TAX EXECUTIVES INSTITUTE, INC.

on

PENDING CANADIAN INCOME TAX ISSUES

Submitted to

THE DEPARTMENT OF FINANCE

November 19, 2014

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 Department of Finance during the November 19, 2014, liaison meeting. If you have any questions about the agenda in advance of the meeting, please do not hesitate to call Paul T. Magrath, TEI's Vice President for Canadian Affairs, at 905-804-4930 or, Grant L. Lee, Chair of the Institute's Canadian Income Tax Committee, at 604-641-2502.

Background

Tax Executives Institute is the preeminent professional organization of in-house business executives who are responsible — in an executive, administrative, or managerial capacity — for the tax affairs of the corporations and other businesses by which they are employed. TEI's nearly 7,000 members represent more than 3,000 of the leading corporations in Canada, the United States, Europe, and Asia.

Canadians make up approximately 15 percent of TEI's membership, with our Canadian members belonging to chapters in Montreal, Toronto, Calgary, and Vancouver, which together make up one of our nine geographic regions. In addition, a substantial number of our U.S., European, and Asian members work for companies with significant Canadian operations. In sum, TEI's membership includes representatives from most major industries, including manufacturing, distributing, wholesaling, and retailing; real estate; transportation; financial; telecommunications; and natural resources (including timber and integrated oil companies). The comments set forth in this submission reflect the views of the Institute as a whole, but more particularly those of our Canadian constituency.

A. Legislative Update and Tax Policy Discussion

1. *Legislative Agenda*

TEI invites an update on the Department's legislative priorities over the coming months.

2. *Tax Policy*

a. TEI invites a discussion of the Department's current views on the direction of Canadian tax policy as well as the Canadian perspective on the effect of the OECD's BEPS initiative on those policies.

b. There has been substantial discussion about how best to encourage innovation in Canada and whether the Scientific Research & Experimental Deduction incentive is sufficient or as effective as it can be. Moreover, questions have arisen whether the administration of the program by Canada Revenue Agency enhances the incentive's efficacy. TEI invites the Department's view in respect of the tax policy direction in this area.

B. Carryover Issues

1. *Bilateral Safe Harbours*

In last year's meeting with the Department of Finance, TEI expressed interest in implementing bilateral safe harbours for transfer pricing of common, routine, or low-risk transactions as recommended by the OECD in its May 2013 revisions to *Chapter IV of the OECD Transfer Pricing Guidelines* (the "Guidelines"). Specifically, TEI recommended the Department begin by adopting rules for two of the most common transfer pricing transactions, limited risk distribution and routine management services.

The Department agreed with the content of the Guidelines but expressed a desire to proceed cautiously and on a coordinated basis with CRA. The Department also noted that a preliminary analysis of safe harbours was in process. TEI understands and concurs with a cautious and coordinated approach. We invite an update on the progress of its analysis.

The Department also posed two questions to TEI, as follows:

1. What is meant by low-risk distribution?

TEI is not aware of any tax authority that has defined the term "low risk distribution." Consequently, we believe the first responsibility of the safe harbour negotiators would be to define the term (the "First Phase"). We understand that a distribution transaction is one for which there is a high degree of comparability available for reference purposes. We note that the transfer-pricing negotiations become bogged down because of the perception that some aspect of a covered distribution transaction does not align exactly with a comparable (the "Difference"). We believe that unless a Difference is unique (*i.e.*, having no comparable such as a one-of-a-kind intangible property), all Differences for low-risk distribution should be able to be accommodated in the First Phase of negotiation.

2. What areas should be prioritized? For example, low-risk distribution or management services?

TEI believes there would be fewer "Differences" in respect of routine management services and thus recommends giving priority to developing a safe harbour for such services.[1]

2. *Regulation 102*

During the Department of Finance update at TEI's 48th Annual Canadian Tax Conference in May 2014, Department representatives said they are aware of taxpayers' concerns about Regulation 102, especially the regulation's application to non-resident employees who spend short periods of time in Canada (in the course of their employment by a non-resident employer) but who are ultimately not taxable in Canada.

The Department stated that it was reviewing the matter.

The 2008 report on *Enhancing Canada's International Tax Advantage*[2] recommended as follows:

> Eliminate the withholding tax requirements related to services performed and employment functions carried on in Canada where the non-resident certifies the income is exempt from Canadian tax because of a tax treaty.[3]

TEI member companies continue to be burdened by the onerous administrative requirements imposed by Regulation 102 as well as its stringent administration by CRA. The 2014 agenda for CRA includes questions relating to the administration of Regulation 102, but CRA has advised previously that its hands are tied by the current legislative framework.

Concededly, reform of these rules may not be simple, but the rules should be *simplified*. Would the Department of Finance consider making revisions to these rules a legislative priority? What specific steps is the Department contemplating in this area? Is there interest in establishing a tripartite (Finance-CRA-TEI) committee to discuss and develop potential solutions?

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

In prior liaison meetings, TEI noted that paragraph 95(2)(b) of the *Income Tax Act, Canada* (hereinafter, the Act) creates a competitive disadvantage for Canadian-based multinationals with foreign subsidiaries performing services outside Canada for related Canadian companies. In order to be competitive, Canadian multinational companies must be able to respond to the globalization of customer markets and perform services outside of Canada. Where a foreign subsidiary provides services to its Canadian parent (or related Canadian companies), then to the extent that the amounts paid or payable are deductible (or can reasonably be considered to relate to amounts that are deductible) in computing income from a business carried on in Canada, the subsidiary's service fee income may be characterized as FAPI even though the

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[1] As an example, the United States has established a service cost method that requires either no or a very low markup on certain defined services.

[2] *Final Report*, Advisory Panel on Canada's System on International Taxation (December 2008).

[3] *Id.* Recommendation 7.3.

subsidiary has an active business providing services principally to arm's length parties. Foreign-owned competitors, of course, can deliver services similar to those provided by foreign subsidiaries of Canadian companies without regard to the FAPI rules.

In its 2008 response to a similar question and subsequently in 2010, the Department said that, while the overall objective of this policy is to protect the Canadian tax base, a re-examination of the base-erosion rules would be appropriate and that the Department is considering various submissions on the issue. The 2008 Advisory Panel on Canada's System of International Taxation also encouraged the Government to review the scope of the base erosion and investment business rules to ensure they are properly targeted and neither impede *bona fide* business transactions nor undermine the competitiveness of Canadian business.[4]

Would the Department provide an update of its review of the area?

C. New Questions

1. *Interaction of Available-For-Use Rule and Half-Year Rule*

Subsection 13(26) of the Act prevents a taxpayer from claiming capital cost allowance (CCA) in respect of a property before the property is considered to be available for use by the taxpayer, as defined in subsections 13(27) and 13(28). Paragraphs 13(27)(b) and 13(28)(c) contain a "two-year rolling start" rule, which provides that property that has not otherwise become available for use is deemed available for use in the first taxation year that begins more than 357 days after the end of the taxation year in which the property was acquired (generally, the second taxation year following the taxation year in which the cost was incurred). In addition, the "half-year rule" in Regulation 1100(2) generally restricts the permitted CCA claim in respect of a property that became available for use in a year to one-half of the amount that could otherwise be claimed. If property is deemed to have become available for use by the taxpayer in the year by reason of paragraph 13(27)(b) or 13(28)(c), the half-year rule does not apply and the full CCA claim is available.

In many instances, a corporation will make a significant capital investment in a particular taxation year (year 1) in respect of a property that is not available for use until the subsequent taxation year (year 2). The corporation is not able to claim CCA in respect of the property in year 1 because of the available-for-use rule. Once the property becomes available for use in year 2, only half of the CCA claim is available. The combined effect of these rules is that the corporation is not able to claim full CCA in respect of a property acquired in year 1 until year 3.

Would the Department consider introducing an amendment to the half-year rule to provide that where a taxpayer's CCA claim in respect of a property has been restricted by the application of the available-for-use rule in a prior taxation year, the half-year rule will not apply once the property is considered to have become available for use by the taxpayer (by reason of any paragraph in subsections 13(27) or 13(28))?

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[4] *Id.* Recommendation 4.6.

2. *Corporation Collection Rule*

The Act currently provides two different collection (or prepayment) rules for taxpayers that wish to dispute an assessment. Determining which rule applies depends upon the characteristics of the taxpayer, with one rule applying to “large corporations” and a separate rule applying to all others. Where a taxpayer that is not a large corporation objects to an assessment, CRA is precluded from collecting until the dispute resolution process is concluded. In addition to delaying CRA’s collection activities, the taxpayer maintains control over resources necessary to invest in business operations and to contest an erroneous assessment.

On the other hand, pursuant to subsection 225.1(7), a large corporation (as defined in subsection 225.1(8)) is required, as a condition of its appeal, to remit 50 percent of all taxes in dispute. This requirement was introduced in 1993 to address the perception that large corporations were filing unfounded objections and appeals in order to delay the payment of taxes. In 1995, amendments to subsection 165(1.11) required large taxpayers to provide extensive details about all issues and amounts under appeal. The 1995 amendment makes it possible to ascertain the amount in dispute and provides assurance that an appeal is based on reasonable grounds.

Assuming the advance collection of 50 percent of disputed assessments from large corporations was justified in 1993, the rationale for the change was seemingly supplanted by the 1995 changes. TEI believes the 50-percent prepayment rule for large corporations should be repealed because:

- Large corporations frequently receive substantial assessments from CRA where the auditor fails to fully understand the issue or fails, perhaps because of an impending statute-barred date, to perform adequate audit work prior to issuing the assessment. These companies are then required to pay 50 percent of the assessed tax until the issue is resolved. Moreover, CRA Appeals Division can take years to consider a case and vacate an erroneous assessment, imposing significant administrative and financing costs on the taxpayer during the appeal.

- The current legislation is detrimental to taxpayers’ businesses. Hundreds of millions of dollars are held for years by the government until the issues are finally resolved. The taxpayer’s funds could instead be invested in capital projects or operations to ensure economic growth in Canada.

- The substantial interest-rate differential between underpayments and overpayments of tax, combined with the non-deductibility of interest on taxpayer assessments, is both (1) a significant disincentive that deters frivolous appeals and (2) a significant incentive to pay 100 percent of the taxes due when issues are no longer disputed.

It is instructive that the amendment in subsection 225.1(7) in the 2013 Federal Budget required taxpayers appealing disputed taxes arising from charitable donation tax shelters to prepay 50 percent of the disputed tax. The rationale for the 50-percent prepayment rule is understandable because it is clearly designed to deter taxpayers from participating in questionable charitable donation tax shelters. On the other hand, large corporations are subject to the 50-percent prepayment rule for disputing an assessment simply because of the size of the company and not because of questionable conduct.

We invite Department of Finance's comments about whether the large corporation 50-percent prepayment provision is, following the 1995 amendments, redundant or superfluous and whether it would consider legislative changes.

3. *Specified Foreign Property Penalties, Relief, and Filing Deadline*

Section 233.3 of the Act requires Canadian resident taxpayers to report worldwide income on Form T1135 (*Foreign Income Verification Statement*). Subsection 233.3(1)(j) of the Act provides a narrow reporting exception for "specified foreign property" that is used or held exclusively in the course of carrying on an active business. Subsection 233.3(3) requires taxpayers to file Form T1135 by the entity's filing-due date for the year, which puts substantial time pressure on taxpayers to comply because the asset-by-asset information required by the form is highly detailed and not easily obtained from foreign locations. Although TEI supports the purpose of the reporting provision, member companies incur substantial costs to comply with the rules and face the risk of hefty penalties for inadvertent nondisclosure of properties. To provide measured relief —

- Would the Department of Finance modify exception (j) to the "specified foreign property" definition under subsection 233.3(1) of the ITA to be for property used or held "*'principally'* in the course of carrying on an active business" instead of "*'exclusively'*" in the course of carrying on an active business as currently defined?

- Would the Department of Finance consider extending the deadline for corporate taxpayers filing Form T1135 to 15 months after the end of the year or taxable period? Such a change would harmonize the filing deadline with the date for filing Form T1134 (*Information Return Relating to Controlled and Not-Controlled Foreign Affiliates*).

4. *Deemed Dividend on Thin Capitalization*

Subsection 214(16) generally deems interest paid by a corporation that was disallowed as a deduction under the thin capitalization rules to be a dividend paid by the corporation subject to dividend withholding tax (DWT) under Part XIII of the Act. Pursuant to subsection 212(2), every non-resident person incurs a DWT at the rate of 25 percent on dividends or deemed dividends received from a corporation resident in Canada. A lower DWT rate may apply under the terms of a tax treaty.

Canadian corporations that are part of a multinational group of corporations finance their operations in part with equity and in part with debt. The group often includes a single-purpose financing or banking corporation ("Finco") that acts, for *bona fide* business reasons, as a lender for other entities in the group. Such arrangements provide protection from creditors and permit the group to minimize borrowing costs (both interest rates and fees) on loans from financial institutions. Since a Finco usually does not own shares in the entities it finances, an interest payment by a Canadian corporation, that is deemed by subsection 214(16) to be a dividend received by a non-resident Finco, would be subject to DWT of either 25 percent (if it is not resident in a tax treaty) or 15 percent (if it is resident in a treaty country, but does not own sufficient shares in the Canadian corporation). Such a DWT is often higher than the rate that would apply to dividends paid by a Canadian corporation to its shareholders. Consequently, a loan from Finco may suffer a higher tax burden compared to debt financing structured directly from a parent corporation. The tax policy reason to support such a result is unclear at best.

TEI recommends amending subsection 214(16) to deem interest that is disallowed under thin capitalization rules to be treated as a dividend paid by the Canadian resident corporation to the entity (or entities) that are, through the Canadian ownership chain, direct or indirect non-resident shareholders. TEI's recommended treatment would be consistent with the foreign affiliate dumping rules and subsection 212.3(2), which deems a corporation resident in Canada (CRIC) to have paid to its parent corporation a dividend equal to the fair market value of certain properties transferred, obligations assumed, or benefits conferred.

5. *Part VI.1 Tax and 110(1)(k)*

Paragraph 110(1)(k) of the Act affords taxpayers a deduction from regular taxable income in order to offset the Part VI.1 tax liability. The policy rationale for the offset is to ensure tax neutrality for profitable taxable Canadian corporations. In prior liaison meetings, TEI noted that amendments to the deduction factor proposed in 2010 to take account of the reduction in corporate tax rates did not (and still do not) provide a full offset. For example, an Ontario company's tax rate is approximately 26.5 percent, but the factor of 3.5 times assumes a corporate tax rate of 28.5 percent. To fully offset the Part VI.1 tax, the deduction factor should be approximately 3.8 times the Part VI.1 tax. Consequently, for each $1,000 dividend paid, a taxpayer based in Ontario is out of pocket $29 for what is intended to be a tax-neutral regime.

At the 2010 liaison meeting, the Department indicated that the provinces were expected to continue reducing their income tax rates and thus it was unreceptive to increasing the Part VI.1 deduction factor. During the 2012 liaison meeting, TEI urged the Department to consider adjusting the deduction factor to 3.8 since the provinces still had not scheduled additional tax rate reductions. The Department said that it did not intend to revisit the rate of Part VI.I tax or the deduction factor under 110(1)(k), noting that it tried to strike a proper balance but realized from the outset that integration is difficult to achieve given the variations in corporations and provincial tax rates.

Since the corporate income tax rates, including the provincial rates, have stabilized and the current deduction factor is not neutral, TEI urges the Department to again consider amending the deduction factor to 3.8. We invite the Department's response.

6. *The At-Risk Rules and Tiered Partnerships*

The "at-risk" rules (set out in subsections 96(2.1) and 96(2.2)) limit losses from a limited partnership available to a limited partner (referred to hereafter as "the taxpayer"). Under paragraph 96(2.1)(e), if a portion of a taxpayer's share of the amount of any loss in a limited partnership exceeds its "at-risk-amount" (as defined in subsection 96(2.2)) in respect of the limited partnership, the amount of loss in excess of the taxpayer's at-risk amount cannot be deducted in computing the taxpayer's income for the year and is deemed to be the taxpayer's "limited partnership loss" in respect of the limited partnership for the year.

Under paragraph 111(1)(e) limited partnership losses that cannot be deducted against other sources of income because of the at-risk rules can generally be carried forward indefinitely and claimed against future limited partnership income. But when the limited partner of a limited partnership is itself a partnership (whether a limited or a general partnership), the limited partnership losses generated by a lower-tier partnership cannot be allocated by the upper-tier partnership to its member partners. The limited partnership losses that are unavailable to members of the upper-tiered partnership are thus lost.

The reason for this result is found in the interaction of subsections 102(2), 96(1), 96(2.1) and paragraph 111(1)(e). As explained by the CRA:

> Subsection 102(2) of the Act states that, for purposes of sections 96 to 103 dealing with partnerships and their members, 'a reference to a person or a taxpayer who is a member of a particular partnership shall include a reference to another partnership that is a member of the particular partnership.' Therefore, subsection 96(2.1) of the Act applies to partnerships who are themselves members of a limited partnership. As a result, the losses allocated by a limited partnership to each of its members, including another partnership, will be deductible by each member, to a maximum of each member's (including the member partnership's) at-risk amount. The excess of the loss over the member's at-risk amount is deemed to be a member's limited partnership loss by virtue of paragraph 96(2.1)(e) of the Act. However, this limited partnership loss cannot be used by the member partnership because a partnership is not a taxpayer for purposes of paragraph 111(1)(e) of the Act. Also, subsection 96(1) of the Act does not allow the transfer of a limited partnership loss to its members.[5]

CRA has reiterated the above analysis in other interpretations denying deductions for lower-tier limited partnership losses in tiered partnership arrangements. The problem arises principally because "a partnership" is not considered a "taxpayer" for purposes of paragraph 111(1)(e) (the provision that allows limited partnership losses to be deductible in future years), and a partnership that is a limited partner of a limited partnership is unable to carry forward limited partnership losses. In addition, subsection 96(1), which outlines the general rules for computation of income and loss from a partnership for a member of a partnership, does not specifically include limited partnership losses, resulting in losses that cannot be utilized where there are tiered partnerships.

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[5] *See* Technical Interpretation 2004-0062801E5, Limited partnership losses -- Tiered Partnership (May 14, 2004).

Would the Department consider amendments to the Act to permit limited partnership losses to be available to a partnership and the upper-tier members of a partnership that is itself a limited partner in a limited partnership? Subsection 96(1) could, for example, be amended to specifically include “limited partnership losses” and paragraph 111(1)(e) (or subsection 102(2)) could be amended to ensure that the term “taxpayer” includes a partnership for purposes of the deductibility of limited partnership losses in paragraph 111(1)(e).

7. *Average Cost*

Subsection 47(3) excludes certain securities from the cost averaging rules in subsection 47(1). Consequently, the adjusted cost base of the securities is determined without reference to other securities that might otherwise be considered identical properties. The excluded securities are those acquired in circumstances where subsections 7(1.1), (1.5), 7(8), 147(10.1), or 7(1.31) apply.

Subsection 47(3) applies to employer shares received by an employee upon distribution of shares from a deferred profit sharing plan (DPSP) where a deferral election is made under subsection 147(10.1). Accordingly, the adjusted cost base of the shares received from the DPSP will not be affected by the cost of identical shares already owned by the employee.

On the other hand, shares acquired by employees from an employee profit sharing plan (EPSP) (as defined in subsection 144(1)) are *not* currently excluded from the application of subsection 47(1). In addition, when employees receive a payout in kind (same class of shares) from a Restricted Share Unit (RSU) Plan (which are generally excluded from the salary deferral arrangement definition in subsection 248(1)(k)), the value of the shares are taxed as employment income. But if shares are received — whether from an EPSP or RSU plan — and immediately disposed of, employees may realize a larger capital gain because the application of the cost averaging rules of subsection 47(1) may reduce the basis of the shares sold.[6] If the shares were not cost averaged, the cost and proceeds would often be identical thereby eliminating any capital gain.

Would the Department of Finance consider expanding the exclusion in subsection 47(3) so that shares acquired from either an EPSP or an RSU are not subject to the requirement to average the cost of shares received from such plans with identical share holdings?

8. *Part XIII Tax – Assessments*

Under subsection 227(10), the Minister can assess a taxpayer at any time with respect to an amount payable under Part XIII but is not obliged to assess the taxpayer or provide written notice that no Part XIII tax is payable. Some commentators have suggested that when the Minister assesses a taxpayer with respect to an amount payable under Part XIII, the reassessment period for Part I tax should apply to the Part XIII tax, but only for the amount previously assessed by CRA under Part XIII. In practice, the CRA only assesses a taxpayer when an amount payable under Part XIII is determined pursuant to a tax audit. When no amount payable under Part XIII is determined pursuant to a tax audit, CRA does not assess or notify the taxpayer

[6] Typically, employees do not control the form of payment from the RSU plan (whether cash or equity settled). If the settlement is made in cash, no capital gain or loss would be realized.

that no Part XIII tax is payable. As a result, the assessment period remains open indefinitely even though the CRA has audited the taxation years. We believe that the indefinite statute-barred period creates substantial uncertainty and risk of tax, interest, and penalties for taxpayers, especially if the documentation is lost or destroyed subsequent to the closing of the audit.

Would the Department consider changing the Part XIII tax to ensure —

- CRA is obliged to assess taxpayers under Part XIII on an annual basis based on the NR4 forms (*Statement of Amounts Paid or Credited to Non-Residents of Canada*) filed by the taxpayer; and

- the normal assessment and reassessment rules applicable to Part I apply to Part XIII?

9. *Taxable Benefit - Personal Use of an Employer-Provided Vehicle*

The taxable benefit determination for an employee's personal use of an employer-provided vehicle includes the cost of the vehicle. As a result, employers replacing old vehicles with hybrid vehicles (for environmental considerations/efficiencies/savings) are facing resistance from employees because the higher cost of the vehicles can produce a higher taxable benefit amount. Another consideration from the employee's perspective is that under paragraph 6(1)(k) the prescribed amount of operating expense benefit per kilometre of employee personal use of the vehicle is the same regardless of the vehicle. Hence, employees have no incentive to select a fuel-efficient vehicle with a lower *actual cost* per kilometre. Would the Department consider establishing a lower prescribed amount for the personal use of a vehicle when an employee drives a fuel-efficient company automobile? Applying different rates would better match the actual value the employee receives when a fuel-efficient vehicle is selected. The Government should also consider whether such a change would better align fiscal and environmental policies. We invite the Department's response.

10. *Partnerships*

In many industries, including mining, oil and gas, and construction, large taxpayers often pool their capital in a partnership or joint venture to develop a project. Hence, many large taxpayers are partners in a substantial number of partnerships. In some partnerships, the taxpayer might be a general partner and operator; in others, it may be a general partner but not an operator.

Subsection 40(3.1) deems a gain for partners with "negative ACB" whose liability is limited or, in the case of a general partner, if the member is a "specified member" of the partnership. Under paragraph (b) of the definition in section 248(1), a "specified member" of a partnership includes "any member of the partnership other than a member who is . . . carrying on a similar business as that carried on by the partnership in its taxation year, otherwise than as a *member of* a partnership." We believe that a company that is a fully active member of a partnership carrying on a similar business should be exempted from being considered a specified member of other partnerships of which it is a member just as it would be if it carried on the other business directly. Would the Department consider amending the definition of specified member of a partnership as "any member of a partnership, other than a member who is . . . carrying on a similar business as that carried on by the partnership in its taxation year, otherwise than as *a specified member* of a partnership?"

Conclusion

Tax Executives Institute appreciates the opportunity to present its comments in respect of pending income tax issues. We look forward to discussing our views with the Department of Finance during the November 19, 2014, liaison meeting.

Respectfully submitted,

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