Volume 2 December 2013

IFA CANADA NEWSLETTER

International Tax News

MESSAGE FROM PRESIDENT OF IFA CANADA

IFA Canada Members,

It is my great pleasure to write to you as the newly elected President of the Canadian Branch of IFA. It is a real honour for me to take on this rather daunting role on behalf of the membership of the Branch. At a time when governments around the world are focused on base erosion and profit shifting, particularly in the form of treaty shopping and transfer pricing, it is difficult to recall a time when IFA has had greater relevance to our day-to-day practices.

My predecessor, Nick Pantaleo, oversaw a number of initiatives that have taken the Branch to a new level. Under his leadership, our programs expanded. Our capabilities as an organization grew in tandem with that expansion. We all owe Nick a great debt of thanks for his energy, leadership and vision. Happily, our practice is to keep the immediate Past President close at hand as a continuing member of our Executive Committee for two years after the end of his or her term as President. I know I speak for the other members of the Executive and of Council when I say that we are looking forward to Nick's continuing contributions to the Branch over the next two years.

With the election of the new Executive, Robert Raizenne completed his two-year term as Past President on the Executive, capping 12 years on the Executive. Robert served in all of our officer positions and most importantly took a key leadership role in the organization and leadership of the 2009 Annual Congress. Canadian members of IFA as well as IFA members around the world will agree that Vancouver was one of the most enjoyable and successful IFA Congresses in memory. While Robert has now stepped down from the Executive, he continues to serve as a member of Council and, as in the case of other Past Presidents, we look forward to his continuing help, advice and ideas.

Congratulations to Ron Durand, Brian Mustard and Sandra Jack on their elections as First Vice-President, Second Vice-President and Secretary of the Branch, respectively. Their continued service to the Branch will provide the experience and continuity that we will need in the busy years ahead.

Last, and in some ways most importantly, we welcome to the Executive our new Treasurer, Patrick Marley. As most of you know, Patrick is a practitioner with Osler Hoskin and Harcourt in Toronto and has been actively involved in IFA for a number of years. We are delighted he has agreed to serve on the Executive and we welcome him into his new role.

And so stands the new Executive Committee. But IFA's not about the Executive. IFA exists for the benefit of its members and, in a real sense, for the benefit of the broader economic and tax community in which we find ourselves. We invite all members to consider how they can become more involved in the activities of the Branch. By serving on Council or our committees, by guiding younger practitioners towards greater understanding of international tax issues, by presenting at our programs, or simply by active engagement through attendance and discussions in and around IFA events, everyone can contribute. As with everything else in life, the more you put in, the more you get out.

Looking ahead, our calendar in 2014 is filling up quickly.

In February, we will be holding what might be thought of as a travelling seminar, co-sponsored with the CTF and combining the multi-city approach of our traditional travelling lectureship with the format of a one-day multi-panel seminar. The program will run in Calgary (February 3) and Toronto (February 5) and will focus on the Government's anti-treaty shopping consulting process. (See page 7 for more on this topic. Presenters will be looking at how other countries and the OECD are

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approaching the issues. We anticipate a thorough and spirited discussion of the Department of Finance consultation paper and an excellent program on a subject that will be top of mind in Canada and around the world for some time to come.

On May 22 and 23 we will hold our annual International Tax Conference in Toronto. The conference will be jointly sponsored by the Canadian and U.S. Branches and there will be presenters from both countries. It will be an excellent opportunity to get a comprehensive view of the U.S.-Canada tax scene and connect with friends and colleagues from the U.S. Branch.

The 2014 Annual Congress will be held in Mumbai from October 14-17. It may seem like a long way to go (and it is) but I can say from personal experience that the Indian tax community is very welcoming, highly attuned to the international tax environment and committed to presenting and hosting a successful and enjoyable Congress.

Over the course of the coming year, our newly constituted YIN Committee will be planning webinars and YIN activities and we will be sending out notices from time to time as they come along. A big thank you to Michael Kandev of Davies Ward Phillips & Vineberg in Montreal for agreeing to chair the YIN Committee, and thank you to the Committee members who agreed to step up and get involved: Nik Diksic (Ernst & Young LLP, Montreal), Marie Blanchard-Sow (KPMG LLP, Montreal), John O'Connor (Stikeman Elliott LLP, Toronto), Jason Vincze (GE Capital, Toronto), David Bunn (Deloitte LLP, Toronto), Jeffrey Shafer, (Blake, Cassels & Graydon LLP, Toronto), Drew Morier (Osler, Hoskin & Harcourt LLP, Calgary), D. Brett Anderson (Felesky Flynn LLP, Calgary), Christine Pound (Stewart McKelvey, Nova Scotia), Kim Maguire (Borden Ladner Gervais LLP, Vancouver) and Karina Yiu (PricewaterhouseCoopers LLP, Toronto).

Rounding out our semi-regular activities will be the newsletters that will provide a periodic round-up of international tax developments.

Without doubt, we can look forward to plenty of international tax to keep us busy day-to-day and plenty of international tax thinking to contribute to, participate in and learn from in 2014 and beyond.

Have a great Christmas, safe and happy holidays, and a terrific 2014.

Stephen Bowman

CANADIAN BRANCH ACTIVITIES 2013

The 2013 year was very busy and successful one for the Canadian Branch. Summarized below are some of the activities sponsored by the Branch.

2013 International Tax Seminar
The 2013 International Tax Seminar was held on May 23 and 24 in Montreal. This successful seminar included many informative sessions, including the Department of Finance and Canada Revenue Agency roundtables. Attendees also received timely updates relating to topics such as the foreign affiliate rules, foreign affiliate dumping rules, permanent establishments, transfer pricing and U.S. tax developments. Significant jurisprudence, rulings and administrative developments over the past year were also reviewed. Richard Tremblay provided timely and insightful comments relating to the role and activities of the OECD.

2013 Copenhagen IFA Congress
The annual IFA Congress was held in Copenhagen from August 25-30, 2013. Subject 1 was “The Taxation of Passive Income for Groups of Companies” and Subject 2 was “Exchange of Information and Cross-Border Cooperation Between Tax Authorities.” The Canadian reporters for Subject 1 were Sandra Slaats (Deloitte LLP) and Barbara Worndl (Aird & Berlis LLP) and Jeffrey Shafer (Blake, Cassels & Graydon LLP) and Nik Diksic (Ernst & Young LLP) for Subject 2. In addition, there was a strong Canadian contribution to the various panels, including: Elizabeth Johnson (Wilson & Partners LLP), Brian Mustard (KPMG LLP), Michael Kandev (Davies Ward Phillips & Vineberg LLP), Steve Suarez (Borden Ladner Gervais LLP), and Scott Wilke (Blake, Cassels & Graydon LLP).

Young IFA Network Activities
Two successful Young IFA Network (YIN) webinars were held this past year. On April 4, 2013 John O’Connor (Stikeman Elliott LLP) and Jamie Mitchell (PwC LLP) presented an update relating to the thin capitalization rules. In November, the IFA YIN network hosted a webinar on recent developments with respect to the OECD’s base erosion and profit shifting (BEPS) initiatives. The presenter was Nicolas Bilodeau (Deloitte LLP) from Montreal with Scott Wilke (Blake, Cassels & Graydon LLP) providing additional insight from Toronto. Both webinars were moderated by Michael Kandev, Canada’s representative on the IFA YIN global network. The webinars were well attended with an average of over 200 attendees calling in and attending in Montreal, Toronto, and Calgary in April and in Montreal and Toronto in November. Stay tuned for our next YIN webinar planned for the spring of 2014.

IFA Travelling Lectureship

This fall Stephen Richardson, former Associate Deputy Minister at the Department of Finance, travelled coast to coast to deliver this year's travelling lectureship to audiences in Vancouver, Calgary, Toronto, Ottawa, Montreal and Halifax. The topic of Stephen's lecture was *"An Overview of Tax Policy for Tax Practitioners."*

The new and improved IFA Canada website is continually being updated, so be sure to log in to review transcripts, audio and video from previous Seminars, Lectureships and Webinars. Updates regarding future events will also be on the website with links to program outlines and registration.

GLOBAL INTERNATIONAL TAX DEVELOPMENTS

International Cooperation – BEPS, Information Sharing, Transparency

2013 has been an interesting year in the area of international tax. The same can be expected for 2014. Setting the stage for what may become an unprecedented level of cooperation between countries is a stalled economy with governments seeking to enrich tax revenues. This factor is coupled with the perception that multinational corporations are not paying their fair share of taxes and the observation that the basic principles of jurisdictional taxation have not kept pace with technological developments and the resulting changing business environment.

The Organisation for Economic Co-operation and Development (OECD) undertook a wide sweeping cooperative project in its report "Addressing Base Erosion and Profit Shifting" (BEPS), issued in February 2013. The report noted a need for greater transparency of the effective tax rate borne by multinational enterprises and identified key pressure areas that are contributing to BEPS. These pressure areas include international mismatches in the characterization of instruments and entities, arbitrage in the tax treatment of group financing, inadequacies in transfer pricing rules and the availability of harmful preferential tax regimes. The report was presented to the G20 finance ministers and central bank governors in Moscow, and was strongly endorsed by this group.

In July 2013, the "Action Plan on Base Erosion and Profit Shifting" was presented and endorsed at the G20 meeting in Moscow. The Action Plan covers 15 areas, including the digital economy, hybrid mismatch arrangements, controlled foreign corporation rule design, tax treaty abuse, transfer pricing, aggressive tax planning arrangements and dispute resolution mechanisms. The Action Plan provides for an ambitious 12-24 month timeline for the development of recommendations.

The OECD Global Forum on Transparency and Exchange of Information has been active this year as well, focusing on encouraging countries to improve transparency and establish wide exchange of information networks. In his report to the G20 leaders in September 2013, the Secretary-General of the OECD advised that there are currently over 800 bilateral tax information exchange agreements in place and the multilateral Convention on Mutual Administrative Assistance in Tax Matters has been expanded in scope and number of signatories over the past two years.

An area of growing interest with respect to transparency and information exchange is the so-called automatic intergovernmental information exchange. At the G20 meeting in September, the OECD Secretary-General noted that "[t]he OECD, working with G20 countries and in close co-operation with the EU, is making very good progress in developing a global model of automatic exchange of information". Such a model would involve a legal platform (i.e., bilateral or multilateral agreements) that would provide for the periodic transmission of taxpayer information by source countries to residence countries and would require, in addition to a procedural framework (i.e., what information and how to transmit it), a legal framework that ensures confidentiality of the information and that it is being used only for the purposes specified in the agreements. A model agreement with detailed guidance and reporting instructions is expected to be released by the middle of 2014. It is anticipated that the Global Forum on Transparency and Exchange of Information will assist in monitoring the implementation of the standard and also will assist developing countries in creating the necessary framework to benefit from this initiative.

The foregoing initiatives may have a significant impact on domestic tax regimes as early as 2014 if the ambitious timelines for BEPS and automatic information sharing are met. Governments are already considering domestic tax law changes in light of these developments. Canada's treaty shopping consultation is one example. As these initiatives evolve, we can anticipate that tax administrations will be challenged to balance the benefits of international cooperation with the need for national economic development and competitiveness.

European Hybrid Entity Proposals

Further to the BEPS action plan on hybrids, the European Commission announced on November 26, 2013 a proposal to combat base erosion through amendments to the EU's

Parent-Subsidiary Directive. Generally speaking, this Directive requires EU member states to exempt from taxation dividends (or other profit distributions) paid between parents and subsidiaries resident in different member states.

The proposed changes would address structures using hybrid instruments (generally treated as debt by the issuer and equity by the holder) by requiring member states to tax dividends received from a subsidiary where the subsidiary is entitled to a deduction in its jurisdiction of residence. The changes also require member states to adopt a common general-anti avoidance rule in relation to the Parent-Subsidiary Directive that would challenge certain "treaty-shopping" arrangements or other perceived abuses of the Parent-Subsidiary Directive. The European Commission expects member states to adopt these changes by December 31, 2014.

Ben Nevis (Holdings) Ltd and another v Revenue and Customs Commissioner[1]

Ben Nevis (Holdings) Ltd. was a British Virgin Islands company that was controlled by a resident of South Africa. The South African Revenue Service sought assistance from the U.K. in collecting a tax debt owed by Ben Nevis. The taxpayer argued that the U.K. could not seize its assets based on the common law "revenue rule." At the time the tax liability accrued (1998-2000) the tax treaty between the U.K. and South Africa did not provide for mutual assistance in tax collection. A subsequent protocol signed in 2010 (coming into force in 2011) introduced a provision for assistance in collection of taxes between the U.K. and South Africa.

The U.K. Court of Appeal held that the U.K. could assist South Africa in collecting the debt on the basis that the 2010 provision for mutual assistance with tax collection was in effect at the time that the government of South Africa made a request for assistance. The temporal limits in the treaty and protocol were relevant to determining the timing of relief, but not to the timing of the tax liability being collected. The Court held this interpretation was in keeping with the purpose of the treaty to assist with enforcement, whereas the temporal argument of the taxpayer would frustrate this purpose. The Court also relied on the *Vienna Convention on the Law of Treaties,* noting that even though South Africa was not a signatory to the Convention it applied for the purposes of interpretation as a declaration of customary international law. The Court accepted that legislation is presumed to be non-retroactive, as per customary international law as reflected in the *Vienna Convention*. However, the Court held that the law was not retroactive in an objectionable sense because it applied only to a state of affairs that existed at a previous time and changed the consequences that flowed from that state of affairs, but did not alter the legal nature of the past act. Put another way, the law did not create the South African tax liability, but only changed the consequences of holding assets in the U.K., which could now be seized to satisfy this liability.

Mexican Tax Reform

Significant reforms to the tax regime in Mexico were approved by the Chamber of Deputies on October 31, 2013 and are slated to take effect on January 1, 2014. Included in the changes are:

- maintaining the domestic corporate tax rate at 30% (abandoning proposals to reduce rate to 28%);
- eliminating accelerated depreciation of certain assets;
- imposition of a 10% withholding tax on dividends paid to non-residents (subject to potential treaty relief), while the rate for non-residents earning Mexican sourced income will be increased from 30% to 35%;
- imposition of a 10% capital gain tax on the sale of shares of companies listed on the Mexican stock exchange (previously exempt);
- joint tax liability for shareholders holding effective control over a company where,
  i. the company has not been registered in the Federal Taxpayers Registry,
  ii. the company changes its tax domicile without giving due notice, or
  iii. the company does not maintain the required accounting records.
- mandatory e-communication & audits;
- limiting deductions on certain related party transactions & fringe benefits; and
- revising the maquiladora tax regime.

Originally the Mexican reforms were to include a new anti-abuse mechanism that would have targeted transactions that did not have economic substance, but this proposed rule will not be introduced as the government believes that existing tools can accomplish the same objective.

Ireland – New Residency Proposals

In May of 2013 a U.S. Senate Committee investigation indicated that a U.S. corporation had established subsidiaries in Ireland that were not treated as being tax resident anywhere. Specifically, the relevant companies were incorporated in Ireland with central management and control in the U.S. The U.S. considered the companies to be resident in Ireland, while Ireland considered the companies to be resident in the U.S.

[1] *Ben Nevis (Holdings) Ltd and another v Revenue and Customs Commissioner* ("Ben Nevis"), [2013] EWCA Civ 578 (UK Court of Appeal).

In response, Ireland has proposed amendments that would treat a company as tax resident in Ireland where it is incorporated in Ireland and managed and controlled in a country with which Ireland has a tax treaty if the company would otherwise:

a. be treated as resident in the other country if it had been incorporated in that country,
b. be treated as resident in Ireland if its central management and control had been in Ireland instead of that Treaty country, and
c. in the absence of this amendment, would not be treated as resident in Ireland or the other country.

The amendment takes effect on October 24, 2013, with transitional relief for existing companies provided to January 1, 2015.

FATCA and Exchange of Information

The United States' *Foreign Account Tax Compliance Act* (FATCA) was enacted in 2010 and is intended to address tax avoidance by U.S. persons holding funds in foreign accounts. In addition to reporting requirements placed on U.S. citizens, FATCA imposes requirements on foreign financial institutions (FFI) to report on U.S. accounts. This can result in legal conundrums for these institutions, as their domestic privacy laws may not permit the dissemination of information about account holders, while the penalty for failure to comply is a withholding tax of 30% on most U.S. source payments. The withholding tax for certain payments is expected to commence on July 1, 2014.

During the course of 2013 the final regulations were released and a number of countries (such as France, Germany, Ireland, Norway, Spain, and Switzerland) entered into bilateral agreements with the U.S. to implement FATCA. The model agreements on which the bilateral agreements are based attempt to resolve the domestic legal issues for an FFI regarding disclosure by allowing the FFI to report the required information to the designated competent authority in the partner country, with this competent authority then responsible for exchanging the information with the U.S. In lieu of an agreement between the partner country and the U.S. the FFI would be required to enter into an agreement with the U.S. Department of Treasury in order to avoid the imposition of the withholding tax. Where an FFI cannot legally disclose information regarding account holders the FFI must ask the U.S. account holder to waive this right and if the account holder refuses the account must be closed by the FFI.

Canada is in the process of negotiating an intergovernmental agreement with the U.S. The FATCA regime is now being applied in international relationships not involving the U.S., with one example being an agreement similar in nature to the FACTA being entered by the U.K. and the Cayman Islands. Also, as discussed above, the G20 has announced a desire for countries to move toward the automatic exchange of information by the end of 2015 – which could extend the flow of information significantly beyond that imposed by FATCA.

India – Vodafone

A Dutch subsidiary of Vodafone indirectly acquired an Indian company (Hutchinson Essar Ltd) by purchasing its Cayman Island parent company for approximately $10.7 billion. The Indian government sought to collect taxes on the transaction of approximately $2.2 billion. In 2012 the Indian Supreme Court held that gains from the transfer of a foreign company's shares were not taxable in India. However, the Indian government proceeded to introduce legislation that retroactively made the transaction (and others like it) subject to tax in India. In response Vodafone filed a Notice of Dispute under the India-Netherlands Bilateral Investment Treaty in April of 2013, which was a step towards pursuing international arbitration.

The international arbitration process is currently on hold, as the parties are proceeding with non-binding conciliation in an attempt to resolve the dispute. These talks were initiated at the suggestion of Vodaphone and the results will be subject to approval by the Indian Cabinet. Initially, Vodafone sought to have the conciliation performed under the United Nations Commission on International Trade Law, but ultimately the government preference prevailed and the discussions are proceeding under the Indian Arbitration and Conciliation Act.

CANADIAN INTERNATIONAL TAX DEVELOPMENTS: YEAR IN REVIEW

A. Legislative Developments

Budget 2013

The 2013 Budget proposed a number of measures to address perceived international tax avoidance. A program was introduced to reward individuals for reporting major international tax non-compliance that leads to the collection of outstanding taxes due, and the reassessment period for form T1135 was extended by three years where the taxpayer has failed to report income from a specified property. In the budget, the government also proposed to extend Canada's thin capitalization rules to branches and trusts, to repeal the rules regarding International Banking Centres, and announced its intention to consult on possible measures to counter treaty shopping (more on this below).

Technical Amendments – July 12th Release

The Department of Finance released draft legislation on July 12, 2013 which included proposed changes related to the taxation of foreign affiliates, the rules relating to international shipping operations, and the functional currency election. The changes to the foreign affiliate rules included the following:

1. A new rule that deems a year-end of a controlled foreign affiliate to arise when a taxpayer's surplus entitlement percentage in respect of that controlled foreign affiliate decreases. Subject to a specific exception, the consequence is that a taxpayer would be required to include any FAPI that accrued up to the time of the deemed year-end.
2. A broadening of the scope of the rules that re-characterize property income as income from an active business such that they can now apply in certain situations where a partnership borrows money to buy shares of a foreign affiliate.
3. A new rule that would provide for foreign affiliate and qualifying interest status between two foreign affiliate chains where one of the chains is owned through a partnership. This change makes the use of an unlimited liability company in the so-called "Tower" financing structure less necessary.
4. Elimination of the "same residence" condition for the application of a re-characterization rule which previously required that the foreign affiliate that incurred interest expense to earn property income be resident in the same jurisdiction as the affiliate from which the property income was earned.
5. Relieving measures to the base erosion rules, including rules in respect of certain services income and certain contract manufacturing arrangements.
6. A new anti-avoidance rule that applies where a foreign triangular merger is used to avoid an existing anti-avoidance rule applicable to shares of a foreign affiliate that are transferred to another foreign affiliate prior to a sale of the first affiliate to an arm's length person.
7. New rules to deal with foreign accrual tax paid by shareholders of entities that are fiscally transparent under foreign tax law. This is particularly relevant to U.S. limited liability companies.
8. New rules that deem certain foreign corporations to have shares where the relevant corporate law does not create formal share capital. Again, this is particularly relevant to U.S. limited liability companies.
9. New rules that provide foreign affiliate status to certain Australian business trusts in which a controlled foreign affiliate of a Canadian corporation has a beneficial interest.
10. Two comfort letters were addressed with draft legislation: one from 2002 regarding the reduction of an interest inclusion under section 17 where the interest is FAPI and another from 2011 regarding the treatment of partnerships in a foreign affiliate group to ensure that inequities are addressed with respect to FAPI inclusions.

Amendments to Foreign Affiliate Dumping Rules – August 16th Release

On August 16th, 2013, the Department of Finance released proposed legislation to amend the foreign affiliate dumping rules. The proposals include several relieving rules, a few of which are summarized below.

1. A rule that excludes a loan that would otherwise be included in the debt calculation for the purposes of the thin capitalization rules where the debt was incurred to make a loan that qualifies for the pertinent loan or indebtedness exception.
2. A rule that limits the application of the foreign affiliate dumping rules where an investment in a foreign affiliate is made prior to the time that the Canadian corporation becomes controlled by a non-resident corporation.
3. A broadening of the automatic paid-up capital set-off rules.
4. A broadening of the rule that reinstates paid-up capital where a corporation resident in Canada distributes to its non-resident shareholder amounts it has received as interest on or from the repayment of or sale of certain debt obligations owed to the corporation resident in Canada by the foreign affiliate.

5. Allowing corporations resident in Canada to meet the condition regarding the principal decision-making authority and residence of officers when a non-arm's length corporation meets those conditions.

Some tightening measures were proposed including a rule that the corporate reorganization exceptions do not apply to exempt an investment where the investment can reasonably be considered to arise from the repayment or settlement of a pertinent loan or indebtedness. For example, it may have been possible to previously avoid the application of the foreign affiliate dumping rules if shares of a foreign affiliate were acquired upon conversion of a pertinent loan or indebtedness to shares of a foreign affiliate.

Treaty Shopping Consultation

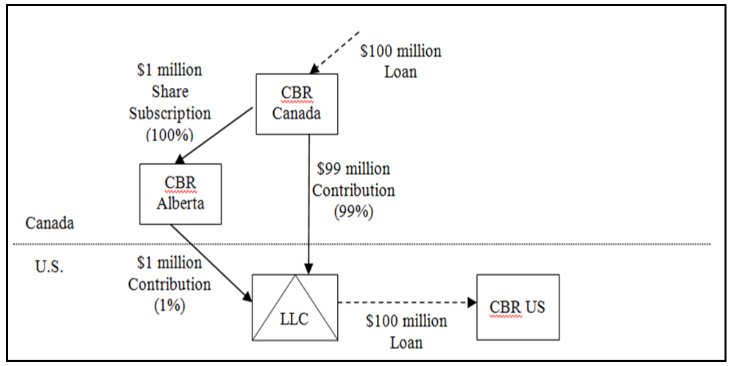
On August 12, 2013, the government followed up on its commitment in the 2013 federal budget by releasing a 25 -page consultation paper on possible measures to prevent treaty shopping. The purpose of the consultation paper, as described by the Department of Finance, is to serve as the basis for a discussion aimed at reaching a workable solution to the problem of treaty shopping. In finding a solution, the Department of Finance's main goals are to ensure that Canada remains an attractive destination for foreign investors and that all of the purposes of Canada's tax treaties are achieved. The consultation paper spells out seven specific areas where the Department of Finance seeks input from stakeholders.

B. Case Summaries

Lehigh Cement Limited v. The Queen, 2013 TCC 176

In Lehigh, the Tax Court of Canada held that the anti-avoidance rule in paragraph 95(6)(b) did not apply to an acquisition of shares that was part of a tax-motivated cross-border series of transactions because the acquisition itself did not result in Canadian tax avoidance.

The taxpayers ("CBR Canada" and "CBR Alberta") were Canadian members of a multinational group headquartered in Belgium. They took part in a series of transactions to refinance a related U.S. corporation ("CBR US") in order to reduce tax, both in Canada and the U.S. In contemplation of the refinancing, CBR Canada incorporated CBR Alberta (for reasons related to external debt covenants) and the two taxpayers established a Delaware LLC ("LLC"), a hybrid entity, in which they held 99% and 1% interests, respectively. The refinancing was then carried out through two series of transactions, through which an aggregate of $100 million borrowed by CBR Canada was ultimately contributed as equity to LLC and loaned from LLC to CBR US.



The Canadian tax savings resulted from the interest deduction to CBR Canada on the $100 million borrowing and the fact that dividends from the LLC would be exempt surplus dividends (as a consequence of the application of the deemed active business income rule to LLC's interest income paid by CBR US).

The Minister reassessed under paragraph 95(6)(b), which deems an acquisition or disposition of shares not to have taken place if the principal reason for the acquisition or disposition was to avoid, reduce or defer tax. The Minister alleged that the taxpayers' acquisition of shares in the LLC was principally tax-motivated.

The Tax Court found that 95(6)(b) applies to any acquisition of shares principally intended to avoid tax, whether or not such avoidance is abusive and whether or not it involves the manipulation of true economic share ownership. The principal purpose of the acquisition of shares, as opposed to the purpose of the overall series of transactions, must be to avoid tax. However, the purpose of the overall series may be relevant in this determination. The court must decide whether the individual transaction was implemented for a purpose different from the overall purpose of the series.

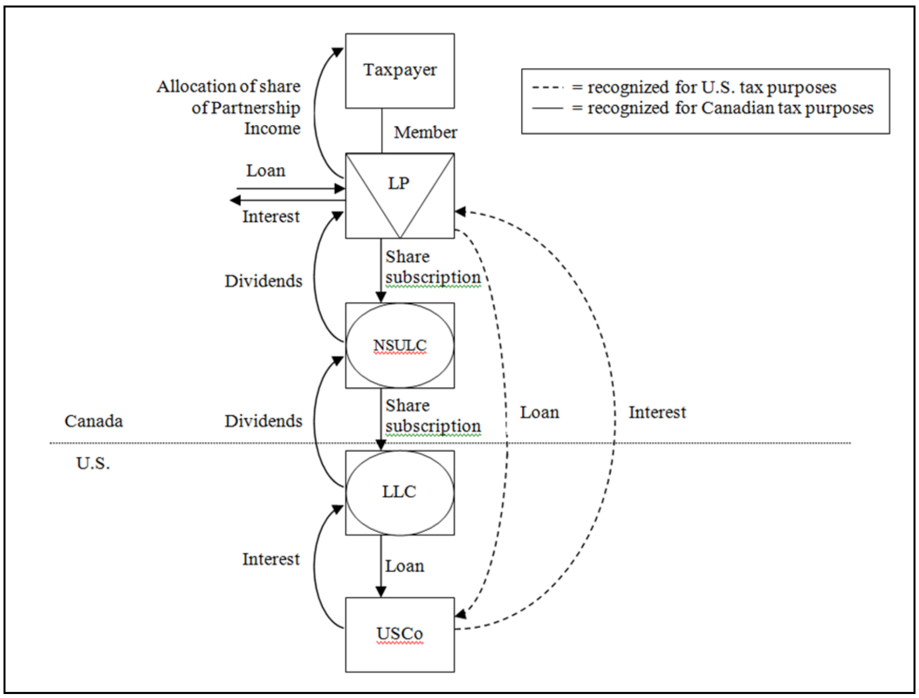
The Tax Court held that the analysis of whether paragraph 95(6)(b) applies to a given set of facts should proceed in three steps: (1) identify the tax otherwise payable that the taxpayers allegedly attempted to avoid, (2) determine whether the acquisition or disposition of shares permitted this avoidance, and (3) assess the taxpayers' principal purpose in acquiring or disposing of the shares. Comparing the impugned transactions with an alternative arrangement in which no LLC shares were acquired (i.e., in which the taxpayers subscribed directly for shares of CBR US), the Court found that the Canadian tax consequences would have been identical.

The acquisition of LLC shares was implemented to reduce U.S. tax, not Canadian tax, and so paragraph 95 (6)(b) did not apply.

This case is currently under appeal to the Federal Court of Appeal.

***FLSmidth Ltd. v. The Queen,* 2013 FCA 160**

The Federal Court of Appeal upheld the Tax Court's decision to deny the taxpayer's subsection 20(12) deduction. The taxpayer attempted to deduct its share of U.S. income tax paid by a limited partnership of which it was a member in the context of the cross-border "tower" financing structure illustrated below.



Due to the hybrid and reverse hybrid entities utilized in the structure, the partnership (which was treated as a corporation for U.S. tax purposes) paid U.S. tax on income which was classified for U.S. purposes as interest received from a U.S. corporation (i.e., USCo, since the LLC and NSULC were treated as disregarded entities for U.S. tax purposes). The Canadian taxpayer sought to deduct its share of the U.S. tax from income which was allocated to it for Canadian purposes from the limited partnership as a dividend received from the NSULC.

Subsection 20(12) permits a taxpayer to deduct foreign non-business income tax paid if such tax: (1) was in respect of the income from which the deduction is sought, and (2) could not reasonably be regarded as having been paid by a corporation in respect of income from a share of a foreign affiliate of the corporation. In FLSmidth, the first requirement stipulated that the U.S. tax be paid "in respect of" the dividend income from the NSULC. The Tax Court judge attributed a broad meaning to the phrase "in respect of" and found there to be a sufficient connection between the tax and the income, but this meant he also found that the second requirement had not been met, and he therefore denied the deduction. Further, he noted that subsection 20(12) was not intended to apply in any case where subsection 113(1) already provided relief from double tax.

The Court of Appeal neither affirmed nor rejected the Tax Court judge's broad construction of the phrase "in respect of" but merely stated that in either case one of the conditions in subsection 20(12) would not be met. As a result, the appeal could not succeed. However, the Court refused to go so far as to find that Parliament intended to exclude the application of subsection 20(12) in all cases in which subsection 113(1) applies. The Court also rejected the taxpayer's argument that the U.S. tax was paid by a partnership, as opposed to a corporation. The issue must be considered by reference to the Canadian Income Tax Act, under which the members of a partnership (not the partnership itself) pay tax on the partnership's income. Consequently, the taxpayer (a corporation), which was a member of the partnership, could be said to have paid the U.S. tax.

Daishowa-Marubeni International Ltd. v. Canada, 2013 SCC 29

The Supreme Court held in Daishowa that a purchaser's assumption of future costs embedded in purchased property does not constitute proceeds of disposition to the vendor.

The case concerns the taxpayer's sale of two forest tenures containing timber-harvesting rights, each of which carried with it the obligation to perform certain reforestation activities. The purchasers assumed these reforestation liabilities as part of the sale, as was necessary to garner Alberta's requisite consent to the transaction. The issue was whether the value of the obligations assumed should be included in the taxpayer's proceeds of disposition.

The Supreme Court focused on whether the reforestation obligations were a distinct debt or whether they were embedded in the forest tenures, illustrating the distinction in the context of a hypothetical sale of real property. The purchaser's assumption of a mortgage encumbering real property would rightly be included in the vendor's proceeds of disposition because the mortgage was separate from the property and did not affect its value. In contrast, any future repair obligations would be embedded in the property and depress its sale price, so the purchaser's assumption of such obligations should not be included in the vendor's proceeds of disposition.

The Court found that the reforestation obligations were more akin to future repair obligations than to a mortgage: they were a future cost embedded in the forest tenures and could not be severed therefrom due to the fact that Alberta was legally required to consent to the transfer. It was irrelevant whether they constituted an absolute or a contingent liability, and also whether or not the contracting parties agreed to a specific estimate of the amount of the liability. The taxpayer's appeal was allowed.

The Queen v. Price Waterhouse Coopers Inc. Acting in the Capacity of Trustee in Bankruptcy of Bioartificial Gel Technologies (Bagtech) Inc., 2013 FCA 164

The Federal Court of Appeal upheld the Tax Court's decision that a unanimous shareholder agreement ("USA") allowed the taxpayer to qualify as a Canadian-controlled private corporation ("CCPC") despite the fact that the majority of its shareholders were non-residents.

The taxpayer was a private corporation that claimed CCPC status in order to qualify for certain investment tax credits. The majority of its shares were owned by non-residents. However, the shareholders had entered into a USA that gave the Canadian resident shareholders the power to appoint a majority of the corporation's directors.

Under paragraph 125(7)(b), the taxpayer would not qualify as a CCPC if a hypothetical person holding all shares owned by non-residents would have de jure control of the corporation. The issue was whether the provisions of the USA should be taken into consideration when determining de jure control.

The Court of Appeal applied the principles from the Supreme Court case of Duha Printers and upheld the Tax Court's decision. In Duha Printers, the Supreme Court held that although ordinary voting agreements between shareholders should not be taken into consideration when determining de jure control, agreements that qualify as unanimous shareholder agreements under the relevant corporate law (generally, unanimous agreements that restrict the powers of directors) should be considered. Applying this principle to the facts, the Court of Appeal found that although the 125(7)(b) hypothetical person would hold the majority of shares in the taxpayer, it would not have the ability to elect the majority of the directors and thus did not control the corporation. The taxpayer was found to be a CCPC and the Crown's appeal was dismissed.

Inter-Leasing, Inc. v. Ontario (Revenue), 2013 ONSC 2927

The Ontario Superior Court of Justice held provincial tax planning designed to avoid Ontario tax on interest income to be ineffective on the basis that interest earned by the taxpayer, an investment holding company established under the laws of the British Virgin Islands, on four specialty deeds of debt of related companies constituted income from a business carried on in Canada and not income from property.

The judge started with the premise that the taxpayer was "carrying on some business activity in Canada" and therefore the issue was whether the interest income was an integral part of that business. Whether such income is actively or passively generated is very important but not determinative. Although interest income received on investments is generally considered to be income from property, this is subject to two exceptions: (1) where investments constitute an integral part of the taxpayer’s business (i.e., where they were employed and risked in such business), and (2) where the activities associated with the generation of interest income are in and of themselves a business. A "level of activity test" should be used to determine whether the generation of investment income constitutes a business in and of itself.

The judge noted several factors supporting the conclusion that the interest income was not income from a business, including the lack of any activity, oversight, monitoring, risk or decision-making involved in holding the debt. However, these were outweighed by other factors, including the presumption that the taxpayer carried on a business in pursuit of its objects, the existence of a permanent establishment in Ontario, the taxpayer's sole purpose of holding investments and earning income from property, and the fact that interest income was the main part of its core activity. The judge found that the true nature of the taxpayer's business was to assist its related entities in an ongoing joint venture to reduce the after-tax cost of capital of entities within the group. Balancing the factors in the context of the taxpayer's commercial objective and activities, he found the interest income to be income from a business carried on in Canada.

The judge was therefore not required to rule on the basis of GAAR, which the Crown also pleaded, though he nonetheless singled out for comment – and adverse inference – the amendment to the taxpayer's Articles to explicitly prohibit the company from carrying on business in Canada (other than as a limited partner) and also the fact that the debts in question were evidenced by specialty deeds physically held in the BVI with the intent of establishing that the legal situs of the debt was the BVI and not the location of the borrowers (i.e., Canada). This case is currently under appeal.

Readers are invited to submit ideas or written material to International Tax News.

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