Comments

of

TAX EXECUTIVES INSTITUTE, INC.

on

PENDING CANADIAN INCOME TAX ISSUES

Submitted to

THE DEPARTMENT OF FINANCE

DECEMBER 5, 2012

Tax Executives Institute welcomes the opportunity to present the following comments on income tax issues, which will be discussed with representatives of the Department of Finance during TEI's December 5, 2012, liaison meeting. If you have any questions about these comments, please do not hesitate to call either 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.

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 10 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.

1. Update on Pending Projects and Carryover Issues

a. *Functional Currency Reporting Rules*

In response to question 1(c) in the 2011 liaison meeting agenda (and question 3 of the 2010 agenda) relating to the Functional Currency Reporting Rules, the Department said it had received a number of comments and submissions, including TEI's. Since there are many interrelated issues, the Department said further study was required before moving forward. We invite the Department provide an update of its review of the issues and prospects for legislative changes and clarification.

b. *General Legislative Update*

On October 24, the Department released a 945-page Notice of Ways and Means Motion consolidating eleven years' worth of proposed legislative changes. In addition, on October 15 the Department released its 2012 budget legislative package, including the foreign affiliate provisions. Both packages comprehensively address longstanding technical and policy issues in the *Income Tax Act*. TEI commends the Department for its impressive and prodigious output. Although we are still assessing the changes, the legislation should generally increase taxpayer certainty, especially for financial statement reporting purposes. Does the Department anticipate releasing additional legislative packages in the coming months? In other words, in addition to developing the government's 2013 Budget Message, "What's next?" on the Department's priority list?

c. *Tax Consolidation System*

We invite the Department to provide an update on the status of its consultation on the *Taxation of Corporate Groups* and the prospects for implementation of a loss- or attribute-transfer system in Canada. Have any policy decisions been made about the scale and scope of a system, *e.g.*, between a full consolidated tax return system and a system permitting transfers of specific tax attributes within a related group? Has progress been made in negotiations with the provinces? What are the next steps in the process?

2. 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 July 2010 the Department of Finance released draft legislation proposing a change to the deduction factor to address the reduction in corporate tax rates. Regrettably, based on the currently scheduled federal and provincial tax rates, the proposed factor does not provide a full offset. For example, an Ontario company's tax rate is approximately 26.5 percent, but the proposed factor of 3.5 times for 2011 and subsequent taxation years 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.)

At the 2010 liaison meeting, the Department said the provinces were expected to continue to reduce their income tax rates and thus it was unreceptive to increasing the Part VI.1 deduction factors. Since the provinces have *not* scheduled additional tax rate reductions (indeed, Ontario recently increased its tax rates), would the Department reconsider adjusting the Part VI.1 deduction factors to more closely align the offset?

3. Subsection 93(2)

The stop-loss rule in subsection 93(2) limits the loss on dispositions of shares of foreign affiliates even where the realized capital loss is attributable to foreign exchange fluctuation rather than the receipt of exempt dividends. Subsection 93(2), however, is not applicable to losses on debt investments. Since Canadian companies can finance foreign affiliates with either debt or equity and since debt instruments and preferred shares possess similar economic attributes features, there is a disconnect between the denial of part or all of a foreign exchange loss realized on preferred shares under subsection 93(2) and the recognition of a foreign exchange loss realized on a foreign currency denominated debt that finances the foreign affiliate. Would the Department consider drafting an amendment to subsection 93(2) to eliminate its application to preferred shares — at least to the extent of the foreign exchange loss?

4. Canada-U.S. Treaty — Withholding Tax Exemptions for Payments of Certain Royalties

Paragraph (3)(d) of Article XII of the Canada-U.S. Tax Treaty exempts "payments with respect to broadcasting as may be agreed for the purposes of this paragraph in an exchange of notes between the Contracting States." The Technical Notes explain that, at the time of the treaty's negotiation, Canada was not prepared to provide an exemption for broadcasting royalties. The exemption in paragraph 3(d) was included in the expectation that an exemption might be negotiated separately from an entire protocol.

Will Canada enter into negotiations for an exchange of notes with the United States in respect of such royalties in the near future? An exemption would facilitate negotiations of broadcasting rights with U.S. vendors, thereby reducing the costs to Canadian companies and customers since, in many cases, Canadians absorb the withholding tax through gross-up indemnification agreements.

5. Upstream Loans

Subsection 90(6) of the Act provides an exception to the upstream loan income inclusion (the "Inclusion") described in subsection 90(4). Specifically, the Inclusion is reduced to the extent it could have been paid as a dividend from the exempt surplus of the dividend payer and been deductible by the dividend recipient pursuant to subsection 113(1) of the Act. We invite discussion of comments made by Department of Finance representatives about the upstream loan inclusions during the May 17-18, 2012, International Fiscal Association Canadian Conference, as follows:

a. Will the Department amend the definition of exempt surplus for purposes of subsection 90(6) to include "downstream" surplus? If an amendment will be proposed, can the Department confirm that "downstream" surplus includes the exempt surplus of the dividend payer and all its related subsidiary corporations (1) provided the subsidiaries are resident in countries with which Canada has a treaty or a Tax Information Exchange Agreement and (2) regardless of whether such country has a consolidated group concept?

b. Will the Department amend the Act to provide an exception to the inclusion where the amount was paid as a reduction of capital, would be deductible to the capital reduction recipient pursuant to subsection 84(4) of the Act, and assuming the capital reduction is not greater than the paid-up-capital of the company making the payment in reduction of its capital?

6. Eligible Property under Subsections 85(1.1) and 97(2)

We recommend that the Department of Finance provide an expanded and consistent definition of eligible property for purposes of Sections 85 and 97, as described more fully below:

A. *Section 85*

Under section 85, a taxpayer or partnership may defer the realization of income and capital gain in respect of a transfer of eligible property (defined below) to a taxable Canadian corporation[1] (the "transferee") where the transferor receives consideration that includes shares of the capital stock of the transferee. Subsection 85(1.1) defines eligible property to include:

1. capital property[2] (with certain exceptions for property held by non-residents);
2. eligible capital property;[3]
3. inventory[4] (other than real property, an investment in real property, or an option in respect of real property);
4. Canadian or foreign resource property;[5] and
5. specified debt obligations[6] (other than mark-to-market property[7]) (hereinafter referred to as "SDO other than MTM") held by a financial institution[8] (FI).

Under paragraph 85(1.1)(f), real estate inventory is excluded as eligible property for the purposes of a section 85 election. In contrast, real estate inventory is eligible for a subsection 97(2) election. In *Loyens v. The Queen,*[9] the taxpayers implemented a series of transactions involving the transfer of real property inventory to a partnership under subsection 97(2) followed

[1] As defined in subsections 248(1) and 89(1).
[2] As defined in subsection 248(1) and section 54.
[3] *Id.*
[4] As defined in subsection 248(1).
[5] As defined in subsections 248(1) and 66(15).
[6] As defined in subsection 142.2(1).
[7] *Id.*
[8] *Id.*
[9] 2003 TCC 214, (2003) D.T.C. 354, (2003) 3 CTC 2381.

in turn on the same day by a transfer of the partnership interests to a corporation under section 85. The Tax Court of Canada held that the general anti-avoidance rule in subsection 245(2) did not apply to the series of transactions.[10]

We recommend that the Department of Finance expand the definition of eligible property in section 85 to include all types of inventory, including real estate inventory.

B. *Section 97*

Under subsection 97(1), a transfer of property to a Canadian partnership is generally deemed to occur at fair market value (FMV), but subsection 97(2) affords taxpayers an election to transfer certain property at an amount other than at FMV. The election applies to the following:

1. capital property;
2. eligible capital property;
3. inventory; and
4. Canadian and foreign resource property.

As noted, "SDO other than MTM" held by a FI is eligible for a section 85 rollover. "SDO other than MTM" held by a FI, however, is not eligible for a subsection 97(2) rollover because it is neither (1) capital property (as defined in section 54) since subparagraph 39(1)(a)(ii.2) specifically precludes realization of a capital gain on disposition of an SDO, nor (2) inventory because paragraph 142.6(3)(a) specifically states the inventory of a FI does not include property that is "SDO other than MTM" for the year.

We recommend that the Department of Finance amend the preamble to subsection 97(2) to include "SDO other than MTM" as property eligible for a subsection 97(2) rollover.

7. Automobile Benefit

In a June 28, 2011, technical interpretation (2011-0399691I7—*Automobile standby charges—leased vehicles*), CRA said that where a company (a) self-insures leased vehicles and (b) pays the cost of collision damage repair to the lessor as part of a terminal charge, the employee who used the company-leased vehicle receives a taxable benefit for the cost of the repair. For example, assume an employee of a company that self-insures for collision damage takes delivery of a leased vehicle from a car dealer. The vehicle has a $30,000 value and, as the employee is driving from the lot, is hit by another driver. The vehicle is totalled, resulting in a complete write-off. Under the technical interpretation, the employee faces a $30,000 taxable benefit for the company's self-insured collision loss. Moreover, the employee will be taxed again for the benefit of a replacement vehicle provided by the employer.

TEI questions whether the result in CRA's interpretation is consistent with the policy underlying the employee taxable benefit rules. With a large fleet and driver safety training

[10] The case was decided prior to the Supreme Court of Canada's decision in *Canada Trustco Mortgage Company v. Canada,* 2005 SCC 54, [2005] 5 C.T.C. 215 (SCC).

programs, a company can minimize vehicle collisions and generally reduce the cost of its fleets significantly enough to warrant a self-insurance approach. It is unclear why employees should be burdened with a tax cost because their employers make a rational decision — based on competitive business reasons — that it believes will reduce the overall cost of providing automobiles to its employees. Would the Department consider an amendment to the Act to eliminate the cost of collision repairs and the collision-related component of terminal charge payments from the employee stand-by charge where the employer self-insures for collision damage? Alternatively, if the Department believes the tax treatment of collision self-insurance should be treated differently from third-party collision insurance, will it consider making the payments to the lessor non-deductible to the employer rather than requiring that the amount be included as a taxable benefit to the employees?

8. 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 the 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 observation 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 budget constraints 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 the Department's views on the potential for the negotiation and use of bilateral safe harbours in Canada's tax treaties.

9. Subsection 34.2(17)

The recently enacted partnership tax rules require, in many cases, an acceleration of the recognition of a partner's income. To mitigate the potential for including taxable income from multiple partnership taxation years in a taxpayer's income in a single year, the legislation provides for Qualified Transitional Income (QTI) to be included over a five-year period. The determination of QTI requires the computation of an Adjusted Stub Period Accrual (ASPA) and Eligible Alignment Income (EAI).

Where a multi-tier partnership is involved, the ASPA calculation is set out in a formula contained in paragraph (b) of the definition in subsection 34.2(1). The formula in subparagraph (b)(ii) applies where the eligible fiscal period of the partnership is the first fiscal period of the partnership that ends in the corporation's taxation year. The amount in Component 'A' of the formula includes the partner's share of income for the eligible fiscal period. Component 'C' of the formula reduces the ASPA by the EAI since the EAI is generally included in component 'A' of this formula. The ASPA is then used to calculate a partner's QTI, which includes the EAI so that the QTI includes both the ASPA and the EAI.

The calculation of the ASPA is based on the income for the "eligible fiscal period." Pursuant to subsection 34.2(16), subsection 34.2(17) applies for a particular year of multi-tier partnerships where that year is the first taxation year after the taxation year in which the partner had an ASPA included in the partner's QTI in respect of the partnership by reason of paragraph (b) of the definition of QTI. Paragraph 34.2(17)(b) adjusts the QTI of a taxpayer by revising the ASPA to include the partner's share of income for the particular period in component 'A' of the formula. At the same time, though, the revised amount of ASPA may be reduced by component 'C' of the formula, which is EAI for the eligible fiscal period.

The definition of ASPA in subsection 34.2(1) includes income from the "eligible fiscal period" so this will generally include the EAI. Pursuant to component 'C' of the formula for the calculation of ASPA in subparagraph 34.2(1)(b)(ii), the EAI amount is deducted to ensure the amount of EAI is not included in the QTI twice.

A literal reading of the description of component 'C', however, seemingly produces odd results. To illustrate the issues, we attach the example in Appendix 1. On TEI's assumed facts, it is unclear whether "eligible alignment income for the eligible fiscal period" in the subsequent years should be zero or the EAI calculated in the first year of the alignment. In TEI's ASPA calculation (for purposes of adjusting the QTI) in subparagraph 34.2(17)(b)(ii), the income defined in component 'A' does not include the EAI since that formula includes only income for the "particular period," which is the income from the partnership for the year following the year of the initial calculation of the QTI. The correct result for the revised ASPA should, in our view, be zero for component 'C' of the formula. If the amount is not zero, income for that "particular period" might be reduced by the original EAI.

Summarizing the pertinent facts from the example in Appendix 1, a corporation with a December 31 year-end owns a partnership (P1) with a January 31 year-end. P1's only asset is an interest in another partnership (P2), which has a June 30 year-end. QTI in 2012 is calculated to be $16,151 based on the total of the ASPA of $9,151 and the EAI of $7,000. The ASPA at December 31, 2012, is calculated in accordance with subparagraph (b)(ii) of that definition in subsection 34.2(1), as follows:

Corporation's share of income for the year: Jan 31/12 P1 Income (A)	$17,000
Less: Eligible Alignment Income for the eligible fiscal period (C)	($7,000)
Subtotal	$10,000
Multiplied by the number of days in the year and the particular period (D) divided by the number of days in the Eligible Fiscal Period ending in the Year (E)	334/365
Adjusted Stub Period Accrual	$9,151

The EAI ($7,000) is then added to the $9,151 ASPA to arrive at QTI of $16,151

The revised ASPA calculated in paragraph 34.2(17)(b), which is then included in the revised QTI, should be computed as follows:

Corporation's income for the particular period	
Jan 31, 2013 P1 Income (A)	$10,000
Less: Eligible Alignment Income for the eligible fiscal period (C)	($0)
Subtotal	$10,000
Multiplied by the number of days in the year and the particular period (D) divided by the number of days in the particular period (E)	334/365
Adjusted Stub Period Accrual per subsection 34.2(17)	$9,151

The EAI of $7,000 is then added to the $9,151 ASPA to arrive at QTI of $16,151. The QTI is then multiplied by 85 percent to arrive at a reserve of $13,728 for the year.

We invite a discussion of the issues highlighted by the example, as follows:

a. To clarify the operation of subsection 34.2(17), would the Department confirm that, for purposes of calculating the revised ASPA amount, component 'C' for January 31, 2013 in the example should be zero?

b. Restating question (a) more broadly, how should subsection 34.2(17) be interpreted to ensure that EAI does not unintentionally reduce the partnership income from the "particular period" identified in subsection 34.2(16)?

c. Read literally, the ratio of D/E in subsection 34.2(17) could result in the same number of days in both the numerator and denominator, but that result seems incorrect. The amount should seemingly be pro-rated based on the partnership's number of days in the period. In the example, we assumed that the amount should include the pro-rata calculation for the partnership's number of days in the period. Does the Department agree with TEI's interpretation and, if so, will it consider an amendment to revise the definition?

10. Subsection 15(2.1) and Partnerships

On October 31, 2011, the Department of Finance released an amendment to section 15(2.1) to include partnerships when determining who is considered connected with a shareholder of a particular corporation. The Explanatory Notes state that this clarification of subsection 15(2) will ensure that partnerships are included in the shareholder debt provisions.

Regrettably, the proposed legislation could produce harsh results for a partnership where the general partner (or a related party of that general partner) funds some of the expenses of a partnership that are widely held by arm's length limited partners. Under such circumstances, the general partner (or its related party) likely will not be dealing at arm's length with the partnership and the partnership would be considered "connected" with the shareholder of the general partner. Consequently, the loan to the partnership would be included in the partnership's income. This seems a harsh, though perhaps unintended, effect of the revision since the loan to the partnership does not create a benefit to the general partner or its shareholders. Indeed, the loan is benefitting the arm's length limited partners since they are not required to fund the partnership.

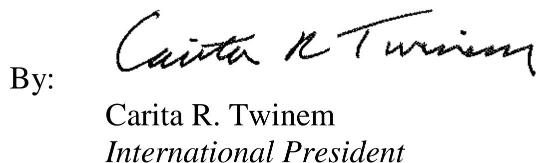
While we agree that a related partnership (or partnership of related persons and entities) should be subject to the rules in subsection 15(2), we recommend removing the reference to "arm's length" in subsection 15(2.1) and replacing the term with a more specific description of the relationship between the partnership and the shareholder. Where a widely held partnership is involved, a test based on "relatedness" or ownership (in terms of the percentage of partnership units) may be more appropriate. We invite the Department's views on TEI's recommendation.

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 you during the Institute's December 5, 2012, liaison meeting.

Respectfully submitted,

Tax Executives Institute, Inc.

By: 

Carita R. Twinem
International President

Appendix 1

Assume a corporate group with the following structure, year ends, and income files a multi-tier election to align to a January 31 year-end:

CORP
C
nominal
P1
P2
Business

- P2 had a June 30 year-end.
- P1 had a January 31 year-end.
- CORP has a December 31 year-end.
- Multi-tier election filed to align to January 31

Corporate Entity has a December 31st year end								
Corporation owns an interest in a partnership (P1) with a January 31st year end								
P1's only asset is an interest in a partnership (P2) with a June 30th year end								
Taxable Income from Partnership (P1) - Summary by Year:	Jan 31/11	10,000		P1 income is income from P2's Jun 30/10 year end				
		10,000		P1 income is income from P2's Jun 30/11 year end				
	Jan 31/12	7,000		P1 income is from P2 to Jan 31/12				
	Jan 31/13	10,000		P1 income is from P2 to Jan 31/13				
	Jan 31/14	10,000		P1 income is from P2 to Jan 31/14				
	Jan 31/15	10,000		P1 income is from P2 to Jan 31/15				
	Jan 31/16	10,000		P1 income is from P2 to Jan 31/16				
	Jan 31/17	10,000	77,000					
		Dec 31/11	Dec 31/12	Dec 31/13	Dec 31/14	Dec 31/15	Dec 31/16	Dec 31/17
Income from P1 before adjustments		10,000	10,000	10,000	10,000	10,000	10,000	10,000
Add: Adjusted Stub Period Accrual (ASPA)		-	9,151	9,151	9,151	9,151	9,151	9,151
Deduct: Previous Year Adjusted Stub Period Accrual		-	-	(9,151)	(9,151)	(9,151)	(9,151)	(9,151)
Net Accrual		-	9,151	-	-	-	-	-
Eligible Alignment Income (EAI)		-	7,000	-	-	-	-	-
Income before Transitional Reserve		10,000	26,151	10,000	10,000	10,000	10,000	10,000
Qualifying Transitional Income (QTI) = (ASPA + EAI) 34.2(1)	16,151							
RQTI	16,151							
Deduct: 100% of QTI (2012)		-	(16,151)					
Deduct: 85% of RQTI (2013)				(13,728)				
Deduct: 65% of RQTI (2014)					(10,498)			
Deduct: 45% of RQTI (2015)						(7,268)		
Deduct: 25% of RQTI (2016)							(4,037)	
Deduct: 0% of RQTI (2017)								-
Add: Previous Year's Reserve		-	-	16,151	13,728	10,498	7,268	4,038
Income from P1 - Under Existing Legislation		10,000	10,000	12,422	13,230	13,230	13,231	14,038
Notes								
ASPA not required until year of multi-tier alignment (34.2(9))								
ASPA in 2012 and therafter is from Feb 1 - Dec 31 (334 days)								
Revised QTI after first year to true-up to actual stub-period amount (34.2(17))								