TAX EXECUTIVES INSTITUTE, INC.

INCOME TAX QUESTIONS

Submitted to

CANADA REVENUE AGENCY

DECEMBER 8, 2009

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 (hereafter "CRA" or "the Agency") during TEI's December 8, 2009, liaison meeting. If you have any questions about the agenda in advance of the meeting, please do not hesitate to call Sherrie Ann Pollock, TEI's Vice President for Canadian Affairs, at 416.955.7373 or Rodney C. Bergen, Chair of the Institute's Canadian Income Tax Committee, at 604.488.5231.

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?

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 for one of the eligible purposes described in subsection 17(8)? 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." We invite CRA's comments.

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, 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.

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

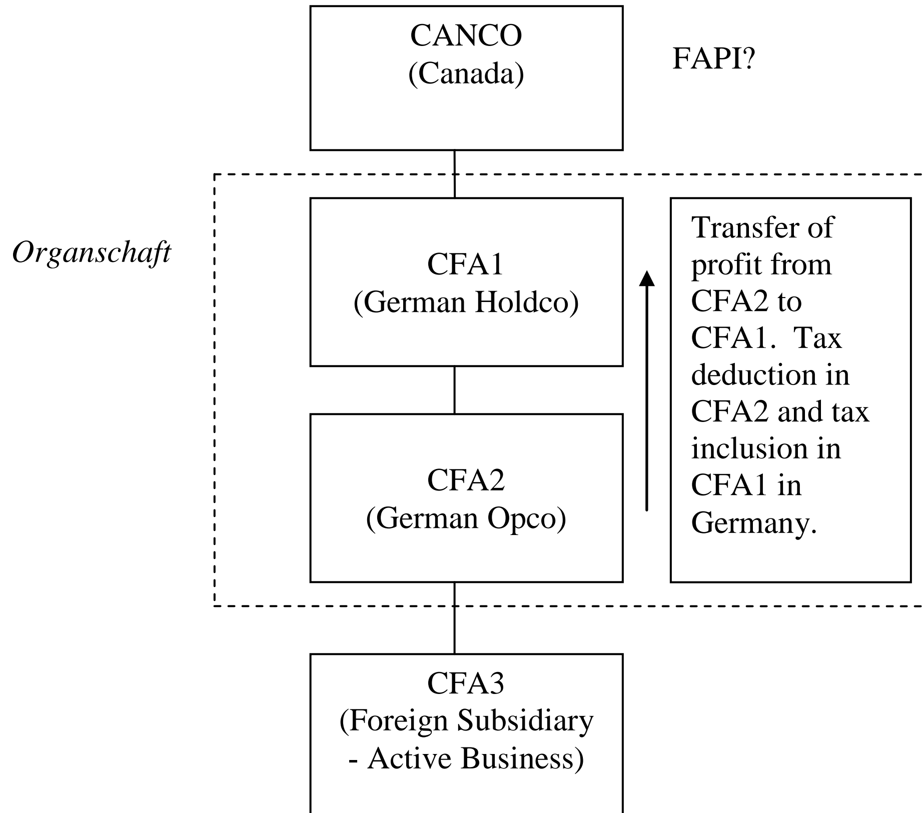
Paragraph 1 of Article XXIX-A of the Convention between Canada and the United States of America, signed on September 26, 1980, as amended by the Fifth Protocol on December 15, 2008 (hereafter "the Treaty"), contains a limitation on benefit (LOB) clause that states that only a "qualifying person" is entitled 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?

5. German Fiscal Unity

Under the *German Corporate Income Tax Act*, the fiscal unity provision (*"Organschaft"*) permits a German controlled foreign affiliate (CFA2 in the diagram below) of a Canadian corporation (CANCO) to transfer its profit or loss to a German parent company (CFA1 below). 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.

Income earned by CFA2 from other than an active business (*e.g.,* a capital gain realized by CFA2 on excluded property) is deemed not to be 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 received by CFA1 from CFA2 as income from an active business because the transfer of such income from CFA2 must be considered *deductible* under Canadian (rather than German) rules in computing CFA2's active 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?

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.

7. Form T661(08) — Scientific Research & Experimental Development (SR&ED) Claims

CRA has released a new Form T661, *Scientific Research & Experimental Development (SR&ED) Claims,* effective November 10, 2008, for use in fiscal years beginning in 2009 or, for claimants with more than 20 projects, for use in fiscal years beginning in 2010. Part 2 — "Project information," which requires that the claimant describe how the project qualifies for SR&ED, has been restructured. The previously open-ended questions of the old form have been replaced with more concise and direct questions, but the format for providing project details is more rigid. In sections 240, 242, and 244, for example, the claimant must describe each project in 350, 350, and 700 words, respectively. Although the limits are sufficient for some projects, the space will not permit many claimants to adequately describe highly complex or lengthy projects. Also, the revised form no longer permits claimants to include pictures, diagrams, or flowcharts to facilitate a reader's understanding of the project.

In addition, CRA has initiated a "process review" whereby the projects and financial information for projects are reviewed and accepted by CRA even before the income tax return is filed. Regrettably, even where all the projects on a process review have been accepted by CRA, taxpayers are still required to complete Part 2 of Form T661 (including sections 240, 242, and 244) to obtain an assessment of the SR&ED claim. Since the goal of collecting the information on Part 2 is to permit CRA to carry out its initial review of the project claim, the completion of Part 2 is an unnecessary paperwork burden for taxpayers that are under process review.

We invite a discussion of the ways in which taxpayers can supply CRA with the relevant information it needs to understand why taxpayers' projects qualify without increasing taxpayers' reporting burdens. Specifically, to improve the information reporting for large corporation's SR&ED claims, would CRA consider:

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

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

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.

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?

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

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)?

9. Subsection 116(5.01)

In order for subsection 116(5.01) of the Act to apply, a purchaser must file a notice 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, especially shares, will include a contingent or variable component (*e.g.*, a post-closing adjustment based on net working capital) 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)?

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.[1] 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?

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?

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.[2] 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

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[1] In response to questions at previous liaison meetings, CRA has stated that standard audit practice is for the Large File Case Manager and the auditor to present issues to taxpayers as they arise, citing the legislation, policy documents such as Interpretation Bulletins, and relevant jurisprudence in support of adjustments. In addition, the model Audit Protocol requires that CRA auditors keep the taxpayer regularly informed about the status of the Department's queries, proposed audit adjustments, and findings. Issuing — or threatening to issue — an unsupported reassessment denying deductions for specific transactions without first discussing the underlying issues with the taxpayer undermines taxpayer confidence in the fairness of the audit process.

[2] *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.

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?

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:

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

b. What portion of that inventory is with the United States?

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

d. What are the predominant issues currently before competent authority?

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?

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

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?

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." (A copy of a sample letter is attached in the appendix.) 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.

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.

17. Transfer Pricing

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.

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 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?

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?

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?

d. *Quality Control Process*

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

e. *Reassessments*

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

f. *Penalties*

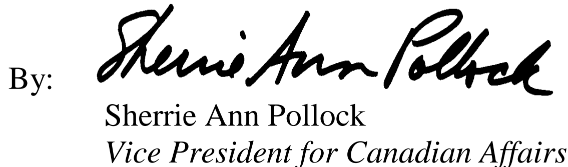
We invite CRA to provide an update on the types of situations where transfer pricing penalties have been applied, noting specifically the number and types of situations that involve a re-characterization of taxpayers' transactions. We also request a summary of CRA's statistics on the number of cases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

Conclusion

Tax Executives Institute appreciates this opportunity to present its comments and questions. We look forward to discussing our views with you during our December 8, 2009, liaison meeting.

Respectfully submitted,

Tax Executives Institute, Inc.

By: 

Sherrie Ann Pollock
Vice President for Canadian Affairs

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Canada Revenue Agency   Agence du revenu du Canada

Re: Compliance Review – Aggressive Tax Planning

Dear Madam:

Please be advised that the above corporate income tax returns for [redacted]. have been selected for audit. We wish to notify you that The Canada Revenue Agency will also be conducting an Aggressive Tax Planning (ATP) compliance review in conjunction with this audit. As such, the ATP section specifically requests the following records:

1. An identification and comprehensive description of the corporation's shareholders and any related entities. Please provide a diagram of the organizational structure including all domestic and foreign related entities;
2. An identification and description of any partnerships, trusts, or unlimited liability corporations utilized in your business structure and their purpose;
3. A comprehensive description of the corporations business line(s), including a detailed explanation of where and how the corporation carries on its business activities both domestically and internationally;
4. A comprehensive description and explanation of all financing arrangements utilized in the corporate structure including the financing of any related entities and the purpose;
5. A detailed explanation and supporting documentation of any reorganization during the period under review including corporate amalgamations, mergers, acquisitions, wind-ups or any other changes. Please include any asset and/or business acquisitions(s) and dispositions(s);

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6. A comprehensive explanation and supporting documentation of all non-operating receivables and/or payables, including inter-company loans between all related entities and their purpose;

7. A explanation and supporting documentation for any gains and/or losses incurred during the period under review;

8. A comprehensive explanation and supporting documentation for any changes to, or reorganization of, share capital including new share issuances, redemptions, retractions, or exchanges of common and/or preferred shares. Please provide the values attached.

9. Please provide an explanation and supporting documentation for all dividends received and paid in the period under review.

10. Please provide an explanation and supporting documentation for the provincial income tax allocations as reported on the T2 Schedule 5.

We request that your provide the above information within forty-five (45) days. Please do not hesitate to contact the undersigned at [redacted] should you have any questions.

Yours truly,