Comments

of

TAX EXECUTIVES INSTITUTE, INC.

on

PENDING CANADIAN INCOME TAX ISSUES

Submitted to

THE DEPARTMENT OF FINANCE

DECEMBER 7, 2011

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 7, 2011, liaison meeting. If you have any questions about these comments, please do not hesitate to call either David V. Daubaras, TEI's Vice President for Canadian Affairs, at 905.858.5309, or, Carmine A. Arcari, Chair of the Institute's Canadian Income Tax Committee, at 416.955.7972.

Background

Tax Executives Institute is the preeminent professional organization of 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 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. *Advisory Panel on Canada's System of International Taxation*

In its August 19, 2011, press release announcing the draft foreign affiliate legislation (hereinafter "the August 19 Proposals"), the Department said that "the Government remains committed to continuing its review and analysis of all [the] recommendations" made by the *Advisory Panel on Canada's System of International Taxation* (hereinafter "the Panel"). We invite a discussion of the following points.

1. The August 19 proposals seemingly deviate from the Panel's recommendations to (i) broaden the existing exemption system to cover all foreign active business income earned by foreign affiliates and (ii) extend the exemption system to capital gains and losses realized on the disposition of shares of a foreign affiliate that derive all or substantially all their value from active business assets. In explanation of the August 19 proposals, the press release states that "the priority of the Government is to encourage countries to enter into Tax Information Exchange Agreements with Canada and to provide exempt surplus treatment as an incentive to those which choose to do so." If the goal remains a broader exemption system, does the Department consider the August 19 proposals transitory and, if so, has it considered the burdens of multiple foreign affiliate transition rules on taxpayers and CRA?

2. The Panel made a number of recommendations that have not yet been acted upon. Which Panel recommendations does the Department consider a priority to implement? Has a timeline for evaluation and action been developed in respect of the remaining recommendations? Specifically, has the Department evaluated the Panel's recommendations for (i) adopting safe harbours for low-value services in documenting transfer pricing and (ii) eliminating 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? What are the prospects for changes in those areas?

b. Loss Transfer 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.

c. *Functional Currency Reporting Rules*

The technical notes to subsections 261(20) and (21) state that the provisions are intended to prevent abuses of the functional currency tax reporting regime. As recommended in Question 3 of last year's agenda, we submit that subsections 261(20) and (21) should include an exception to the anti-avoidance rule for transactions undertaken for *bona fide* business purposes. The impetus for a taxpayer to make a functional currency election for tax purposes is that International Financial Reporting Standards or Canadian generally accepted accounting principles may require a taxpayer to maintain one or more (but

not all) of its corporate accounts in a foreign currency. By making the election, the taxpayer is endeavouring to save the time and expense of maintaining two sets of books of original entry for the affected accounts. In response to Question 3 last year, the Department stated that it would consider developing narrow legislative changes to address *bona fide* intercorporate financing arrangements such as that cited in TEI's question. Would the Department provide an update on its review of the issues?

2. Calculation of Amount under Subparagraph 247(3)(b)(ii)

Pursuant to TPM-07 *Referrals to the Transfer Pricing Review Committee* (August 2, 2005), "the application of penalties under subsection 247(3) *must* be considered in all cases where the total of transfer pricing capital and income adjustments for a taxation year, exceed $5,000,000 *or* exceed 10% of gross revenue for the year as calculated under subparagraph 247(3)(b)(i)." Although subsection 247(3) seemingly applies on a taxpayer-by-taxpayer basis, there may be facts and circumstances where the requirement for automatic referral to CRA's Transfer Pricing Review Committee and, more important, the automatic consideration or assertion of penalties should be tempered.

For example, consider a situation where a transfer-pricing adjustment is proposed (hereinafter "the Proposed TP Adjustment") for transactions between a Canadian taxpayer and a foreign subsidiary that has a Canadian permanent establishment. We believe that an important consideration in the calculation of the threshold amount under subparagraph 247(3)(b)(ii) should be a consequential downward transfer-pricing adjustment (hereinafter the "Consequential TP Adjustment") in respect of income previously subject to tax in Canada for the Canadian permanent establishment of the foreign subsidiary. Assuming the transfer pricing methodology used was selected in good faith and the taxpayer makes reasonable efforts to support its transfer-pricing methodology by creating and maintaining contemporaneous documentation of the methodology, any proposed adjustment would arise solely because the CRA economist disagrees with the taxpayer's analysis of the transfer-pricing methodology. Although the gross Proposed TP Adjustment to the Canadian taxpayer may exceed the $5 million threshold of subparagraph 247(3)(b)(ii), the net adjustment (*i.e.*, the Proposed TP Adjustment less the Consequential TP Adjustment to the Canadian PE) may well be less than the threshold. We invite the Department's view on whether it would consider providing an amendment to subsection 247(3) to take the Consequential TP Adjustment into account in applying the $5 million threshold and thereby eliminate the subjective evaluation of whether the taxpayer has complied with the contemporaneous documentation requirement.

3. Subclause 95(2)(a)(ii)(D)(IV)

Subclause 95(2)(a)(ii)(D)(IV) of the *Income Tax Act, Canada* (hereinafter the Act) treats interest income received by one foreign affiliate (FA 1) from another foreign affiliate (FA 2) as active business income where the interest is in respect of money borrowed and used for the purpose of earning income from "property." Property means excluded property of FA 2, including shares of the capital stock of a third foreign affiliate (FA 3) provided that FA 2 and FA 3 are resident in the same country (hereinafter the "Same Country Requirement").

Taxpayers and tax practitioners are challenged in understanding the tax policy purpose of the Same Country Requirement.[1] Would the Department tap its archives to provide an explanation of the purpose of the Same Country Requirement? TEI believes the Same Country Requirement may have outlived its tax policy function and since it remains part of the Act it is an impediment to the efficient and effective acquisition and operation of foreign affiliates. If the Department agrees that the Same Country Requirement no longer serves a valid policy purpose, would it consider eliminating the requirement?

4. Comfort Letters

In prior liaison meetings, TEI has voiced concern about the increasing time lag between the issuance of comfort letters and the adoption of remedial technical legislation. The time lag imposes financial burdens on companies since they cannot reflect in their financial statements the changes to the Act presaged by the comfort letter. (Comfort letters are not considered "substantively enacted" for purposes of Canadian generally accepted accounting principles.)

Owing to a succession of minority government during the past several years, it has been difficult for the Government to enact legislation of any stripe, including technical amendments implementing comfort letter interpretations. The Auditor General of Canada has noted the compliance and administrative challenges that the comfort letters pose for taxpayers and CRA alike and, in response to the Auditor General's recommendations, the Department said that it has a plan to clear the backlog of comfort letters for which legislation has not yet been proposed. Would the Department provide an update on the status of its plan and timeline for clearing the backlog of comfort letters? Can the Department identify and discuss which of the many comfort letters will be addressed, in what time frame, and what the process is for prioritizing letters for legislative action?

5. Upstream Loans

The August 19, 2011, proposed legislation in respect of foreign affiliates contained a number of significant new provisions. TEI was pleased to participate in the consultation on the draft legislation, submitting comments and recommendations in a letter dated October 19. We invite a discussion on TEI's recommendations, focusing especially on the policy changes in respect of the treatment of "upstream loans."

Specifically, we understand that the Department was aware of, and acquiesced in, CRA rulings that permitted Canadian taxpayers to fund foreign financing affiliates with equity where those financing affiliates would, in turn, loan the funds to related parties offshore. Since the income on these loans would be included in the Canadian tax base as foreign accrual property income (FAPI) where the loans are made to affiliates that are less than 10-percent owned by the Canadian taxpayer, Canada would, over time, likely obtain a greater amount of taxes than it would collect by encouraging a cross-border distribution of the

---

[1] See, *e.g.*, Shawn D. Porter and David Bunn, "The Same Country Requirement in Clause 95(2)(a)(ii)(D)," *International Tax Planning*, Vol. XVI No. 2 FEDERATED PRESS (2010).

cash with related withholding taxes (and foreign tax credits). Would the Department please comment on the background and what drove the policy change in respect of upstream loans? Among the issues, questions, and concerns highlighted in our submission, we wish to understand the Department's perspectives on the following points:

a. Since the policy is contrary to what many taxpayers viewed as ordinary and accepted business and tax practices for the use of offshore cash, the change undermines confidence in the stability of Canadian tax policy and creates uncertainty about taxpayers' ability to rely on CRA rulings in structuring their affairs. We invite the Department's views on the issue.

b. We are curious whether during its review the Department balanced the overall effect of potential withholding taxes on distributions against the revenues from FAPI inclusions.

c. We believe the legislation may lead companies to convert loans into permanent investments in offshore activities rather than reinvesting the amounts in Canada (even if in the form of an upstream loan). We invite the Department's view and whether this is an intended policy effect.

d. Companies are likely to incur significant foreign exchange gains and losses in restructuring extant loans during the two-year transition period. Were the resulting taxpayer burdens and the corresponding revenue effects considered while formulating the proposals?

e. TEI believes the proposals may increase tax deductible interest expense for Canadian companies (in replacing extant loans) and, as important, eliminate common cash management efficiencies such as cash-pooling techniques. We invite the Department's views on whether it agrees and, if so, whether the effects are intended.

f. TEI recommends that transactions and structures implemented in reliance on CRA's upstream loan rulings be permanently grandfathered rather than being subjected to a "rebirth" rule. We invite the Department's response.

6. Revocation of Waivers Filed During the Extended Reassessment Period

A March 12, 2009, amendment to subsection 152(4) of the Act permits taxpayers to file a waiver under paragraph 152(4)(c) during the *extended* assessment period of paragraph 152(4)(b). Although the amendment to subsection 152(4) is generally "good news" for taxpayers, there are potential drawbacks to an extension of the waiver deadline. Specifically, no current provision would permit a taxpayer to revoke a waiver granted during the extended reassessment period. Subsection 152(4.1), which governs revocations of waivers, applies solely to waivers filed during the normal reassessment period. TEI believes that a proposed

amendment to subsection 152 (4.1) — incorporated in draft legislation released July 16, 2010 — would correct the anomaly. Would the Department provide an update on the status of this draft legislation?

7. Accountant's Privilege

Since 1989, Australian administrative practice has permitted a range of documents to remain confidential even where they do not enjoy the protection of legal professional privilege. This "accountants' concession" is explained in the Australian Tax Office's *Access and Information Gathering Manual*. The ATO's according of an accountant's concession recognizes that a taxpayer "should be able to comprehensively consult with professional accounting advisers, and have full and frank discussions about their rights and obligations under tax laws."[2]

On April 15, 2011, the Australian Treasurer released a discussion paper that explores the appropriateness of establishing a broader tax advice privilege. The paper considers a 2007 recommendation by the Australian Law Reform Commission (ALRC) to establish a tax advice privilege in order to protect from the tax authority's information-gathering powers the confidentiality of tax advice given by independent accounting professionals. The 2007 recommendations said that the tax advice privilege should be formalized and that implementing legislation should provide that a taxpayer required to disclose information pursuant to the information-gathering powers of the Commissioner of Taxation need not disclose a "tax advice" document prepared for that taxpayer. The ALRC recommended that the tax advice privilege include the following features: (1) the privilege should apply to tax advice documents created by an independent professional adviser who is a registered tax agent; (2) an advice document should be protected if its dominant purpose (but not its sole purpose, as in the test in the accountants' concession) was to provide tax advice; (3) the privilege should not apply to a tax advice document created in relation to the commission of a fraud or offence or the commission of an act that renders a person liable to a civil penalty; (4) the privilege should not extend to a source document, even if it was given to a tax agent for the purpose of obtaining advice; and (5) the privilege should not extend to documents, or parts of documents, that provide "contextual information."

The United States, the United Kingdom, and New Zealand currently accord taxpayers a statutory tax advice privilege and Quebec also provides a limited privilege. Because of the ever-increasing complexity of tax legislation and compliance, TEI recommends that Canada adopt tax advice privilege legislation that facilitates full and frank discussion of tax matters between taxpayers and external advisers. We invite the Department's reaction to the creation of a tax advice privilege for accountants.

8. Eligible Dividend Designations

Subsection 89(14) provides as follows:

---

[2] *See* Albert Baker and Geraldine McCann, "Australian Privilege for Tax Advice," Vol. 19 No. 7, *Canadian Tax Highlights*, CANADIAN TAX FOUNDATION (July 2011), which is reproduced in the Appendix.

> A corporation designates a dividend it pays at any time to be an eligible dividend by notifying in writing at that time each person or partnership to whom it pays all or any part of the dividend that the dividend is an eligible dividend.

Thus, to be an "eligible dividend," a dividend payment must be designated as such to shareholders of the corporation on or before the date the dividend is paid. In an interpretation, CRA has ruled that the *entire amount* of a dividend paid by a corporation must be designated as an eligible dividend and fractional dividends cannot be designated.[3] In addition, since subsection 89(14) requires the quantum of eligible dividends to be specified, CRA has ruled that a corporation cannot satisfy the designation requirement by advising shareholders that the amount of the eligible dividend will be equal to the amount "in an income pool balance."[4] Accordingly, a corporation cannot specify an amount of dividend that is to be paid from its low rate income pool (LRIP) and then specify that the residual dividend is an "eligible dividend."

Under certain circumstances a public corporation that pays a fixed-rate annual dividend (*e.g.*, 25 cents per share, some of which may not be an eligible dividend) will not be able to satisfy the designation requirements until it knows the number of shareholders of record. The reason for uncertainty is that the total dividend amount is unknown until the number of shareholders of record becomes fixed and that number can change after the dividend is approved but before the record date.

CRA has advised that acceptable methods for corporations to make a designation include:

(A) posting a notice on the corporation's website;

(B) providing notice in a quarterly or annual report or other shareholder publication; and

(C) issuing a press release indicating that a dividend is an eligible dividend.[5]

Option C is not a viable option for public companies to designate an eligible dividend because the amount of the eligible dividend will generally be unknown at the time of the press release. Option B is also not a viable option since publication of the information may not be timely (*i.e.*, the dividend may be paid before publication of the documents). Although option A is a workable option, shareholders may not become aware of the designation. In addition, in some situations, after a notice is posted on the corporation's website, a corporation may subsequently realize an amount includible in its LRIP. Because of the dividend ordering rule, an increase in LRIP would have the same effect as an increase in the number of eligible shareholders between the website posting date and the payable date (*i.e.*, decrease the amount

---

[3] *See* Interpretation 2010-0387541E5 (January 10, 2011).

[4] *See* Interpretation 2007-0249941E5 (May 2, 2007).

[5] *See* Interpretation 2006-0217891Z0 (December 20, 2006).

eligible for designation). In either case, the amount specified as an eligible dividend in the website posting would exceed the balance in the corporation's general rate income pool. Although the corporation can revise website notice, the shareholder may not become aware of the change. Moreover, even though the corporation made reasonable efforts to comply with the designation rule, it may be subject to a 20-percent penalty for an excess dividend designation pursuant to section 185.1.

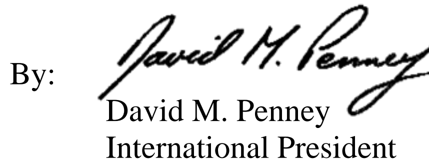
Would the Department consider permitting corporations to make a fixed-dollar designation for a period as being paid from the corporation's LRIP with any remaining amount of dividends being deemed an eligible dividend? Alternatively, would the Department consider adding an election (similar to the elections available for excess capital dividends or capital gains dividends) for excess eligible dividend designations to address situations where the actual amounts change subsequent to the date designations are required to be made whether because of changes in (1) the amount of LRIP or (2) the number of public company shares outstanding?

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 7, 2011, liaison meeting.

Respectfully submitted,

Tax Executives Institute, Inc.

By: 

David M. Penney
International President

Appendix 1

Australian Privilege for Tax Advice
(See citation in footnote 2 of the main text)

On April 15, 2011, the Australian Treasurer released a discussion paper that explores the appropriateness of establishing a tax advice privilege. The paper considers a 2007 recommendation by the Australian Law Reform Commission (ALRC) to establish a tax advice privilege in order to protect from the tax authority's information-gathering powers the confidentiality of tax advice given by independent accounting professionals. The discussion paper sought the views of practitioners and other stakeholders on whether it is appropriate to establish the ALRC-recommended tax advice privilege and other related issues; the closing date for submissions was July 15, 2011. The development of this undertaking in Australia may provide an interesting precedent for Canadian initiatives.

In Australia, both lawyers and accountants provide tax advice and act for their clients, but only the lawyer-client relationship is protected by legal professional privilege. The Commissioner of Taxation has wide-ranging statutory powers to gain access to the information of Australian taxpayers. However, the Australian Tax Office (ATO) has acknowledged that certain documents should remain confidential to the taxpayer and his, her, or its advisers. Since 1989, the Australian administrative practice has been to allow a range of documents to remain confidential even if they do not otherwise enjoy the protection of legal professional privilege. This "accountants' concession" is explained in the ATO's *Access and Information Gathering Manual*. The ATO's creation of the accountants' concession recognizes that a taxpayer "should be able to comprehensively consult with professional accounting advisers, and have full and frank discussions about their rights and obligations under tax laws."

The accountants' concession is available only to restricted source and non-source documents; but because the concession is not enshrined in law, in exceptional circumstances the ATO can depart from the practice. Consequently, in its current form the accountants' concession fails to provide certainty, and accounting practitioners have expressed concern about the consistency of its interpretation and administration and the practicalities of claiming the concession.

In 2007, the ALRC proposed that the tax advice privilege be formalized and that empowering legislation be drafted to provide that a taxpayer who must disclose information pursuant to the information-gathering powers of the Commissioner of Taxation need not disclose a tax advice document prepared for that taxpayer. It was recommended that the tax advice privilege include the following features. (1) The privilege should apply to tax advice documents created by an independent professional adviser who is a registered tax agent. (2) An advice document should be protected if its dominant purpose (not its sole purpose, as in the test in the accountants' concession) was to provide tax advice. (3) The privilege should not apply to a tax advice document that is created in relation to the commission of a fraud or offence or the commission of an act that renders a person liable to a civil penalty. (4) The privilege should not extend to a source document, even if it was given to a tax agent for the

purpose of obtaining advice. (5) The privilege should not extend to documents, or parts of documents, that provide "contextual information."

A statutory privilege for tax practitioners currently exists in the United States, the United Kingdom, and New Zealand. The ALRC report supports the model of creating a separate tax advice privilege rather than simply extending legal professional privilege to advice given by accountants, an approach that leaves control over the operation and scope of the privilege with the Australian Parliament. The ALRC concluded that legislation would avoid the slow and expensive processes of a common-law resolution of issues. Furthermore, in order to promote tax compliance, "clients ought to be protected fully in their communications in relation to tax law in the same way they are in other areas of the law."

The Treasury's 2011 discussion paper sought input on whether establishing an ALRC-recommended tax advice privilege is appropriate and also on the issues surrounding such a privilege, such as the following:

> 1) Taking into account international experience, which model for the privilege best serves the underlying policy objectives? For example, the New Zealand approach codifies a privilege for tax law advice provided by a tax agent; the US approach extends legal professional privilege to that advice.
>
> 2) Should a codified privilege apply equally to communications with lawyers and tax agents and replace legal professional privilege for tax matters?
>
> 3) Should a codified privilege apply to other financial advisers who provide tax advice, to economists who advise on transfer pricing, to accountants who provide asset and liability valuations for thin capitalization situations, and to in-house accountants?
>
> 4) To which documents and communications should a tax advice privilege apply—to the same material covered by legal professional privilege, or only to the advice portion (as recommended by the ALRC)?

As tax law evolves and becomes increasingly complex, taxpayers are seeking professional advice from both lawyers and tax specialists (who may not be lawyers) to ensure compliance with the responsibilities imposed by various taxation statutes. As the discussion paper indicates, any benefits of a properly used tax advice privilege must be weighed against the disadvantages that arise if the privilege is abused. If a tax advice privilege is established, procedures need to be put in place to provide an appropriate balance between protecting client information and ensuring that the investigative functions of the ATO are not unduly delayed or frustrated.