TAX EXECUTIVES INSTITUTE, INC.

INCOME TAX QUESTIONS

Submitted to

DEPARTMENT OF FINANCE CANADA

DECEMBER 11, 2019

Tax Executives Institute Inc. ("TEI") welcomes the opportunity to present the following questions and comments on income tax issues for discussion with representatives of the Department of Finance Canada (the "Department") during our annual liaison meeting on December 11, 2019. Should you have any questions about the agenda in advance of our meeting, please contact Josephine Scalia, TEI's Vice President for Canadian Affairs, at (514) 205-6243, or Kurtis L. Bond, Chair of TEI's Canadian Income Tax Committee, at (403) 260-1156.

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A. Legislative Update and Tax Policy Discussion

1. *Legislative Priorities*

TEI invites the Department to provide an update regarding its near-term tax legislative priorities coming out of the 43rd Canadian General Election.

2. *Tax Policy Discussion*

The following questions are intended to raise broader questions of tax policy on a discussion basis. All discussions are conducted under the Chatham House Rule, whereby participants are free to use the information received, but neither the identity nor the affiliation of the speaker(s), nor that of any other participant, may be revealed.

a) *Taxation of the Digital Economy and Global Electronic Commerce*

In response to the Standing Committee on International Trade's report entitled *E-Commerce: Certain Trade-Related Priorities of Canada's Firms*, which was tabled in the House of Commons on April 26, 2018, the Minister of Finance affirmed the government's commitment to maintaining a tax system that is fair and equitable for all Canadians. With respect to corporate income tax on a firm's profits, the Minister explained that generally accepted principles (or norms) of international tax policy provide that jurisdiction to tax is based not on the location of consumption but on where the productive activities by the firm which give rise to the underlying profits take place. Under these well-established norms, business profits of a non-resident corporation are taxable in a country only when the corporation has a physical presence in that country. The Minister added, however, that Canada is actively participating in a multilateral effort—the OECD/G20 Inclusive Framework on BEPS—examining what updates may be required to those norms to reflect new digital business models.

TEI appreciates the cautionary, principle-based approach the Department has heretofore taken in respect of the tax challenges arising from the digitalisation of the economy. Earlier this fall, however, we learned that the government may be contemplating the introduction of reactive measures to tax digital products and services. Most notably, the Liberal Party of Canada recently announced that, if re-elected, it would "replicate the proposed digital services tax announced by the French government" by introducing a new three-percent tax on the income of businesses in certain sectors of the digital economy, which would be implemented on April 1, 2020.[1] If enacted, this policy would epitomize the very kind of uncoordinated, unilateral tax measure that the OECD/G20 Inclusive Framework on BEPS seeks to discourage. Rightfully so,

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[1] Office of the Parliamentary Budget Officer, Cost Estimate of Election Campaign Proposal, Taxation of Large Technology Companies (Sept. 29, 2019), https://www.pbo-dpb.gc.ca/web/default/files/Documents/ElectionProposalCosting/Results/32977970_EN.pdf?timestamp=1569835806287.

as such measures undermine the relevance and sustainability of the international tax framework and damage global investment and growth.[2]

TEI invites the Department to provide an update regarding the status of the OECD/G20 Inclusive Framework on BEPS and the extent of Canada's participation therein. In particular, TEI would appreciate learning the Department's views concerning:

i. the scope and form of the recently released Secretariat proposal for a "Unified Approach" under Pillar One;

ii. the highly anticipated Pillar Two proposal and its potential implications with respect to Canada's existing foreign affiliate tax rules; and

iii. the aforementioned campaign proposal for the uncoordinated, unilateral adoption of a federal digital services tax.

TEI is deeply concerned that Canada's adoption of such a unilateral measure would undermine the aims of the OECD/G20 Inclusive Framework on BEPS, as well as Canada's position therein.

b) *Tax Competitiveness with the United States*

In December 2017, the United States enacted sweeping federal tax reform legislation that, among other things, significantly cut the U.S. federal corporate income tax rate—from 35 percent to 21 percent—and introduced 100-percent bonus depreciation (full and immediate expensing) for certain business assets that are acquired and placed in service before January 1, 2023.[3] These pro-growth measures have significantly improved U.S. business tax competitiveness on the global stage and eliminated the relative business tax advantage that Canada had enjoyed for over a decade.

The Department acknowledged in its *Fall Economic Statement 2018* that U.S. tax reform posed "important challenges that, if left unaddressed, could have significant impacts on investment, jobs and the economic prospects of middle class Canadians."[4] This acknowledgment was followed by the introduction of temporary accelerated depreciation for qualifying assets to "support Canada's competitiveness" in response to U.S. tax reform.[5] The policy was intended to improve competitiveness by allowing the full cost of machinery and equipment used in the

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[2] *See* OECD, Public Consultation Document, *Secretariat Proposal for a "Unified Approach" Under Pillar One* para. 7 (2019), http://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf.

[3] Act of Dec. 22, 2017, Pub. L. No. 115-97, 131 Stat. 2054 (colloquially known as the Tax Cuts and Jobs Act).

[4] Dept. of Fin. Can., *Investing in Middle Class Jobs: Fall Economic Statement 2018*, at 54 (Nov. 21, 2018).

[5] *Id.*

manufacturing and processing of goods to be written off immediately for tax purposes, and by introducing the "Accelerated Investment Incentive" to support investment by businesses of all sizes and across all sectors of the economy.[6] Under the latter incentive, capital investments are generally eligible for a first-year deduction equal to 1.5 times the normal capital cost allowance rate for depreciable assets.

TEI views these temporary measures as a positive first step toward addressing the competitiveness challenges posed by U.S. tax reform. But while the allowance for accelerated depreciation in Canada may respond, at least in part, to the introduction of 100-percent bonus depreciation in the United States, it leaves other important challenges unaddressed. Most notably, accelerated depreciation fails to address the structural challenges posed by the law's comprehensive reforms to the U.S. international tax system. Consider the U.S. base erosion and anti-abuse tax ("BEAT"), which is a new corporate minimum tax intended to address the familiar base erosion problem posed by outbound, deductible payments to foreign affiliates.[7] Where applicable, the BEAT can directly affect Canadian-based multinational corporations with U.S. subsidiaries, which often have key employees, intellectual property, and other intangible assets in Canada that serve as key value drivers in their global supply chains. The specter of BEAT liability creates an incentive for such corporations to shift additional people and functions (i.e., income) to the United States.[8]

The favorable U.S. tax rate on foreign-derived intangible income ("FDII") raises additional competitiveness challenges for Canada, whereby certain Canadian companies exporting to the United States may now find it more advantageous to produce their products in the United States—and perhaps even to produce there for sale into Canada. The lower U.S. statutory rate may also encourage more equity financing and less debt financing of Canadian-owned U.S. subsidiaries, which would further shift tax revenue from Canada to the United States.[9] The net effect of these (and other) reforms to the U.S. international tax system is to encourage the concentration of investment and high value-added activity in the United States—to the potential detriment of countries like Canada. TEI therefore invites the Department to discuss the range of additional measures the government may—or should—be considering to address these critical challenges posed by U.S. tax reform.

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[6] News Release, Dept. of Fin. Can., *2018 Fall Economic Statement: Investing in Middle Class Jobs* (Nov. 21, 2018).

[7] E.g., the mismatch created by the reduction to U.S. taxable income via outbound, related-party payments and the recognition of foreign income attributable to those payments but never subject to U.S. tax.

[8] Where BEAT liability arises with respect to a wholly owned U.S. subsidiary, the Canadian parent corporation economically bears the cost through a reduction in the value of its investment in the U.S. subsidiary.

[9] *See, e.g.*, Peter Harris et al., *International Effects of the 2017 U.S. Tax Reform – A View from the Front Line*, 67 Can. Tax J. 27, 32 (2019).

c) *Taxation of Cross-border Cash Pooling Arrangements*

Cash pooling is a common arrangement entered into by multinational enterprises to retain internal control over financing. Intercompany cash pooling arrangements enable multinationals to more efficiently manage liquidity and currency risk among their affiliates on a worldwide basis, reduce borrowing costs, and increase return on excess cash. Under such arrangements, it is not unusual for an affiliate to be both a lender and a borrower in the same taxation year.

Canada has an extremely restrictive regime that governs all cross-border financing arrangements. While the tax rules governing cross-border financing arrangements were enacted to protect the Canadian tax base, they also severely restrict the Canadian operations of multinational companies from the efficient and timely deployment of working capital. These rules can also require complicated analyses on the part of taxpayers and Canada Revenue Agency ("CRA") audit teams, even where the amounts arising from cash pooling arrangements are insignificant.

TEI understands the Department is participating in various OECD/G20 BEPS Project working groups and domestic public consultations regarding the taxation of cross-border cash pooling arrangements. We invite the Department to discuss its current views on the taxation of cross-border cash pooling arrangements and the status of its various consultations on this subject.

d) *Legislative Imbalance*

i. Tax Disputes – Prepayment Requirement

TEI believes the statutory provisions governing the objection and appeals process for a large corporation taxpayer that disagrees with an assessment or reassessment made by the CRA is inappropriately imbalanced in the government's favour. Most notably, an objecting large corporation taxpayer is required to pay 50 percent of the amount in dispute when assessed, with non-deductible interest accruing at 6 percent on the unpaid amount.

TEI invites further discussion of this troublesome rule requiring large corporation taxpayers to prepay 50 percent of the amount in dispute to contest a reassessment.

ii. Legislative Drafting and the Importance of Legal Certainty

Canadian taxpayers have observed a trend of increasingly comprehensive and complex tax laws, which often result in legal uncertainty and increased compliance costs for taxpayers and the government alike. TEI invites a general tax policy discussion with the Department regarding the competing interests of certainty and simplicity on one side, and comprehensiveness on the other. Considering the greater public demand for administrative simplicity, the significant need for resources at the Tax Court of Canada, and the presence of an

effective general anti-avoidance rule, it appears reasonable to question whether these principles are in proper balance.

B. Carryover Matters and Follow-up Questions

1. *Prohibited Investments*

This question follows up on question B.4 from our December 2018 liaison meeting concerning the prohibited investment rules for Registered Retirement Savings Plans ("RRSP"), Registered Retirement Income Funds ("RRIFs"), and Tax Free Savings Accounts ("TFSAs"), which had been extended to retirement compensation arrangements ("RCAs"). Effective March 23, 2011, subsection 207.01(1) of the Income Tax Act was amended to provide an excluded property exemption from the concept of "prohibited investments" for RRSPs, RRIFs, and TFSAs, but not for RCAs.[10]

At our December 2018 meeting, TEI asked whether the Department would consider proposing an amendment to conform the prohibited investment for RCAs to the amended rules for RRSPs, RRIFs and TFSAs, with an effective date of March 29, 2012 (the date on which the prohibited investment rules were extended to RCAs). The Department provided the following response:

> As part of ongoing efforts to improve consistency of tax rules in respect of deferred income arrangements, Budget 2017 added Registered Education Savings Plans and Registered Disability Savings Plans to the Part XI.01 rules that apply to non-qualified investments and prohibited investments held by registered plans. As a next step, the Department is prepared to review the Part XI.3 rules applicable to investments held by RCAs and consider if greater consistency, where merited, should be sought with the rules applicable to registered plans, including the definitions of "prohibited investment" and "excluded property."

TEI invites the Department to provide an update regarding this matter.

DEPARTMENT OF FINANCE RESPONSE

The Department is continuing to review whether Part XI.3 rules applicable to investment held by RCAs and should be updated for greater consistent with the Part XI.01 rules that apply to RRSPs, RRIFs and TFSAs. One area of concern relates to potential influence wielded by individuals who do not deal at arm's length with the employer and who are beneficiaries of a RCA.

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[10] Unless otherwise indicated, all references to "section," "subsection," or "paragraph" herein are to sections, subsections, or paragraphs of the federal Income Tax Act, R.S.C. 1985, c. 1 (5th Supp.), as amended (the "Act").

The Department is interested in obtaining additional information from TEI about the types of investments that RCAs are interested in holding but which would be prohibited investments under current tax rules.

Amendments, if any, would be part of a future technical bill.

C. New Matters

1. *Executive Compensation – RCAs and the Subsection 207.5(2) Election*

RCAs are plans under which an employer makes payments to a custodian in connection with benefits that are to be, or may be, paid to an employee on, after, or in contemplation of his retirement or termination. Contributions to RCAs and income earned thereon are subject to a special 50-percent refundable tax under Part XI.3 of the Act. As benefits are paid out of the plan, the employee is taxed on those he receives and the special 50-percent tax is refunded.

Where all the subject property of a RCA at the end of the year consists only of cash, debt obligations, shares listed on a designated stock exchange, or any combination thereof, the RCA can make an election under subsection 207.5(2) to have the refundable tax of the arrangement equal the total current fair market value of the subject property. Subsection 248(1) defines the term "share" for this purpose as a share or a fraction of a share of the capital stock of a corporation. As a result, units in exchange traded funds ("EFTs") constituted as trusts and listed on the Toronto Stock Exchange are not permitted property in this context. This result seems anomalous for two reasons: (i) the fair market value of ETF units is readily ascertainable; and (ii) ETF units are a low-cost, diversified holding that is ideally suited to the investment objectives of many RCAs.

Would the Department consider introducing the necessary amendment(s) to allow a RCA holding listed EFTs to make a subsection 207.5(2) election?

DEPARTMENT OF FINANCE RESPONSE

An election under subsection 207.5(2) can be made if all the subject property of the RCA at the end of the year consists only of cash, debt obligations, shares listed on a designated stock exchange, or any combination thereof. Further analysis is required to determine if RCAs holding units in listed ETFs should be allowed to make a subsection 207.5(2) election.

The Department is interested in obtaining additional information from TEI concerning such ETFs and their similarities to listed shares, which are included in investments listed in subsection 207.5(2), and mutual funds, which disqualify an RCA from making an election under subsection 207.5(2).

2. *Capital Cost Allowance Classification of Short-life Catalysts*

Under Part XI of the Income Tax Regulations, a taxpayer's depreciable property is grouped into various classes described in Schedule II.[11] Class 26 of Schedule II includes property that is: (a) a

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[11] All references to "Regulations" herein are to the current federal Income Tax Regulations, C.R.C., c. 945.

catalyst; or (b) deuterium enriched water (commonly known as "heavy water") acquired after May 22, 1979. The cost of property described in Class 26 is depreciable at a rate of 5 percent per year on a declining balance basis.

The term "catalyst" is defined in neither the Act nor the Regulations, therefore the common industrial and scientific definition would generally apply. Common definitions of the term "catalyst" include:

- something that makes a chemical reaction happen more quickly without itself being changed;[12] and

- a substance that speeds up a chemical reaction, but is not consumed by the reaction; hence a catalyst can be recovered chemically unchanged at the end of the reaction it has been used to speed up, or catalyze.[13]

Catalysts are extensively used in the oil and gas industry, with two major varieties: long-life and short-life. Long-life catalysts used in refining are precious metals with replacement lifecycles of 20 years or more. These long-life catalysts meet the foregoing definitions of the term since they remain unchanged during the chemical reaction (i.e., the refining process). This is demonstrated by the fact that, during a shutdown for regular maintenance, these catalysts can be regenerated and returned to the operating unit. It follows, therefore, that long-life precious-metal catalysts are appropriately classified as Class 26 depreciable property for tax purposes.

The same thing cannot be said for short-life catalysts, however, which change during the chemical reaction and are completely exhausted at the time of replacement (i.e., they do not meet the ordinary and scientific meaning discussed above). In the upgrading and refining processes, these "catalysts" (typically called pellets) are metal-based compounds used to increase the rate of chemical reactions and have useful lives of anywhere between six months and five years. The catalyst pellets are chemically changed and become unusable as catalysts following the end of the period.

The CRA's Position

The CRA has adopted the unnuanced position that all catalysts, of both long-life and short-life varieties, are invariably classified as Class 26 depreciable property.[14] TEI believes this position is problematic from a tax policy standpoint. In general, the annual capital cost allowance for depreciable property is intended to represent the reduction, during the year, of the capital asset

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[12] Cambridge Dictionary, https://dictionary.cambridge.org/dictionary/english/catalyst.

[13] Chemicool Chemistry Dictionary, https://www.chemicool.com/definition/catalyst.html.

[14] *See* 7 June 2017 CPTS Roundtable, 2017-0695131C6, Question 7, https://taxinterpretations.com/cra/severed-letters/2017-0695131c6.

through exhaustion or wear and tear of the property used. By according the same depreciable property classification to both short-life and long-life catalysts—two qualitatively different assets with disparate useful lives—the CRA's approach is arguably distortive.

TEI's Questions

In view of the above, could the Department confirm TEI's view that short-life catalyst pellets used in the upgrading and refining processes should not be classified as Class 26 property, and that other classes described in Schedule II—such as Class 41.1, or Classes 29 and 53—are broad enough to include such expenditures as a matter of policy?

Alternatively, would the Department consider affirmatively including short-life catalysts in another class of depreciable property that more appropriately reflects their useful lives, such as Class 41, 41.1, or 53?

DEPARTMENT OF FINANCE RESPONSE

The Department appreciates the efforts of the CRA in applying the applicable measures of the Income Tax Act.

The Department does acknowledge the issue related to long-life versus short-life catalysts. To determine whether a legislative change is appropriate, the Department requests more information from TEI, including:

i. an explanation of what has increased the importance of this issue today as compared to in the past (e.g., changes in how catalysts are used, new processes that use catalysts in different ways with differing lifespans);

ii. a description of the industries and their applicable processes that use catalysts;

iii. an explanation of how one would distinguish between long-life and short-life catalysts;

iv. industry data showing the lives of various catalysts; and

v. the amount of capital investment in various types of catalysts.

3. *Order of Application of the Transfer Pricing Rules – Proposed Subsection 247(1.1)*

Chapter 4 of the government's 2019 federal budget plan ("Budget 2019") proposes to "further strengthen Canada's international tax rules" by, inter alia, introducing an ordering rule to

ensure that the transfer pricing rules in the Act apply before other provisions of the Act.[15] The proposal would add a new subsection 247(1.1) to the Act to clarify that the transfer pricing rules in Part XVI.1 apply in priority to the application of the provisions in other parts of the Act, including the provisions relating to income computation in Part I.[16]

TEI invites the Department to provide an overview of, and share its latest views on, the scope and potential implications of proposed subsection 247(1.1). For instance, Budget 2019 referenced implications with respect to the calculation of penalties imposed under Part XVI.1. And during the ensuing 2019 IFA International Tax Conference in Montreal, representatives from the Department mentioned that it was looking into the issue of circular interactions between section 247 and other parts of the Act such as subsection 18(4).

DEPARTMENT OF FINANCE RESPONSE

Proposed subsection 247(2.1) is intended to provide an ordering for the application of transfer pricing adjustments, and the technical notes released in July address the ordering. The technical notes also describe the potential circularity and explain how subsection 247(2.1) would apply. Although the date for formal submissions had elapsed, the Department remains interested in receiving comments on the proposed legislation.

The transfer pricing rule is a rule of general application and takes precedence over other provisions of the Act. The fact that the potential base for penalties may be larger due to this measure is a correct policy outcome.

The Department wishes to note that the transfer pricing penalty is a compliance penalty and not an accuracy penalty. The penalty would apply only if the taxpayer did not make reasonable efforts to determine and use arm's length transfer prices. Therefore, if the taxpayer makes the required reasonable efforts, there would be no penalty regardless of the quantum of any transfer pricing adjustment.

4. *Withholding Tax Rates on Dividends Under the U.S–Canada Income Tax Treaty*

Article X(2) of the current U.S.–Canada income tax treaty (the "Treaty")[17] provides for limited residence-country taxation of dividends (i.e., a five-percent rate of withholding tax) with respect to certain dividends distributed by a company resident in one country to a company resident in the other. The United States, however, has bilateral income tax treaties in force with many other G7 and OECD member countries that provide for *exclusive* residence-country taxation of

[15] Dep't of Fin. Can., Budget 2019, *Investing in the Middle Class* 202 (Mar. 19, 2019). Budget 2019 was tabled in the House of Commons by the Honourable William Francis Morneau, P.C., M.P., Minister of Finance, on March 19, 2019.

[16] *See* Dep't of Fin. Can., Budget 2019, *Tax Measures: Supplementary Information* 385 (Mar. 19, 2019).

[17] Convention with Respect to Taxes on Income and Capital, U.S.–Can., Sept. 26, 1980, 1469 U.N.T.S. 189.

dividends (i.e., a zero-percent rate of withholding tax) in certain circumstances, including with Australia, Belgium, France, Germany, Luxembourg, Japan, the Netherlands, New Zealand, Sweden, and the United Kingdom.

The most recent protocol amending the Treaty, which was signed in 2007 ("Fifth Protocol"),[18] eliminated withholding tax on most cross-border interest payments between qualifying Canadian and U.S. companies, but maintained limited withholding tax on dividends. Canadian multinationals have significantly expanded into the United States since the adoption of the Fifth Protocol. With recent U.S. tax reform reducing that country's federal corporate income tax rate from 35 percent to 21 percent, many U.S. subsidiaries of Canadian companies have excess cash that could be repatriated to and deployed in Canada. The five-percent rate of withholding tax on cross-border dividend payments, however, remains a significant cost that, in many cases, effectively prevents such repatriation. Similarly, the withholding tax on dividends remains a significant cost for U.S. companies investing, or seeking to invest, in Canada. What are the Department's views regarding the potential elimination of withholding tax on dividends in the next round of treaty negotiations?

DEPARTMENT OF FINANCE RESPONSE

The Department cannot discuss whether any particular article in a given treaty is being renegotiated. The Department can provide general comments on Canada's treaty approach.

Canada's longstanding policy for dividends is the current 5%/15% present in most Canadian income tax treaties. The withholding tax on dividends is a significant revenue generator for the country.

Canada is not currently reviewing its policy of dividend withholding tax rates in Canada's tax treaties. The Department notes that a number of Canada's treaty partners have a 0% domestic withholding tax rate on dividends compared to Canada's 25% domestic rate.

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[18] Protocol Amending the Convention with Respect to Taxes on Income and on Capital of September 26, 1980, as Amended, U.S.–Can., Sept. 21, 2007, T.I.A.S. No. 08-1215.2.