TEI-CRA Liaison Meeting
December 8, 2009

Question 1 - International Financial Reporting Standards (IFRS)

During last year's liaison meeting, CRA provided a report on the steps it is undertaking in preparation for the incorporation of IFRS into Canadian GAAP. Being one year closer to the January 1, 2011, effective date, would CRA provide an update on the effects of the change and its planning for that change?

CRA Response

As IFRS introduces fundamental changes to how business reports its income, CRA will support Canadian businesses by providing them with appropriate information so that they may continue to meet their tax obligations. We have established an International Financial Reporting Standards website in order to continue communicating to interested parties the results and recommendations stemming from our ongoing analysis.

The corporate and trust Income Tax Guides for 2009 contain certain basic changes identified to date. We are continuing our review of the extent of IFRS changes to determine how to best revise the returns and schedules.

An IFRS Advisory Committee on Tax Administration (Committee) was established in March, 2009. The members of this Committee include representatives from the large accounting firms, the accounting associations, and a cross-section of industries. The focus of the Committee is to determine the effect that IFRS will have on the reporting, filing and compliance changes due to the implementation. It has established three external working groups based on the issues identified by its members:

- Revenue Recognition and Computation of Profit
- International Issues
- Transitional/First Time Adoption Issues

The Committee is expected to meet at least annually until the implementation of IFRS.

Awareness training for CRA auditors regarding the upcoming accounting changes is underway. We are continuing our analysis of the impact of the introduction of IFRS on the Agency with regard to the processing and examination of Income Tax and GST/HST Returns.

Question 2 – Subsection 17(8)

Subsection 17(8) of the Income Tax Act, Canada (hereafter the Act) provides that subsection 17(1) does not apply to an amount owing to the taxpayer by a controlled foreign affiliate (CFA) to the extent that it is established that the amount owing is used by the CFA for certain eligible purposes. For audit purposes, how does CRA establish "the extent… that the amount owing" is used for one of the eligible purposes described in paragraph 17(8)(a)? TEI recommends that CRA employ the approach described in paragraph 12, et seq. of IT-533 (Interest Deductibility and Related Issues (October 31, 2003)) in respect of the "use of borrowed money".

CRA Response

The CRA agrees that the approach described in paragraph 12, et seq. of IT-533 (Interest Deductibility and Related Issues (October 31, 2003)) in respect of the "use of borrowed money" should be used for the purpose determining the use of funds for purposes of the test in paragraph 17(8)(a).

Question 3 - Eligible Dividend Designations

Subsection 89(14) states that "a corporation designates a dividend it pays at any time to be an eligible dividend by notifying in writing at that time each person or partnership to whom it pays all or any part of the dividend that the dividend is an eligible dividend." The written and contemporaneous designation requirement in subsection 89(14) ensures the certainty of the tax treatment of the distribution to the recipients, but imposes an administrative burden on dividend payers. To reduce the burden on public corporations with large numbers of corporate entities within the group, the Canada Revenue Agency ("CRA") has adopted an administrative position in respect of the designation requirement that affords relief in certain situations.

Where a wholly-owned subsidiary of a corporation pays a dividend to its parent (a public corporation or a corporation controlled by a public corporation), would CRA accept as a written and contemporaneous designation a dividend resolution that is signed by the officers of the subsidiary? In many instances, the officers of the paying corporation are the same as the officers of the receiving corporation and thus the tax policy objective of affording certainty to the recipient will be satisfied. Adopting TEI's recommendation would reduce compliance costs for public companies with large numbers of corporate entities within the group. We invite CRA's response.

CRA Response

First of all, we reiterate our position as set out in our documents no. 2007-0249941E5 and 2008-0300381C6, wherein we opine that the need to provide taxpayers with certainty regarding the tax consequences associated with corporate distributions is the main tax policy objective underlying the legislation of a written and contemporaneous designation requirement in subsection 89(14).

In the latter document we also discuss our position regarding the administrative relief extended solely to public corporations with respect to the designation requirements in subsection 89(14), for 2007 and subsequent taxation years. We opine that the administrative relief for public corporations will, among other things, reduce the potential burden associated with providing written and contemporaneous notification to hundreds or even thousands of shareholders. In addition, we further specify that this administrative relief will not impact the need for taxpayer certainty in light of the practical application of the eligible dividend rules for public corporations.

On December 20, 2006, we issued a News Release titled "Designation of Eligible Dividends" (Document 2006-0217891Z0), wherein we outlined general guidelines for corporations for purposes of the designation requirements.

In this news release, we stated our intention to provide public corporations with administrative relief from the statutory designation requirements in subsection 89(14), as well as provided clarification to all other corporations, other than public corporations, in respect of notification requirements and examples of acceptable methods of notification. On the latter point, we stated, among other things, the following:

> For 2007 and subsequent taxation years, for all corporations other than public corporations, the notification requirements of proposed subsection 89(14) must be met each time a dividend is paid. Examples of notification could include identifying eligible dividends through letters to shareholders and dividend cheque stubs, or *where all of the shareholders are Directors of a corporation, a notation in the Minutes*. [emphasis added]

In particular, we note that we have allowed corporations, other than public corporations, to notify their shareholders of an eligible dividend designation by way of a notation in the Minutes, where *all* of the shareholders are the *directors* of the corporation. Our position is based on the fact that, for practical purposes, non-public corporations will generally have fewer shareholders than public corporations, and such shareholders may often have a seat on the corporation's Board of Directors in order to take part in the internal management of the corporation. Thus, where all of the shareholders are also directors of the corporation, we consider that a directors' resolution declaring a dividend and containing a designation that such dividend is an eligible dividend constitutes valid notification in writing for the purposes of subsection 89(14). In these circumstances, such resolution provides certainty to the taxpayers receiving the dividends with respect to the tax consequences of the corporate distributions.

In the context of a subsidiary wholly-owned corporation that pays a dividend to its parent (a public corporation or a corporation controlled by a public corporation), the CRA would accept that a directors' resolution of the subsidiary declaring a dividend and containing a designation that such a dividend is an eligible dividend, would constitute a valid notification in writing for the purposes of subsection 89(14), provided that the directors' resolution of the subsidiary is delivered to the parent on a timely basis. In circumstances where the Boards of Directors of the subsidiary and the parent are the same, the CRA would normally consider the directors' resolution as being effectively delivered to the parent upon signature.

It is our view that this position is consistent with the position adopted in respect of valid methods of notification for non-public corporations as previously described. Furthermore, we feel that this position is reasonable considering the powers and duties of directors and their significant role in the corporate and business context. Finally, we believe that this position is in accordance with the tax policy objectives underlying subsection 89(14) and that it provides an appropriate balance between the entitlement of dividend recipients to certainty with respect to the tax

consequences of corporate distributions and the administrative burdens of the notification requirements as experienced by dividend payers.

Question 4 - Definition of "Qualifying Person" under the Canada-U.S. Treaty

Paragraph 1 of Article XXIX-A of the Convention between Canada and the United States of America, signed on September 26, 1980, as amended by the Fifth Protocol on December 15, 2008 (hereafter "the Treaty"), contains a limitation on benefit (LOB) clause that states that only a "qualifying person" is entitled to all benefits of the Treaty. Under subparagraph 2(c) of Article XXIX-A, a "qualifying person" includes a company whose principal class of shares is primarily and regularly traded on one or more recognized stock exchanges. The term "principal class of shares" is defined under subparagraph 5(e) of Article XXIX-A as shares that represent the majority of the voting power and value of the company. Where no single class of shares represents the majority of the aggregate voting power and value of the company, the "principal class of shares" consists of the classes that in the aggregate represent a majority of the aggregate voting power and value of the company. Once the several classes of shares have been aggregated to constitute the principal class of shares, the deemed principal class of shares must be considered regularly traded in order to satisfy the definition of qualifying person.

The term "regularly traded" is not defined in the Treaty, but the Technical Explanation (TE) provides that the term is defined by reference to the domestic tax laws of the respective countries. In the case of the United States, the term has the meaning given by U.S. Treas. Reg. § 1.884-5(d)(4)(i)(B). Under the regulation, a class of shares is considered to be "regularly traded" if (i) trades of the class of shares are made in more than de minimis quantities on at least 60 days during the taxable year (hereafter the "de minimis test"), and (ii) the aggregate number of shares in the class traded during the year is at least 10 percent of the average number of outstanding shares during the year (hereafter the "10-percent test").

The TE states that, subject to the adoption of other definitions by Canada, the U.S. interpretation of "regularly traded" will apply, but with modifications as circumstances require for purposes of Canadian taxation. In Canada, many publicly traded companies have multiple classes of voting shares. If each class of shares must be considered separately for purposes of satisfying the de minimis or 10-percent tests in the U.S. tax regulations, very few Canadian corporations with multiple classes of voting shares will be considered "qualifying persons" for purposes of the LOB clause. Would CRA issue guidance clarifying when Canadian resident public corporations with multiple classes of voting stock are deemed to satisfy the "regularly traded" requirement so that they might qualify for the intended Treaty benefits?

CRA Response

The CRA is currently of the view that each class of shares must be considered separately for the purposes of satisfying the de minimis and the 10 percent test. We understand that this interpretation is in line with the views of the U.S. tax authorities. We suggest that those Canadian resident corporations that are not qualifying persons under the above interpretation should seek relief from the relevant competent authority under paragraph 6 of Article XXIX-A.

We appreciate that the relieving provision in paragraph 6 of Article XXIX-A may not represent a satisfactory solution to corporations that ought to be qualifying persons but technically are not under the above interpretation. Accordingly, we have initiated dialogue with the US Competent Authority in hopes of reaching a solution that will allow affected taxpayers to gain treaty benefits in appropriate circumstances without the need to make a request under paragraph 6 of Article XXIX-A. The CRA is currently awaiting the reaction of the U.S. Competent Authority.

Question 5 - German Fiscal Unity

Under the German Corporate Income Tax Act, the fiscal unity provision ("Organschaft") permits a German controlled foreign affiliate (CFA2) of a Canadian corporation (Canco) to transfer its profit or loss to a German parent company (CFA1) which is also a controlled foreign affiliate of Canco and which owns 100% of CFA2. For German income tax purposes, the transfer payment is deductible by CFA2 and taxable in CFA1.

When CFA2 earns income from an active business, the income derived by CFA1 from the income transfer payment received from CFA2 is generally deemed to be from an active business under clause 95(2)(a)(ii)(B) of the Act. Under the definition of "earnings" in subsection 5907(1) of the Regulations, such income is included in CFA1's "earnings" from an active business.

A capital gain realized by CFA2 on the disposition of excluded property is not included in its Foreign Accrual Property Income (FAPI) under paragraph 95(1). Clause 95(2)(a)(ii)(B), however, would seemingly not apply to re-characterize the transfer payment in respect of such gain received by CFA1 from CFA2 as income from an active business because the transfer of such income from CFA2 must be considered deductible in computing CFA2's active business income. TEI does not believe that the income transfer payment should be treated as FAPI where it is deductible from income that is not otherwise treated as FAPI. Would CRA confirm that the income transfer payment to CFA1 (income in CFA1) under the fiscal unity regime will not be treated as FAPI and thus not included in the income of Canco?

CRA Response

The CRA is of the view that an income transfer payment received by CFA1 from CFA2 is income from property to CFA1. The portion of such amount transferred by CFA2 to CFA1 that represents the amount of the capital gain realized by CFA2 from the disposition of its excluded property would be included in the FAPI of CFA1 because that amount is not deductible by CFA2 in computing the amount that is prescribed to be its earnings from an active business (other than an active business carried on in Canada). In our view an amendment to the legislation would be required in order to produce a different outcome.

Question 6 - International Tax Forms Simplification

In conjunction with the work of the Advisory Panel on Canada's System of International Tax, the Panel's Secretariat undertook a study of the tax forms currently used by taxpayers to comply with Canada's international tax system. The purpose of the review was to determine, with input from representatives from CRA and industry, whether forms can be eliminated or streamlined thereby reducing taxpayers' compliance burdens while providing CRA with the information necessary to administer Canada's tax system. Significant revisions to Form T1134A, Information Return Relating to Foreign Affiliates That Are Not Controlled Foreign Affiliates and Form T1134B, Information Return Relating to Controlled Foreign Affiliates, in particular, were recommended, and a new draft of each was developed. Please provide an update of the status of the forms simplification project that was initiated as part of the Advisory Panel's work, including a summary of which forms might be revised, what the changes might be, and whether a timetable has been developed to implement revised forms, especially the T1134s. TEI would be willing to work with CRA in completing its redesign of the forms.

CRA Response

We are currently reviewing suggestions that we have received from both internal and external stakeholders on revisions to various forms, including the T1134A and T1134B. When this review is completed the CRA will consult with various stakeholders on any proposed changes.

Question 7 – SR&ED

To improve the information reporting for large corporations' SR&ED claims, would the CRA consider:

Question 7(a)

Replacing the absolute word limit in sections 240, 242, and 244 with a suggested limit or range?

CRA Response

The 1,400-word limit on the description of a project at lines 240 to 244 of Form T661 is intended to encourage claimants to focus on the technical aspects of the project rather than describe the business aspects of the project. In general, lines 240 to 252 are designed to encourage shorter and more direct responses to help claimants provide the information needed to meet the eligibility requirements. Clear and concise descriptions will allow the CRA to speed up the review and process the claim as quickly as possible. It should be noted that the CRA will not disallow a project based on the quality or technical content of the narratives for these lines. CRA consultations with claimants, claim preparers and other internal and external stakeholders have shown that the number of words allowed is more than adequate to provide sufficient information to meet the filing requirements.

The example of a completed Form T661 posted on the SR&ED Web site demonstrates how a clear and concise project description can be written within the stipulated word limits when the answers to the questions focus on the technical facts and are written in the technical language and style of those who actually performed the work described. The example not only meets the filing requirements but also contains sufficient information for the CRA to conduct an initial review without the need to contact the claimant for further information or clarification.

Question 7(b)

Providing a means for claimants to include pictures, diagrams, or flowcharts?

CRA Response

The CRA considers diagrams, charts, tables, photographs or flowcharts to be supporting evidence. Claimants can indicate on lines 270 to 282 of the form that they have these types of supporting evidence and provide them upon request or during the technical review. We are also discouraging any type of attachments to the form to encourage claimants to use the new corporation electronic filing

capability. Electronic filing will be mandatory for corporations (with some exceptions) for tax years ending after 2009.

Question 7(c)

Exempting taxpayers under process review from having to complete Part 2 of Form T661? Instead, taxpayers might be able to check a box on the form indicating that the project or financial information described on the Form was subject to a process review.

CRA Response

Process Review is an alternative approach to an SR&ED claim review that has many advantages for large claimants. It is not intended to relieve claimants of the filing requirements which apply to all claimants.

Question 7(d)

Consulting further with taxpayers with a large number of projects? For example, would CRA consider permitting taxpayers with greater than a threshold number of projects to use the previous form? As another example, would CRA permit similar projects to be grouped by technology or therapeutic area?

CRA Response

The CRA has consulted widely with SR&ED claimants and other external stakeholders on the issue of submitting descriptions for all projects claimed and other subjects related to the form. The vast majority of claimants have indicated that they are pleased with the CRA's undertaking to simplify and streamline the form and reduce the administrative burden related to claiming SR&ED investment tax credits. Although a large number of claimants have fewer than 20 projects, a small percentage of claimants with more than 20 projects have requested more time to adapt to the new requirement of submitting part 2 of the form for all projects being claimed instead of for only the 20 projects with the largest dollar value. To respond to this concern, the CRA extended the time to comply with this requirement by an additional year for all claimants. As such, the CRA will not permit claimants to use the previous version of the form.

Furthermore, the CRA has been working with the Information Technology Association of Canada (ITAC) to derive further adaptive measures related to this requirement.

Lastly, with respect to permitting the grouping of similar projects by technology or therapeutic area, it should be noted that the required method is for claimants to

file project information in keeping with the instructions and the SR&ED Project Definition in the Guide to Form T661.

Question 7(e)

Permitting large corporations to use the previous version of the form?

CRA Response

The CRA cannot permit a specific group of claimants to use the previous version of the form. As previously mentioned, however, the CRA is working with ITAC to derive further adaptive measures for large filers.

Question 8 - Application of Paragraph 80(2)(k) to Debt-Parking Rules

Subsection 80(2) of the Act states that paragraph 80(2)(k) applies solely for purposes of section 80. In addition, paragraph 80(2)(k) is not among the paragraphs enumerated in paragraph 80.01(2)(a) that apply expressly to the debt-parking rules of section 80.01. On the other hand, the definition of "forgiven amount" in subsection 80.01(1) expressly refers to the definition of "forgiven amount" in subsection 80(1). By implication, the cross-reference to subsection 80(1) seemingly incorporates the deeming rule in paragraph 80(2)(k) because paragraph 80(2)(k) applies in determining the "forgiven amount" under subsection 80(1). This interpretation of the cross reference seems supported by the Crown's arguments, and the Federal Court of Appeal decision, in Earling Marvin Olsen v. The Queen, 2002 DTC 6770 (January 14, 2002). Yet technical interpretation 2008-0267831E5 (June 4, 2008) held that paragraph 80(2)(k) does not apply to adjust the amount deemed to have been paid on the settlement of a foreign-denominated debt under subsection 80.01(3) upon the amalgamation of the debtor and creditor.

Would CRA confirm that paragraph 80(2)(k) applies for purposes of the debt-parking rules, especially to subsection 80.01(8)?

CRA Response

In technical interpretation 2008-0267831E5 (June 4, 2008), the impact of paragraph 80(2)(k) was considered when determining the "forgiven amount" in a case where subsection 80.01(3) of the Act applied. However, as we stated, since the amount deemed paid pursuant to subsection 80.01(3) was converted at the historical exchange rate (i.e. the exchange rate at the time the Debt was issued), it was not adjusted by paragraph 80(2)(k) to arrive at the amount paid, for purposes of subsection 80(1). Thus, although, paragraph 80(2)(k) was applicable, its application had no impact in the facts of that particular case.

We are of the view that paragraph 80(2)(k) of the Act applies for purposes of determining the "forgiven amount" that arises as a consequence of the application of the debt parking rules in section 80.01 of the Act. Moreover, paragraph 80.01(11) of the Act provides that the deemed settlement of an obligation under 80.01(8) or (9) will not trigger the recognition of any foreign currency gain or loss by the debtor that has accrued in respect of the debt. Rather, such foreign currency gain or loss would be realized on the actual settlement of the obligation in accordance with subsection 39(2).

Question 9 - Subsection 116(5.01)

In order for subsection 116(5.01) of the Act to apply, a purchaser must file a notice (T2062C) with the Minister under subsection 116(5.02) on or before the day that is 30 days after the date of the acquisition and must state in the notice the amount paid or payable by the purchaser for the property. Sometimes the purchase price of property, for example shares of a corporation, will include a contingent or variable component (e.g., a post-closing adjustment based on net working capital of the corporation at the time of sale) that is not known until well after the due date for the subsection 116(5.02) notice.

In the event the exact purchase price is unknown at the time the required notice under subsection 116(5.02) is due and the purchaser files a subsection 116(5.02) notice within the required 30-day period indicating an estimated purchase price or a range of purchase prices, will CRA permit the application of subsection 116(5.01)? In the event the purchaser files a subsection 116(5.02) notice within the required 30-day period and the purchase price is subsequently modified, will CRA deny the application of subsection 116(5.01)?

CRA Response

The CRA will consider the purchaser to have complied with subsection 116(5.02) notwithstanding that the amount paid or payable by the purchaser set out on the notice (T2062C) includes a portion that has been estimated. The fact that the amount on the notice includes a portion that has been estimated should be indicated. If the actual amount paid or payable turns out to be different, provided that a revised notice is filed by the purchaser forthwith, the purchaser will continue to be considered to have complied with subsection 116(5.02). To avoid confusion, a copy of the original notice should be attached to the revised notice along with a brief explanation.

Question 10 - CRA Policy Concerning Waiver Requests by Large File Case Managers

Recently, several taxpayers have been requested to sign waivers prepared by Large File Case Managers. The taxpayers were informed that unless the waivers were signed, CRA would reassess the taxation year under audit disallowing all deductions relating to specific, significant transactions. In each case, the taxpayer had been both collaborative and diligent during the course of the audit, promptly responding to all audit queries and timely providing all requested documents. Indeed, in all cases there were no open audit queries and, in some cases, no audit queries had been issued for several months prior to the issuance of the letters requesting the waiver. As important, CRA had neither identified nor discussed with the taxpayer any preliminary or potential adjustments that would support the reassessment position asserted in the letters. In all cases, the auditor's letter was issued as the statute-barred date approached for the period under audit. Such action appears inconsistent with the goal of conducting transparent audits and also circumvents the spirit and purpose of the statute of limitations. What are CRA's views of this practice? What recourse does the taxpayer have?

CRA Response

A T2029 Waiver in Respect of the Normal Reassessment Period should be filed when a taxpayer/registrant wishes the CRA to delay issuing a notice of assessment beyond the normal period of reassessment in order to give the taxpayer/registrant time to produce additional information.

When the CRA proposes an adjustment, a waiver may be requested from the taxpayer/registrant to allow additional time to consider all relevant information and for the taxpayer/registrant to submit representations. The waiver's purpose and the tax matters to which it applies should be clearly specified in the waiver (i.e. a full description of the subject matter, not just references to sections of the relevant act) and explained to the taxpayer/registrant.

The CRA will not ask a taxpayer/registrant to file a waiver solely for the purpose of keeping a tax year open for reassessment beyond the statue-barred date. The practice of asking for a blanket waiver in advance of an audit or of asking for a waiver for the sole purpose of extending the time needed to complete the audit is not acceptable.

In the examples provided it is not clear whether the requests for waivers were accompanied by a full description of the audit issues with references to sections of relevant acts. If this was not the case, then the taxpayer would have the right to take the issue up with the Large Case File Manager and/or Assistant Director of Audit of the Tax Services Office which issued the requests.

Question 11 - Large Corporations and Double Taxation Cases

Paragraph 7.24 of the Report by the Advisory Panel on Canada's System of International Taxation states:

> Rules regarding tax prepayment or security and deficiency interest in transfer pricing cases should differ from the general rules applying to other tax cases because, in double taxation cases, tax has already been paid to another government in respect of that amount.

We understand that CRA's Legislative Policy and Regulatory Affairs branch is reviewing the policy that requires large corporations to prepay 50 percent of the disputed tax prior to seeking competent authority relief in double taxation cases. Would CRA please comment on the status of its deliberations on this issue?

CRA Response

A CRA working group has been established to review the recommendations of the Advisory Panel on Canada's System of International Taxation. This review also incorporates the recommendations included in the report by the Transfer Pricing Subcommittee. The working group's deliberations are ongoing.

Question 12 - Industry-Based Audit Approach

Remarks attributed to CRA representatives indicate that CRA is increasingly moving to implement an industry-based audit approach for taxpayers in the financial institution, natural resource, and pharmaceutical industries[1]. Would CRA describe how industry-based audits are being implemented and comment on how an industry-based audit differs from a traditional audit? What is the role of the taxpayer's local TSO in an industry-based audit? In addition to the industry sectors noted, what other industries have been selected or are being considered for this approach?

CRA Response

The CRA industry-based audit approach was first announced by the Commissioner last fall. Although in the initial stages, it is being piloted in a few select industries and Tax Services Offices as follows: Laval – pharmaceuticals; Toronto North – banking; Windsor – automotive; Calgary – oil and gas. These offices will be called "Coordinating Offices" and will be responsible for ensuring that the CRA has a consistent, effective, efficient audit treatment across the industry.

The Coordinating Offices will offer their services nationally to other tax services offices ("Participating Offices") that have files within the above mentioned industries. These services include assistance with risk assessment, audit planning and taxpayer interviews in the early stages of an audit. The Coordinating Offices will also develop national industry specific audit procedures that will supplement CRA standard risk assessment techniques.

The role of the taxpayer's local TSO in the industry-based audit approach has not changed that much from the traditional audit approach. They will still be responsible for selecting audits based on HQ planning guidelines and will still have ultimate responsibility for the conduct of the audit. However, they will invite the Coordinating Office, along with Industry Specialist Services of the Audit Professional Services Directorate ("APSD"), to participate in the risk assessment phase. In addition, the Participating Office will be responsible for discussing significant, novel or contentious audit issues with the Coordinating Office before the proposal stage in order to ensure national consistency and to exchange best practices.

The CRA has had internal discussions regarding extending the industry-based approach to other industries beyond the four being currently piloted. However, no decision has been made to date.

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[1] *See, e.g., For Double Tax Cases, Canada Reviewing Requirement on Tax, Interest Prepayments,* Bureau of National Affairs, 159 *Daily Tax Report* (August 20, 2009) at I-2.

Question 13 - Status and Inventory of Competent Authority Cases

With respect to taxpayer cases and issues currently under consideration by Canada's competent authority, would CRA please provide an update, as follows:

Question 13(a)

What is the current inventory of competent authority cases and how has that inventory changed during the past year?

CRA Response

The inventory of the Negotiable (*) MAP and APA cases during the 2008-2009 fiscal year is as follows:

Program	Inventory as at April 1,08	Accepted	Completed	Inventory as at March 01, 09
MAP	160	109	83	186
APA	63	32	11	84

MAP Program

83 cases were completed in 2008-2009 fiscal year compared to 49 cases in 2007-2008;
109 cases were accepted in 2008-2009 fiscal year compared to 71 cases in 2007-2008;

There are many factors which contributed to the increase in MAP cases accepted in 2008-2009. MAP cases are a mandatory workload. In general, case volumes vary with the level of CRA audit activity and the decision by the taxpayer to request competent authority assistance or not (for example, pursue domestic resolution process).

Note:
(*) Negotiable cases require bilateral negotiations with another tax administration to resolve double taxation or taxation not in accordance with an income tax convention.

APA Program

11 cases were completed in 2008-2009 fiscal year compared to 8 cases in 2007-2008;
32 cases were accepted in 2008-2009 fiscal year compared to 23 cases in 2007-2008.

Over the past few years there has been growth in the APA program. Inventory levels and the number of applicants expressing an interest in APA program have risen. As at March 31, 2009, there are 84 APAs in inventory and an additional 33 applications under consideration.

Generally, case completion varies with the complexity of the issue(s) and/or transaction(s), the timely provision of requested information, adequate staffing levels at the Canadian and other competent authorities to handle the cases and the volume of those cases.

Question 13(b)

What portion of that inventory is with the United States?

CRA Response

About 80% of MAP and APA cases at March 31, 2009 are with the United States. This percentage is fairly consistent over the years.

Question 13(c)

After the United States, what countries have the most cases in CRA's inventory?

CRA Response

In addition to the United States, CRA also receives MAP and APA requests with a number of other countries. The number of cases with other specific countries is small and greatly varies from year to year. For example, 68 of 83 MAP cases (or 82%) completed in 2008-2009 are with the United States, the other 15 cases (or 18%) are with 7 other countries. Most of those countries are OECD member countries.

Question 13(d)

What are the predominant issues currently before competent authority?

CRA Response

53 of 83 MAP cases (or 64%) completed in 2008-2009 are related to transfer pricing adjustments under Article 9 – Associated Enterprises. In general, this percentage varies from 60% to 70% from year to year.

CRA has received less than 5 cases on the determination of residency (Article 4 – Residence), and the determination and allocation of income to a permanent establishment (Article 5 - Permanent Establishment and Article 7 – Business Profits).

We also receive MAP requests with issues such as pension income, withholding tax, and deferral of gains.

Question 13(e)

We understand that competent authority staffing has increased significantly during the past several years. In addition to the increased staffing, are any process improvements being contemplated to ensure that cases are resolved quickly?

CRA Response

After a significant amount of attrition leading up to the 2005-2006 year, CRA has actively been staffing and has only now reached historical staffing levels. In addition, CRA is actively seeking additional resources to support the growth in our MAP and APA programs.

CRA is not solely depending upon new resources to meet its needs. It continues to grow and seek better and efficient means of conducting its business in order to improve the quality and timeliness of services to taxpayers. Some examples are:

- Enhance the Competent Authority Tracking System (CATS) to ensure MAP and APA requests proceed on schedule;
- Regular review by the Director of the status of MAP and APA cases where timelines have exceeded standards;
- Elevating cases to the Director level as necessary;
- Better utilization of technology to minimize time spent away from the office;
- Utilization of specialized expertise to expedite the resolution of cases and to ensure consistency in the treatment of issues and cases; and
- Development of risk assessment tools, to better allocate resources in the development of position papers and resolution of cases.

Question 13(f)

Please provide an update on the arbitration process, including the number of cases referred and their status.

CRA Response

The competent authorities from Canada and the U.S. have met several times to develop the procedures necessary to implement mandatory arbitration. Good progress has been made and the competent authorities are optimistic that the procedures will be finalized over the next few months.

Given that that the procedures have not yet been finalized, no MAP cases have been scheduled for arbitration. It should be noted that while the competent authorities would like the arbitration process to be operational at the earliest possible date, the Fifth Protocol provides that the first cases become eligible for arbitration two years from entry into force (December 15, 2008).

Question 14 - Non-resident Services

Assume the following: A company that is a non-resident of Canada owns and maintains a computer server and software outside of Canada. (The non-resident might or might not be in a treaty country.) Canadian residents, while in Canada, connect to and use the non-resident's server that is located outside Canada. The Canadian resident can use the software to process data, but cannot (1) download the software onto its own computer or server located in Canada, (2) alter the source code of the programs residing on the server outside Canada, or (3) resell or sub-license the software to other parties. Examples of the computer processing performed on the server located outside Canada ranges from tax return preparation and financial report compilation to computer games and software development for the games.

The Canadian resident and the non-resident service provider enter into a contract and agree to an arm's length fee for services relating to the information processing. The service paid for is the computer processing time necessary to compile financial reports, prepare tax returns, and ensure the program codes or game engines work properly. In addition, the processed data may be stored on the server outside Canada. If so, a separate storage fee would be charged in addition to the processing fee. The fee does not depend on the benefits derived from the production, sales, or profits of the Canadian user of these services. Rather, the fee is computed by reference to the amount of computer processing time, the number of CPU requests, the gigabytes of stored information, and similar data processing criteria. The service contract is signed in Canada by the Canadian service recipient and signed in the foreign country by the non-resident service provider.

Under these facts, would CRA confirm:

a. The data processing and storage services are not subject to Part XIII withholding tax under paragraph 212(1)(d) of the Act because they are not rent, royalties, or similar payments for the use of or the right to use in Canada the software and the server?

b. Even though the users receive the services in Canada, the non-resident company would not be considered as providing services in Canada or carrying on business in Canada since the server is located outside, and the processing takes place in a country other than, Canada?

CRA Response

CRA is not able to conclude that the payment is for services.

Question 15 - Aggressive Tax Planning Compliance Review

Several Large File taxpayers have recently received copies of a letter from CRA entitled “Compliance Review — Aggressive Tax Planning.” The letters request extensive and detailed information in 10 broad categories and require the taxpayer to respond within 45 days.

Most Large File taxpayers have hundreds of corporations in their worldwide organizational structure. The vast amount of information requested in the Aggressive Tax Planning letter and the abbreviated time for responding is extremely burdensome. Moreover, some of the requested information is in the public domain while other information has already been provided to CRA (e.g., to the Large File case manager in current or prior audits, on information returns, or with the Corporation’s Form T2 tax return). In addition, no specific compliance risk or concern is cited in the letter. We invite CRA’s comments on the purposes and uses of this new initiative and information letter. Will an “Aggressive Tax Planning compliance review” become routine practice for all Large File cases? If not, how does CRA determine which files are subject to an “Aggressive Tax Planning compliance review?” We are especially interested in CRA’s comments on the breadth and depth of the request and the burden it places on Large File taxpayers for an unspecified purpose or compliance risk.

CRA Response

The CRA is mandated with ensuring that all taxpayers comply with the provisions of the Income Tax Act. One of the key issues in undertaking its duties is striking a balance between obtaining sufficient information to properly identify and review the issues which it considers to pose the greatest compliance risk and the need for taxpayers to compile and provide this information. By their very nature, large file cases are the most complex audits that must be performed by the CRA. Given the complexity inherent in these audits, the CRA has mandated a team approach to these types of audits. This team approach mandates the involvement of both our International Tax and Aggressive Tax Planning areas in all Large File audits. In addition, the CRA has recently taken a new approach in auditing large file cases. Whereas in the past, attempts were made to audit a large portion of large taxpayers on a recurring basis, the CRA is seeking to identify those large taxpayers who pose the greatest compliance risk in order to increase its efforts on those files and to reduce its audit frequency in less risky files.

Requests for documents and information during the planning and conducting of the audit are generally dependent on a number of factors such as:

past compliance history of a particular taxpayer; past history in delays in obtaining requested information and/or documents; complexity inherent in and frequency of changes in a taxpayer operations and corporate structure; extent of inter-corporate transactions; and previously identified compliance issues in the industry.

In recent years, the CRA has detected a significant increase in the complexity of tax planning activities; the number of transactions undertaken; and the involvement of accommodating third parties in order to achieve these tax minimization goals. These issues certainly increase the compliance risk and hence the amount of audit work and information required to complete an effective audit of the activities of taxpayers.

Where a taxpayer believes that the amount of information requested can not be provided within the time limits provided in communications provided by the CRA, maintaining an open dialogue with the Large File Case Manager and members of the audit team can resolve many of these issues through the prioritizing of requested information and development of a more manageable period for the compilation and delivery of the requested information.

Question 16 - Requirement and Pre-Requirement Letters

Recently, CRA has adopted a practice of issuing "pre-requirement" letters requesting extensive documentation including "all minutes, resolutions, memoranda, letters, emails, presentations, notes, working papers, and calculations whether these documents were prepared by or on behalf of or were received by or on behalf of" the taxpayer. The letters state that if the information is not supplied within 30 days, notice is served that the Agency will issue a formal requirement letter pursuant to section 231.2 of the Act.

The "pre-requirement" letters frequently relate to significant and complex transactions. Many people within and outside the taxpayer's organization may have participated. Identifying the participants, locating the documentation, reviewing the information for relevance, and printing, copying, and collating the material within the 30-day timeframe is an extremely burdensome undertaking. Indeed, the requests are so broad and vague in scope that taxpayers must frequently produce volumes of information that are tangentially related to the tax matter. As important, since the requests ask for "all" information, it is virtually impossible to determine whether the response is complete. Finally, some of the material may be subject to solicitor-client privilege and the taxpayer must incur significant legal costs to determine whether the requested information is subject to a privilege claim.

We invite CRA's comments and explanation of its policies and procedures for the issuance of a requirement or "pre-requirement" letter. Is the Department of Justice involved in the policy or the process? If so, please describe the scope and nature of the Department of Justice's involvement.

CRA Response

A requirement is a legal document issued by the CRA that compels a taxpayer/registrant or third party to provide information and/or documents under section 231.2 of the ITA and section 289 of the ETA. To the best of CRA's knowledge, there is no such thing as a "pre-requirement letter".

Requirements are normally issued after thoroughly considering the circumstances of each case. When recommending that a requirement be issued, the facts of the case will normally justify the recommendation. The overriding concern in all cases is to obtain the evidence necessary to adequately evaluate the matter at issue in terms of the tests or criteria imposed by the acts administered by the CRA.

The decision to issue a requirement is a matter of professional judgment and normally is made whenever:

- a significant non-compliance issue is present,

- the information or documents sought are material to a proper assessment of tax, and/or
- a taxpayer is reluctant to provide the information or has not done so in a timely manner.

The ability to demonstrate the relevancy and need for the demand if the requirement is challenged in court must be available. The court must be satisfied that the information is required for a purpose related to the administration or enforcement of the Act and that it is:

- necessary to establish the facts relevant to a person's tax liability, and/or
- essential as the best evidence available for the court.

At the same time, requesting too much documentation must be avoided. The information must be essential and the exercise of the administrative power must be tempered by consideration of whether a requirement is necessary in the circumstances of each case.

The CRA will not normally issue a requirement unless it is prepared to prosecute in the event of non-compliance. Therefore, a useful test for deciding on the issuance of a requirement is usually whether the information or documentation is material enough that the CRA is willing to prosecute the person to get it.

The CRA may in certain situations consult with the Department of Justice in the preparation of a requirement. This will depend on the facts of each case. The CRA will always consult with their regional Department of Justice office when there is non-compliance with requirements. Once again, if the CRA is not prepared to follow the process through, possibly to prosecution, then we will not issue the requirement.

Conclusion

Decisions to issue requirements are a matter of judgment. Factors the CRA normally considers include:

- how critical the material would be to our case,
- whether the demand is justifiable in the circumstances,
- whether our action could be considered an abuse of process or would bring the administration of justice into disrepute, or
- if the material relates to a new and separate issue which has arisen.

Question 17 - Transfer Pricing

Question 17(a) - Comparables

We invite CRA to provide its views on the acceptability of averaging of comparable data over a three- or five-year period for the determination of a comparable price. Some taxing authorities (e.g., the U.S. Internal Revenue Service) require the use of data averaging and interquartile ranges in the determination of comparables so CRA's view of the acceptability of the practice is critical. The global recession of 2008-2009 has had a significant effect on reported comparables using averages and we would appreciate understanding CRA's view.

CRA Response

The prices used in related party transactions for Canadian taxpayers should be determined to be arm's length for each individual year using the results obtained from comparable transactions in the relevant individual year[2]. The relevant individual year of comparison is generally expected to be the year in which the controlled transactions were undertaken.

In applying this policy, the CRA expects taxpayers and, where appropriate, auditors, to calculate taxable income, and adjustments thereto, arising from a transfer pricing analysis, on a year-by-year basis in accordance with the statutory provisions of the Income Tax Act and the application of the arm's length principle.

Note that in an Advance Pricing Arrangement (APA) context, the averaging of historical outcomes of otherwise comparable transactions over multiple years may form part of the analysis with respect to establishing reasonable expectations for the application of a transfer pricing methodology or critical assumptions regarding anticipated outcomes under a specific arrangement. However, even in this context, transfer prices used by taxpayers will be verified against the terms of the arrangement on a year-by-year basis.

Question 17(b) - Intra-group Charges

We invite CRA to provide a comprehensive list of charges that it considers stewardship expenses. CRA's guidance would be beneficial to taxpayers and auditors alike, especially if it includes examples of each type of expense. In addition, how should Canadian taxpayers reconcile inconsistencies between CRA's and IRS's approaches to intra-group charges, especially in respect of stock-based compensation costs and stewardship costs? Is there any initiative

[2] Note that for the purpose of this guidance, it is not relevant whether the determination of the price is undertaken at the time the transaction is organized or undertaken (i.e. contemporaneous with the transaction) or at a later date by either the taxpayer or tax administration to test the prices actually used. The guidance on how to appropriately use multiple years of data does not vary with the time period in which the pricing determination is being made. The relevant data should be applied on a year-by-year basis.

by CRA to develop broad-based guidance to assist taxpayers in complying with potentially inconsistent U.S. and Canadian rules? For example, would CRA consider issuing guidance based on the resolution and settlement of issues and cases by the U.S. and Canadian competent authorities?

CRA Response

Custodial costs are those costs that are incurred by the parent company in its custodial capacity as shareholder

Costs that are incurred for the sole benefit of shareholders are known variously as custodial, stewardship, or shareholder costs. The OECD Guidelines uses the term "Shareholder activity" in paragraph 7.9 and 7.10. Examples of Shareholder activity costs are:

- cost of activities relating to the judicial structure of the entity itself:
  - costs of issuing shares
  - share transfer expenses
  - meetings of shareholders
- costs relating to the reporting requirements of the entity:
  - consolidation of reports
  - maintaining shareholder's records
  - filing of returns, etc
  - filing of a prospectus
- cost of managerial and control activities related to the ownership, control and protection of the parent assets or investments:
  - legal costs
  - director's fees
  - legal or other costs involved in negotiating or resisting a take-over bid

The CRA's policy on shareholder activity costs is discussed in paragraphs 156 and 157 of IC 87-2R. Such costs are considered incurred for the sole benefit of shareholders and should therefore not be charged to other members of the group. The rationale is that an arm's length corporation would not bear the costs of shareholder meetings of another corporation. Consequently, utilizing the arm's length principle, a subsidiary would not bear any costs of a parent's shareholder meetings. Similarly, costs related to legal structure or general financial reporting of a particular group member should not be charged to another group member.

One of the purposes of Canada's tax treaties is to avoid double taxation. Taxpayers are encouraged to avail themselves of the services of Competent Authority in an effort to relieve double taxation where there is inconsistent treatment of an issue between jurisdictions.

Question 17(c) - Cost Contribution Arrangements

1. We invite CRA's views on the Temporary Regulations relating to Cost Sharing Arrangements (CSA) released by the IRS on December 31, 2008. We are especially interested in hearing CRA's views about the periodic adjustment rules that permit the IRS to make adjustments to the amount paid for a Platform Contribution Transaction (PCT) or "buy-in transaction." Will CRA accede to these adjustments?

CRA Response

The CRA will review transactions on a case by case basis and make decisions based on CRA policy and guidance and the OECD Transfer Pricing Guidelines. Any legislation of a foreign jurisdiction will not impact our analysis.

2. Memorandum TPM-07 Referrals to the Transfer Pricing Review Committee states that cases involving potential Qualifying Cost Contribution Arrangements (QCCAs) should be referred to the Transfer Pricing Review Committee (TPRC) for review. How many QCCAs have been referred to the TPRC and what has been the outcome of these referrals?

CRA Response

It should be clarified that QCCA referrals are required only if it forms part of a subsection 247(3) penalty referral. If a penalty under subsection is not being considered, no QCCA referral is required. TPM-07 will be revised to clarify this point.

The TPRC has received 3 QCCA referrals from the field. Of the three, one was determined not to be a QCCA and the remaining two were found to be QCCA's.

Question 17(d) – Quality Control Process

How does CRA ensure quality control and consistency in transfer-pricing adjustments related to management fees, royalties, and interest charges?

CRA Response

The International Tax Division is in the process of instituting a mandatory referral process for significant issues including royalties in order to ensure consistency. In addition training courses are provided to auditors which provide guidance on how to address specific issues including management fees and interest charges. The centralization of the International Advisory Services Teams in Ottawa allow for the coordination of consistency in our analysis of issues.

In addition, the Quality Assurance and Ministerial Correspondence Division is responsible for promoting the consistent application of standards of quality in all programs administered by the Compliance Programs Branch, to communicate best practices, and to identify learning needs.

The International and Large Business Directorate ("ILBD") also conducts regular program monitoring visits on a sample basis to review the operations of ILBD programs for consistency with CRA policies and procedures.

Question 17(e) - Reassessments

We invite CRA to provide an update on the types of transactions that are generating the most transfer pricing reassessments.

CRA Response

The CRA continues to encounter numerous transfer pricing issues in the following areas:

- intangibles, including off-shoring, and royalties related to intangibles
- financing transactions, including hedging, swaps, derivatives, and guarantee fees
- business restructuring
- cost allocations

Question 17(f) - Penalties

We invite CRA to provide an update on the types of situations where transfer pricing penalties have been applied, noting specifically the number and types of situations that involve a re-characterization of taxpayers' transactions. We also request a summary of CRA's statistics on the number of cases where transfer-pricing penalties have been considered and assessed as well as a summary of the percentage or amount of assessed penalties that were ultimately sustained.

CRA Response

As of September 30, 2009, the TPRC has received a total of 199 penalty referrals. Of these referrals, the penalty was recommended in 106 of cases. In 34% of these cases, the contemporaneous documentation was not received within three months of the request for the information being issued. In 22% of the cases, the documentation was not prepared contemporaneously.

The TPRC has received a total of 33 re-characterization referrals. Of these, 9 files were approved at stage 3 (ie: proceed with reassessment). Fifteen cases have been abandoned, and 9 are ongoing. Cases that have been abandoned generally have been pursued through other provisions of the Income Tax Act.

We do not have the information on how many of the assessed penalties were ultimately sustained.