TAX EXECUTIVES INSTITUTE, INC.

INCOME TAX QUESTIONS

Submitted to

CANADA REVENUE AGENCY

DECEMBER 4, 2012

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 (hereinafter "CRA" or "the Agency") during the December 4, 2012, liaison meeting. If you have any questions about the agenda in advance of the meeting, please do not hesitate to call Kim N. Berjian, TEI's Vice President for Canadian Affairs, at 403.614.8572 or, Bonnie Dawe, Chair of the Institute's Canadian Income Tax Committee, at 604.331.4864.

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

a) *Partnership Returns and My Business Account*

In response to question 1(c) of the December 2011 liaison meeting agenda with TEI, CRA said that it was working toward an online solution that would permit taxpayers to track the filing status of partnership information returns, perhaps as part of the *My Business Account* web portal. CRA's goal was to have the system in place for 2012 fiscal periods. Can CRA provide an update on the status of the online notification process? We also invite a discussion whether other partnership return details will be available online. Finally, are enhancements to the *My Business Account* web portal or other online resources contemplated, including the capability of e-filing Form T5013 (*Statement of Partnership Income*)?

b) *Foreign Reporting Forms*

In response to question 1(a) during the December 2011 liaison meeting agenda with TEI, CRA said that revisions to Forms 1134A (*Information Return Relating to Foreign Affiliates That Are Not Controlled Foreign Affiliates*) and 1134B (*Information Return Relating to Controlled Foreign Affiliates*) were nearly complete and revised forms would be released soon. Also, in response to question 2 of the same meeting agenda, CRA said that the International Tax Data Working Group was exploring e-filing for foreign reporting forms, including Form T106 (*Information Return of Non-Arm's Length Transactions with Non-Residents*), T1134A, and T1134B. We invite CRA to provide an update on these initiatives.

c) *Replacement of Income Tax Technical Publications with Income Tax Folios*

CRA recently announced the launch of Income Tax Folio publications (hereinafter "Folios") to update and supersede information currently found in the Income Tax Interpretation Bulletins and to improve web functionality. At the same time, CRA announced that "all of the archived Income Tax Interpretation Bulletins, nine of the current Income Tax Interpretation Bulletins and all archived ITTNs were cancelled, effective September 30, 2012." Finally, to expedite the development and publication of the Folios, the Income Tax Rulings Directorate has undertaken an External Contributor Framework with external organizations.

We invite a discussion of the effect of the initiative and its timeline to completion based on the following questions:

i. Will CRA be able to add resources or devote additional resources from other sources in order to ensure that taxpayers have access to income tax technical publications and that the Folios remain current? How is CRA prioritizing the development and issuance of the Folios? Will topics identified through the External Contributor Framework (*i.e.*, by way of a submitted Topic Selection Form) receive priority consideration for updates?

ii. The webpage summarizing the Folio project states that the updates will require several years to complete. Can CRA provide a timeline for completion as well as interim milestone dates (*e.g.*, which Folio subjects it anticipates completing by particular dates)?

iii. Can CRA provide additional explanation about the process, including why nine current ITs were cancelled before they were replaced by a Folio? Will the cancelled ITs subsequently be incorporated in a Folio? Can taxpayers rely on the positions included in the cancelled ITs until a Folio is issued with revised or restated guidance?

iv. Can CRA clarify what an "archived" Advance Income Tax Ruling is and what (or how) taxpayers may be affected by their cancellation? The Folio announcement does not refer to the "archived Advance Income Tax Rulings," but all were cancelled effective September 30, 2012, along with "all archived Income Tax Bulletins," nine current Interpretation Bulletins, "all archived Income Tax Technical News," and "all archived Income Tax Directives."

2. Vision 2020

During TEI's May 2012 Annual Canadian Tax Conference, Assistant Commissioner for Legislative Policy and Regulatory Affairs Brian McCauley and Assistant Commissioner for Strategy and Integration Catherine Bennett outlined CRA's *Vision 2020 Strategic Plan*. Can CRA provide an update on its initiative?

3. Scientific Research & Experimental Development (SR&ED)

Under subsection 127(9), a "contract payment" for research and development will qualify as an eligible expenditure for investment tax credit (ITC) where the payment is made to a "taxable supplier." It is not always possible, however, for a Canadian taxpayer to determine whether a non-resident is a taxable supplier. We invite CRA's views on how a Canadian taxpayer can determine the "taxable supplier" status of a non-resident. For example, if a Canadian taxpayer obtains an affirmative representation of taxable supplier status from non-residents, will that be sufficient documentation?

4. Prepaid Rent

For a property lessor, the interaction of subparagraph 12(1)(a)(i) and paragraph 20(1)(m) of the *Income Tax Act, Canada* generally results in amortization of prepaid rents over the term of a lease agreement. In technical interpretations 9924585 (November 15, 1999) and 9909965 (September 7, 1999), CRA was asked to comment on the treatment of the prepaid rent received prior to a sale of the underlying property subject to the lease. CRA's view was that when prepaid rents covering a period of 20 years are received by a taxpayer, the prepaid rents may be considered proceeds of disposition of a property rather than prepayment of rent. We invite CRA to confirm the views expressed in these two technical interpretations and whether prepaid rent covering a 20-year period received prior to an actual sale of the property may be considered proceeds of disposition of a property by the seller.

5. Settlement Date

In recently cancelled IT-133 *Stock Exchange Transactions Date of Disposition of Shares* (November 30, 1973), CRA said that the sale of shares for tax purposes occurs on the "settlement date" as determined by the rules of a stock exchange where the trade takes place. Typically, the "settlement date" on a disposition of shares is two to three days subsequent to the trade date. We invite CRA to confirm that, notwithstanding cancellation of the IT, it considers the settlement date to be the date of disposition of shares for tax purposes.

6. Review of Corporate Tax Returns at the Initial Assessment Stage

Recently, CRA began reviewing T2 returns for large corporations at the initial assessment stage soon after a return is filed. This review at the initial assessment stage is separate from a regular audit, but the requests for information from the Tax Services Office (TSO) are often extensive and elaborate. Members report receiving requests for:

- An explanation why the amortization of tangible and intangible assets reported on Schedule 1 does not agree with the amounts shown on the General Index of Financial Information (GIFI) or the amounts reported on the taxpayer's financial statements;

- An explanation why the amount of reserves added back or deducted on Schedule 1 does not agree to the GIFI or the amounts reported on the financial statements;

- A detailed breakdown of all lines included on Schedule 1; and

- Submission of a revised Schedule 8 because the "claimed CCA in certain classes exceeded permitted rates" and "recapture information is incomplete."

When the affected taxpayers questioned the practices with the TSO or Large File Case Manager (LFCM), the explanation was that the new process allowed CRA to gather data in a more timely fashion for risk assessment purposes. One LFCM explained that he has no control over this practice. Hence, we invite a discussion of the following:

a) How does this risk-assessment practice fit with the risk-based audit approach being introduced by CRA? This practice seems to make the risk review performed by the TSO and LFCM duplicative.

b) An initial assessment by CRA that differs from the return as filed by the taxpayer will require the taxpayer to file a notice of objection and appeal before the issues are even reviewed by the LFCM. This seems premature at best and an unnecessary waste of resources at worst for both taxpayers and CRA. Please explain the policy of compelling taxpayers to file a notice of objection and appeal before its regular full-scope audit commences.

c) Why is this initial review separate from and outside the control of the LFCM?

d) Why is this practice appropriate for large corporate taxpayers that are subject to perennial, recurring audits?

7. CRA Audit Practices — Taxpayer Field Experience

CRA and large taxpayers share a common interest and goals in promoting a smooth and efficient audit. The goals include:

- Ensuring that audits are current;
- Avoiding the use of waivers to extend the audit period unnecessarily or habitually;
- Focusing audit queries on high-risk compliance issues;
- Using accepted audit sampling procedures to expand stretched resources;
- Maintaining transparency in decision-making and the determination of tax positions;
- Promoting timely, consistent, and effective issue resolution;
- Deploying human resources as effectively as possible; and
- Maximizing cost controls.

Over the course of the last several years, CRA has developed new audit approaches based upon an enhanced relationship with large taxpayers and a risk-based audit approach. TEI supports CRA's new audit approach not only because of the common interest and shared goal of promoting efficiency, but because it promotes certainty of tax treatment sooner. That said, many large taxpayers have experienced behaviours seemingly at odds with the shared interests and goals. Examples include:

a) LFCMs are declining to discuss issues (or assert control over certain issues), saying they lack authority to make a decision in respect of subject matter. This suggests that issue resolution may be increasingly managed by CRA Headquarters in Ottawa as opposed to the TSOs. TEI believes that the objectives identified above can be advanced only if the LFCM is empowered to make decisions on issues and taxpayers are able to communicate directly with the decision-makers.

b) Auditors are asking for information on behalf of an undisclosed CRA source or seeking opinions or advice from CRA Headquarters without communicating the issue to the taxpayer or informing the taxpayer of the request. Where an opinion or advice is solicited, the TSO is generally bound by the Headquarters decision even though the taxpayer had little or no input into the development of the facts upon which the opinion is based.

c) Many auditors and LFCMs assert that they have no jurisdiction over specialty areas (*e.g.*, SR&ED, International or Tax Avoidance matters). Thus, there seems to be no overriding coordinator or decision-maker.

d) The scope and nature of the tax treatment of items seem to change dramatically from previous years (*i.e.,* fewer adjustments are proposed, but high-level conceptual challenges to a taxpayer's filing position are asserted with minimal or no apparent technical analysis). Examples include challenges to reclassify amounts long treated (and frequently reviewed) as current expenses into capital items or challenges to the longstanding (and frequently reviewed) classification of capital items into longer-lived capital asset pools.

e) Adjustments are proposed without discussion or explanation of the technical position despite requests for the rationale, which leaves taxpayers questioning the quality of the audit or propriety of the asserted position. Without discussion, the position can seem arbitrary, and may be a consequence of the Tax Earned by Auditor (TEBA) metric.

f) Information requests or proposals for adjustments are submitted shortly before a taxation year becomes statute barred.

g) Certain audit queries seem intended to audit the taxpayer's financial statements rather than the tax returns (*e.g.*, there are instances where an auditor is verifying account balances in audited financial statements rather than trying to

understand the adjustments on the tax returns to the financial accounts and the rationale for the adjustments).

h) Requests are made for significant amounts of data as opposed to relying on sampling where practical (*e.g.*, requests for all professional fee invoices). In addition, information requests require taxpayers to produce enormous amounts of data within an abbreviated time frame. Response times should be reasonable and proportional to the volume of information requested.

i) Some auditors have refused to make taxpayer-favourable consequential changes and adjustments in subsequent years, even where the changes flow directly from an accepted audit adjustment to an earlier period. Instead, taxpayers are compelled to file amended returns to claim the consequential adjustments.

In addition to a general discussion of the member perceptions of audit behaviours and whether those behaviours are counterproductive to the shared goals of expeditious audits, transparency, and an enhanced relationship, TEI invites a discussion of the following**:**

a) In connection with the new risk-based audit approach, have quality control reviews been performed on the audit files since the approach was adopted? If not, will the quality control review be conducted on all files or all files above a certain size? Will new roles be created within CRA to conduct the quality control reviews independently of the field auditors?

b) Can CRA confirm whether the TEBA metric has been eliminated, as announced at the May 2012 TEI Annual Conference? If so, what measures will the Agency employ internally and for reporting its activities to other parts of the Government (*e.g.*, Finance, Parliament, and the Auditor General)?

c) What other changes are being implemented at Headquarters and the TSOs to support the risk-based audit initiative?

8. Reporting of Payments in Respect of Construction Activities — Section 238 of the Income Tax Regulations:

Under paragraph 238(2) of the *Income Tax Regulations*,

> *Every person or partnership that pays or credits, in a reporting period, an amount in respect of goods or services rendered on their behalf in the course of construction activities shall make an information return in the prescribed form in respect of that amount, if the person's or partnership's business income for that reporting period is derived primarily from those activities*.

According to Technical Interpretation 2000-0016205 — *Payments to Contractors* (October 4, 2000), a joint venture is not a person or partnership for tax purposes and, as a

result, cannot produce and file T5018 (*Statement of Contract Payment*) slips (*i.e.*, the prescribed information return required to comply with paragraph 238(2)). In CRA's view, each member of a joint venture that meets the test of being a partner or partnership is required to report payments made to contractors providing construction goods or services.

Consider the effect of CRA's position in the following examples:

Example 1:

Canadian companies A, B, and C form joint venture ABC (owned 40 percent by A, 40 percent by B, and 20 percent by C) to provide construction services to a client. According to the Joint Venture Agreement governing ABC's operations, the joint venture will keep its own books and records, have a separate bank account, and sign all agreements with the client and suppliers. The joint venture is also responsible for paying all suppliers. At the end of each year, each member of the joint venture is allocated its portion of the revenues and expenses from the joint venture.

During construction, the joint venture subcontracts and pays $2,000 (HST included) to a Contractor to perform a portion of the construction services. Under Section 238 of the *Income Tax Regulations*, each company in the Joint Venture is required to produce a T5018 information slip for its pro rata share of payments made to Contractor. Thus, Company A is required to produce a T5018 slip for Contractor reporting $800 paid; Company B is required to produce a T5018 slip for Contractor reporting $800 paid; and Company C is required to produce a T5018 slip for Contractor reporting $400 paid.

Since the supplier was paid by the joint venture, the required payment information for each payee (including amounts paid, business number, or business address) is not available in each co-venturer's financial reporting or accounts payable system. As a result, manual intervention is required for each co-venturer to gather the information and report it on a T5018. It is unclear whether or how reporting the information on multiple slips by co-venturers enhances the accuracy of the information reported to CRA or to the Contractor or promotes compliance by the Contractor.

To increase the reporting efficiency of payers, enhance the capability of CRA to match payments, and promote compliance by subcontractors to joint ventures, would CRA consider affording the same flexibility under section 238 of the Income Tax Regulations as is currently permitted under the Excise Tax Act (ETA)? That is to say, although a joint venture is not considered a "person" under the ETA, rules of administrative convenience permit the members of a joint venture to elect an "operator" for the joint venture. The operator remits the GST or HST applicable to supplies made by the joint venture and also claims the input tax credits for amounts paid to suppliers. Under TEI's proposal (and assuming A is named the operator), Company A would produce one T5018 slip for Contractor to report the total $2,000 amount.

Example 2:

Assume the same facts in Example 1 except that the Contractor is also a joint venture DE composed of two co-venturers with Company D owing 60 percent and Company E owning 40 percent. The Joint Venture Agreement between companies D and E names Company D as the operator. Joint Venture DE invoices Joint Venture ABC for the construction services performed for an amount of $2,000 (HST included). Under Section 238 of the *Income Tax Regulations*, Company A is required to produce a T5018 slip for Company D to report a payment of $480 and another T5018 slip for Company E to report a payment of $320. Similarly, Company B will be required to produce a T5018 slip for Company D reporting payment of $480 and another T5018 slip for Company E to report payment of $320. Finally, Company C will be required to produce a T5018 slip for Company D reporting a payment of $240 and another T5018 slip for Company E to report a payment of $160.

As noted in Example 1, the detailed information (including the share percentage, business address, and business number) to produce the T5018 will not be kept in any of the payers' financial systems. To enhance the quality of the information reported to the payees and CRA and promote compliance by payees, would CRA consider permitting the joint venture to report the payments made to contractors for construction services based on the entity that issues the invoice (*i.e.*, the joint venture)? Under TEI's proposal, Joint Venture ABC would be required to produce one T5018 slip for Joint Venture DE to report the total amount paid of $2,000. The name and address of the joint venture DE and the joint venture operator's business number (*i.e.*, Company D's business number) would be reported on the T5018 slip.

We invite CRA's reaction to TEI's proposals.

9. Real Time Audits

In 2002, CRA announced an initiative to afford taxpayers an opportunity to obtain a real-time audit on material, completed transactions. For taxpayers, the real-time audit affords certainty about the treatment of a specific transaction at a much earlier date; for CRA, the audit of the transaction can be conducted more efficiently since the taxpayer's personnel and records are fresh and available. Is CRA still receptive to performing real-time transaction-based audits when requested by the taxpayer?

10. Bilateral Safe Harbours

In the 2010-2011 Advance Pricing Agreement Program Report (hereinafter the "APA Report"), CRA states that there are certain transactions that will not be accepted into the APA program because they are outside the scope of the APA Program (*e.g.*, one-time events or transactions such as business restructurings). The APA Report also shows a decline in the number of files accepted into the program, an increase in the number of files withdrawn, and an increase in the average elapsed time for completion of an APA. Many cases that are not accepted for the APA process will likely find their way to the Mutual Agreement Procedure (MAP) process because of disputes over transfer pricing. Indeed, this is borne out by CRA's

2010-2011 MAP Program Report which shows that the MAP process is experiencing an increasing number of cases and an increase in average time to completion, likely because of increased audit activity without a corresponding increase in MAP resources.

Given the lack of budget resources to accommodate the growth in cases and the increased scrutiny of transfer-pricing issues by CRA (and by tax authorities in Canada's principal trading partners), we invite a discussion of the prospects for using bilateral safe harbours for common, routine or low-risk transactions. Transfer prices established under such rules would be automatically accepted by the tax administrations because the tax administrations would have negotiated and adopted agreements in respect of the "safe harbours" (as outlined in the June, 2012, OECD Discussion Draft on the proposed revision of the section on safe harbours in the OECD transfer-pricing guidelines).

The benefits of adopting a safe-harbour approach to transfer-pricing matters include:

- Redirecting tax administrations' resources to more complex, high risk, and more time consuming transactions;

- Increasing certainty for taxpayers that the "safe harbour" transfer prices will be accepted by the tax administrations; and

- Reducing compliance costs for taxpayers and audit costs for tax administrations.

We invite CRA's views on using bilateral safe harbours.

11. Transfer-Pricing Adjustments under Paragraph 18(1)(a)

In denying the deductibility of items charged to Canadian corporations via a transfer-pricing adjustment, CRA has increasingly been reassessing taxpayers pursuant to paragraph 18(1)(a) rather than section 247. As a result, taxpayers face an increasing number of cases of double taxation because the Competent Authority in the other contracting state will not recognize an adjustment under paragraph 18(1)(a) as a Canadian transfer-pricing matter. Can CRA comment on the policy behind reassessing under paragraph 18(1)(a) as opposed to section 247?

12. Risk-based Audit Process

In 2011 CRA announced it was instituting a risk-based approach to audits whereby CRA would meet with senior representatives of the taxpayer to:

- Explain the redefined risk-based approach to large business compliance and how the approach affects taxpayers;

- Share CRA's findings and observations noted during the taxpayer's risk assessment; and

- Understand how the taxpayer manages tax risk at its highest governance levels.

With the first round of meetings with taxpayers complete, TEI has the following questions in respect of the approach:

a) Would CRA share its general observations, findings, trends, or conclusions with respect to the state of tax-risk governance?

b) In the interests of transparency, will CRA consider publishing a document outlining and discussing its review and risk-assessment process?

c) Has the first round of meetings with taxpayers led CRA to consider changes to its risk-assessment process and will it publicly announce the changes? Will affected taxpayers be apprised of changes to the scope of the risk-management approach that apply to their cases?

d) Will CRA review the risk assessment with the affected taxpayer, including discussing the criteria and factors used to determine a taxpayer's risk rating? If a taxpayer disagrees with its risk-assessment rating, what steps can it take to address its concerns?

e) Assuming a taxpayer's risk profile can change over time, will CRA revisit its risk-assessment ratings on a regular basis? If so, how often will the assessment be revised? Will CRA meet again with the taxpayer's senior executives to review the revised rating?

f) Can CRA provide any details about the factors affecting a taxpayer's risk rating?

g) Will CRA inform other tax jurisdictions (provincial or foreign) of its findings in respect of a taxpayer's risk rating?

h) What guidance has been provided to the TSOs to ensure that the objectives of the new audit approach are applied consistently by all the TSOs?

13. Partnership Information Returns

In February 2012, the CRA issued revised Form T5013 *Partnership Information Return* with a modified SCH 50 *Partner's Ownership and Account Activity*. The revised form requires the partnership to report reconciliations of each partner's respective Adjusted Cost Base (ACB) and At-Risk Amount (ARA). The form's requirements apply to all partnerships regardless of whether the partners are related or unrelated.

In prior years, the SCH 50 disclosure involved a "Reconciliation of Partner's Capital Account," an amount that can be reconciled directly to the partnership financial statements. In

other words, since the partnership financial statements and capital accounts are both maintained by the partnership, the capital accounts are easily tracked and reported.

Where a partnership is held by non-arm's length partners, the information required to complete the revised Schedule 50 is often accessible. When unrelated partners own interests in a partnership, however, the information required by the revised SCH 50 may not be (and often is not) available. The filing of the T5013 (and thus the revised SCH 50) is generally the responsibility of the managing partner.

We invite CRA's comments on the following questions:

a) Since the ACB and ARA amounts are unique to the partners and are not partnership attributes, is there a requirement that partners share this information with the managing partner?

b) If arm's-length partners do not provide the information when the managing partner requests it, will an incomplete SCH 50 be accepted by CRA?

c) Does CRA expect the partnership or the partner to prove the accuracy of the amounts reported on the SCH 50 in respect of ACB or ARA? Who bears the burden of penalties and interest if CRA determines the amounts were incorrectly reported — the partner(s) or the partnership?

The purpose of the new requirements for SCH 50 and CRA's use of the information is unclear. More important, since the partnership does not track that information and each partner maintains the historical ACB and ARA information with respect to its respective partnership interest, TEI recommends eliminating the requirement that partner's ACB and ARA be disclosed on the partnership return.

14. Competent Authority

Article IX of Canada's Tax Conventions generally imposes a limitation period on transfer-pricing adjustments. Where CRA makes or proposes an adjustment, the other contracting state is required to make the appropriate adjustment to the profits of the associated enterprise in that other state, but only if the competent authority of the other state is notified within a prescribed period of time.

What is CRA's policy with respect to proposing transfer-pricing adjustments after the limitation period on transfer-pricing adjustments specified in the relevant Tax Convention has passed?

If CRA's policy is not to propose transfer-pricing adjustments after the limitation period, does CRA support protective notifications being made immediately prior to the expiration of the limitation period when CRA did not have the time to complete the audit? Would the previous answer be the same in a situation where the information to determine the

quantum of a potential transfer-pricing adjustment is not available prior to the expiration of the limitation period?

15. Referral to Tax Court

Sections 173 and 174 of the Act allow a determination of specific tax issues by referral of questions of law, fact, or mixed law and fact to the Tax Court of Canada. Section 173 affords the Minister and taxpayers the ability to resolve contentious issues by agreeing to place that issue before the Tax Court at any stage in the dispute resolution process, including during the audit. Given the magnitude of the amounts at stake and the complexities of the tax returns of large taxpayers, section 173 is an efficacious means for the Minister and large corporate taxpayers to obtain a Tax Court judgment to settle disputes which may have ramifications in succeeding tax years.

Since section 173 requires the Minister and the taxpayer to agree to an early referral to the Tax Court, what factors does the Minister consider in evaluating whether to proceed by way of a section 173 (or section 174) referral to the Tax Court?

Will CRA disclose how many applications it has received from taxpayers in respect of proceedings via section 173 or section 174? Of the applications received, can CRA disclose how many have been allowed?

16. Corporate Online Services

Corporate taxpayers welcome and appreciate CRA's online services such as the *Represent a Client* or *My Business Account* web platforms. We invite a discussion of the prospects for expanding those services to include:

a) Linking associated companies so that payments may be transferred between companies at the taxpayer's initiative;

b) Amending corporate income tax returns through an online function similar to that available for individuals; and

c) Printing customized remittance forms (through either the *Represent a Client* or *My Business Account* web platforms) to attach to the wire-transfer instructions to the financial institution making the payment.

17. Administration of Trusts

a) CRA's current practice is to assign a trust identification number when the initial *Trust Income Tax and Information Return* (T3) is assessed. Would CRA consider permitting a trust, especially a mutual fund trust, to apply for a trust number upon the trust's formation? Assigning a trust number prior to the initial assessment would aid both CRA and taxpayers in identifying the trust when necessary prior to the date of the initial assessment.

b) Interest has been expressed in seeing the online services available to corporations expanded to include trusts. What are the prospects for permitting online access, *e.g.,* through the *Represent a Client* or *My Business Account* web portals, for trust administration, including mutual fund trusts?

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 4, 2012, liaison meeting.

Respectfully submitted,

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By: 

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