TAX EXECUTIVES INSTITUTE, INC.

INCOME TAX QUESTIONS

Submitted to

CANADA REVENUE AGENCY

NOVEMBER 17, 2015

Tax Executives Institute welcomes the opportunity to present the following comments and questions on income tax issues, which will be discussed with representatives of the Canada Revenue Agency during the November 17, 2015 liaison meeting. If you have any questions about the agenda in advance of the meeting, please do not hesitate to call Lynn Moen, TEI's Vice President for Canadian Affairs, at 403.232.6430, or Grant L. Lee, Chair of the Institute's Canadian Income Tax Committee, at 604.641.2502.

A. Introduction

In prior years, the Assistant Commissioner for Legislative Policy and Regulatory Affairs has provided a helpful update on the Agency's overall strategic direction. We invite the Assistant Commissioner to provide an update that includes his thoughts on the vision for the future of the branch and feedback on the role TEI can play in achieving that vision.

B. Follow-up Questions and Carryover Items from Prior Years

1. *Employer-Provided Social Events*

At the 2013 liaison meetings, TEI discussed with representatives of the CRA the current threshold for employer-provided social events. The CRA treats the cost of employer-provided social events that are available to all employees at a particular place of business as a nontaxable benefit, provided the cost per employee is reasonable, which is currently set at $100 per person. See ITTN-15 – Income Tax Technical News (December 18, 1998-cancelled).

As it has been 15 years since the interpretation was issued, taking into consideration:

a. Inflation: per the Consumer Price Index, $100 in 1998 is worth approximately $140 today;

b. Increase in automatic group gratuity charge, which is currently 18-20% for greater than eight people;

c. Increase in minimum wage for the food service industry; and

d. GST/HST/QST;

the $100 threshold in today's environment is too low and difficult for companies to administer in accordance with the current guidance.

In many cases attendance at employer-provided social events is mandatory or strongly encouraged. The benefit of the employer-provided social event is often for the employer as a whole to facilitate team building and cross-department networking.

After the 2013 liaison meeting, the CRA asked TEI to provide data points on current costs of providing social events. TEI responded to this request and we are waiting to hear from the CRA on its review and consideration of the sample case of costs.

We kindly request that the CRA provide an update on this review. TEI also recommends that the CRA increase the employer-provided social-events cost threshold to $200 per person to account for the rising costs of providing social events to employees, with any amounts above this threshold being treated as an employee-taxable benefit.

C. Administrative Matters

1. Employer-Requested Resolution

Before 2007, CRA policy allowed large employers to pay employees' tax and interest resulting from taxable-benefit errors. These payments were originally called "Negotiated Settlements" and were renamed "Employer Requested Resolution" in 2001. This policy reduced administrative costs for both the CRA and the employers who wanted to compensate employees for these errors; the CRA avoided the cost of amending hundreds or thousands of T4s and reassessing T1s. Unfortunately CRA cancelled this policy, per Communication TSDMB-2007-113, Nov. 26, 2007, and an employer can no longer make a payment in lieu of amending employees' T4s. Would the CRA consider reinstating this policy?

2. Voluntary Disclosures Program (VDP)

The CRA offers taxpayers the opportunity to correct mistakes or deficiencies in reporting income on their tax returns under the Voluntary Disclosures Program. This program allows taxpayers to pay only taxes owed plus interest while avoiding the assessment of penalties and potential prosecution on the information accepted under the program.

a. General information request:

We respectfully request an update on CRA's decision-making process regarding voluntary disclosure files. In particular:

i. What should a taxpayer expect in a decision-making process, and who will be the decision maker in the following situations?:

1. Eligibility for entry into the program
2. Technical matters associated with the file
3. Final number of years and interest, if any, to be assessed

ii. Does the CRA decision-making process consider Red Tape Reduction initiatives and potential impacts on employer-employee relationship?

b. The following is an example of a voluntary disclosure concern:

A corporate taxpayer with a unionized work force identifies a deficiency in the amount of taxable benefits assessed to employees in prior years. To correct for this, the corporation pays additional income tax, as well as CPP and EI remittances, both for the employee and employer contributions.

i. Can the CRA outline how the matter could be resolved without needing to involve the employees or report on their circumstances?

ii. Would the CRA waive the requirement to file amended T4s if the employees have reached the maximum CPP- and EI-remittance requirements for the periods subject to voluntary disclosure?

3. Large Business Compliance

We respectfully request that the CRA provide an update on the Large File Case Program, including any changes in the executive leadership, risk assessment, and risk-profiling process, as well as the Large File Case Manager's span of control.

We also respectfully request the CRA's response to the following questions regarding its approach to Large Case Files:

a. Many taxpayers experience audit-scope levels that do not always reflect the rating received under the Approach to Large Business Compliance program.

Is the CRA still following this program and, if not, how will the CRA conduct Large Business audits in the future?

b. Many taxpayers often experience inconsistencies in audit approach because of case-file manager transitions, often including reversals of previously agreed courses of action, which leads to inefficiencies and delays. Will the CRA be addressing this issue and, if so, how?

c. Some large businesses understand that tax service offices from cities outside of the businesses' respective cities are now handling their audits, such as audits of Calgary-based businesses taking place in Edmonton or Winnipeg. How will such audits generally be conducted in the future and how will they address industry knowledge and experience of auditors, handling of audit queries, and data sharing and logistics for face-to-face meetings?

d. What are the CRA's goals for achieving currency in the audit-cycle process?

D. Audit Matters

1. *Taxpayer Audits and Adjustments*

We understand the CRA currently has a quality-assurance program to review field audits for consistency and appropriateness. Would the CRA consider adopting a centralized quality-assurance program to streamline its transfer-pricing operations and audit procedures to ensure consistency on transfer-pricing issues for all taxpayers and appropriate support for (proposed) pricing adjustments, including technical and unbiased benchmarking support? If not, why not?

2. *Regulatory Requirements and Transfer Pricing*

In highly regulated industries such as banking and securities, regulators in each jurisdiction closely monitor related-party transactions to ensure they occur at "fair market prices" so that appropriate revenues are attributed within their jurisdictions. Regulators may often stipulate the pricing arrangements in related-party transactions, which may be a condition for allowing these transactions to occur. Noncompliance with regulatory requirements may result in significant fines as well as the complete cessation of business operations. As regulators have the ability to restrict or close business operations entirely, taxpayers are very careful to comply with these regulatory requirements in all the relevant jurisdictions. Taxpayers can sometimes find themselves in situations where the transaction's arm's-length price, as otherwise determined outside the regulatory sphere, differs from the price stipulated by the local regulator. What is the CRA's position in these cases, and is the CRA willing to work with taxpayers to arrive at solutions that satisfy the arm's-length principle while still satisfying the regulatory requirements?

E. Technical Matters

1. BEPS Action 13

On October 5, 2015, the members of the OECD's Centre for Tax Policy and Administration delivered its final recommendations for the BEPS project. We know that the Department of Finance and the CRA have been highly involved with the formation of some of the recommendations. We would like to hear the CRA's comments to the following questions:

a. As system changes and information- and documentation-gathering processes take time to implement, what is the timeline for implementing OECD BEPS Action 13, specifically its country-by-country reporting requirements and transfer-pricing documentation requirements? Can we expect changes in law or administrative guidance on methods of implementing these requirements? When can we expect such guidance and their associated effective dates?

b. What safeguards does the CRA expect to put in place to ensure confidentiality of information submitted to CRA pursuant to BEPS Action 13? Will there be limitations in the sharing of the information similar to those indicated by the IRS as indicated in the IRS' comment listed below?

* * *

Comment from the IRS

This was published in BNA in the form of a quote from an IRS official. BNA article Published July 21, TP report 304: CBC Reporting only for U.S. tax treaty partners.

July 21 — The U.S. is planning strict limits on the information that can be shared under the country-by-country reporting regime being developed under the OECD's base erosion and profit shifting project, an IRS official said.

Right now, the U.S. will exchange information only with its partners in treaties and tax information exchange agreements, said Karen Cate, a senior international tax law specialist in the office of the U.S. Competent Authority within the Internal Revenue Service.

Treaty and TIEA-based exchanges "will allow the United States to ensure that the information is used only for the intended and permitted purposes, and help us protect the confidentiality of commercially sensitive data," Cate said at a transfer pricing symposium sponsored by the National Association for Business Economics.

> The U.S. wants to be sure the information will be used only for assessing high-level transfer pricing risks, BEPS-related risks and in some cases economic analyses, she said, stressing that "countries may not use the data as a substitute for detailed transfer pricing analyses of individual transactions."

* * *

c. Will the changes to information requirements under Canadian law resulting from BEPS Action 13 be limited to addressing the Action 13 requirements, or should we anticipate additional information requirements specific to Canada?

d. Has the CRA contemplated any potential Red Tape Reduction opportunities in order to partially offset the additional costs and compliance burdens resulting from the country-by-country reporting process? For example, would the CRA consider revising certain de minimis thresholds or contents of forms T106 and T1134? Would the CRA be willing to work with TEI to identify such Red Tape Reduction opportunities?

e. Has the CRA discussed with other tax authorities participating in the BEPS framework whether, in the interests of transparency and Red Tape Reduction, each tax authority should produce periodic public reports to show its progress against an agreed set of objective criteria related to the country-by-country reporting requirements? Such criteria could include measures taken to protect confidential taxpayer information under country-by-country requirements, measures taken to simplify existing tax-reporting requirements, additional volume of information collected under country-by-country requirements, additional CRA resources hired or required by CRA to handle country-by-country reporting reviews, or additional collected revenues attributed directly to country-by-country requirements. If not, would the CRA be willing to discuss adopting such measures on its own accord?

2. *Section 55 of the Income Tax Act*

Ordinary commercial structures typically include a parent corporation with a number of subsidiaries and sub-subsidiaries, both domestic and foreign. A common and prudent cash-management business practice is to move and manage cash within such a group by paying intercorporate dividends.

In the past, a Canadian company could confidently pay a Canada-to-Canada intercorporate dividend without the dividend being taxed as long as the transaction was truly an "inter-group" transaction, relying on the related-party exception of Income Tax Act subsection 55(3). A Canadian company could also rely on the "safe income" exception for this

purpose. However, due to the complexity of the safe-income calculation and the long history of some subsidiaries, Canadian corporations typically have not incurred the time and expense of ascertaining a safe-income balance to support an intercorporate ordinary dividend.

We have heard informally that the revisions to section 55, which are intended to strengthen its anti-avoidance purposes, are not intended to require taxpayers to resort to share reorganizations followed by share redemptions in the place of ordinary course dividends. We have also heard that these revisions are not intended to tax intercorporate ordinary course dividends that cannot be established to derive from "safe income." However, TEI members remain concerned that, because all dividends result in a reduction of the fair-market value of shares held by the dividend payor and increase the cost of properties held by the dividend recipient, the CRA may try to reassess ordinary course dividends on the basis that a purpose of every dividend is a tainted purpose.

Can the CRA confirm its positions on these concerns for the record? Also, assuming the revisions to section 55 are not intended to apply to ordinary course dividends (and taxation of these ordinary course dividends that cannot be established to be from "safe income" will not occur), can the CRA comment as to whether the following scenarios would be ordinary course dividends?:

a. Paying dividends up a corporate chain to fund a parent corporation's dividend.

b. Paying dividends up a corporate chain to fund general corporate expenses such as servicing debt, funding growth, and repurchasing shares.

c. Paying dividends up a corporate chain to settle intragroup indebtedness resulting from centralized banking systems.

d. Paying dividends between corporations in a closely held group to facilitate intergroup loss utilization as previously sanctioned by the CRA.

Finally, what does the CRA consider to be "significant" in the context of applying proposed subparagraphs 55(2.1)(b)(i) and (ii)?

3. Schedule 33 – Taxable Capital Employed in Canada – Large Corporations

With the elimination of the large corporations tax, a corporation that was neither a financial institution nor an insurance corporation no longer had to file Schedule 33. However, according to the Corporate Taxprep 2014 release notes, Schedule 33 must be filed for taxation years ending after December 31, 2013 if the total taxable capital employed in Canada of the related group is greater than $10 million. We are not aware of any explanation for requiring

Schedule 33 in these circumstances, and the value of completing the form is not apparent to us. We request that the CRA reconsider its position on requiring Schedule 33.

4. Gift Certificates

The CRA has an administrative policy that exempts non-cash gifts and awards given to employees as taxable benefits in certain circumstances. Gift certificates, however, are excluded from this administrative policy exemption. As a result, employers often avoid giving gift certificates to their employees because of the associated tax liability to the employees. There is little difference between an employee receiving a gift directly from his or her employer and an employee purchasing that same gift with a gift certificate from the employer. We believe that gift certificates, particularly those from a named vendor or service provider that are not redeemable for cash, should be included in the administrative policy exemption. This would not frustrate the exemption's intent. Furthermore, the definition of "excluded gift" and "excluded award," which does not include gift certificates, in Subsection 37.1.5 of the Quebec Tax Act sets a precedent for this position. Would the CRA similarly consider exempting vendor- or service provider-specific gift certificates in the same manner as it does for non-cash gifts and awards?

5. Certificates of Residency

To eliminate or reduce the withholding requirements on international payments, taxpayers must often provide foreign tax authorities or foreign business partners, such as their customers, with proof of Canadian residency status, per the relevant tax treaty. This is an annual requirement and, for taxpayers with extensive international business activities across numerous countries, may involve numerous requests. The CRA has made progress in centralizing the production of certificates of residency and streamlining the Canadian partnership certificate-of-residency process. However, a standard request may still take eight to ten weeks or longer during peak periods. A more complex request, such as a partnership request, may take even longer. In one instance, it took several months for the taxpayer to receive a response to the request even though the taxpayer provided the information as noted on the CRA website. This delays collections from foreign customers who use it as a convenient excuse to delay payments.

a. As international business arrangements and transactions tend to remain in place for many years, would the CRA be willing to establish an automatic annual renewal process for certificates of residency?

b. Would the CRA consider setting up a certificates-of-residency specific "help line," as opposed to the general business enquiries hot line, to assist taxpayers in expediting the processing of these requests and avoid costly delays in collecting amounts owing?

c. Can the CRA confirm whether the taxpayer services regional correspondence centres are still the appropriate place to submit certificate requests, or has the CRA changed where these requests should be sent?

d. Many of our treaty partners have their own certificate-of-residency templates and procedures, which can require formal notarization of original-signed documents, certification from a foreign embassy or consulate, and, in some instances, an official translation. Because this process is time consuming and repetitive, TEI welcomes the CRA's views on whether Canada's treaty partners would be open to standardizing the annual certification process and coordinating a redesigned certificate of residency containing all of the information necessary to expedite issuing certificates of residency and meeting all foreign jurisdictions' requirements for applying the reduced treaty withholding rate. We suggest this issue could be a good item to address at the OECD BEPS Action 15 ("Develop a multilateral instrument") discussion scheduled for next year.

6. Back-to-Back Loans – Notional Pooling Arrangements

Does the following fact pattern implicate a "specified right" under Income Tax Act subsection 18(5)?

Multinational corporate groups often enter into "cash pooling" arrangements with financial institutions to efficiently manage cash balances. Cash pooling arrangements typically fall into one of two categories: physical and notional. Under a physical cash pooling arrangement, a master or "header" account is typically held by a member of the corporate group with the financial institution. Each participant in the pooling arrangement has a subaccount linked to the master/header account. Cash balances in the subaccounts are transferred to the master/header account on a daily basis thus creating an intercompany loan owing to the participant by the master/header account holder. Balances in the master/header account are transferred to the subaccounts from time to time to meet the cash requirements of the participants.

Under a notional cash pooling arrangement, participants have separate bank accounts with the same financial institution and retain their cash balances or incur overdraft balances directly with the financial institution, as opposed to transferring cash to a header/master account. Each participant earns deposit interest and incurs overdraft interest on its respective account balance, but the rate of overdraft interest charged to a participant is typically reduced to match the deposit interest rate to the extent the aggregate balance of the participating accounts is positive.

Additionally under notional cash pooling arrangements, financial institutions often require participants to grant the institutions the right to formally offset overdraft balances in pool accounts against deposit balances in other pool accounts. In the absence of the ability to set-off overdraft balances in this manner, the financial institutions could be required to treat the overdraft balances as non-performing loans for regulatory purposes.

For example, suppose that Canco, a Canadian-resident corporation, is a wholly-owned subsidiary of Parentco, a non-resident corporation that has a number of other wholly-owned subsidiaries not resident in Canada and that operate in various jurisdictions. Parentco and its other subsidiaries, including Canco, have a notional cash pooling arrangement that has been established with an arm's-length financial institution (the "Bank") not resident in Canada. Under the relevant pooling agreement, the Bank has the right to offset overdraft balances of any pool participants against deposit balances of other pool participants without prior notice. Canco has an overdraft balance on its pool account and has overdraft interest charges owing to the Bank.

As this fact pattern may implicate taxation of non-residents, does the Bank's right to offset the deposit balances of other pool participants against Canco's overdraft balance constitute a "specified right" within the meaning of subsection 18(5)?

7. U.S. Donations

Article XXI(7) of the Canada-U.S. Tax Convention permits a Canadian corporation to take a donation deduction against its U.S.-sourced income when the Canadian corporation makes a donation to a U.S. charitable organization. Can the CRA clarify the definition of U.S.-sourced income for this purpose? For example, can U.S.-sourced capital gains qualify?

If the Canadian corporation has no U.S.-sourced income for the year in question, does a carryforward system exist, and if so, how long is it? As Schedule 2 on T2 makes no mention of U.S.-bound donations, what would be the mechanism for disclosing such a donation and claiming a corresponding deduction in the corporation's tax return?

8. Scientific Research and Experimental Development (SR&ED) Tax Incentive Program

The CRA recently attempted to clarify various SR&ED issues while stating that it was not changing its SR&ED policies. One of the changes to come out of this process was the Eligibility of Work for SR&ED Investment Tax Credits Policy ("Eligibility Policy") that introduced subtle policy changes despite overall claims to the contrary. Because of the Eligibility Policy, some Research and Technology Managers and Advisors have since determined there to be no eligible SR&ED in many claims due to a lack of scientific or technological advancement, or a lack of scientific or technological uncertainty at the lowest, underlying technological levels. These projects are therefore considered to be "routine" or "standard practice" and not eligible for SR&ED tax benefits even though they were previously

SR&ED-eligible. The determinations are often inconsistent with the policy and result in some taxpayers receiving tax credits while others do not, despite the same or similar circumstances.

a. Criterion of Scientific or Technological Uncertainty

During the SR&ED clarification process, the CRA consolidated Information Circular (IC) 86-4R3 into the new Eligibility Policy paper, the former of which had been a widely accepted authority on SR&ED matters. For example, in the case *Northwest Hydraulic Consultants Ltd. v. The Queen*, [1998] 3 C.T.C. 2520, Judge Bowman referred to IC 86-4R3 as a generally useful document because it was jointly developed by industry and the CRA, stating specifically, "It represents a broad consensus of persons in the public and private sector who are likely to be affected by or to have an interest in the interpretation of the SRED provisions of the Income Tax Act." *Id*.

IC 86-4R3 had provided the SR&ED criterion of scientific or technological as follows:

> "Whether or not a given result or objective can be achieved, and/or how to achieve it, is not known or determined on the basis of generally available scientific or technological knowledge or experience. This criterion implies that we cannot know the outcome of a project, or the route by which it will be carried out without removing the technological or scientific uncertainty through a program of scientific research or experimental development.
>
> "Specifically, scientific or technological uncertainty may occur in either of two ways:
>
> - it may be uncertain whether the goals can be achieved at all; or
> - the taxpayer may be fairly confident that the goals can be achieved, but may be uncertain which of several alternatives (*i.e.*, paths, routes, approaches, equipment configurations, system architectures, circuit techniques, etc.) will either work at all, or be feasible to meet the desired specifications or cost targets, or both of these."

This criterion is not specifically listed in the new Eligibility Policy. Please confirm that a project meeting this definition of scientific or technological uncertainty still meets the definition of SR&ED as defined in Section 248(1) of the Income Tax Act.

b. The Baseline from Which to Measure Technological Uncertainty

Second, IC 86-4R3 also discussed application of SR&ED-eligibility criteria in a way not specifically addressed by the Eligibility Policy. Section 2.11 of IC 86-4R3 had stated,

> "The technical uncertainties encountered by one taxpayer may well be looked upon as facts easily obtained by another. The judgement as to eligibility should be made within the context and environment of a single company and its field of business. Specifically, the activities undertaken to resolve technical uncertainties are eligible if the taxpayer cannot obtain the solutions through commonly available sources of knowledge and experience in the business context of the firm."

Section 2.13 of IC 86-4R3 had elaborated further on "experimental development" by stating that in order to be SR&ED eligible "it must seek to advance the taxpayer's technological knowledge base. The technological advance achieved only needs to be slight."

Please confirm that when a taxpayer cannot obtain solutions through commonly available sources of knowledge and experience in the business context of the firm, then its activities associated with resolving these technological uncertainties still meet the definition of SR&ED as defined in Section 248(1). Is the baseline for measuring the technological uncertainty faced by a taxpayer specifically the taxpayer's baseline, which includes information available to the taxpayer?

c. Interpretation of "Standard Practice"

Third, IC 86-4R3 specifically interpreted when a "standard practice" might lead to SR&ED ineligibility, but the Eligibility Policy is not so specific. Section 4.2 of IC 86-4R3 had stated, "Standard practice refers to directly adapting a known engineering or technological practice to a new situation when there is a high degree of certainty that the known technology or practice will achieve the desired objective." IC 86-4R3 had gone on to state in section 4.3, "In other words, if the project involves directly adapting a known technology to a new situation, when it is reasonably certain that the approach will work, it is ineligible."

Please confirm that a standard practice used in experimental development without a high degree of certainty that the known technology will achieve the desired objective, or when it is not reasonably certain that the approach will work, continues to qualify as technological uncertainty and therefore meets the definition of SR&ED as defined in Section 248(1).

d. Advancing Underlying Technology

In order to distinguish between: (a) work that is done to advance the underlying technology of a sub-system that results in technological advancement and (b) work that does not require the underlying technology to be advanced but allows for the system improvements that advances new technology, can the CRA confirm that the policies that had derived from IC 86-4R3 sections 2.10.1 and 2.10.2 are still valid?

Those sections had read as follows:

* * *

2.10.1 The criterion of scientific or technological advancement is as follows:

- The search carried out in the scientific research and experimental development activity must generate information that advances our understanding of scientific relations or technologies. In a business context, this means that when a new or improved product or process is created, it must embody a scientific or technological advancement in order to be eligible.

2.10.2 The criterion of scientific or technological uncertainty is as follows:

- Whether or not a given result or objective can be achieved, and/or how to achieve it, is not known or determined on the basis of generally available scientific or technological knowledge or experience. This criterion implies that we cannot know the outcome of a project, or the route by which it will be carried out without removing the technological or scientific uncertainty through a program of scientific research or experimental development. Specifically, scientific or technological uncertainty may occur in either of two ways:

—it may be uncertain whether the goals can be achieved at all; or
—the taxpayer may be fairly confident that the goals can be achieved, but may be uncertain which of several alternatives (i.e., paths, routes, approaches, equipment configurations, system architectures, circuit techniques, etc.) will either work at all, or be feasible to meet the desired specifications or cost targets, or both of these.

- The scientific or technological uncertainty, rather than the economic or financial risk, is important in characterizing scientific research and experimental development—and, hence, eligible activities.

- Sometimes there is little doubt that a product or process can be produced to meet technological objectives when cost targets are no object. In commercial reality, however, a reasonable cost target

is always an objective, and attempting to achieve a particular cost target can at times create a technological challenge which needs to be resolved. A technological uncertainty may thus arise that is imposed by economic considerations. Otherwise, the more general question of the commercial viability of the product or process is not relevant to whether or not a technological uncertainty is present and, hence, to whether a project is eligible or ineligible.

- This criterion applies equally to work on new or existing processes or products. The description of technological uncertainty contained in this subsection applies wherever the text of this circular refers to the criterion.

* * *

e. Follow-up with the CRA

If a dispute arises between a claimant and the CRA about policies or interpretations concerning the criterion of scientific or technological advancement, or the criterion of scientific or technological uncertainty, and the facts of the case are generally not in dispute, can the claimant seek clarification from CRA headquarters on these policies or interpretations?

F. Conclusion

Tax Executives Institute appreciates this opportunity to present its comments and questions. We look forward to discussing our views with the CRA during the November 17, 2015 liaison meeting.

Respectfully submitted,

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