TEI/DOF Liaison Meeting
Responses to Finance Questions
December 8, 2010

1. Update on Pending Projects and Carryover Issues

a. *Advisory Panel on Canada's System of International Taxation*

Several Advisory Panel recommendations have been implemented to date (repeal of proposed section 18.2, Taxable Canadian property, FIEs and NRT, certain foreign affiliate changes, *etc*). Since many of the recommendations have a fiscal effect, the Department continues to respond on an *ad hoc* basis in these times of deficit reduction. The long term goal is to address the remaining recommendations, but there is no immediate plan to implement any of the outstanding significant recommendations.

b. *TEI Comments on Salary Deferral Arrangements*

The Department of Finance summarized the submission saying there are two distinct proposals put forward in the letter: (A) the SDA rules should be limited to tax-exempt employers and (B) provisions to "turn-off" the deferral test should be added to the Act. With respect to (B), the TEI letter actually requested that conditions be prescribed to deem the SDA NOT to violate the tax deferral purpose test, which would, in effect, allow SDAs to have a longer deferral period. TEI suggested a 10-year period.

The Department indicated that limiting the provision to tax-exempt employers would potentially be very costly to the government, so this would have to be reviewed very closely. On the second point, this area is highly complex with many overlapping provisions. The Department would have to review the SDA rules in conjunction with other rules governing deferred retirement and supplementary plans, such as the RCA rules. The Department would review whether these rules and the exceptions are still appropriate under current executive compensation practices.

In conclusion, the Department agrees that the rules should be reviewed but the timing and scope of any potential amendments is unclear.

c. *Foreign Accrual Property Income (FAPI) on Intercompany Services — Paragraph 95(2)(b)*

Finance stated that its position has not changed since 2008. Finance's view is that the concern about taxing intercompany services under the FAPI rules should diminish as Canadian corporate tax rates decline (*i.e.*, because the "hit" from FAPI would be less). The Department is considering various submissions on the issue, but can only acknowledge the comfort letter issued March 23, 2010. That comfort letter provided that Finance would recommend to the Minister that clause 95(2)(b)(ii)(B) be amended so that a described entity includes only a person who is an individual resident in Canada, a corporation resident in Canada, or a non-resident person that performs the services in the course of a business carried on in Canada where that individual, corporation, or non-resident person does not deal at arm's length with the affiliate or any taxpayer of whom the affiliate is a foreign affiliate.

2. Large Corporation Notices of Objection

a. *Objections Invalidated by Reassessments*

The Department acknowledged that it does not have the same practical experience in working with the provision as TEI.

Finance stated that the taxpayer has a right to object to a notice of reassessment. After a subsequent reassessment, CRA needs a signal whether the taxpayer wishes to proceed through CRA's administrative Appeals process or go directly to the Tax Court. Finance said that it did not understand why it would be difficult for a large corporation to re-file an updated Notice of Objection containing the existing issues and identify any new issues raised by the subsequent reassessment. Finance asked how a taxpayer would deal with an objection if, for example, CRA accepted it in part? TEI stated that CRA could simply send a letter to the taxpayer indicating whether the issue was accepted in totality, in part, or rejected. Until that time, the taxpayer would not have to re-file. Finance indicated that adopting the Ontario approach would definitely be a change for CRA because a taxpayer would be objecting to the amount of tax being assessed rather than issues. The Department agreed to discuss TEI's request with CRA and to gather additional information.

b. *Requirement to State the "Maximum Relief" in Notices of Objection*

The Department said that it had considered TEI's recommendation in 2008 and would be unable to accommodate the request to eliminate the requirement to state the maximum potential relief. The government has to be aware of the maximum exposure.

3. Functional Currency Reporting Rules

Finance said that these rules are intended to apply in very narrow situations. Affording taxpayers broader exemptions would create opportunities for potential abuse in the foreign exchange area. (The Department cited the facts in *Shell Canada Ltd. v. The Queen (99 DTC 5669)* as an example where taxpayers can predict — and take advantage of — trends in foreign exchange rate fluctuations). More specifically, the Department said it regularly receives comments that subsections 261(20) and (21) are too broad. The Functional Currency reporting provisions are designed to help corporate groups avoid financial statement distortions and these specific subsections close tax planning opportunities around those rules. However, the Department is considering some narrow recommendations, including the specific example cited in the TEI agenda involving an inter-corporate financing arrangement established for bona fide purposes (i.e., the Department is considering providing relief by permitting a realized loss to be recognized where there is an offsetting gain in back-to-back loans within a corporate group). It is expected that the approach will be consistent with proposed changes to subsection 93(2).

4. Foreign Paid-Up Capital

The Department indicated that FPUC is a concept that has developed through comfort letters. Since significant changes to subsection 88(3) are being contemplated and a package of amendments would soon be released, Finance did not believe that it would be appropriate to answer the question at this time.

5. Part VI.1 Tax

The Department is not receptive to addressing the matter at this time. From a policy perspective, the gross up is a proxy (not an exact offset) for the Part VI.1 tax amount. In addition, because of the impact of the provision on Federal/provincial tax-sharing agreements, TEI's proposed solution on Part VI tax will not work. The expectation is that as provinces (hopefully) bring their income tax rates down to the suggested 10 percent rate, the current "gap" will diminish. The Department acknowledges that until then the current limit will be slightly to the government's advantage.

6. Regulation 102

Both CRA and the Department of Finance are sympathetic to the issues raised in the agenda. Finance is also interested in meeting with TEI and CRA to investigate the various issues and alternatives to find a potential resolution.

7. Interest Rates applicable to Arrears/Refunds/Excess Cash

The Auditor General's Report found that taxpayers were making cash deposits to CRA and accumulating credit balances that could result in significant tax refunds at a substantial interest cost to the government. Although most taxpayers post cash deposits with CRA in order to pay tax deficiencies (and avoid non-deductible deficiency interest), some were purposely depositing cash with CRA in order to obtain a higher interest rate on tax refunds than would be available by direct purchase of government securities.

The AG's Report required a response, so the interest rate on refunds was reduced. According to the Department, the simplest solution to administer is to retain the same interest rate across the board on refunds and deficiencies. There is no appetite on Finance's part to implement TEI's intermediate interest rate proposal. Given the political fallout from the AG's report, convincing Parliament to make a change is out of the question.

8. Risk-of-Litigation Settlements

The Department is unwilling to grant CRA authority to settle on a risk-of-litigation basis and was surprised at comments that CRA may have resolved cases on such a basis in the past. The Department favours a principles-based approach and is uncomfortable from a "checks and balances" view to grant additional authority to the CRA. The Department's response did not change when TEI suggested that the Department of Justice could be involved in the settlement discussions as well in order to ensure that there is no abuse of authority.

9. Taxpayer Requests for Determinations of ACB and other Amounts

The Department commented that it did not see a need to add rules to encourage taxpayers to accumulate information that is already required to be kept. It is not the purpose of the loss confirmation provision of subsection 152(1.1) to create certainty for potential transactions. The tax system is already stressed and creating a process for making requests for ACB or safe income determinations would add to that stress. The Department sees no real benefit to either taxpayers or the tax system generally in facilitating transactions that (a) may not

happen for many years and (b) could be challenged then. Finally, there are a host of tax attributes, such as UCC, *etc.,* for which taxpayers might request a determination. It was unclear which attributes should be eligible for a determination and which should not. As such, Finance is not receptive to this request.

10. Specified Energy Property Rules

The Department indicated that a comfort letter was issued (October 2010) where Finance agreed to recommend that a tiered partnership not be subject to the CCA restriction in cases where all partners are either principal business corporations or principal business partnerships.

11. Proposed Subsection 220(2.1)

The Department is aware of the concern about the reclassification of expenditures on audit. The proposed amendment to subsection 220(2.1) was made after consultation with CRA.

Finance believes that the SR&ED program is designed to incentivize taxpayers to undertake particular kinds of work. Where taxpayers are unaware of the potential SR&ED benefit or fail to file for the SR&ED tax credit for all identified costs within the prescribed 18 month timeframe, the incentive effect is muted and the benefit is more like a windfall. Similarly, under the existing provisions, taxpayers were in effect allowed an extended time beyond the 18-month period to file SR&ED claims via taxpayer-requested adjustments for work undertaken that they did not know qualified for SR&ED tax credits at the time of the work. Finance does not believe it is appropriate to provide SR&ED tax credits in such circumstances because it would represent a benefit for activities undertaken that were not specifically incented by the SR&ED Program.

In response to a follow-up question, Finance said that is not prepared to amend the effective date of November 17, 2005.