On November 26, 2013, the Canada Revenue Agency ("CRA") participated in the annual Roundtable session at the 65th Annual Tax Conference of the Canadian Tax Foundation held in Toronto, Ontario. The CRA was represented by Randy Hewlett, Director of Income Tax Rulings; Mark Symes, Director of Income Tax Rulings; and Jeff Sadrian, Director of Compliance Programs Branch. The Roundtable was chaired by Elio Luongo of KPMG LLP and John Tobin of Torys LLP.

The Roundtable session was presented in a question and answer format. The summary below is based on notes taken by attendees during the session and a PowerPoint presentation prepared by the panellists and released by the Canadian Tax Foundation ("CTF") which sets out the questions. Any references to the Act are references to the Income Tax Act unless otherwise indicated. Due to its length, this summary is divided into two parts. Part II includes summaries of answers to questions 8–16. Part I included summaries of answers to questions 1–7 and was published in Tax Topics No. 2179 on December 12, 2013.

**Question 8: Part XIII Tax on Convertible Debentures**

The panellists were asked to discuss the CRA’s position with respect to Part XIII tax being applied to convertible debentures owned by foreign lenders.

The CRA panelists limited their comments to convertible debentures of public corporations. The panelists noted that deemed interest under subsection 214(7) of the Act from the assignment of a convertible debenture is not "participating debt interest" as defined in subsection 212(3) of the Act.

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• it must be made to the government of a foreign country or to the government of a state, province, or other political subdivision of a foreign country;

• it cannot be conditional on the availability of a foreign tax credit in Canada or a deduction in respect of a dividend received from a foreign affiliate under section 113; and

• it must be an income or profits tax.

The panellists noted that if a foreign affiliate of a Canadian taxpayer elects to pay tax on gross revenue, as opposed to tax on net income, then this tax may be considered to be an “income or profits tax” for the purpose of foreign affiliate and foreign tax credit rules.

The panellists highlighted three factors to apply when determining whether a tax qualifies as an income or profits tax:

• whether the tax is imposed under the same statute as regular income tax;

• whether an annual election is available to choose between being taxed on net income or gross revenue; and

• whether the rate of tax is reasonable.

If these factors are met, then the tax may qualify as an income or profits tax. This is based on an example provided in CRA Document No. 2011-0431031E5, “Guatemala’s Taxes” (September 5, 2013).

The panellists advised that the CRA will update its folios on foreign tax to set out its position on the subject.

**Question 10: NPO Audit Project**

The CRA was asked for an update on the progress and status of its not-for-profit organizations (“NPO”) audit project.

The CRA panellists noted that the only provision pertaining to NPOs in the Act is paragraph 149(1)(l), which traces its roots back to the *Income War Tax Act*. The panellists stated that the CRA is taking a fresh look at the NPO sector and a review process identifying various NPOs, activities, trends, and risks is now complete. Approximately 1,400 NPO files were reviewed on a random basis. The data analysis stage of the project has been completed and the findings will be shared with the public in the near future.

The CRA also noted that it is having an open discussion with the Department of Finance regarding potential amendments to paragraph 149(1)(l), which could provide further legislative guidance on defining a qualifying NPO and what activities are permissible *vis-à-vis* obtaining and maintaining tax-exempt status.

**Question 11: Cross-Border Butterfly Transactions**

The CRA panellists were asked to comment on the increase in favourable rulings for cross-border butterfly transactions in the last few years.

Mark Symes stated that, as of 2007, these transactions began to be structured using the “three-party vaccine” (i.e., a three-party circular exchange so that the foreign “spinco” is never a shareholder of the Canadian distributing company) to avoid problems created by paragraph 55(3.2)(h). This was held to be not abusive by the CRA. Recent favourable rulings of such transactions include:

• CRA Document No. 2012-0439381R3, “Cross-Border Spin-Off Butterfly” (2012);

• CRA Document No. 2011-0431101R3, “Cross-Border Spin-Off Butterfly” (2012); and


The panellists noted that the details in such transactions are crucial. For example, one panellist noted that, in a recent ruling request, the CRA was unable to issue a favourable ruling because the minority shareholders did not want to participate in the butterfly transaction.

The panellists cautioned that the general anti-avoidance rule (“GAAR”) would be applied to any transactions that were viewed as abusing the third-party exchange and the CRA will always look to determine if a “series” of transactions exists.
Question 12: GAAR and Subsection 93(2)

The CRA was asked to comment on its response to a question on the GAAR and subsection 93(2) at the 2013 IFA Conference. As noted in CRA Document No. 2013-0486741C6E, "Loss on Disposition of FA Share" (May 23, 2013), subsection 93(2) applies to deny a loss on the disposition of a share of a foreign affiliate to the extent that exempt dividends are received on that share or on a substituted share prior to the disposition.

At the 2013 IFA Conference, the CRA stated as follows:

It is our view that the GAAR would apply to a series of transactions undertaken by a taxpayer primarily for the purpose of avoiding the application of subsection 93(2), including in those circumstances where the otherwise denied foreign exchange loss on the disposition of FA shares would effectively offset what the taxpayer views as a foreign exchange gain on a related debt or hedging instrument, unless that foreign exchange gain is a gain described in proposed subparagraph 93(2.01)(b)(ii).

The panellists at the Roundtable confirmed that the conclusion reached at the 2013 IFA Conference would remain the same even if the funds were borrowed from a party at arm’s length 30 days prior to the acquisition.

Question 13: Surplus Stripping

The CRA panellists were asked to reconcile the CRA’s comments in CRA Document No. 2012-0433261E5, “55(5)(f) and Surplus Stripping” (June 18, 2013), that it intends to demonstrate an overall scheme in the Act against surplus stripping with recent cases including Gwartz v. The Queen (2013 DTC 1122), Canada v. Collins & Aikman Canada Inc. (2010 DTC 5164), and Copthorne Holdings Ltd. v. Canada (2012 DTC 5007).

The panellists noted that surplus stripping, the act of converting dividends to capital gains, is not defined in the Act and includes a broad spectrum of activities. Full conversion of income from non-arm’s length parties falls on the “bad end” of the spectrum. In the past year, approximately 37 assessments were on the “bad end” of the surplus stripping spectrum. The 37 assessments included issues of paid-up capital fabrications, subsection 75(2) strips, and capital dividend account duplication.

The panellists cited recent wins by the CRA with respect to surplus stripping including The Queen v. MacDonald (2013 DTC 5091) and Brent Kern Trust v. The Queen (2013 DTC 1249), where specific provisions — and not the GAAR — were applied to prevent surplus stripping. In MacDonald, the Court found that subsection 84(2) deemed the repayment of a note in a pipeline-type strategy used on the taxpayer’s emigration from Canada to be a dividend. In Brent Kern Trust, the Court found that the attribution rules in subsection 75(2) did not apply, as property was sold to a trust for fair market consideration. This position was consistent with the decision in The Queen v. Sommerer (2012 DTC 5126).

The panellists conceded that the CRA lost the Gwartz case and the case was not appealed since the legislation was subsequently amended. In this case, the Crown did not allege GAAR.

The panellists were of the opinion that the CRA has yet to prove its case that GAAR applies to surplus stripping transactions and if the CRA alleges abusive surplus stripping in future cases it is mindful that Copthorne principles will apply and a specific provision of the Act will be used to challenge surplus stripping (rather than alleging that there is an overarching anti-surplus stripping policy in the Act).

Question 14: Related Party Initiative

The CRA panellists briefly confirmed that the related party initiative remains targeted towards individuals and related groups with a net asset value of $50 million or more and groups comprised of 30 or more entities. The CRA is satisfied with the progress of the project.

Question 15: Subsection 15(1.1) and Payment of a Stock Dividend

The CRA was asked which factors the ITRD considers in determining whether subsection 15(1.1) applies. Subsection 15(1.1) requires the fair market value of a stock dividend to be included in a taxpayer’s income if a purpose of the payment is to alter, in a significant manner, the position or interest of a “specified shareholder” in the
corporation. In the Act, a “specified shareholder” is defined as a taxpayer who owns, directly or indirectly, at any point in the year, more than 10% of the issued shares of a class of the capital stock of the corporation. This provision would not apply if the amount of the stock dividend has been included under paragraph 82(1)(a).

The following explanation and example was provided by the panellists. Assume there are three parties: Canco, ForOpco, and ForHoldco. Canco incorporates ForHoldco in Country B. ForOpco amends its organizing documents and reduces outstanding shares by a factor of 100,000. ForOpco returns capital to Canco and Canco subscribes for common shares of ForHoldco. ForHoldco subscribes for preferred shares of ForOpco and ForOpco pays a stock dividend on the preferred shares consisting of common shares to ForHoldco.

After the stock dividend, ForHoldco owns 99.8% of the outstanding common shares of ForOpco and Canco owns 0.2%. In this example, the panellists noted that the CRA would apply subsection 15(1.1), given the substantial transfer in equity value as a result of the stock dividend.

**Question 16(a): Tax Earned by Auditor**

The CRA panellists were asked whether tax earned by audit (“TEBA”) remained a relevant metric for performance evaluation for the CRA and its auditors. The panellists confirmed that TEBA is still being used to gauge the effectiveness of audit practices, but the metric is not used to measure an auditor’s performance.

Jeff Sadrian stated that he didn’t consider tax to be “earned” by the CRA until the conclusion of the audit and appeal process. Therefore, he didn’t agree that the Audit Division “earns” any tax. Instead, Mr. Sadrian proposed another metric for consideration: additional tax assessed by audit, which, he stated, is not used to measure the performance of individual auditors.

Mr. Sadrian stated that, in consultation with the Tax Services Office, individual auditors are evaluated on the following factors:

- integrity of conduct;
- quality of the audit (i.e., whether the appropriate provisions of the Act were applied);
- adherence to CRA policies and values;
- professionalism to clients; and
- adherence to procedural guidelines.

**Question 16(b): Risk-Based Audit Approach**

The CRA confirmed that it continues to utilize a risk-based approach to audit and classifies large taxpayers in low-, medium-, and high-risk categories. The goal is to dedicate audit resources to the highest risk files.

This risk profile is determined based on 500 variables, including 200 variables relating to international activities, 75 relating to aggressive tax-planning activities, and 225 relating to domestic activities.

Approximately 26,000 Canadian entities are considered large corporations and have gross revenues of greater than $250 million. These 26,000 entities are owned by 1,200 entities.
The panellists noted that large corporations are divided as follows (approximately):

- 34% in the high-risk category;
- 30% in the medium-risk category; and
- 36% in the low-risk category.

The low-risk corporations will likely not be subject to audit, medium-risk corporations will receive some attention from auditors, and the focus will remain on high-risk files.

Jeff Sadrian stated that he would prefer to rank the 1,200 entities from 1 through 1,200 based on risk. He stated that, in such a system, the CRA could start auditing the top risk entity and work its way down the list until the CRA had exhausted its audit resources for the year.

Conclusion

Due to time constraints, the final question on in-house loss utilizations was not answered during the Roundtable discussion. It is expected that the CRA will publish written answers to all of the Roundtable questions in the near future.

A number of tax lawyers from Dentons Canada LLP write commentary for CCH’s Canadian Tax Reporter and sit on its Editorial Board as well as on the Editorial Board for CCH’s Canadian Income Tax Act with Regulations, Annotated. Dentons Canada lawyers also write the commentary for CCH’s Federal Tax Practice reporter and the summaries for CCH’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 CCH: 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 Denton’s Canada LLP and a member of the Editorial Board of CCH’s Canadian Tax Reporter, is the editor of the firm’s regular monthly feature articles appearing in Tax Topics.

For more insight from the tax practitioners at Dentons Canada LLP on the latest developments in tax litigation, visit the firm’s Tax Litigation blog at http://www.canadiantaxlitigation.com/.

BILL C-4 RECEIVES ROYAL ASSENT

Bill C-4, Economic Action Plan 2013 Act, No. 2, which contains the remaining provisions of Budget 2013 as well as certain technical amendments, received Royal Assent on December 12, 2013, becoming law as S.C. 2013, c. 40. The amendments from former Bill C-4 will be added to CCH’s Income Tax Act online and on DVD as soon as possible and will be included in the 97th edition of CCH’s Canadian Income Tax Act with Regulations, Annotated, which will be published this spring. Commentary in the Canadian Tax Reporter will be revised as soon as possible for the former Bill’s amendments.

TAX PROTOCOL BETWEEN CANADA AND LUXEMBOURG ENTERS INTO FORCE

On December 10, 2013, the Protocol between the Government of Canada and the Grand Duchy of Luxembourg regarding avoidance of double taxation and prevention of fiscal evasion with respect to taxes on income and on capital entered into force. Signed on May 8, 2012, the Protocol has effect in accordance with the provisions of its Article II.

PRESCRIBED INTEREST RATES — FIRST QUARTER OF 2014

The prescribed interest rates for the first quarter of 2014 were released by the Canada Revenue Agency on December 13, 2013. Except for corporate taxpayers’ rates for interest on pertinent loans and indebtedness (which will be 4.94%), the rates have all decreased by 1% from the fourth quarter of 2013 and are noted below.
• 1% to calculate a deemed interest taxable benefit on subsidized employee and shareholder loans;
• 1% on refunds of income tax overpayments paid to corporate taxpayers;
• 3% on refunds of income tax overpayments paid to non-corporate taxpayers; and
• 5% on payments of overdue income taxes, insufficient income tax instalments, unremitted employee source deductions, CPP contributions or EI premiums, and unpaid penalties.

These rates will be in effect from January 1, 2014 to March 31, 2014.

A listing of the prescribed interest rates for each quarter, dating back to 1994, is reproduced at ¶300 and under “Quick Links” in the Canadian Tax Reporter on DVD and online.

RECENT CASES

Minister’s decision to deny taxpayer’s requests to amend tax returns to remove poker earnings lacked intelligibility and fell outside range of possible, acceptable outcomes

The taxpayer filed a judicial review application regarding a decision made by the Canada Revenue Agency ("CRA") to deny his adjustment requests for 2004 to 2007. The taxpayer had a full-time job working for the federal government, but was also making money playing online poker. He was very good and earned significant amounts from his poker activities. For 2004, the taxpayer began to report his poker earnings as income for tax purposes. He claimed his poker earnings for all relevant years. At some later point, he filed adjustments to those returns to remove the poker earnings as income following conversations he had with other poker players in similar circumstances. The CRA did not make the requested adjustments. The question before the Court was whether the CRA’s decision to deny the adjustments was reasonable.

The taxpayer’s application was granted. There was no evidence of procedural unfairness or bad faith on the part of the CRA. The proposals to the taxpayer were reasonable and afforded him an opportunity to present his case. However, the Minister’s decision lacked intelligibility and justification and fell outside the range of possible, acceptable outcomes that are defensible in respect of the facts and law.

¶48,592, Radonjic, 2013 DTC 5152

Crown failed to establish essential facts to support penalty

The Crown was appealing an order of the Tax Court of Canada that struck the Crown’s Reply to the taxpayer’s appeal from a penalty assessment and the subsequent judgment allowing the taxpayer’s appeal. The taxpayer had been assessed a penalty in excess of $2 million and accrued interest of almost $500,000 on the basis that he had been a principal or agent involved in the sale of a tax shelter ("SLRP") before the Minister had issued an identification number for the shelter. Such a penalty may only be imposed if there is a tax shelter, which is defined as a gifting arrangement or a property. At issue was whether the Reply set out enough facts to support the assessment of a penalty.

The Crown’s appeals were dismissed. For pleadings to be struck it must be obvious that the allegations in the Reply have no reasonable chance of success. The Minister had stated in its Reply that SLRP was a tax shelter when only the units of the partnership can be a tax shelter. That in itself would not have been fatal. For a property to be a tax shelter, certain representations must be made prior to the sale of that property indicating the losses that would be incurred and their deductibility. No such allegations were set out in the Reply. The Reply merely stated that the majority of the expenses would be incurred in 2006, which failed to indicate what losses would be incurred and their deductibility, the expected expenses and whether they would be deductible, or the expected revenues. As well, the taxpayer was described as both a principal and an agent and it was unclear from the pleadings on what basis the taxpayer was being assessed a penalty. The Crown had ample opportunity to amend its pleadings and failed to request
to do so until after the taxpayer’s counsel made oral submissions. As the Crown admitted that all representations were identified in the Reply, its request to amend its Reply was denied. The Minister failed to establish the essential facts necessary to support the assessment of a penalty.

¶ 48,595, O’Dwyer, 2013 DTC 5156

Minister ordered under Privacy Act to release to taxpayers some documents relating to case

On April 7, 2008, the Canada Revenue Agency (“CRA”) began an official investigation of the taxpayers for tax fraud. The CRA refused the taxpayers’ request for information, including internal correspondence it held respecting the taxpayers relating to the period from January 2004 to May 2010. The taxpayers then complained unsuccessfully to the Privacy Commissioner under the Privacy Act about the CRA’s decision. In the Privacy Commissioner’s view, the taxpayers’ complaint was without foundation. The taxpayers applied to the Federal Court for judicial review.

The taxpayers’ application was granted. The parties agreed that the CRA was entitled, under paragraph 22(1)(a) of the Privacy Act, to refuse disclosure of documents it obtained or prepared after the inception on April 7, 2008 of its investigation of the taxpayers for tax fraud. The CRA, however, was unable to establish that all of the materials it was refusing to disclose had been obtained or prepared after April 7, 2008. The Minister was therefore ordered, under section 48 of the Privacy Act, to make available to the taxpayers all documents relating to them that had been obtained or produced by the CRA prior to April 7, 2008, with the exception of any documents that might reveal the identity of any police informants.

¶ 48,596, Palmerino, 2013 DTC 5157

Taxpayer’s RRSP contribution room properly reduced to account for corresponding pension contribution in relevant year

The issue was whether the taxpayer’s RRSP limit for 2010 was properly adjusted to reflect pension contributions made in the same year, factoring the pension adjustment provisions. The taxpayer’s employment was terminated in 2010, but he continued to receive compensation and pension contributions for 12 months after that time. He argued that his RRSP contribution room for 2010 should not have been reduced by the pension adjustment figures, as those payments were made after ceasing employment and membership in the pension plan. The taxpayer referred to two previous decisions of the Court in Emmerson (1997 UDTC 277) and Bussière (2000 DTC 1910) to support his position.

The taxpayer’s appeal was dismissed with costs. The two decisions referred to by the taxpayer were distinguishable because the taxpayer in each of those cases had withdrawn the prior year’s registered pension plan contributions, unlike this case. The taxpayer’s arguments were otherwise devoid of merit.

¶ 48,598, Graham, 2013 DTC 1235

Taxpayers’ business loss deductions allowed

The taxpayers, who were husband and wife, acquired a vacant lot (the “Lot”), allegedly for the purpose of constructing a suite of office buildings with a view to earning business income. When they discovered they could not find tenants, and therefore could not obtain financing, they sold the Lot 20 months after they had acquired it. On reassessment, the Minister: (a) disallowed each of their deductions of $11,995 for 2007 and $6,420 for 2008 as business losses; and (b) added to each of their incomes $12,651 as a taxable capital gain from their unreported disposition of the Lot. On the taxpayers’ appeal to the Tax Court of Canada, they contested the disallowance of the business loss deductions claimed, but not the inclusion of the taxable capital gain in their income.

The taxpayers’ appeals were allowed in part. The taxpayers prepared construction plans, applied for a building permit, retained a consultant, incurred advertising expenses, and arranged for an evaluation to support their attempts to obtain financing. They had, therefore, approached their project in a sufficiently businesslike manner to justify their deduction
of expenses without further analysis. They had not acquired the Lot with the sole purpose of resale at a profit. They were, therefore, each entitled to business expense deductions of $8,163 for 2007 and $5,344 for 2008. The Minister was ordered to reassess accordingly.

¶48,600,  *Beauregard*, 2013 DTC 1237

**Taxpayer’s application was collateral attack on assessment and outside Court’s jurisdiction**

The taxpayer brought an application to determine whether amounts she received from her former employer, the Federal Department of Justice ("DOJ"), were taxable and subject to source deductions. She argued that the lump-sum amount she received as settlement of her resignation from the DOJ was liquidated damages and not subject to tax. She further argued a breach of contract by the DOJ and sought a writ of *mandamus* for the Minister to issue an amended T4. The defendant argued that the action was a collateral attack on a notice of assessment and outside the Court’s jurisdiction.

The taxpayer’s action was dismissed without costs. The Court did not have jurisdiction. The action was an impermissible collateral attack upon the assessment.

¶48,606,  *Newcombe*, 2013 DTC 5160