CANADIAN TAX Highlights

Editor: Vivien Morgan, JD

Volume 27, Number 12, December 2019

Executive Director's Note

The December issue of *Canadian Tax Highlights* marks the final appearance of this newsletter, whose founder and long-serving editor, Vivien Morgan, will be retiring from the Foundation at the end of the month. With *Highlights*, Vivien has given us a monthly newsletter that, since its launch over a quarter of a century ago, has been an important part of the Canadian Tax Foundation's publication program and a fixture in Canadian commentary on tax. Twenty-seven years ago, Vivien had the vision to conceive and establish this newsletter; since then, as the sole editor of *Highlights* during its long, successful run, she has had the energy and dedication to bring it to life each month. Please join me in thanking Vivien and in wishing her a long and happy retirement.

Heather L. Evans
Executive Director and CEO
Canadian Tax Foundation, Toronto

In This Issue

Kibalian v. Canada: TCC Breached the Principle of Natural Justice

In *Kibalian v. Canada* (2019 FCA 160), the FCA considered a TCC order that included a conditional dismissal of the appellant's TCC appeal. The FCA held that the order amounted to a breach of the principle of natural justice.

The relevant facts are very simple. Discoveries for the proceeding before the TCC were not completed at the time the parties were required to provide a status update to the court. In its status update, the respondent informed the TCC of this fact and indicated that the appeals should not be set down for trial until at least 15 days after the completion of discoveries. The respondent's status update also advised the TCC that the appellant had not yet paid an outstanding costs award. On its own initiative, the court then issued an order requiring the appellant to pay the outstanding costs award and stipulating that "[s]hould the appellant not comply with this Order, the appeal will be *automatically dismissed without further notice or formality and with additional costs* [emphasis added]."

The appellant appealed this, and another TCC order, to the FCA. Of particular importance in the reasons rendered by Woods JA was the conditional dismissal that was included in the TCC order. In rendering the decision, the FCA noted that the order was a "drastic step" that breached the principle of natural justice. In particular, the FCA concluded that the appellant's right to be heard was violated because the order was issued on the TCC's own initiative, without an opportunity for submissions by the parties.

The FCA made two further comments criticizing the TCC order: (1) courts should not award costs where they are not requested by one of the parties; and (2) when a judge issues costs of a punitive nature, reasons for rendering such a costs award must be provided to the parties.

Ultimately, the FCA allowed the appeal in part—setting aside the conditional dismissal contained in the order.

This case is of particular interest because of the finding that the TCC breached the principle of natural justice and because of the questions it raises regarding the TCC's ability to enforce its orders. While the FCA explicitly recognized the implied jurisdiction of the TCC to address non-compliance with its own orders, it nonetheless set aside the portion of the order that sought to address the appellant's non-compliance. If the parties had been provided with an opportunity to make submissions regarding the conditional dismissal, would the TCC's order have been considered acceptable? What other practical means could the TCC have employed to address the

CTF CANADIAN TAX FOUNDATION
FCF FONDATION CANADIENNE DE FISCALITÉ

appellant's non-compliance? Where is the line between adequately severe remedies for non-compliance and overly severe remedies?

E. Rebecca Potter and Julia Ji
Thorsteinssons LLP, Toronto

US Federal Estate and Gift Tax Update

At the end of every calendar year, the Internal Revenue Service (IRS) provides inflation adjustments for certain purposes under US tax law, and also often issues a large number of final regulations. This year is no different, and certain of these inflation adjustments and regulations are particularly relevant for US estate and gift tax planning matters that may affect Canadians with US connections.

On November 6, 2019, the IRS announced the 2020 inflation adjustments for various tax items, including increases in the estate and gift tax unified credit "exemption amount." US citizens or US-domiciled individuals ("US persons") are subject to US federal estate and gift tax regimes on the value of their worldwide assets. (In addition, some states have separate taxing regimes on gifts and transfers at death.) For 2020, a US person will have an estate and gift tax exemption of $11.58 million, an increase of $180,000 from the current exemption of $11.4 million. (All amounts in this article refer to US dollars.) This means that a US person can leave up to $11.58 million to heirs without such property being subject to US federal estate and gift tax. Married couples who are both US persons can take advantage of a $23.16 million combined federal estate and gift tax exemption (double the amount available to single US persons, or to US persons who are married to individuals who are not US persons ["non-US persons"]). These increased exemption amounts, however, are scheduled to expire at the end of 2025 and revert to the pre-2018 exemption level of $5.6 million (indexed for inflation).

A non-US person who owns US-situs assets, including US real property interests, US stocks, certain types of US debt instruments, tangible personal property located in the United States, or certain other assets situated in the United States, is subject to the US federal estate tax regime on the value of such assets at his or her death. Likewise, a non-US person who owns real or tangible personal property located in the United States is subject to US federal gift tax on the value of such assets that he or she transfers to another person for no consideration during his or her life. A Canadian individual who is not a US person but who owns US-situs assets generally has a US estate tax exemption (but no similar exemption for US gift tax) that is equal to the proportion that the value of his or her US-situs assets is of the value of his or her worldwide assets, multiplied by the estate tax exemption amount available to a US person. For example, if 10 percent of the value of the Canadian decedent's assets were US-situs, his or her estate would have an exemption amount of $1,158,000 (10 percent of $11.58 million) in 2020. Therefore, increases in the US federal estate tax exemption amount can be very helpful for Canadians who are non-US persons but who own US real estate, stocks, or other assets in the United States. As noted, however, the US federal estate tax exemption amount is scheduled to be effectively cut to half of the 2018 amount after 2025. Therefore, careful attention to US estate planning is still important for Canadians who own US assets.

While a non-US person does not have a gift tax exemption like the one described above that is available to US persons, there may still be an annual gift tax exclusion available to mitigate US gift tax for both US persons and non-US persons. In 2020, the regular US annual exclusion amount remains at $15,000 (per donee), unchanged from 2019. However, for gifts from a US citizen spouse to a non-US citizen spouse, there is an enhanced annual exclusion amount that has increased to $157,000 for 2020 (a $3,000 increase from the 2019 amount). Otherwise, as long as the donee spouse is a US citizen, gifts between spouses are excluded from US federal estate and gift tax.

With the very large US gift tax exemption now available to US persons, wealthy individuals may wish to consider making substantial gifts now, to avoid US estate tax later when the estate tax exemption amount is lowered. However, there was uncertainty concerning whether significant gifts made before the gift tax exemption is reduced in 2026 would be "clawed back" and subject to US tax if the donor dies after 2025 (in a year when the estate tax exemption is lower than it was during the year of the gift). Happily for generous Americans, the IRS just released final regulations that confirm that no such clawback will occur. In other words, US persons who are considering significant lifetime gifts do not have to worry about a clawback of the enhanced ability to make gifts tax-free, but this is a "use it or lose it" benefit that will expire after 2025.

Carol A. Fitzsimmons
Hodgson Russ LLP, Buffalo

FCA To Hear Atlas Tube Appeal

The case of *Canada (National Revenue) v. Atlas Tube Canada ULC* (2018 FC 1086) involves a number of interesting issues surrounding a tax diligence report prepared by an accounting firm for a potential purchaser of a target corporation. The report contained information on the tax profile and attributes of the Canadian target entities and an evaluation of their tax exposures drawn from their four most recent tax returns. The FC determined, inter alia, that the report was not protected from disclosure under solicitor-client privilege. The court's findings on the privilege issue in particular are open to question on a number of fronts, all of which one hopes will be considered by the Federal Court of Appeal.

First, the FC applied the wrong legal test as to when work product may come within the protection of solicitor-client privilege. The court stated that privilege applies to a document that is not itself legal advice only where the "principal purpose" of the document's creation was obtaining such legal advice; the FC cited as authority only a master's decision on an interlocutory motion involving litigation privilege. This is the wrong legal test: obtaining legal advice need only be one of the document's purposes. In *Gower v. Tolko Manitoba Inc.* (2001 MBCA 11, at paragraph 36), the Manitoba Court of Appeal considered and specifically rejected the use of a "dominant purpose" test for solicitor-client privilege:

> Legal advice privilege is not dependent upon there being litigation in progress or even in contemplation at the time the communication takes place. Nowhere in the definition of legal advice privilege is there any requirement that the communications between the lawyer and his/her client be for the dominant purpose of litigation. Rather, what must be present is the provision of legal advice as one of the purposes of the document, but that legal advice is not confined to a situation where litigation is contemplated.

For a more detailed discussion of this issue, see Steve Suarez, "Canadian Court Orders Disclosure of Accounting Firm Diligence Report in Atlas Tube," *Tax Notes International*, December 24, 2018, at 1283.

Second, the court's conclusion that the primary purpose of the report was to inform the buyer's business decision as to whether to buy the target (and at what price) seems questionable. It was the buyer's lawyers who recommended that the accounting firm perform the tax diligence investigative work, and who subsequently received and used a copy of the resulting report. In this writer's 30 years of tax practice (most of which has been transactional), issues arising from tax diligence have virtually never caused a buyer to decide not to purchase, and have rarely been so consequential as to affect the price. Moreover, the judgment does not suggest that the report in fact disclosed tax issues or exposures significantly out of the ordinary; therefore, it is baffling to claim that the report's primary purpose was to inform a go/no-go purchase decision or price.

To the contrary, in virtually every M & A transaction, the results of tax diligence are used primarily to inform the lawyers drafting the share purchase agreement as to what representations and warranties to demand, what covenants to seek, and the scope and structure of the indemnities required to adequately protect the buyer. In the vast majority of cases, tax exposures are addressed by drafting the purchase agreement to give the buyer a legal indemnity against the seller should a tax issue result in actual damages. This is the very core of the legal advice the buyer's lawyers provide to their client to preserve the client's legal rights against the seller.

Similarly, an understanding of the target's tax attributes is the basic information the buyer's lawyers need to determine how best to structure the transaction from a tax-law perspective and make optimal use of those tax attributes. Again, these activities are clearly the provision of legal advice.

These are the principal (if not the exclusive) purposes of incurring the expense of the type of tax diligence contained in the report. If a buyer's lawyers genuinely use such a report (even if it was created by non-lawyers) to render legal advice to their client, there is no policy reason for not protecting it from disclosure. Indeed, the CRA's own most recent administrative statement (AD-19-02R, "Obtaining Information for Audit Purposes," June 3, 2019) acknowledges the important distinction between facts (which the CRA needs to do its job) and the taxpayer's own subjective analysis:

> It is important not to be influenced by any subjective analyses, comments or opinions contained in the information or documentation reviewed. While CRA officials may, in certain circumstances, request a list of what the taxpayer has determined to be its uncertain tax positions, in considering the structures and transactions outlined, CRA officials should perform their own research and analysis in forming the basis of any reassessment. Provided all the relevant facts of the transactions are disclosed, including the taxpayer's purpose or purposes in undertaking a transaction or series of transactions, exclusions of their advisors' analysis of the legal and tax effects of the transactions may be accommodated.

This, in turn, leads to a third concern. To some extent the court seems to conflate the separate questions of what constitutes the giving of legal advice and what the client does with that advice. Clients obtain legal advice to assist them in making commercial decisions, not because they are interested in the state of the law as an academic exercise. The fact that a client may use the lawyer's legal advice as an input in making a business decision (whether or not to buy, and at what price) in no way detracts from the fact that the lawyer is providing legal advice to the client; this is important to remember when applying the relevant privilege tests to documents or communications. Where a work product has been used by the buyer's lawyers as an input to the legal advice they render, the client's use of that legal advice to make a commercial decision should be irrelevant as to whether that legal advice (and the work product generated wholly or partially for that purpose) is protected from disclosure under solicitor-client privilege. In regard to solicitor-client privilege, diligence work on financial or other non-legal issues stands in a different position from diligence work on legal issues, such as compliance with or transaction structuring within tax laws.

Finally, the court's primary authority on the question of when non-lawyer work product may come within the scope of solicitor-client privilege was *Redhead Equipment v. Canada (Attorney General)* (2016 SKCA 115). That case (which represents a restrictive view) held that "the privilege extends only to communications in furtherance of a function essential to

the solicitor-client relationship or the continuum of legal advice provided by the solicitor, for example: . . . employing expertise to assemble information provided by the client and explaining the information to the solicitor" (at paragraph 45). Even on that limited definition, using non-lawyers to assemble and document information needed by a tax lawyer to render legal advice qualifies for solicitor-client privilege. As the Manitoba Court of Appeal stated in *Gower*:

> [L]egal advice is not confined to merely telling the client the state of the law. It includes advice as to what should be done in the relevant legal context. It must, as a necessity, include ascertaining or investigating the facts upon which the advice will be rendered. Courts have consistently recognized that investigation may be an important part of a lawyer's legal services to a client so long as they are connected to the provision of those legal services. As the United States Supreme Court acknowledged: "The first step in the resolution of any legal problem is ascertaining the factual background and sifting through the facts with an eye to the legally relevant." [*Upjohn Co. v. United States*, 449 U.S. 383 (1981) (S.C.) at para. 23] . . .
>
> It is clear that the client requested [that the investigator] make recommendations based on the facts that she gathered and provided advice with respect to the legal implications of those recommendations. Thus, the fact gathering was inextricably linked to the second part of the tasks, the provision of legal advice.

These observations are equally applicable to tax diligence legwork performed by non-lawyers for the buyer's lawyers to use in rendering tax-law advice to their client. The tax community will be very interested in the FCA's disposition of the *Atlas Tube* appeal. CPA Canada has been granted intervenor status.

Steve Suarez
Borden Ladner Gervais LLP, Toronto

No Reduced Withholding Tax for Pension Payout to US Resident

In a recent technical interpretation (TI 2017-0732681E5, September 12, 2019), the CRA confirms that when an individual pension plan (IPP) distributes an actuarial surplus to a US resident on windup, the surplus does not qualify for the reduced 15 percent withholding tax rate under the Canada-US tax treaty. Instead, the CRA states that the distribution is subject to the higher 25 percent domestic withholding tax rate. In this TI, the CRA also gives examples of other distributions from an IPP that are ineligible for the reduced withholding tax rate under the treaty.

The TI describes a situation in which Ms. X is the sole member of an IPP. Since retiring, Ms. X has received monthly lifetime retirement benefit payments, which are subject to a 10-year guarantee period. Ms. X dies during the guarantee period, so the remainder of her monthly benefits will be paid out to her daughter, who is a US resident. The IPP will be wound up at the end of the guarantee period, once all benefit obligations are satisfied. At this point, any remaining funds will be distributed to her daughter.

IPPs are generally created specifically for individual business owners and incorporated professionals to provide lifetime retirement benefits to their members. An IPP is defined in regulation 8300(1) as a registered pension plan that contains a defined benefit provision and either has fewer than four members, at least one of which is related to the employer-sponsor of the plan, or is a designated plan.

Under regulation 8503(26), an IPP is also subject to a minimum payout for each year after the year in which a member turns 71. The minimum payout amount is typically calculated based on the value of the IPP's assets and the plan member's age, as described in the definition of "IPP minimum amount" in regulation 8500(1).

Pension benefits paid to a non-resident of Canada are generally subject to 25 percent withholding tax under paragraph 212(1)(h). However, under section 2(a) of article XVIII of the Canada-US tax treaty, pension benefits are generally eligible for a reduced 15 percent withholding tax rate if they are periodic pension payments paid to a US resident.

"Periodic pension payment" is defined in section 5 of the Income Tax Conventions Interpretation Act and specifically excludes lump-sum payments and any payments that may reasonably be considered to be an instalment of a lump-sum payment under a registered pension plan.

In the TI, the CRA states that the IPP's final pension distribution to Ms. X's US-resident daughter would not qualify for the lower 15 percent withholding tax rate, since it is a lump-sum payment of an actuarial surplus relating to the IPP.

The CRA says that the final distribution payment made from the IPP is separate and distinct from the IPP's guaranteed monthly payments. The IPP's monthly payments are periodic benefits payable under the terms of the IPP funded by the employer; however, the IPP's final distribution payment is a lump-sum payment of an actuarial surplus related to the IPP. Thus, the final distribution payment does not meet the definition of a "periodic pension payment," and therefore this payment does not qualify for the reduced 15 percent withholding tax rate under the treaty.

The CRA also comments on two other types of IPP payments that would not qualify for the reduced treaty withholding tax rate of 15 percent: additional payments that an IPP must make to comply with the IPP minimum amount rules in regulation 8503(26) and commutation payments are not considered periodic pension payments because they are separate and distinct from the series of periodic payments that make up a member's lifetime retirement benefits.

Marlene Cepparo
KPMG LLP, Toronto

Amendments to the Act: The Impact of Proposed Subsection 247(2.1) on Section 17

In the March 19, 2019 federal budget, the Department of Finance announced a series of measures to further strengthen Canada's international taxation rules. One of those measures was the introduction of an ordering rule to ensure that the transfer-pricing rules in part XVI.1 apply before other provisions of the Act.

In its first iteration, the rule was proposed as new subsection 247(1.1) and simply stated that "for the purpose of applying the provisions of the Act, the adjustments under Part XVI.1 shall be made before any other provision of the Act is applied." Subsection 247(8), which contains a much narrower ordering rule, was to be repealed at the same time. In legislative proposals released on July 30, 2019, Finance replaced proposed subsection 247(1.1) with subsection 247(2.1), a much more detailed provision, and amended the mid-amble of subsection 247(2). Proposed subsection 247(2.1) lays out a three-step process to apply transfer-pricing adjustments in the context of the provisions of the Act. More specifically, where the conditions of subsection 247(2) are met, subsection 247(2.1) provides that

- under paragraph (a), the taxpayer is first required to determine each of the amounts that would be determined for the purpose of the Act, if the Act were read without reference to sections 247 and 245 ("the initial amounts");
- under paragraph (b), the quantum or nature of the initial amounts are then adjusted to "the adjusted amounts" under subsection 247(2); and
- under paragraph (c), each of the provisions of the Act, other than subsection 247(2) but including section 245, is to be applied using the adjusted amounts.

Since transfer pricing affects not only intragroup sales of goods and services but also intragroup financing, the new ordering rule will have an impact on provisions of the Act dealing with cross-border debt transactions. In particular, its interaction with section 17 raises some concerns.

In its explanatory notes to subsection 247(2.1), Finance gave the example of Forco, a non-resident company, which has a loan of $100 payable to Canco. Forco is not a controlled foreign affiliate of Canco and does not deal at arm's length with Canco. Interest at a rate of 1 percent is payable on the loan, but an arm's-length interest rate is determined to be 3 percent. The first step is to determine the initial amount, being the $1 of interest on the loan. Then, under subsection 247(2), the initial amount is adjusted to reflect the 3 percent arm's-length interest rate, resulting in an increase of $2. Finally, section 17 is considered and is found not to apply, on the basis that a 3 percent rate of interest is assumed to be reasonable (that is, the condition in paragraph 17(1.1)(c) is not met).

This example illustrates that with the new ordering rule, section 17 would likely no longer apply in most non-arm's-length situations. If the initial amount of interest on a loan is first adjusted to reflect an arm's-length rate, arguably this adjusted rate should always be a reasonable rate for the purposes of section 17 (see *Shell Canada Ltd. v. Canada*, [1999] 3 SCR 622, at paragraph 34). This marks an important shift in policy with respect to debt transactions involving non-arm's-length non-residents: the new benchmark to assess interest on such debt becomes an arm's-length rate in lieu of the prescribed rate.

Subsection 247(2.1) will also affect the exceptions contained in section 17. Subsections 247(7) and (7.1), which deal with situations in which a Canadian-resident corporation has an amount owing from, or extends a guarantee in respect of an amount owing by, a controlled foreign affiliate, will continue to apply. However, subsection 247(2) could now apply to non-arm's-length debt transactions in situations where section 17 does not apply (other than because of subsection 17(8)).

The first situation occurs where a debt is outstanding for less than one year. Although they are outside the scope of section 17 under paragraph 17(1.1)(b), such debts could nonetheless be subject to subsection 247(2), which will now apply first. This means that cross-border short-term loans that do not meet the conditions of subsection 17(8) could now be subject to an imputation of interest based on an arm's-length rate (the CRA argued this position in document no. 2017-0691071C6, April 26, 2017, but without explicit legislative support).

Another situation affected is where part XIII tax has been paid on an amount owing to a corporation resident in Canada. Previously, relying on subsection 17(7), a Canadian lender would have reasonably expected not to suffer an imputation of interest in that case. However, subsection 247(2) will now apply first. This raises the possibility that an amount of interest will be included in the lender's income in addition to the recognition of a shareholder benefit for the borrower equal to the amount of the loan. In a sense, this result goes against the spirit of the pertinent loan or indebtedness election in the Act, which allows taxpayers to choose an interest imputation under section 17.1 over a deemed dividend under subsection 15(2).

Finally, section 17 has detailed deeming rules that are included in subsections 17(2) for indirect loans, 17(4) for loans through partnership, 17(5) for loans through trusts, 17(6) for loans to partnerships, and 17(11.2) for back-to-back loans. Subsection 247(2), which will now apply before section 17, contains no such deeming rules, but it has a rule that may allow for the recharacterization of transactions (see the condi-

tions in subparagraphs 247(2)(b)(i) and (ii) and comments in *Cameco Corporation v. The Queen*, 2018 TCC 195). While more straightforward non-arm's-length debt transactions should now be evaluated against the arm's-length principle, transactions involving intermediaries or non-corporate entities may be more difficult to evaluate under section 247, and in some cases might be addressed only under section 17 through the operation of its deeming rules. For these more complex transactions, the prescribed rate could apply instead of an arm's-length rate, resulting in asymmetrical treatment.

Proposed subsection 247(2.1), although presented as a mere ordering rule, marks an important shift in policy with respect to non-arm's-length debt transactions involving non-residents. This article highlights some concerns raised by this change regarding the interaction of sections 247 and 17. Other existing provisions dealing with debt transactions involving non-residents could also be affected, including sections 17.1 and 18 and subsection 80.4(2), as well as existing provisions that deal with other matters.

François Fournier-Gendron
SNC-Lavalin, Montreal

Ecological Land Donations "Clarified"

A recent TCC decision, *Yellow Point Lodge Ltd. v. The Queen* (2019 TCC 178), interprets the carryforward rules surrounding donations of ecologically sensitive land. In this respect, the court confirmed that these tax incentives may begin to apply during the taxation year in which the gift of ecological property is made, irrespective of whether the taxpayer has obtained the certificates needed to claim the deduction. Although the statutory language may provide a basis for the decision, the result does not make sense, as Parliament has now acknowledged.

This case involved a corporation, Yellow Point Lodge Ltd. ("Yellow Point"), that owned real estate on Vancouver Island. In 2008, Yellow Point granted a covenant to protect ecologically sensitive aspects of the land. Fifty percent of the covenant was granted to the Land Conservatory of British Columbia ("TLC"), and 50 percent was granted to the Nanaimo & Area Land Trust Society ("NALT")—both registered charities. At that time, the covenant had a total FMV of $5,810,000.

Eligible charitable gifts of ecologically sensitive land, including the gift of the covenant granted by Yellow Point, may qualify for a tax deduction (or a tax credit if the gift is by an individual) under the Act. Pursuant to paragraph 110.1(1)(d), a corporation may deduct the total of the eligible amount of a gift of land to a qualified recipient. To qualify for the tax incentives, paragraph 110.1(1)(d) and subsection 110.1(2) allow a corporation to claim a deduction in computing its taxable income in a taxation year if the following criteria are met:

1) the deduction must be in respect of a gift of land, including a covenant or easement to which the land is subject or, in the case of land in Quebec, a real servitude;
2) the FMV of the gift must be certified by the federal minister of environment and climate change;
3) the land must be certified by the federal minister of environment and climate change (or by a designate) to be ecologically sensitive land;
4) the gift must have been made in the taxation year or in any of the five preceding taxation years to a qualified recipient; and
5) the corporation claiming the gift must evidence the gift by filing with the CRA a receipt for the gift containing prescribed information and the two certificates provided by the federal minister of environment and climate change.

In filing its income tax return for its 2008 taxation year, Yellow Point did not initially claim a deduction in respect of its gift of the covenant because it had not obtained the certificates required under paragraph 110.1(1)(d). In 2009, Yellow Point received both the statement of FMV and certificate of ecologically sensitive lands, and both TLC and NALT issued tax receipts to Yellow Point, each in the amount of $2,905,000.

Yellow Point subsequently requested that the minister reassess its 2008 taxation year to allow it to claim a deduction for the gift of the covenant made in 2008. The minister reassessed and, ultimately, Yellow Point claimed a total of $2,836,818 in deductions from income with respect to its gift of the covenant in its 2008 through 2013 taxation years. As a result, the amount of the gift that remained unclaimed after its 2013 taxation year was $2,973,182.

In filing its income tax return for its 2014 taxation year, Yellow Point claimed a further deduction from income with respect to the gift of the covenant. The minister assessed and denied the deduction on the basis that the gift was made in 2008, and therefore Yellow Point was not permitted to claim a deduction outside the five-year carryforward period provided in paragraph 110.1(1)(d).

Yellow Point appealed the assessment on the basis that the five-year period did not start until 2009. An attempt was made by Yellow Point to argue that the gift was "made" in 2009, when all of the preconditions to qualify as an ecological gift were completed, as opposed to 2008, when the covenant was legally granted to TLC and NALT. On this basis, Yellow Point argued that it was entitled to claim the deduction for its 2014 taxation year, which fell within the five preceding taxation years from when the gift was made.

The TCC held that the five-year carryforward of the gift allowed under paragraph 110.1(1)(d) ended in Yellow Point's

2013 taxation year. The court found that the language in paragraph 110.1(1)(d) separates clearly the making of the gift of property from the determination of the FMV of the property and obtaining the necessary certificates from the minister of environment and climate change. Following this line of reasoning, the court rejected Yellow Point's argument that the concept of a "gift" in paragraph 110.1(1)(d) refers to when an "ecological gift" is completed—that is, when all of the conditions precedent to making an ecological gift are completed. The TCC held that the concept of a "gift" refers to when an ordinary gift at common law is made.

The TCC applied a technical interpretation of the provision, citing an emphasis on achieving consistency, predictability, and fairness when interpreting the Act. The application of a largely textual interpretation of the Act does not break new ground; it has long been established as a matter of statutory interpretation that the ordinary meaning of the words play a dominant role when interpreting Canadian tax legislation. According to the court, the wording is clear that each of the criteria set out in paragraph 110.1(1)(d) must be considered separately. In particular, it held that each characteristic does not form part of the determination of when a gift has been made—it occurs when a donor legally effects a voluntary transfer of property to a donee.

It is clear that when courts interpret the meaning of words set out in statutes, they do so with a goal of clarifying rules and making the application of rules more predictable. That said, in the present case, clarifying the meaning of what constitutes making a gift for the purposes of claiming a tax deduction means that the corporation making a gift bears the risk of obtaining the required certificates if it wishes to claim the deduction, but the process for obtaining the necessary certificates is at the discretion of and subject to the timing whims of the minister of environment and climate change.

While the TCC's analysis may provide for a predictable interpretation, the corresponding implications of this decision on donors are concerning. There are a number of steps that must be completed as part of the donation process, including preparing and filing assessment information on ecological sensitivity to obtain a certificate of ecologically sensitive land, and filing a request for a determination of FMV by the minister of environment and climate change. While the Act provides that the determination of FMV should be made "with all due dispatch," the timing of the issuance of the certificates is at the discretion of the minister of environment and climate change. This decision confirms that donors cannot claim any deductions for any of the years that the gift was made, even if they have taken all the necessary steps to meet the preconditions set out in the Act, until they have received the requisite certificates.

It is notable that the TCC specifically states that it is the responsibility of Parliament, not the court, to address policy issues and to make reforms to the Act. In 2014, paragraph 110.1(1)(d) was amended to extend the carryforward period from 5 years to 10 years for gifts made after February 10, 2014. The extended carryforward period should make it easier for taxpayers to make full use of the deduction.

Robert Hayhoe
Miller Thomson LLP, Toronto

Jordyn Allan
Miller Thomson LLP, Saskatoon

TFSA Swap Transactions Continue To Produce Indirect Advantages

In *Louie v. Canada* (2019 FCA 255), the FCA held that the taxpayer was subject to "advantage tax" on the FMV increase in her tax-free savings account (TFSA) because the increase was indirectly attributable to swap transactions she'd undertaken in an earlier tax year. The FCA partially overturned an earlier TCC decision (*Louie v. The Queen*, 2018 TCC 225) on the basis that the TCC used an overly narrow interpretation of the advantage rule. Specifically, the TCC had concluded that the advantage tax did not apply because the FMV increases to the taxpayer's TFSA in 2010 and 2012 were not "directly or indirectly" attributable to her 2009 swap transactions, which moved the underlying shares into her TFSA. However, the FCA upheld the TCC's decision that the taxpayer should be assessed for advantage tax equal to the FMV increase in her TFSA in 2009, the year in which she initially engaged in the swap transactions.

In general, if a TFSA holder receives or is extended a benefit in relation to his or her TFSA, that person is subject to a 100 percent advantage tax under section 207.05. "Advantage" is defined in subsection 207.01(1). Under subparagraph (b)(i) of the definition, advantage generally includes a benefit that occurs when the increase in the total FMV of the property held in a TFSA can reasonably be considered to be attributable, directly or indirectly, to a transaction or a series of transactions (1) that would not have occurred in a normal commercial or investment context in which parties deal with each other at arm's length and act prudently, knowledgeably, and willingly; and (2) where one of the transaction's main purposes is to enable the taxpayer to benefit from the exemption from part I tax.

At the time of the transactions, subparagraph (b)(i) of the definition of "advantage" in subsection 207.01(1) was substantially the same as it is now, but it referred to an "open market" rather than a "normal commercial or investment context."

After TFSAs were introduced in 2009, Finance amended the definition of "advantage" to specifically disallow swap transactions in subparagraph (b)(iii), effective October 17, 2009.

In the situation at issue before the FCA, the taxpayer, Ms. L, had three investment accounts with a Canadian bank: a Canadian direct trading account, a self-directed RRSP, and a TFSA.

Ms. L was actively engaged in multiple swap transactions in 2009, under which she exchanged publicly listed shares between her TFSA, trading account, and RRSP. The swaps were not executed through the stock exchange, and the price of the shares swapped was selected by Ms. L from the day's range of the listed share price for the particular share on the day of the transfer. Although Ms. L generally swapped the shares shortly before the close of market, she transferred securities into her TFSA at the low end of the day's price range, and transferred them out from the TFSA at the high end of the day's price range. In this way, Ms. L was able to transfer value from her RRSP and trading accounts into her TFSA, sometimes swapping the same shares in and out of her TFSA within 24 hours. The swap transactions did not result in contributions to or withdrawals from the TFSA or RRSP, but were purchases and dispositions of shares within the accounts.

As a result of these swap transactions, the FMV of Ms. L's TFSA increased by approximately $200,000 during 2009.

Ms. L stopped engaging in swap transactions when Finance amended the advantage definition to specifically prohibit these transactions in mid-2009, but left the shares she acquired through the swaps in her TFSA. The FMV of Ms. L's TFSA subsequently increased in 2010 and 2012 (by $71,000 and $29,000, respectively), but suffered a loss in 2011.

The CRA assessed Ms. L for an advantage tax of approximately $200,000 for her 2009 taxation year, and approximately $100,000 for her 2010 and 2012 taxation years.

Ms. L appealed the assessments to the TCC, which found that the swap transactions were part of a series of transactions and the increase in the FMV of her TFSA in 2009 was attributable to that series. In addition, the TCC said that the transactions would not have occurred in an open market, and that one of the main purposes for Ms. L entering into the swap transactions was so that she could benefit from the TFSA's tax exemption. As a result, the TCC upheld the CRA's assessment of Ms. L's 2009 taxation year. However, the TCC allowed Ms. L's appeal for the 2010 and 2012 taxation years, and found that her TFSA's FMV increase in 2010 and 2012 could not be reasonably attributed, either directly or indirectly, to the 2009 swap transactions.

In its decision, the FCA dismissed Ms. L's appeal for her 2009 tax year, and concluded that the TCC correctly found that Ms. L received an advantage as a result of her series of swap transactions. However, the FCA allowed a CRA cross-appeal and found that Ms. L also received an indirect advantage in 2010 and 2012 and should therefore be liable for advantage tax for those years.

The FCA found that the TCC interpreted the definition of "indirectly" too narrowly, and that the FMV increase to Ms. L's TFSA in 2010 and 2012 was indirectly attributable to the 2009 swap transactions, since those transactions had increased the number of shares held in her TFSA and, accordingly, their value. As a result, the FCA concluded that Ms. L continued to enjoy an advantage during those years that was indirectly attributable to her 2009 transactions, making her liable for advantage tax in those years as well.

The FCA found that, in the legislative phrase "directly or indirectly," Parliament intended to capture any and all methods through which a transaction could increase the FMV of a TFSA. Further, according to the FCA, the TCC's concerns as to when or how far into the future an advantage could be considered to be attributable to an abusive transaction did not justify a restrictive interpretation of the definition of "advantage." The FCA noted that other mechanisms are available to address this concern, such as the CRA's ability to waive or cancel advantage tax or to reset an individual's TFSA room.

The FCA found that the TCC erred when it applied a narrower interpretation of "directly or indirectly" to conclude that the increases in FMV in Ms. L's TFSA in 2010 and 2012 were attributable only to market factors. The FCA held that, although the FMV of her TFSA during those years may have been directly attributable to market factors, its FMV was also indirectly attributable to the swap transactions, since the 2009 transactions allowed Ms. L to move more shares into her TFSA.

Dino Infanti
KPMG LLP, Toronto

Simple Planning Around Outbound Loans Using Tax Incentives

Within the Act, sections 15 and 17 prevent a non-resident-controlled Canadian corporation ("Canco") from transferring capital in the form of zero- or low-interest loan/debt financing to a foreign parent ("Parentco").

The transfer of capital requires compliance with timing restrictions and withholding tax remittance requirements where applicable, and the rules can become complex. If the loan remains unpaid for a year, then subsection 17(1) determines the loan interest to be included in Canco's income. A test of reasonableness for interest costs is also required should Canco include interest income that is lower than the prescribed rate (see CRA document no. 2002-0178357, March 6, 2003). Subsection 17(1) income inclusion does not apply if Canco has paid withholding tax under part XIII on the outstanding loan. In addition, deemed imputed interest, per subsection 80.4(2), is calculated for the period during which the loan remains unpaid and is subject to withholding taxes. There are exceptions to subsection 17(1); however, a discussion of these is outside the scope of this article.

There is a timing question about when the interest income should be included. Specifically, the wording in paragraph 17(1.1)(b) refers to a loan amount that has been *or* remains outstanding for more than a year. Should the imputed interest income apply to Canco on the one-year anniversary of the loan date or, retroactively, on the date when Canco loaned the amount? According to CRA document no. 2002-0148547 (August 2, 2002), the interest income inclusion will apply to each taxation year during which the loan was outstanding, provided that the amount ultimately remains outstanding for more than 12 months.

If the loan continues to be unpaid in the second year, Canco can be subject to a subsection 15(2) shareholder benefit. As a relief measure, Canco can elect under subsection 15(2.11) for the loan to be a pertinent loan or indebtedness (PLOI). An election is required for each loan assignment and should be made on or before Canco's tax return filing-due date. This election absolves Canco from withholding taxes, which can be expensive, and provides for the deferral of a shareholder benefit and better timing for compliance. However, the interest income to be included can still be material; the interest rate computed under regulation 4301(b.1) will be 4 percent plus the prescribed rate. Overall, an outbound capital transfer can be an expensive tax liability, especially when the capital transfer becomes large.

What if Canco is a technology corporation and can take advantage of the tax credits from scientific research and experimental development (SR & ED) as defined in subsection 248(1)? Conventional technology corporations in Canada that are not CCPCs do not benefit from enhanced tax credit rates and therefore are less motivated to apply for SR & ED tax credits or to consider banking such tax credits for future use. This is especially true if the corporation is currently not taxable or if the eligible SR & ED expenses are not expected to be high, thus leading to lower non-refundable tax credits. Often, management may look at the immediate costs and benefits (including the potential cost of professional services to claim the credits) when considering whether to apply for SR & ED tax credits. In a simple example, we see how this thought process can be challenged, especially when a corporation has accumulated cash that is being considered for use in an outbound loan transaction such as the one discussed here. Specifically, combining SR & ED tax credits with the PLOI election can allow for simple, cost-effective tax-deferral planning.

Consider a hypothetical example of a $1 million loan from Canco to Parentco, which is subject to a subsection 15(2) shareholder benefit; assume that the loan is not subject to an exception under subsections 15(2.2) to (2.6). Pursuant to paragraph 214(3)(a), there is a deemed dividend paid by Canco to Parentco that is subject to part XIII withholding tax. Calculated at a (say, treaty-based) 15 percent rate, this will amount to $150,000 of taxes on a dividend amount of $1 million. Canco is entitled to a full refund of the withholding taxes of $150,000, provided that it applies for the refund within two years of the end of the calendar year in which Parentco fully repays the loan. This poses a compliance and timing issue for Canco. If it does not apply in time, Canco will lose the $150,000 withholding tax refund (see CRA document no. 2014-0542061E5, November 7, 2014). Canco can elect under PLOI and essentially defer the tax liability attached to the shareholder benefit. This election will not trigger a deemed dividend and withholding tax, thus saving $150,000 of tax cost in our example.

While the PLOI election appears advantageous, the loan is subject to imputed interest under section 17.1, and this will result in deemed interest income to Canco of $50,000 (assuming a 5 percent interest rate). Assuming a 26 percent corporate tax rate, this interest income translates into a tax cost of $13,000 for Canco.

If Canco activities qualify for SR & ED expenses under section 37, Canco will be eligible for non-refundable tax credits of 15 percent at the federal level. A nominal qualifying expense of, for example, $100,000 in labour for SR & ED-eligible activities would result in $23,250 of non-refundable tax credits. (For simplicity, this example ignores any applicable provincial or territorial credits or other forms of assistance that can induce a recapture of the qualifying federal expenses.) This non-refundable credit of $23,250 can be used to offset the $13,000 tax cost that results from the PLOI imputed interest income. In such a scenario, the non-refundable tax credits have, in a way, been converted to cash savings, since the tax liability from interest income is offset by non-refundable SR & ED tax credits. As a passing remark, this analysis can be extended to other lucrative tax credits.

In summary, taking advantage of SR & ED and other available business tax credits, when combined with a PLOI election, can provide a simple tax deferral on a shareholder loan. In our example, there is an overall benefit after paying the tax costs associated with PLOI interest income. Note that SR & ED tax credits are based on current expenses, so there is no guarantee that a future taxation year will include development activities eligible for SR & ED tax credits. SR & ED tax credits have a 12-month hard-stop deadline from the date when the corporation's tax returns are due; therefore, if Canco is contemplating an outbound loan to Parentco (even if it is not considered in the current period), some form of prudent planning for available tax credits (such as SR & ED) and timing should be considered.

Bal Katlai
Toronto

Outbound Partnerships: FAPI in Unexpected Places

Where a non-resident corporation is held through a partnership, the application of the FAPI rules may yield unexpected results. Practitioners should be aware that even a nominal interest in a partnership may attract FAPI, as discussed below.

Central to the FAPI regime are the concepts of a foreign affiliate and a controlled foreign affiliate (CFA) that rely on ownership thresholds. Pursuant to subsection 91(1), FAPI of a non-resident corporation is included in the income of a taxpayer only if the non-resident corporation is a foreign affiliate that is a CFA of the taxpayer. In simplified terms, a non-resident corporation is a foreign affiliate of a taxpayer if the taxpayer holds, directly or indirectly, at least 1 percent individually, and together with related persons 10 percent or more, of any class of shares of the non-resident corporation. Such foreign affiliate is a CFA if it is controlled by the taxpayer, non-arm's-length persons, or the taxpayer and up to four other Canadian residents (even if they are at arm's length). Control for this purpose means de jure control manifested through ownership of more than 50 percent of the corporation's voting shares. Thus, there would typically be an expectation that CFA status arises only where a small group of Canadians (or persons not at arm's length with the Canadians) controls the non-resident corporation. However, where a non-resident corporation is held through a partnership, these basic rules may apply in an unexpected manner, such that the Canadian-resident taxpayers that fall under the typical threshold (by participating in a widely held partnership, or otherwise) may have a FAPI inclusion.

Where a Canadian-resident person is a member of a partnership, paragraph 96(1)(a) requires that the income of the partnership be computed as if the partnership were a separate person resident in Canada. Effectively, the partnership should be considered "the taxpayer" for the purposes of the relevant provisions. Once the income of the partnership is computed at partnership level, pursuant to paragraph 96(1)(f), it is allocated to the partners to the extent of their share of that income. Notably, the allocated income maintains its character.

Since it is "the taxpayer" for the purposes of paragraph 96(1)(a), the partnership is required to include in its income computation any FAPI of *its* CFAs. Accordingly, where the partnership holds shares of a foreign affiliate that it controls, the foreign affiliate would be a CFA of the partnership, and its FAPI would be included in computing the income of the partnership. Where a foreign affiliate of a taxpayer is a member of a partnership, for the purposes of determining the foreign affiliate's FAPI, subparagraph 95(2)(f.11)(ii) states that section 91 is to be applied in determining the income or loss of the partnership, and subsection 96(1) is to be applied to determine the foreign affiliate's share of that income or loss.

In summary, CFA status is determined vis-à-vis the partnership, and any FAPI is allocated as a FAPI inclusion to the partners (including Canadian taxpayers and their foreign affiliates) based on their share of the income of the partnership rather than their ownership interest in the underlying non-resident corporation generating FAPI. Accordingly, FAPI of a non-resident corporation may be included in the income of a Canadian-resident person notwithstanding that the non-resident corporation may not, in fact, be a foreign affiliate or CFA of such person.

For example, consider a corporation resident in Canada (Canco) that has a 5 percent interest in a general partnership. The remaining partnership interest is held by an arm's-length non-resident corporation. The partnership holds all of the issued and outstanding shares of Forco, a non-resident corporation, and Forco's income includes FAPI. For the purposes of computing its income under subsection 96(1), which includes the application of subsection 91(1), Forco is a CFA of the partnership. As a result, the FAPI of Forco must be included in the income of the partnership, and 5 percent of such FAPI must be allocated to Canco. This result may be surprising, given that Canco has only a 5 percent indirect interest in Forco and the remaining 95 percent indirect interest is owned by a non-resident of Canada. Furthermore, in practice, it may be difficult or impractical to determine the FAPI allocation to a Canadian member of a partnership that holds only a minority interest.

While these rules may be considered a "trap" because FAPI may arise unexpectedly, in some cases they may lead to more favourable results. For example, consider a situation in which four arm's-length Canadian corporations (Cancos) each own 25 percent of the shares of a non-resident corporation (Forco 1). In turn, Forco 1 owns 30 percent of the shares of another non-resident corporation (Forco 2), and Forco 1 makes an interest-bearing loan to Forco 2 to fund Forco 2's active business. The interest income earned by Forco 1 would be FAPI unless it was recharacterized. Because most of the recharacterization rules in paragraph 95(2)(a) rely on the taxpayer having a qualifying interest in the foreign affiliate (generally, 10 percent direct or indirect ownership is required) and because none of the Cancos have a qualifying interest in Forco 2, the recharacterization rule in clause 95(2)(a)(ii)(B), for example, would not be available since each Canco would hold less than 10 percent of Forco 2 on a lookthrough basis.

Alternatively, if the Cancos formed a partnership and the partnership held the shares of Forco 1, FAPI would be determined at the level of the partnership. In this case, the partnership would have a 25 percent indirect interest in Forco 2 and would therefore have a qualifying interest in Forco 2. In that case, the recharacterization rule in clause 95(2)(a)(ii)(B) may apply (subject to various other conditions being met) and the interest income may not be FAPI.

Finally, it should be noted that the foregoing discussion is applicable only to the determination of FAPI. By contrast, for the purposes of surplus computation and payment of dividends, section 93.1 looks through any partnerships and determines the status of non-resident corporations directly vis-à-vis Canadian corporate taxpayers. In some cases, it is possible to meet ownership thresholds to recharacterize income for FAPI purposes and to fall below such thresholds when seeking to recharacterize the same income for surplus purposes. The approach for determining whether a property of a foreign affiliate is excluded property is also different; in this case partnerships are deemed to be corporations. The patchwork of rules and various approaches adopted over the years to deal with partnerships suggests that the foreign affiliate regime was not designed with partnerships in mind. Thus, practitioners should be particularly cautious when dealing with partnerships in the foreign affiliate context.

Ilia Korkh and Eivan Sulaiman
Ernst and Young LLP, Vancouver

Big Trouble for Little Carriers?

The GST/HST zero-rating rules for interline freight (which apply to both domestic and international freight movements) were supposed to be straightforward and help small Canadian freight carriers, their employees, and independent contractors (who are often tasked with moving the freight with company-owned or independently owned trucks). The complexity of these rules has led to interpretive difficulties, particularly by these small carriers, and the CRA administration of them has also not helped.

By way of background, the zero-rating rules for interline freight go right back to the inception of the GST in 1991, and sections 1 and 11 of part VII of schedule VI to the ETA ("the interline freight rules"). The interline freight rules zero-rate interline settlements between freight carriers, whether the settlements are in respect of domestic or international movements. Additionally, payments by a trucking company to independent owner-operators are supposed to be included under the interline freight rules. According to the explanatory notes to the interline freight rules, the zero-rating of interline settlements was supposed to "substantially simplify the operation of the GST for freight carriers given the complex and ambiguous legal relationships that may exist between carriers and shippers."

Under the rules, only the carrier who settles a *domestic* freight bill directly with the shipper or consignee ("the first carrier") is required to collect GST on the bill. If the first carrier makes payments to other interline carriers to help move the property, the rules deem each interline carrier to have supplied freight transportation services to the first carrier—not to the shipper. Under the rules, those freight transportation services between carriers, and any other disbursements to the interline carriers, are zero-rated. The theory underlying these rules is that it would be easier for the government to collect the totality of GST/HST from the first carrier dealing with the shipper, rather than having each of the individual subcontracted carriers (expected to be small, owner-operated businesses) pay their portion of the net tax.

A recent TCC case, *2237065 Ontario Inc. v. The Queen* (2019 TCC 189), has looked at this issue and clarified it going forward. In *2237065 Ontario*, the TCC considered an appeal from an interlining carrier ("223 Ontario") that had supplied transportation services to another company ("the recipient"). More specifically, the court considered whether 223 Ontario could zero-rate those services. The CRA's position was that the services were not zero-rated, and that the appellant, 223 Ontario, should have charged GST/HST to the recipient. The answer came down to an application of the interline freight rules.

The appellant was a corporation solely owned and operated by Shammy Mohan Das, who drove trucks on behalf of the company. Mr. Das incorporated 223 Ontario in 2009 because that was a condition of his beginning to work with Dhatt Transfreight Service Inc.—a common arrangement for individuals seeking to work with larger freight companies. Dhatt then engaged 223 Ontario as an independent contractor "performing as an interlining carrier" and Mr. Das began to drive Dhatt-owned trucks on 223 Ontario's behalf.

This arrangement continued until 2013, when Mr. Das purchased a truck for 223 Ontario's own use and 223 Ontario began to operate on its own. While working with Dhatt, 223 Ontario and Mr. Das were under the impression that since 223 Ontario was providing freight transportation services as an interlining carrier, 223 Ontario not required to charge HST on supplies of those services.

On audit, the CRA took the position that 223 Ontario's supplies to Dhatt were taxable because 223 Ontario did not meet the definition of a "carrier" under the interline freight rules. "Carrier" is defined in subsection 123(1) of the ETA as "a person who supplies a freight transportation service," and the interline freight rules further provide that a "freight transportation service" is a service that transports tangible personal property (with some exceptions). The CRA took the view that 223 Ontario was not a carrier because Mr. Das drove Dhatt's trucks, providing services as a *driver* rather than freight transportation services. The CRA assessed 223 Ontario for $14,384.37 in unremitted HST over the relevant reporting periods.

In considering the appeal, the TCC relied on its earlier decision in *Vuruna v. The Queen* (2010 TCC 365) and the explanatory notes to the interline freight rules. The court concluded that there is no requirement in the ETA that a per-

son physically perform a freight transportation service in order to be a "carrier." In other words, to be a carrier, a person needs only to assume the liability as a supplier of the freight transportation service. This means that a shipper who subcontracts the physical transportation of the goods to another party is still considered a carrier even though the shipper is not performing the physical shipping service himself or herself—all seemingly good news for the appellant.

However, the TCC concluded that although Dhatt was a carrier, the same was not true for the appellant because 223 Ontario did not assume any liability as a supplier—it simply operated Dhatt's trucks. As a result, the TCC concluded that during the two periods 223 Ontario was a supplier of driving services to Dhatt rather than a carrier supplying a freight transportation service. Consequently, 223 Ontario's supplies were not zero-rated and it should have collected GST/HST. The appeal was dismissed.

As an aside, Mr. Das also raised the issue during testimony that he had telephoned the CRA and was provided with incorrect advice on which he based his decision to not collect tax. This is a common issue raised by many self-represented taxpayers. The TCC dismissed this with the oft-cited rule from *Moulton v. The Queen* (2002 CanLII 798 (TCC)), which states that the court is not bound by erroneous departmental interpretations and advice.

By way of commentary, while 223 Ontario's position is sympathetic—having relied on both the CRA and representations from Dhatt, which turned out to be erroneous—this case is another example of a taxpayer who failed to fully understand and appreciate the tax consequences of his business. Careful up-front planning was required, but was perhaps absent here. In hindsight, the distinction between supplying "driving services" to a "carrier" and supplying a "freight transportation service" as a "carrier" appears to be a fine one, and one wonders if there may be some merit in taking this issue forward to the FCA. For now, the immediate take-away is that even small transportation companies need to follow the old Benjamin Franklin axiom, "an ounce of prevention is worth a pound of cure," and take proactive steps to fully appreciate the tax consequences of the services they provide.

Robert G. Kreklewetz and Stuart G. Clark
Millar Kreklewetz LLP, Toronto

"GloBE": A New Architectural Blueprint of International Taxation

On November 8, 2019, the OECD released the second of the two pillars of what is now known as BEPS 2.0, the "Global Anti-Base Erosion" or "GloBE" proposals. This document comes one month after the release of the first pillar, the "Unified Approach," in which the OECD methodically articulated a process through which countries could expand their right to tax profits that are beyond their current reach. The GloBE proposals, initially introduced in February 2019, develop an integrated set of rules to ensure that profits are subject to at least a minimum rate of tax. These two pillars, initially conceived to tax highly digitalized businesses, will change the international tax architecture even if they do not represent the consensus view of the countries in the Inclusive Framework. Their reach is wide and could potentially affect every company in the business-to-consumer sector.

Given the pace at which the OECD has advanced its work on this issue, it is important to provide a contextual background for these developments. The digital economy was clearly a priority for the OECD back in 2013, at the early stages of the BEPS project. "Addressing the Tax Challenges of the Digital Economy" formed the first part of the 15-part action plan and recognized, upon the release of the BEPS final reports in 2015, that the digital economy was "increasingly becoming the economy itself."

This reality reaffirmed the urgency to develop an effective set of rules designed to address the challenges of digitalization—most importantly, the ability of highly digitalized multinationals to participate "remotely" in the domestic economies of certain countries without the need to have a physical presence in those countries.

In March 2018, the OECD released an interim report outlining a plan of work to develop an international set of rules by 2020. This plan was agreed to by the Inclusive Framework member countries, confirming a global consensus on the issues. Almost a year later, the OECD released a policy note, followed by a public discussion draft summarizing the countries' proposed solutions. The two pillars above were introduced as a framework for a potential solution, culminating in the Unified Approach paper of October 9, 2019 and the GloBE proposal paper of November 8, 2019.

The mechanics of the worldwide minimum tax rate introduced in the GloBE proposal are premised on two sets of rules. The first set of rules, discussed in detail in the November 8 paper, is designed as a top-up tax imposed at the level of the parent company where the income of a subsidiary (or branch) is not subject to the worldwide minimum tax rate: specifically, an income-inclusion rule that would tax the income of a foreign branch or a controlled entity if that income was subject to tax at an effective rate that is below a minimum rate. Additionally, the rules include a switchover rule that would permit a residence jurisdiction to switch from an exemption to a credit method where the profits attributable to a permanent establishment (PE) or derived from immovable property (which is not part of a PE) are subject to an effective tax rate below the worldwide minimum rate.

The second set of rules is designed as a tax on base-eroding payments, not dissimilar to the base erosion and anti-abuse

tax (known as BEAT) introduced in the 2017 US tax reform. Specifically, an undertaxed-payment rule would operate by denying a deduction or imposing source-based taxation (including withholding tax) for a payment to a related party if that payment was not subject to tax at or above a minimum rate. Similarly, a subject-to-tax rule would complement the undertaxed-payment rule by subjecting a payment to withholding or other taxes at source and adjusting its eligibility for treaty rates.

Combined, these measures work to achieve the OECD's overarching objective to align effective tax rates across multinationals to a new aspirational minimum tax rate. No indications of where that level may be were provided by the OECD at this stage. Considering the G20 sponsorship for this project, is it reasonable to expect a consensus minimum rate to be within the range of the current statutory tax rates for these countries and close to the 25-26 percent average? Or should it be viewed as a baseline rate, closer to (or below) 10 percent? Would the European endorsement of these measures pull the rate closer to the Franco-German level of 30-31 percent? Or would the heavy concentration of US companies in the S&P 500, the so-called FAANG group (Facebook, Amazon, Apple, Netflix, and Google), push the rate closer to the US statutory rate of 21 percent?

It may be purely speculative to ponder these questions at this stage, but it is certainly clear that striking international consensus on a global minimum rate is an ambition that is fraught with political considerations that transcend academia and "better policy" aspirations. Taxation has long lived in the shadow of politics, and a few warning shots have been fired between the United States and France on the digital tax issue.

Regardless, the progress made by the OECD on this issue is remarkable, despite the aggressive target consensus date of 2020. An incredible amount of complexity remains to be addressed, as demonstrated in this latest GloBE paper. How should multinationals determine a consolidated tax base? How should they address differences between financial accounts and tax accounts? How should they calculate their consolidated effective tax rate across high- and low-tax jurisdictions, and what blending methods should they adopt? Should there be a limit to these proposals and, if so, what carve-outs should be explored? These technical questions also require global consensus at a time of great uncertainty and a changing political landscape.

One thing is certain: BEPS 2.0 is the new architectural blueprint of international taxation, even if it remains fuzzy at this stage. Unlike the original BEPS reports, it abandons the convention of the separate legal entity approach to taxation in favour of group-wide apportionment using formulas or transfer-pricing tools. Canadian taxpayers are no strangers to this approach; the CRA has long adopted a group-wide view of transfer pricing under audit, even if it has been largely unsuccessful in the Canadian courts.

Canadian multinationals would be wise to pay attention, particularly at this juncture, since governments are moving faster than the tax function is able to keep up. The new international tax reality requires more than simple tweaks to existing intercompany transfer-pricing policies; it requires a holistic review at a group-wide level and, more concerningly, it assumes that multinationals have access to perfect segmented data. Significant investment may be required just to adapt to this new reality, even though there is still a high degree of skepticism around the ability to reach consensus on these proposals.

Waël Tfaily
Ernst & Young LLP, Montreal

The Rise of Crypto Funds and the Offshore Investment Fund Property Rules

It has now been over a decade since the birth of Bitcoin—currently the most prevalent form of cryptocurrency. Originally envisioned as a purely peer-to-peer version of electronic cash, permitting payments to be sent directly between parties without the participation of third-party intermediaries, cryptocurrencies have expanded to uses beyond their peer-to-peer roots and have made their way into sophisticated investment structures.

This evolution is perhaps most clearly visible in the hedge fund industry. There are more than 150 active hedge funds focused mainly or exclusively on trading cryptocurrencies ("crypto funds"). The cryptocurrency asset-class market is estimated to be worth over US$800 billion. As this market begins to mature, the number of crypto funds is expected to grow.

Like traditional hedge funds, most crypto funds are domiciled in tax havens, with the Cayman Islands being the most popular location. Part of the reason behind the popularity of locating crypto funds in offshore jurisdictions is that fund managers are already familiar with the legal and regulatory framework in these locations. Beyond familiarity, offshore jurisdictions with an established foreign-investment structure may be attractive because they have high-quality service providers and custodians, a stable political climate, and a neutral tax system.

The popularity of offshore structures means that Canadians looking to invest in crypto funds may find themselves running into the Canadian tax rules surrounding foreign investment. In this regard, the offshore investment fund property (OIFP) rules

in section 94.1 are particularly relevant. Although other rules may apply, in this article we consider how the unique nature of crypto funds fits within the OIFP rules.

Section 94.1

Section 94.1 is an anti-avoidance rule aimed at Canadian residents who, motivated by tax considerations, invest in portfolio investments via a foreign entity (other than a controlled foreign affiliate). Where section 94.1 applies, the taxpayer is required to include in income a percentage (equal to the prescribed rate plus 2 percent) of the designated cost (generally the taxpayer's cost) of its investments on an annual basis, to the extent that this amount exceeds the taxpayer's income from the OIFP. The section 94.1 income inclusion increases the taxpayer's cost basis in the OIFP, thereby reducing the taxpayer's gain otherwise arising on the disposition of the interest in the OIFP. Section 94.1 applies when three requirements are satisfied, as discussed below.

First Requirement

The first requirement is that the OIFP be a share or a debt of a non-resident entity. Most crypto funds are domiciled in low-tax, offshore jurisdictions. As with investments in traditional hedge funds in these jurisdictions, Canadian investors generally participate in crypto funds through an offshore corporation. Therefore, it is probable that the first requirement will be met in most cases.

Second Requirement: The Value Test

The second requirement—the so-called value test—is that the taxpayer's interest in an OIFP derive its value primarily from portfolio investments listed in subparagraphs 94.1(1)(b)(i) to (ix). Among the listed investments are "commodities" (subparagraph (iv)) and "currency of a country other than Canada" (subparagraph (vii)). It is worth noting that for this and other purposes of the Act, the CRA takes the position that cryptocurrencies constitute commodities rather than currency. Since crypto funds focus mainly or exclusively on trading cryptocurrencies, the value test will also typically be met.

Third Requirement: The Motive Test

If the taxpayer meets the first two requirements, the next step is to determine whether it is reasonable to conclude that one of the main reasons for the taxpayer acquiring, holding, or having the OIFP interest is to defer or reduce Canadian income tax. This requires giving thought to all the circumstances, including three that the Act specifically points out:

1) the nature, organization, operation, form, terms, and conditions governing the non-resident entity (that is, the crypto fund);
2) the extent to which any income is taxed significantly less than it would be if that income were earned directly by the Canadian taxpayer; and
3) the extent to which the crypto fund distributes income.

This third step will be where the bulk of the analysis is undertaken. It is not enough to say that tax reduction or deferral was a reason—the tax motive must be "one of the main reasons." Taxpayers must weigh their business motives or non-tax motives against their tax motives. Given the commonalities between hedge funds and crypto funds, *Gerbro Holdings Company v. Canada* (2016 TCC 173; aff'd *Canada v. Gerbro Holdings Company*, 2018 FCA 197)—which dealt with the application of section 94.1 to investments in offshore hedge funds—is relevant. Using the three factors outlined above, and the evaluation of those factors by the TCC in *Gerbro*, we discuss the nuances of crypto funds and some factors to consider in applying the motive test.

Role in Designing Fund Structure

A main tax motive can be evident where a taxpayer plays a role in structuring the fund or its distribution policies. Crypto funds are more susceptible to investor influence in this regard than traditional hedge funds, since they face less stringent regulation than traditional hedge funds. This permits crypto funds to solicit investments from a broader range of investors, including small to mid-sized investors. With smaller capital requirements, a small group of influential investors can play a significant role in structuring a crypto fund's tax jurisdiction and distribution policy to defer or reduce Canadian taxes.

The distribution policy, or lack thereof, can also suggest a tax motivation. The redemption frequency for crypto funds can vary. Funds that invest in highly liquid, established cryptocurrencies allow investors to redeem and extract funds more frequently. In contrast, funds that invest in initial coin offerings (ICOs) tend to have long lockups and less frequent redemption periods. Since cryptocurrency markets lack the liquidity, stability, and regulatory certainty of traditional securities markets, crypto funds may choose not to pay dividends, especially those involved with longer-term investments, such as ICOs.

Non-Tax Reasons for Investment

There are several non-tax reasons that investors may choose to invest in cryptocurrencies through a reputable crypto fund, rather than investing directly. Examples include the following.

Ability To Access and Invest in Underlying Investments Directly

Given the lack of available information, the lack of regulation, the complexity of the technology involved, previous fraud

Canadian Tax Foundation
145 Wellington Street West, Suite 1400
Toronto, ON M5J 1H8
Telephone: 416-599-0283
Fax: 416-599-9283
Internet: http://www.ctf.ca

ISSN 1496-4422 (Online)

incidents, and large-scale cryptocurrency thefts by hackers, many see the crypto world as lawless and obscure. For investors intrigued by the upside potential in cryptocurrencies, reputable crypto funds may address these concerns in the following ways:

- Crypto funds may take additional special measures to safeguard currencies from hackers. This could include soliciting specialized independent custodians to safeguard cryptocurrencies and hiring in-house cybersecurity tech professionals.
- Crypto funds typically consist of a team of several experienced investment and non-investment professionals to stay on top of the market and regulatory matters that are unique to this asset class.
- Crypto funds undertake in-depth research and due diligence in the ICO space to identify investment opportunities, and may therefore be in a better position to do so. (In an ICO, fund developers seek to develop a new cryptocurrency system. In exchange, the developers issue a small number of "coins" or "tokens." Investors accept these tokens with the hope that they will become functional in the future and grow in value. ICOs require sophisticated legal, financial, and technological understanding.) In addition, only certain accredited investors can participate in ICOs directly, closing the door for other investors to invest directly.

Because of these practices, crypto funds are even more of a turnkey investment than hedge funds that invest in traditional securities. The investor does not need to concern himself or herself with the added resources needed to participate successfully in this emerging sector—especially since this asset class may form only a small part of the taxpayer's overall investment portfolio.

Locus of Reputable Funds and Fund Managers

Given the nature of, and the risks involved with, cryptocurrency investments, the reputation of the fund manager should be a key non-tax consideration in selecting a crypto fund. Since Canada is not a significant player in the crypto fund industry, and since countries like the Cayman Islands and the British Virgin Islands dominate the space, there is a high probability that investors will find themselves investing in an offshore fund in order to access a reputable fund manager.

Conclusion

Crypto funds are relatively new and are evolving rapidly. As the asset class matures, it is anticipated that more institutional players will enter this market, with the result that crypto funds will end up in the portfolios of more and more Canadian investors. We have highlighted many non-tax reasons for investing in offshore crypto funds that may be relevant in the context of the OIFP rules. Since many of these reasons are primarily driven by the novelty of cryptocurrencies as an asset class, they should continually be revisited as the market, regulatory environment, security, and mainstream understanding of cryptocurrencies evolve.

Thanusan Raveendran
LRK Tax LLP, Kitchener, ON

Anjali Navkar
PricewaterhouseCoopers LLP, Toronto