreign property, including shares of a foreign corporation that is not a foreign affiliate of the taxpayer.

The penalty under subsection 162(7) for failing to file an information return for a taxation year, such as a form T1135, is the greater of $100 and $25 per day for up to 100 days during which the failure continues (to a maximum of $2,500).

The TCC found that because Mr. M exercised appropriate due diligence in filing his returns, he should not be subject to the CRA's penalty. The TCC noted that Mr. M had acted in good faith and voluntarily disclosed his late filing to the CRA. The TCC also noted the steps that Mr. M took, including that he properly reported the benefit and all income received on

the shares, paid the appropriate amount of tax, promptly filed his T1135 notification form for subsequent taxation years after learning about the requirement, notified the CRA in writing about the 2015 obligation, and filed a 2015 form T1135.

The TCC also found that, as an average Canadian, Mr. M could not reasonably be expected to recognize what constituted "specified foreign property" for the purposes of determining whether he had a form T1135 filing obligation by referring to the "General Income Tax and Benefit Guide 2015," as directed on the 2015 tax return. The TCC found that the information in the guide for taxpayers around this particular disclosure requirement was unclear at best, and that it had a misleading table of contents which an "average Canadian" could not be expected to decipher.

In its decision, the TCC reviewed case law that vacated certain administrative penalties, including cases in which the court applied the judge-made due diligence defence. The court found that, in certain circumstances, a taxpayer should not be subject to even strict penalties where he or she takes all reasonable measures to comply with the legislation, even if there is not a statutory due diligence defence in the Act for those penalties. The TCC found that the judge-made due diligence defence, while it should be used sparingly, applied in this case. As a result, the TCC allowed the appeal and referred the matter back to the CRA for reconsideration and reassessment.

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Corporate Rate Update

The federal general (and M & P) corporate income tax rate remains 15 percent. Provincial and territorial general (and M & P) rates remained mostly steady, but decreased in Alberta and Quebec for December 31, 2019 year-ends.

The general (and M & P) rate in Alberta decreased from 12 percent to 11 percent after June 2019, and will continue to decrease, to 10 percent after 2019, 9 percent after 2020, and 8 percent after 2021 (Alberta Bill 3, Job Creation Tax Cut (Alberta Corporate Tax Amendment) Act; royal assent: June 28, 2019). Quebec's general (and M & P) rate decreased from 11.7 percent to 11.6 percent after 2018 and will further decrease to 11.5 percent after 2019 (Quebec Bill 112, An Act to give effect mainly to fiscal measures announced in the Budget Speech delivered on 17 March 2016; royal assent: February 8, 2017). Table 1 shows the 2018 and 2019 combined general, M & P, and small business rates.

The federal small business tax rate decreased from 10 percent to 9 percent after 2018 (Federal Bill C-74, An Act to implement certain provisions of the budget tabled in Parliament on February 27, 2018 and other measures; royal assent: June 21, 2018); as a result, all combined federal and provincial/territorial small business rates decreased in 2019. In addition,

Table 1 2018 and 2019 Federal and Combined Corporate Income Tax Rates and CCPC Small Business Taxable Income Thresholds (December 31 Year-End)

	General (and M & P)		CCPC small business (and M & P) up to $500,000		CCPC threshold	
	2018	2019	2018	2019	2018	2019
	percent				*dollars*	
Federal	15.00	15.00	10.00	9.00	500,000	500,000
Alberta	27.00	26.50	12.00	11.00	500,000	500,000
British Columbia	27.00	27.00	12.00	11.00	500,000	500,000
Manitoba	27.00	27.00	10.00 or 22.00[a]	9.00	450,000	500,000
New Brunswick	29.00	29.00	12.62	11.50	500,000	500,000
Newfoundland and Labrador	30.00	30.00	13.00	12.00	500,000	500,000
Northwest Territories	26.50	26.50	14.00	13.00	500,000	500,000
Nova Scotia	31.00	31.00	13.00	12.00	500,000	500,000
Nunavut	27.00	27.00	14.00	12.50	500,000	500,000
Ontario	26.50 (25.00)	26.50 (25.00)	13.50	12.50	500,000	500,000
Prince Edward Island	31.00	31.00	14.00	12.50	500,000	500,000
Quebec	26.70	26.60	17.24[b] (14.00)[c]	15.00[b] (13.00)[c]	500,000	500,000
Saskatchewan	27.00 (25.00)	27.00 (25.00)	12.00[d]	11.00[d]	600,000	600,000
Yukon	27.00 (17.50)	27.00 (17.50)	12.00 (11.50)	11.00 (10.50)	500,000	500,000

[a] The lower rate applied in Manitoba to a CCPC's active business income up to $450,000 for 2018. The higher rate applied to active business income above this threshold and up to $500,000.

[b] A Quebec CCPC (1) must meet the "activities" test or "hours paid" test to be eligible for the province's non-M & P small business tax rate, and (2) if neither test is met, will be subject to a tax rate between the province's non-M & P small business tax rate (for a December 31 taxation year-end, 7.24% [2018] and 6.00% [2019]) and its general tax rate (for a December 31 taxation year-end, 11.70% [2018] and 11.60% [2019]). The maximum combined rates for a December 31 taxation year-end are (1) for 2018, 21.70% (10.00% federal rate plus 11.70% Quebec rate) and (2) for 2019, 20.60% (9.00% federal rate plus 11.60% Quebec rate).

[c] Eligibility for Quebec's M & P small business tax rate of 4% depends on the percentage of the CCPC's activities attributable to M & P and the primary sector (based on M & P and primary sector labour costs). If the percentage is (1) 50% or more, the M & P small business tax rate of 4% applies; (2) under 50% and more than 25%, the 4% rate increases proportionately (straightline) to the non-M & P small business tax rate (for a December 31 taxation year-end, 7.24% [2018] and 6.00% [2019]) or the general Quebec rate (for a December 31 taxation year-end, 11.70% [2018] and 11.60% [2019]), depending on the

(Table 1 is concluded on the next page.)

Table 1 Concluded

circumstances; and (3) 25% or less, the rate is between the non-M & P small business tax rate and the general Quebec rate. The maximum combined rates for a December 31 taxation year-end are (1) for 2018, 21.70% (10.00% federal rate plus 11.70% Quebec rate) and (2) for 2019, 20.60% (9.00% federal rate plus 11.60% Quebec rate).

[d] The combined rate that applies to active business income in Saskatchewan from $500,000 to $600,000 is 17% for 2018 and 2019.

for December 31, 2019 year-ends, provincial and territorial small business rates decreased in New Brunswick, Nunavut, and Prince Edward Island (and in Quebec for the non-M & P small business rate only).

The provincial/territorial small business rate in New Brunswick decreased from 3 percent to 2.5 percent after March 2018 (New Brunswick Bill 23, An Act To Amend the New Brunswick Income Tax Act; royal assent: December 20, 2017), and in Nunavut from 4 percent to 3 percent after June 2019 (Nunavut Bill 26, An Act To Amend the Income Tax Act; first reading: May 29, 2019). In Prince Edward Island, the small business rate decreased from 4 percent to 3.5 percent after 2018 (Prince Edward Island Bill 57, An Act To Amend the Income Tax Act (No. 2); royal assent: December 5, 2018) and will further decrease to 3 percent after 2019 (Prince Edward Island Bill 12, An Act To Amend the Income Tax Act; royal assent: July 12, 2019). Quebec's non-M & P small business tax rate decreased from 8 percent to 7 percent after March 27, 2018, and to 6 percent after 2018, and will further decrease to 5 percent after 2019, and to 4 percent after 2020 (Quebec Bill 13, An Act to amend the Taxation Act, the Act respecting the Québec sales tax and other legislative provisions; royal assent: June 19, 2019).

Small business thresholds remain unchanged in 2019 (see table 1) except in Manitoba, where the province's small business threshold increased from $450,000 to $500,000, effective after 2018 (Manitoba Bill 34, The Budget Implementation and Tax Statutes Amendment Act, 2018; royal assent: November 8, 2018).

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CRA Reviews Transfers of Life Insurance Policies

In a recent technical interpretation (TI 2019-0799051C6, May 14, 2019), the CRA considers whether specific deeming rules for life insurance policies apply if a corporation transfers a corporate-owned life insurance policy either to a former shareholder for nominal proceeds or to an employee for no consideration. In both cases, the CRA considers whether the deeming rules that apply for transfers by corporate distribution, by gift, or to a non-arm's-length person could deem the corporate transferor's proceeds from the disposition of the interest in the life insurance policy (and the acquiring person's ACB) to be in excess of the actual consideration paid. The CRA also states that it may consider applying GAAR if a transaction is intentionally structured to avoid the deeming rules. This TI is the CRA's formal response to a question posed at the 2019 Canadian Life and Health Insurance Association (CLHIA) round table.

Generally, when a policyholder disposes of an interest in a life insurance policy, an amount is included in his or her income equal to the excess of the proceeds of disposition over the ACB of the policy, under subsection 148(1).

However, special rules in subsection 148(7) ("the deeming rules") apply to only certain transfers of an interest of a policyholder in a life insurance policy—including dispositions by way of a gift, by distribution from a corporation, or by operation of law—to any person, or in any manner whatever to a person with whom the policyholder does not deal at arm's length.

For dispositions that occur after March 21, 2016, paragraph 148(7)(a) deems the policyholder to have received proceeds of disposition equal to the greatest of (1) the policy's value (generally the cash surrender value), (2) the FMV of any consideration received by the policyholder from the disposition, and (3) the policy's ACB immediately before the transfer. Under subparagraph 148(7)(b), the person acquiring the interest in the policy is deemed to acquire it at a tax cost equal to the policyholder's deemed proceeds.

The CRA considers two different scenarios in the TI. In the first, a company (Canco) has a permanent life insurance policy on its sole shareholder (individual A). The cash surrender value (CSV) and FMV of the policy is $50,000 and the ACB in the policy is $20,000.

Individual A sells her Canco shares to individual B (who is not related to individual A or to Canco before the sale) for $10 million (which is the FMV of the Canco shares at the time of the disposition, including the underlying FMV of the life insurance policy). The sale takes place after March 21, 2016.

After the share sale, Canco sells the life insurance policy to individual A for $1. The FMV, CSV, and ACB of the insurance policy have not changed. Individual A and Canco are no longer related after the Canco shares are sold.

The CRA was asked whether Canco's sale of the insurance policy to individual A would be considered a non-arm's-length transaction, so that the deeming rules for life insurance policies apply to deem Canco's proceeds of disposition (and individual A's ACB in the insurance policy acquired) to be greater than the $1 transfer price.

In this scenario, the CRA does not conclude whether the deeming rules would apply. The CRA states that it is a question of fact whether Canco's sale of the life insurance policy

to individual A was at arm's length. However, the CRA says that the two sales in this example may be steps in a series of transactions. The CRA says that it would need to review documentation and facts relating to these transactions before determining whether individual A and Canco were in fact dealing at arm's length.

The CRA also indicates that it will consider whether GAAR or the benefit conferral rules in subsection 246(1) apply to any series of transactions that are intentionally structured to avoid the deeming rules in subsection 148(7) or the shareholder benefit rule in subsection 15(1).

In the second scenario, individual C deals at arm's length with his employer (Employerco) and is a key employee (but not a shareholder or executive). Employerco owns a "key person" permanent life insurance policy on individual C. Several years later (after March 21, 2016), individual C is no longer considered a key employee, and Employerco agrees to transfer the life insurance policy to individual C for no consideration. At the time of the transfer, the CSV and FMV of the policy is $50,000 and the ACB is $20,000.

The CRA says that individual C is deemed to receive an employment benefit under paragraph 6(1)(a) as a result of Employerco's disposition of the insurance policy to him. The benefit equals the FMV of the insurance policy ($50,000), less any consideration paid (nil in this case).

The CRA says that the deeming rules in subsection 148(7) also apply to this transaction. As a result, Employerco is deemed to have received proceeds of disposition of $50,000 on the disposition of the insurance policy, resulting in a gain of $30,000 under subsection 148(1).

Finally, the CRA noted that, pursuant to paragraph 148(7)(b), individual C's ACB in the life insurance policy is $50,000, which equals Employerco's deemed proceeds of disposition under paragraph 148(7)(a).

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FATCA and the Canadian Charter of Rights

The US Foreign Account Tax Compliance Act (FATCA) was enacted in 2010 in an attempt to deter and detect US taxpayers who were evading US taxes by hiding their assets offshore. FATCA requires non-US financial institutions to report information about accounts held by US taxpayers and by entities in which US taxpayers hold a substantial ownership interest. Under FATCA, a Canadian financial institution failing to register with the IRS or fulfill its obligations under FATCA is liable to a 30 percent US withholding tax on certain US-source payments.

In an effort to (1) minimize the impact of FATCA on Canadian financial institutions, their customers, and the Canadian economy as a whole and (2) eliminate legal impediments in Canadian privacy and banking law, effective June 27, 2014, Canada and the United States entered into an intergovernmental agreement (IGA) that incorporated the obligations imposed by FATCA into Canadian law. Under the IGA, Canadian financial institutions are not required report information to the IRS; they are instead required to report information about "reportable accounts" of "US persons" to the CRA. The CRA then transfers this information to the IRS.

In *Deegan v. Canada (Attorney General)* (2019 FC 960), several taxpayers who were both US and Canadian citizens, but otherwise had minimal connection to the United States, challenged the validity of the IGA under the Canadian Charter of Rights and Freedoms. (This case may be considered the second in a set of cases involving an overlapping set of plaintiffs. The first case was *Hillis v. Canada (Attorney General)* [2015 FC 1082], in which the FC concluded that the IGA did not contravene Canadian law or the Canada-US tax treaty and declined to issue an injunction preventing the transfer of information under the IGA.) The FC concluded that the 2014 Canada-US IGA—implemented through the enactment of the Canada-US Enhanced Tax Information Exchange Agreement Implementation Act and sections 263-269 of the Canadian Income Tax Act—did not result in (1) an unreasonable search or seizure under section 8 of the Charter or (2) discrimination based on national origin under section 15 of the Charter.

Unreasonable Search and Seizure

Plaintiff's counsel argued that the search and seizure authorized by the IGA was unreasonable because (1) it is warrantless and lacks judicial supervision, (2) it is impossible to test its reliability in achieving its objective, (3) it captures information on a number of individuals who have no American tax or reporting obligations, and (4) the CRA's use of the information for Canadian tax compliance purposes is unrelated to the objectives underlying the IGA.

In rejecting the plaintiff's arguments, the court cited with approval the SCC decision in *R v. McKinlay Transport Ltd.* ([1990] 1 SCR 627) and held that because of the self-assessing and self-reporting nature of the income tax scheme, the minister must be permitted broad powers to supervise the regulatory scheme. In general, the court held that a less stringent and more flexible standard of reasonableness is warranted in the case of administrative or regulatory searches and seizures (such as the reporting required under the IGA) as opposed to criminal or quasi-criminal searches and seizures. In addition, the court held that taxpayers' privacy interest in records that are relevant to the filing of income returns is relatively low.

The court also held that the search and seizure was reasonable because the sharing of taxpayer information between countries has received international acceptance. In addition,

the information shared with the IRS under the IGA is eligible for protection under the Canada-US tax treaty, which imposes confidentiality requirements and restrictions on the use that can be made of the information exchanged under the provisions of treaty articles II and III(7).

Discrimination on the Basis of National Origin

The court set out a two-step approach to assess whether the IGA was discriminatory under section 15 of the Charter: it considered (1) whether the IGA draws a distinction, either on its face or in its impact, on the basis of an enumerated or analogous ground in section 15 of the Charter, and (2) whether the IGA imposes a burden or denies a benefit in a way that has the effect of reinforcing, perpetuating, or exacerbating disadvantage, including historical disadvantage.

In the first step of the analysis, the court concluded that the IGA draws a distinction between US persons and non-US persons on the basis of their citizenship and/or their national origin, which is an enumerated or analogous ground in section 15 of the Charter. However, in the second step of the analysis, the court found that the provisions of the IGA do not

> reinforce, perpetuate or exacerbate disadvantage, nor do they violate the norm of substantive equality in subsection 15(1) of the *Charter*. I am also not persuaded that the [IGA provisions] involve the oppression or unfair dominance of one group by another, or a denial to one group of protections that are basic or necessary for full participation in Canadian society.

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Subsection 152(4.3) of the Act Is Not an Alternative to Judicial Review

In *Bakorp Management Ltd.* (2019 FCA 195), a tax procedure case, the appellant appealed unsuccessfully to the FCA to overturn the TCC decision denying the appellant's request, pursuant to subsection 152(4.3), to require the minister to reduce a non-capital loss applied in excess against its January 1992 year-end and to apply the excess non-capital loss against income of its March 1992 year-end. The appellant's March 1992 year-end was triggered by an amalgamation. The appellant's predecessor had been in litigation with the minister concerning the size of a non-capital loss that could be carried over from 1987. This dispute was not settled until April 10, 2010.

After finalization of the dispute, the appellant filed its predecessor's March 1992 return and at the same time requested that the minister reduce the excess loss that was utilized on the appellant's predecessor's January 1992 return. The minister refused to reduce the excess loss and assessed the appellant's March 1992 tax return, which was prepared on the basis that the minister would acquiesce to its request and that the excess loss from its January 1992 return would be available for its March 1992 return. At issue before the court was not whether there was a loss carried forward, but whether the minister could be required by the TCC to amend the appellant's January 1992 return allowing the excess loss to be applied to the appellant's March 1992 year-end through the consequential assessment provision of subsection 152(4.3).

Subsection 152(4.3) authorizes, or at the taxpayer's request requires, the minister to reassess outside the normal period after a successful appeal has altered a taxpayer's balance in a particular taxation year, "but only to the extent that the reassessment can reasonably be considered to relate *to the change in the balance of the taxpayer* for the particular year [emphasis added]" (*Sherway Centre Ltd.*, 2003 FCA 26). Given that the purpose of subsection 152(4.3) is to reassess tax, the appeal pursuant to subsection 152(4.3) did not make sense. Webb JA, in paragraph 29 of his decision, observed that

> [p]rior to this request being made, no taxes were payable in relation to the January 1992 taxation year. If the request would have been granted, the amount of taxes payable for that taxation year would not change, *i.e.* no taxes would be payable for that year. This led to a question during the hearing of this appeal of whether this was a request to reassess the tax for that taxation year.

The appellant argued that subsection 152(4.3) should not be read as a part of the assessment regime set out in sections 165 and 169 and should not be subject to these provisions; therefore, the TCC had jurisdiction through subsection 152(4.3) to order the minister to reduce the excess loss applied against its January 1992 year-end. The FCA rejected that argument by citing the TCC jurisdiction set out in section 12 of the Tax Court Act, which allows the TCC to hear references and appeals under the Income Tax Act.

The jurisdiction of the TCC is limited to considering the correctness of assessments, pursuant to section 171, and references, pursuant to section 174; only the minister may apply to the TCC for the determination of a question. The FCA cited subsection 169(1), which provides that an appeal can be brought to the TCC only if a notice of objection has been served on an assessment. The FCA recognized that no objection could have been filed, given that an assessment for January 1992 would have resulted in a nil assessment.

At paragraph 41, Webb JA noted that in this appeal there was no dispute that the non-capital losses as claimed for the January 1992 taxation year were valid non-capital losses and could be claimed in that year. The return as filed did not contain any errors with respect to the non-capital losses that were claimed. The dispute centred on the minister's refusal to make the adjustment as requested by the appellant on the January 1992 tax return. At paragraph 42 the FCA stated:

> However, this disagreement between Bakorp and the Minister in relation to the application of subsection 152(4.3) of the Act in this case should have been resolved by Bakorp making an application to the Federal Court for judicial review of this decision of the Minister. The Tax Court does not have the jurisdiction to judicially review decisions of the Minister. The jurisdiction of the Tax Court is limited to references and appeals as provided in the Act. There is no provision in the Act that would permit the Tax Court to judicially review the decision of the Minister in this case. Having failed to seek judicial review of this decision before the Federal Court, Bakorp cannot effectively ask the Tax Court to interpret and indirectly apply this provision.

This case is a reminder to the practitioner to tread carefully when disputing a taxation year that involves a prior loss year. In *Bakorp*, an objection to the appellant's January 1992 return was not filed and could not be filed because one cannot object to a nil assessment. However, where there is a dispute on the quantum of a loss that can be carried forward, a taxpayer can avail itself of a loss determination under subsection 152(1.1) and appeal the later year.

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ITC Denials in the Scrap Industry Over False Invoice Concerns

Recent court cases have highlighted the taxing authorities' focus on the scrap industry, with many businesses dealing in scrap paper and various scrap metals being reassessed over the past several years. These cases have seen the CRA and Revenu Québec attempt to deny input tax credits (ITCs) claimed by the businesses, primarily on the basis that the invoices provided in support of the ITCs are false invoices or "invoices of convenience." A discussion of these cases follows, along with a brief overview of the new mandatory disclosure requirements that were introduced in Quebec, partly to address this issue.

There are two main types of allegations being made by the government in respect of the false invoicing issue. The first is that the invoices issued to the taxpayer were entirely fraudulent—that is, there were no goods actually being supplied to the taxpayer. The invoices were merely part of a scheme by the taxpayer and the suppliers to generate tax refunds.

The second type of allegation is that, even where there were actual goods being supplied to the taxpayer, the invoices were issued under false supplier names. In this situation, the suppliers charge the GST/HST but fail to remit it to the taxing authorities, and then disappear when the authorities attempt to collect the tax owing. Where the taxing authorities are unable to locate the suppliers, their solution is often to turn to the purchasers and deny their ITCs. This is understandable where the purchaser was a party to the false invoicing scheme; however, it can also lead to harsh consequences where an innocent purchaser may simply have been duped by its suppliers.

As an example of the former scenario, *TricomCanada* (2016 TCC 8) dealt with a situation where the taxpayer was found to be involved in a scheme to mask the identity of its true suppliers, and its ITCs were consequently denied.

In cases that fall under the latter scenario, the courts have generally taken the position that the ITCs should be allowed where the GST/HST registrant has made reasonable efforts to verify the identity and legitimacy of its suppliers—although we have seen different standards applied to this duty of verification.

To illustrate, *SNF L.P.* (2016 TCC 12) involved SNF, a scrap metal recycling business that acquired metals from various suppliers. SNF paid GST on its purchases, but its suppliers did not remit this GST to the government; Revenu Québec reassessed to deny ITCs claimed in respect of these transactions. At trial, the Crown conceded that SNF did in fact purchase the supplies of metal for the prices indicated on the invoices. However, the Crown's position was that the names on the invoices were not the names of the real suppliers and were merely "prête-noms" (that is, nominees or agents) of the real suppliers—therefore, the invoices did not meet the documentary requirements to claim an ITC under section 3(a)(i) of the Input Tax Credit Information (GST/HST) Regulations, SOR/91-45 ("the regulations").

The TCC accepted that the names on the invoices were prête-noms for the real suppliers; however, this was not sufficient to disentitle SNF from claiming the ITCs. Section 3(a)(i) of the regulations allows for the ITC documentation to contain the name of the supplier *or the intermediary*—and although it is not entirely clear from the TCC's decision, the court presumably found that the prête-noms were intermediaries for the real suppliers.

The TCC further noted that in order to claim ITCs, it was sufficient for SNF to have made inquiries as to whether its purported suppliers had valid GST registration numbers. Since SNF had verified the GST registration numbers of 11 of the 12 suppliers at issue, and there was no evidence that SNF was involved in or wilfully blind to the fraudulent scheme of these suppliers, SNF was allowed to claim its ITCs on these transactions. With respect to the last supplier, the TCC found that SNF was not entitled to its ITCs because SNF had not taken reasonable precautions to verify that supplier's GST registration number and had reason to suspect that person's legitimacy as a supplier.

In the subsequent case of *Papier Reiss* (2016 TCC 289), the TCC appeared to expand the scope of the duty of verification. Here, the names on the invoices were found not to be intermediaries,

since there was no evidence adduced as to the nature of the relationship between the true supplier and the names on the invoices. Further, it was not held to be sufficient for the taxpayer to verify only the GST registration numbers of its purported suppliers. According to the TCC, additional steps were required to verify the suppliers' identities, such as verifying the officers and directors of the corporate suppliers. However, the court did not provide much guidance in this respect, making it difficult to determine the requirements of this duty of verification.

There is a further case (*C C Gold Inc.*, 2018 TCC 155) currently under appeal before the TCC that could shed some more light on this.

(While not a factor in these cases, another point to note is that it is not uncommon in the scrap industries for the purchaser to issue its own invoices for the goods that it acquires, rather than to receive these invoices from its suppliers. At the 2005 Canadian Bar Association GST round table, the CRA indicated that these "reverse invoices" are acceptable where both parties agree to them, and where the ITC documentary requirements are otherwise met.)

To address the taxing authorities' concerns around the use of prête-noms or nominees in transactions (in both false invoicing and other commercial contexts), the Quebec government has introduced new measures around the mandatory disclosure of nominee agreements—that is, agreements whereby a principal allows a nominee to transact under the principal's name and to bind the principal as a party to the agreement.

Under these new measures, there is a prescribed form that must be filed whenever a nominee agreement is used as part of a transaction that has tax consequences. Although the form has not yet been published, the required disclosure will include the identities of the parties to the nominee agreement and "a full description of the facts of the transaction or series of transactions to which the nominee agreement relates and the identity of any person or entity for which such transaction or series of transactions has tax consequences."

By way of commentary, this case has somewhat wider application to all GST/HST registrants seeking ITCs on business inputs. It is another indication that the CRA will be looking very strictly at ITC documentation requirements, and looking to ensure that the information and documentation is being obtained by GST/HST registrants *prior* to the claiming of any ITCs. The CRA has not yet gone the same direction as Quebec, but best practice for all GST/HST registrants prior to claiming ITCs is to know their suppliers and obtain the required information to support their ITCs. This likely remains the number one audit issue for the CRA.

Businesses in the scrap industry should be extra careful in documenting and verifying the identities of the parties from whom they are purchasing supplies. The taxing authorities will be eager to deny ITC claims with respect to transactions where GST/HST was collected but not remitted, and businesses must take steps to ensure that they are not left paying the price.

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De Facto Control and Enhanced SR & ED Tax Credits in Quebec

This article outlines the upside for a Quebec corporation that claims scientific research and experimental development (SR & ED) tax credits in the context of the relatively untested subsection 256(5.11) for interpreting de facto control. However, there are still remaining challenges that may not have been intended by the imposition of this legislation.

The internal technical interpretation (TI) released by Revenu Québec (RQ) (17-037925-001, September 25, 2017; see also "Non-Resident Control for Quebec Enhanced SR & ED," *Canadian Tax Highlights*, May 2019) seems to offer promise for Quebec corporations that are not Canadian-controlled private corporations (CCPCs) through de jure control. The TI may enable them to benefit from enhanced SR & ED tax credits at the federal rate of 35 percent and at 30 percent provincially for Quebec. Corporations other than CCPCs (as defined in subsection 125(7)) can benefit from a lower federal rate of 15 percent and a provincial rate of 14 percent for Quebec.

As we shall see, the TI from RQ is a test case wherein a de jure non-CCPC corporation can be favourably treated as a de facto CCPC for the purposes of obtaining enhanced SR & ED tax credits. This treatment is applicable only under certain circumstances, but it is important to observe that such circumstances are easily conceivable.

In its TI, RQ considered the case of Mr. X, founder of Canco, who held 40 percent of its voting shares and was a non-resident of Canada. Canco's financing arrangements required Mr. X to be continually involved with its operation. Canco was not a CCPC because more than 50 percent of its shares were held by non-residents. In this fact pattern, the RQ auditor denied enhanced tax credit treatment for Canco on the basis of its de jure control. In contrast, RQ considered the critical role of Mr. X at the operational level and applied de facto control to him; however, RQ stated that Canco was not a CCPC solely because Mr. X was a non-resident. The results of the RQ auditor and RQ were identical but the rationales were not.

The impact of this TI should be understood in the wake of *McGillivray Restaurant Ltd. v. Canada* (2016 FCA 99) and the challenges in applying the notion of de facto control prior to that case. The primary question was whether there should be an operational consideration or a narrower test when there is an influence over the board of directors. *McGillivray* reaffirmed that the narrower test of de facto control applies

when there is an influence at the board of directors' level; see also the decision in *Silicon Graphics Ltd. v. Canada* (2002 FCA 260). Proving influence at the board of directors' level in general can be onerous, especially for small to mid-sized technology corporations, which are constantly cash flow-starved and seeking funds for development work.

The court in *McGillivray* ruled against using influence at the operational level as a test for de facto control:

> In my view, an interpretation of *de facto* control as contemplated by subsection 256(5.1) that fails to include a requirement that the influence in question must be grounded in a legally enforceable right or ability runs counter to the clear admonition of the Supreme Court of Canada in *Canada Trustco Mortgage Co. v. Canada*, 2005 SCC 54 (CanLII), [2005] 2 S.C.R. 601 wherein, at paragraph 12, the Chief Justice and Justice Major unequivocally stated:
>
> > The provisions of the *Income Tax Act* must be interpreted in order to achieve consistency, predictability and fairness so that taxpayers may manage their affairs intelligently.

McGillivray went further to state that an interpretation based on operational control will lead to a certain level of subjectivity in the de facto control analysis; this unpredictability goes against the spirit of the law (the court referred to the *Canada Trustco* interpretive approach to control).

RQ's approach is important to consider, because the TI offers much-needed administrative support and clarification for the new de facto control rules following *McGillivray*, as stated in subsection 256(5.11). The RQ rationale now allows for the possibility that a non-resident corporation may be treated as a CCPC for the purposes of enhanced SR & ED tax credits.

The following observations may be helpful (especially in regard to the impact of the TI):

- Other cases have considered operational-level influence as a test for de facto control, such as *Mimetix Pharmaceuticals Inc. v. Canada* (2003 FCA 106). Such cases demonstrate the complexity and challenges of applying tests for de facto control.
- The spirit of *McGillivray* preserves a legal basis for control owing to operational-level control and influence that is not otherwise clear. (See also Philip Friedlan and Adam Friedlan, "256(5.1)—De Facto Control: A Return to the Past," 2017 Ontario Tax Conference; and "Buckerfield to McGillivray—Testing CCPC Status: Can This Now Open a Pandora's Box," Taxnetpro Tax Dispute and Resolution Centre, RP-2018-13, 2018.)

Following *McGillivray*, Finance widened the de facto control test in subsection 256(5.11), effective March 21, 2017. The provision now tests the legal meaning of control using a high level of subjectivity, owing to its broad scope and generality. It states, inter alia, that factors are not limited to whether the taxpayer has a legally enforceable right or ability to effect a change in the board of directors of the corporation, to change the board's powers, or to exercise influence over the shareholder(s) by using that right or ability. This is a critical change that leads to the high level of subjectivity in this new legislation.

With the above observations in mind, consider a slight change to the example provided in the TI. Mr. X is now a Canadian resident. Also, as part of a market capitalization, Canco has issued voting shares, options, or contingent rights to multiple investors. This scenario is not uncommon for many small to mid-sized technology corporations that are constantly seeking cash flow for their development activities and sustainability.

Within the Act, control commonly refers to de jure control if share ownership carries a voting right and an ability to elect the board of directors (see *Duha Printers (Western) Ltd. v. Canada*, [1998] 1 SCR 795). The test for control was established in the well-known case, *Buckerfield's Ltd. et al. v. MNR* (64 DTC 5301 (Ex. Ct.)). Subsection 251(5) sets out rules for the purposes of the CCPC definition and, depending on the residence of the investors and combined voting rights, Canco may still be a non-CCPC. In CRA document no. 2015-0565741E5 (February 4, 2015), the CRA took the position that a private corporation was not a CCPC on the basis that subparagraph 251(5)(b)(i) applied to a contingent right to acquire shares of the corporation on a default event (the right was held by a public corporation).

Notwithstanding the legal conclusions based solely on a CCPC test, it appears that as long as Mr. X is operationally involved (in a significant manner) with Canco, the RQ TI allows Canco to be treated as a CCPC and to benefit from the enhanced rates when claiming its SR & ED tax credits. There are some important questions that follow from such a conclusion. The list below is by no means exhaustive, but it is intended to illustrate certain, perhaps unintended, consequences of the RQ TI:

- How will RQ's conclusions be accepted by other provinces, and what if Canco is multijurisdictional? This can strain the parity of treatment regarding CCPC status between different provinces. The Act does not differentiate based on province of residence of a corporation—including where a different province or a federal authority differs from RQ in its treatment regarding CCPC status.
- As it stands, the RQ TI is likely an annualized test for CCPC status and will depend on Mr. X's residence, among other factors. This may increase the requirements for costly and continuous compliance for Canco in future taxation years.
- Control can affect many other sections of the Act, and how this will be handled for Canco remains to be seen. Will there be a bigger difference in how reported

income is taxed at the federal level (which may not recognize Quebec's test for CCPC status) and for Quebec purposes (which may allow CCPC status)? This issue is independent of Canco's ability to benefit from SR & ED tax credits.
- Additionally, will there be a "deemed" de facto director under common law who can be held vicariously liable for any corporate liabilities? See *Information Circular* IC89-2R3. This can be an unintended consequence, and liabilities may be imposed even on a de facto director (see *Wheeliker v. R*, [1999] 2 CTC 395 (FCA)).

The RQ TI may be welcome news for technology corporations, and its benefits may be extended to other industries, but it has raised and rekindled some important and complex questions relating to control of a corporation. There might be some beneficial planning opportunities for Quebec-based technology corporations, but the complexity of disentangling legal control from operational control still remains an unresolved consequence of subsection 256(5.11).

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Loan Comparables: A Missed Opportunity

A recent review of the public comments received in response to the OECD transfer-pricing paper on financial transactions, issued one year ago, reveals a concerning reality. Selecting an appropriate comparable for an intercompany loan for benchmarking purposes remains largely an ambiguous, and even possibly misunderstood, practice in transfer pricing.

Intercompany loans are by far the largest intercompany transactions on corporate tax returns, and their volume has been growing at the exponential rate of global corporate consolidations. Yet, despite the large potential tax exposure of these loans and their inherent vulnerability to slight quantitative tweaking, the long-awaited OECD paper did not advance the thinking in this respect. If anything, it may have highlighted an alarming gap in professional practice instead.

In response to the OECD's request, 78 respondents—including professional practitioners, industry associations, and academics—shared their views on a number of questions. One of those questions, arguably the most important, received very little attention. Only 22 respondents answered the OECD's request under box C.6 to "identify financial transactions that may be considered as realistic alternatives to intra-group loans." This question followed a proposition by the OECD that "[a]rm's length interest rates can also be based on the return of realistic alternative transactions with comparable economic characteristics . . . for instance, bond issuances." To receive a response rate of less than 30 percent on that question is a cause for concern.

The OECD may be criticized for using the potentially confusing term "realistic alternatives" to mean "comparables" (as one of the respondents pointed out), but not for raising the question outright. In fact, selecting loan comparables is far from evident and their consequences on rates may be very material. Bond issuances are indeed abundant in public debt markets, but a bond issuance is hardly an appropriate comparable to an intercompany note, especially when examined through the contextual framework of the "economically relevant characteristics" outlined in the paper. Perhaps the OECD was inviting a public debate on the technical differences between intercompany loans and bond issuances, but the public's reluctance to engage suggests either a lack of interest in the topic or a more fundamental underappreciation of the issue at play.

The issue of comparability for intercompany loans is technically challenging, and transfer-pricing professionals are not aligned in their practice. To be fair, there is a broad consensus among practitioners on the comparable uncontrolled price (CUP) method as the primary yardstick for intercompany debt. The CUP method is based on the notion that directly "observable" transactions entered into by unrelated parties under similar circumstances provide the most reliable basis for pricing. This notion carries perfectly for intercompany debt, because corporate bonds are highly liquid, standardized in their structure, and highly regulated in their dealings. To establish an arm's-length interest rate, a practitioner need only observe the continuous fluctuation of corporate bond yields as direct evidence of perfectly functioning debt markets.

But in what respect is a corporate bond even the right comparable to start with? Some have argued this question from the traditional perspective of business valuation, often defining an arm's-length rate as the best rate available in an open and unrestricted market, between informed and prudent parties acting at arm's length and under no compulsion to transact, expressed as a percentage. Viewed from that angle, a highly liquid market such as the corporate bond market must therefore provide the most accurate reflection of an arm's-length price.

But how does that reconcile with the key comparability criteria in chapter 1 of the OECD's transfer-pricing guidelines? More specifically, how is a bond issuance comparable to an intercompany loan along the five dimensions discussed under section B.2 of the paper?

Those dimensions may have been the most valuable insights provided by the OECD in this paper. Specifically, intercompany loans must be delineated along five "economically relevant characteristics" to be able to identify appropriate comparables to benchmark them against—namely, (1) contractual terms, (2) functional analysis, (3) characteristics of

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financial products or services, (4) economic circumstances, and (5) business strategies. A bond may be comparable to an intercompany loan on the basis of its contractual terms, its functional profile, and its characteristics. Taxpayers may be able to structure an intercompany loan to mirror the legal borrowing terms of a public bond, and to create the conditions such that the actual conduct of the parties matches their respective debtor-creditor relationships. Taxpayers may even be able to align their intercompany loans to reconcile with the business strategies of certain public bond issuers, or at least restrict their data set to those bond issuances that match the taxpayer's fact pattern.

However, taxpayers cannot align an intercompany loan with a public corporate bond along the dimension of "economic circumstances." The OECD rightly insists that "[t]o achieve comparability requires that the markets in which the independent [that is, bond issuers] and associated enterprises [that is, the taxpayer] do not have differences that have a material effect on price." Except that there is a material difference in market structure between the highly liquid market from which bond comparables are derived and intercompany debt that is very rarely (if ever) liquid. Illiquidity carries a premium, as largely supported by academia and evidenced directly during the financial crisis of 2008-2009, when liquidity premiums on government debt exceeded 5 percent.

It is also important to note that "appropriate adjustments" for liquidity differences are not easily calculated. Many equate reduced liquidity in intercompany loans with increased credit risk, and adjust for it by notching down an intercompany loan's credit rating by benchmarking it against a lower-rated—and hence riskier—public bond; except that those two things are not the same. First, the lower-rated bond, albeit riskier, is still much more liquid and would still yield a significantly lower rate than an otherwise identical illiquid bond. Second, as a bond moves down the rating scale, adjusting one or two notches drops the rating toward the speculative end of the market, where bonds are rarely uniform, and the resulting interest rate ranges are unreliably wide. And because practitioners and tax administrations alike find comfort within the interquartile area of the range, this approach often results in confining an intercompany loan's transfer price to a narrow interquartile band capped at a rate that is materially lower than an otherwise comparable debt instrument, and vastly underestimating this difference in "economic circumstances."

And yet, less than 30 percent of respondents brought that issue to light. This explains why the few who did respond seem to endorse "public bonds as comparables" by default, and not by conviction. Maybe transfer pricing needs to concede to the imperfect reality that the only acceptable measure of arm's-length rates is the lower yields of perfectly liquid bonds. Having missed a great opportunity to clarify an important area of technical interpretation, the transfer-pricing world yields to the OECD once again to set the standard of the practice for the future, and possibly leaves this sophisticated debate, unfortunately, in the hands of field auditors.

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