Insights and Commentary from Dentons

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2007 Canadian Tax Foundation Annual Conference CRA Round Table

On Tuesday, November 27, 2007, at the Annual Conference of the Canadian Tax Foundation (the “CTF”) in Montreal, a panel of two tax practitioners and two representatives of the Canada Revenue Agency (the “CRA”) participated in a round-table discussion of the CRA’s policies on a variety of issues. The CRA was represented by Richard Montroy, Director General, Legislative Policy Directorate and Mickey Sarazin, CA, Director, Income Tax Rulings Directorate. The practitioners were Gabe Hayos, CA, of the Toronto office of KPMG LLP and Stephen S. Heller of the Toronto office of Borden Ladner Gervais LLP.

The discussion was carried out in a traditional question and answer format. The summaries below are based on notes taken during the session, as well as on power point slides prepared by the panelists. A complete summary of the Round Table is expected to be published at a later date by the CTF. The CRA also usually publishes this session in an issue of its Income Tax Technical News (“ITTN”). Unless otherwise stated, all statutory references in this article are to the Income Tax Act (Canada) (the “ITA”).

CRA Announcements

1. Fifth Protocol to Canada–U.S. Tax Treaty

The CRA has received many questions on a broad range of issues arising from the recently signed Fifth Protocol to the Canada–U.S. Tax Treaty. There has been special interest with respect to cross-border pension and employment issues; the application of changes to the treatment of LLCs; arbitration; and limitations on benefits. The CRA is working with the Department of Finance to update and develop new procedures, forms, and guides in respect of the Fifth Protocol. The CRA has already
met with the U.S. Internal Revenue Service ("IRS") regarding the details of binding arbitration and the two agencies will continue to work on this and other issues related to the Protocol. It is expected that the Technical Explanation that is prepared by the U.S. Treasury Department will be instrumental in resolving a number of interpretive and policy questions. The CRA hopes that the majority of questions that it has received can be resolved before the Protocol enters into force.

2. Single Administration of Ontario Corporate Tax

In 2008, the CRA will begin administering the corporate income tax on behalf of Ontario. In the CRA's view, the single administration of corporate tax in Ontario will provide a significant benefit for Ontario businesses in terms of reduced compliance costs, including one single point of contact for Ontario corporate taxpayers; one set of rules; one tax return; one audit; and one appeals process. Full harmonization of the provincial and federal tax systems will begin in the 2009 tax year. As of February 2008, the CRA will begin to accept combined federal–provincial instalment payments for the 2009 tax year, and as of January 2009, Ontario businesses will file a single T2 tax return with the CRA. To speed the process of streamlining compliance procedures, the CRA will perform most of the administrative functions for Ontario's corporations tax for taxation years ending prior to 2009. As of April 2008, the CRA will begin to audit Ontario corporate tax returns, and will undertake most of Ontario's objections, appeals and rulings functions.

3. CRA Auditors' Access to Audit Working Papers

The CRA is currently reviewing its policy on when it would be appropriate for a CRA auditor to request access to the working papers of a taxpayer's auditor. The CRA is working with the CICA's Task Force on Auditor Working Papers and Confidentiality. It was announced that a draft CRA policy will be circulated for comments. It should be noted that this response is similar to the CRA's response at the 2004 Roundtable (Income Tax Technical News No. 32 (July 15, 2005)), the 2005 Roundtable (Income Tax Technical News No. 34 (April 27, 2006)), and the 2006 Roundtable (Tax Topics, No. 1814 (December 14, 2006)).

4. Interprovincial Tax Planning Arrangements

In recent years, the CRA has intensified efforts to review some interprovincial tax planning arrangements. The CRA and the provinces are concerned about transactions undertaken to erode provincial income tax bases, especially where the transactions result in little or no provincial tax being paid. Among other plans, the CRA has identified an arrangement referred to as the Q-YES Plan (i.e., Quebec “Year-End Shuffle” Plan) as being problematic. No rulings have been requested on any of these arrangements. The CRA intends to identify and challenge all perceived abusive provincial tax avoidance arrangements.

International Issues

1. Thin Capitalization – Meaning of “Beginning of Calendar Month”

The CRA interprets the term “beginning of a calendar month” in subparagraph 18(4)(a)(ii) as meaning the earliest moment on the first day of the month. For newly incorporated corporations, the CRA stated that this means the date of incorporation.

2. Imperial Oil – Treatment of Foreign Currency Loans

The CRA was asked whether it agrees with the obiter comments by the Supreme Court of Canada in Imperial Oil (2006 DTC 6639), namely that, “[a]bsent currency conver-
sion, mere repayment of principal cannot yield profit or loss”. In response, the CRA stated that it agrees with the Supreme Court’s ratio decidendi, but the CRA does not consider that it is bound by comments made in obiter.

3. Application of Paragraph 95(6)(b)

The CRA was asked about the text of ITTN No. 36 concerning paragraph 95(6)(b). An early draft of ITTN No. 36 addressed certain “offensive” situations, but some of these situations were not addressed in the final draft, and the commentary relating to “series of transactions” also was deleted from the final version. The CRA stated that it believes paragraph 95(6)(b) applies where the principal purpose of a transaction is tax avoidance, reduction or deferral and its application is not limited to cases where the policy intent of one or more other provisions is frustrated. Some examples were eliminated from ITTN No. 36 because they were redundant or required unreasonable assumptions. In respect of “series of transactions”, the CRA stated one must look at the facts surrounding a transaction to determine the principal purpose of an acquisition or disposition. Where an acquisition or disposition is part of a series, the CRA may look at other transactions to determine the principal purpose.

4. Foreign Entity Classification

The CRA was asked about its new approach to classifying foreign entities. The CRA stated that it follows a two-step approach. Firstly, it determines the characteristics of foreign business associations under foreign commercial law and secondly, it compares those characteristics with recognized categories of foreign business associations under Canadian commercial law. The CRA considers that the most important attributes in this determination are the nature of the relationship between the various parties and the rights and obligations of the parties. The CRA has concluded that the following are corporations for Canadian tax purposes: Polish LLCs, U.S. LLCs, S Corporations, and French Societes par Actions Simplifiees. Other entities have qualified as corporations based on an analysis of foreign legislation and agreements related to their creation, for example; a Dutch cooperative, a Chilean Special contractual mining company, and a Chinese-Foreign Contractual Joint Venture.

5. Canada–U.S. Tax Treaty’s Competent Authority Provision – Residence of Trust or Estate

According to the CRA, determining the residence of an estate or trust under Article IV(4) of the Canada–U.S. Tax Treaty is a question of fact, based on the strength of the trust’s ties to Canada versus those to the United States. Other factors that may be relevant include: those set out in IT-447, “Residence of Trust or Estate”; the residence of the settler; the residence of the beneficiaries; the location of the trust property; and the reasons the trust was established in a particular location.

In the past, there have been few requests to Canada’s competent authority to settle dual residence of a trust or estate. However, recently there has been a rise in requests on questions of dual residence in light of the proposed changes to section 94, which is an anti-avoidance provision of the Act. The CRA considers that the test for residency under section 94 is highly relevant. The CRA has discussed these issues with the U.S. competent authority, however, both countries are at an impasse on the matter.

See also Perry et al. v. M.N.R. et al., 2007 FC 1071 (F.C.), where the taxpayer sought judicial review of the Minister’s refusal to consider the residency of a trust under proposed section 94 (application dismissed for being time-barred).

**Trusts and Specified Investment Flow-Through (SIFT) Entities**

1. Control of a Corporation Owned by a Trust – Impact of Change in Trustees

The CRA was asked about its view on the impact on control of a corporation owned by a trust which undergoes a change in trustees. The CRA referred to technical interpretation 2004-0087761E5, dated May 24, 2005, and stated that where the trust has sufficient voting shares to control a corporation, any change in trustees of the trust could trigger an acquisition of the corporation. In ITTN No. 34, the CRA stated that it is unlikely that two trustees could control a corporation to the exclusion of a third trustee. However, ITTN No. 34 does not address income trusts and so a review of the factual situation would be required to determine the impact on control for an income trust.

2. CCPC Determination: Impact of Sedona

The CRA was asked about its view on the treatment of employee stock rights in light of the Federal Court of Appeal decision in Sedona Networks (2007 DTC 5359) (determination of CCPC status under subsection 125(7)). The CRA replied that the Court did not explicitly hold that paragraph 251(5)(b) must be applied considering the rights held by all persons and so Sedona does not preclude the CRA from applying paragraph 251(5)(b) on a holder-by-holder basis.
3. Deemed Year-End on Loss of CCPC Status – Paragraph 251(5)(b) Conditional Agreements

In reply to the question of whether the year-end triggered under subsection 249(3.1) (becoming or ceasing to be a CCPC) was subject to paragraph 251(5)(b), the CRA stated that where a party’s entitlement to acquire shares is subject to a condition, the party would have a contingent right to acquire shares, and so paragraph 251(5)(b) would apply to that right.

4. SIFT Rules – Transitional “Normal Growth” Guidelines

Under the SIFT rules, transitional relief from SIFT tax is available until 2011, but that transitional relief is lost in the first year that the SIFT entity exceeds “normal growth” guidelines. The CRA was asked about the consequences of exceeding the safe harbour limit where it can be shown that the growth is “normal” in the circumstance. In response, the CRA stated that its statutory direction to apply the guidelines is in paragraph 122.1(2)(b) of the ITA. The CRA intends to apply these guidelines consistently. Therefore, transitional relief is lost if a SIFT entity exceeds normal growth as determined under the guidelines.

5. SIFT Rules – Definition of “Real Estate Investment Trust”

The CRA was asked whether, for the purpose of REIT revenue tests, trust income retains its underlying character when earned by the beneficiary of the trust. The CRA stated that nothing in section 122.1 counteracts the effect of subsection 108(5), which states that, generally, the income is income of the beneficiary of the trust. The CRA believes that subsection 108(5) is clear, but some taxpayers have raised questions about this position. The CRA is giving further consideration to this issue and has asked for additional representations.

Other Issues

1. Income Tax Treatment of GST Interest and Penalties

The CRA was asked about the deductibility of interest assessed for GST purposes after April 1, 2007 and relating to a period before that date. The CRA stated that GST interest accrued in a tax year that commenced on or after April 1, 2007 is not deductible, regardless of the period in which the GST/HST liability arose.