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IFA CANADA NEWSLETTER

International Tax News

MESSAGE FROM PRESIDENT OF IFA CANADA

Greetings from the Canadian Branch of IFA.

As we approach the end of 2014, we look back on a year of intense international tax activity in Canada and around the world. Practitioners and scholars have had much to consider, and members of the Branch have been active participants in the discussion in Canada and internationally.

We kicked off 2014 with our first IFA/CTF Travelling Seminar. Born out of our experience with our traditional travelling lectureship, the travelling seminar was our response to the scope and scale of the OECD BEPS project. We quickly agreed with the CTF that a joint effort was warranted and we are grateful to the CTF for its support, involvement and logistical assistance with our Calgary and Toronto seminars. The presentations were excellent, the discussion was informative and thought provoking, and the reaction of everyone in attendance was enthusiastic. Thank you to everyone who pulled it together. Looking ahead, we will be repeating that format on February 10, 2015 in Toronto and February 12, 2015 in Calgary with another IFA/CTF travelling seminar co-production. Stay tuned for details.

In May, we had a very successful joint Canada-U.S. International Tax Conference in Toronto. With participants from across Canada and the U.S., we had the chance to catch up on international tax developments in the Canada-U.S. space and beyond, and were able as always to get together with old friends and make new acquaintances. Organizers and presenters again did an outstanding job.

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Over the course of the year, the YIN Committee has been active and productive. We congratulate them on two successful webinars, "Back-to-Back Arrangements in a Cross-Border Context" and "Basics of Inversions for Canadians". We look forward to more of the same in 2015. This year's IFA Congress was held in Mumbai. The Indian Branch mounted a very enjoyable and successful Congress, with much of the discussion revolving, as you might expect, around BEPS. Next year's Congress in Basel promises to be another success and we look forward to seeing many of you there. It will run from August 30 to September 3.

2014 saw considerable activity by members of the Branch at the IFA Central level. We congratulate Brian Schneiderman, past President of the Branch, on his election to the IFA Executive Committee, filling the spot previously held by our most recent past President, Nick Pantaleo.

IFA's key programme committee, the Permanent Scientific Committee, also has renewed its connection to Canada, with the appointment of Scott Wilkie as its Vice-Chair. Scott restores the Canadian representation on the PSC that was previously filled by past PSC Chair Robert Couzin. Congratulations again to two of our past Presidents.

Rounding out the Canadian representation is Michael Kandev, who serves as Chair of our Canadian YIN Committee and is a member of the IFA Central YIN Committee. Michael has been honoured to be the first member of the IFA Central YIN Committee to be invited to sit as a non-voting observer at the proceedings of the PSC. Congratulations Michael.

Apart from programmes and committee work, the Branch has provided financial support this year to the United Nations project to analyze the OECD's BEPS project from the perspective and for the benefit of developing countries. Brian Arnold has taken a leadership role in that endeavour and the Branch is pleased to be a contributor along with our friends at the CTF to the UN project's costs.

Also on the academic front, we have also paid the first installment of a 3-year commitment to support the University of Waterloo Centre for Taxation in a Global Economy.

These financial commitments reflect our continuing goal to support international tax scholarship and dialogue not only

within the professional community in Canada but more broadly in the academic world and internationally.
On the membership front, we have seen a significant number of new members join us this year, primarily in the YIN category. Welcome to all of you. We look forward to your input and participation in 2015 and beyond. More broadly, our membership numbers remain solid, with notable growth in Alberta. We hope to see continued growth in our visibility and reach in Western Canada in 2015. We look forward to seeing as many of our western members as possible, as well as new members, in Calgary at our May 28 and 29 annual International Tax Conference.

In pursuit of our two objectives of supporting international tax education and membership renewal, we will continue to forge links academic institutions and students through a variety of programmes including special offers to encourage students to attend our programmes.

I am happy to report that our financial situation remains strong. We were very successful this year in undertaking an active and professional sponsorship campaign in connection with our International Tax Conference in May. Sponsorship support was a strong endorsement of the program that was offered, and was very successful financially. We intend to continue with this approach and hope to achieve sustainable support from the business and professional communities who recognize the value in IFA's programmes.

Finally, some thank you's. To the writers and editors of this newsletter, thank you for taking time in the busiest season of the year to provide an update on international tax developments. To our Council and Executive, thank you for your ongoing participation, efforts and support. To Events Management and Elizabeth Hooper, thank you for another year of ongoing care and attention that keeps things running smoothly through all of our various programs and projects. Finally, to our members, thank you for your continuous feedback and engagement. By letting us know your concerns and interests we can continue to provide a framework for international tax study, discussion and education.

Best wishes to you all for a safe and happy holiday season. Here's to a great 2015!

Stephen Bowman

CANADIAN BRANCH ACTIVITIES 2014

The Canadian Branch had another busy and successful year, participating in a number of notable events:

2014 Joint U.S.-Canada IFA International Tax Seminar
The 2014 International Tax Seminar was held on May 22nd and 23rd in Toronto and was hosted jointly with the U.S. branch, the first such joint seminar since 2007. The Seminar was co-chaired by Brian Mustard (KPMG LLP) and Patrick Marley (Osler Hoskin & Harcourt LLP) of the Canadian Branch and Peter Glicklich (Davies Ward Phillips & Vineberg LLP) and Steven Hannes (McDermott Will & Emery LLP) of the USA Branch. Topics included International co-ordination (BEPS/Exchange of Information/ FATCA); Transfer Pricing, Legislative Developments; Government Roundtables; E-Commerce and Cross-border M&A. Speakers included representatives of the U.S. Treasury and the IRS. The Honourable Michael Wilson, Chairman of Barclays Capital and the former Canadian Minister of Finance and former Canadian Ambassador to the United States gave an insightful luncheon address.

2014 Mumbai IFA Congress
International tax met Bollywood at the annual IFA Conference in Mumbai October 11-16. Subject 1 was "Cross-border Outsourcing – Issues, Strategies and Solutions" with Canadian reporters Howard Quon (PwC LLP) and Elie Roth (Davies Ward Phillips & Vineberg LLP). Subject 2 was "Qualification of Taxable Entities and Treaty Protection" with Canadian reporters David Bunn (Deloitte LLP) and Nigel Johnston (McCarthy Tetrault LLP).

The Canadian Branch was represented at the plenary session on Subject 2 by Stephen Bowman (Bennett Jones LLP), in the Judges' Seminar by The Hon. ACJ Eugene Rossiter of the Tax Court of Canada and at the Recent Developments in International Taxation seminar by Scott Wilkie (Blake Cassels & Graydon LLP).

YIN Activities
Two successful Young IFA Network (YIN) webinars were held in 2014. On April 9, Nadia Rusak (Osler, Hoskin & Harcourt LLP, Montreal) and Mathieu Champagne (Deloitte LLP, Vancouver) presented on "Back-to-Back Arrangements in a Cross-Border Context". The moderator of the webinar was Michael Kandev (Davies Ward Phillips & Vineberg LLP, Montreal), Chair of the Canadian YIN Committee and a member of the central YIN committee.

On November 6, Paul Seraganian (Osler, Hoskin & Harcourt LLP, New York) and Marie-Emmanuelle Vaillancourt (Davies Ward Phillips & Vineberg LLP, Montreal) presented on "Basics of Inversions for Canadians". The moderator of the webinar was Drew Morier (Osler, Hoskin & Harcourt LLP, Toronto). Stay tuned for our next YIN webinar planned for early in 2015.

This year, the Joint Canada-US IFA International Tax Seminar in Toronto had several YIN features: the conference panels had YIN rapporteurs, as well, the Thursday Dinner was followed by a YIN Party at SpiritHouse, which was well attended by YIN members and more seasoned IFA members alike.

Joint IFA Branch and CTF Seminar on Treaty Shopping
The Canadian Branch teamed up with the Canadian Tax Foundation to offer a joint seminar that provided a comprehensive examination of treaty shopping issues by a distinguished panel of international experts from Australia, the U.S. and Canada. In keeping with the tradition of the Branch's Travelling Lectureship, the Seminar was hosted in Toronto and Calgary and it was

GLOBAL INTERNATIONAL TAX DEVELOPMENTS

A. OECD BEPS Overview

When the OECD announced the base erosion and profit shifting (BEPS) initiative in February 2013, it set an ambitious agenda. For the most part, the timetable has been adhered to and several of the 15 action items were reported on. Some are more draft than originally contemplated for this point in time and still require further work, but important issues have been advanced and many governments are considering their priorities and approaches in addressing BEPS. The reports for Actions 1 and 15 are considered to be final consensus documents. BEPS developments in 2014 are highlighted below.

March 14, 2014 release of discussion draft on BEPS Action 6 – Treaty Abuse

On March 14, 2014, the OECD released the first discussion draft on treaty abuse. (A second discussion draft was released on September 16, 2014 and a third on November 21, 2014.) The key proposals in the March discussion draft, which have evolved in the subsequent drafts (discussed below), were:

- **Limitation on benefits clause:** A specific anti-abuse rule is proposed based on the limitation on benefits (LOB) provision already included in many US treaties. The rule is designed to limit treaty benefits to companies (and individuals, non-profit organizations, pension funds and government bodies) with sufficient presence in the relevant country. The rule operates based on the legal nature, ownership in, and general activities of residents of a treaty country. One of the issues discussed is whether the rule should include a “derivative benefits” clause to allow a contracting state to look through to the ultimate parent.

- **Purpose rule:** Similar to the proposed Canadian domestic law test (that has been placed in abeyance pending BEPS outcomes) a broadly drafted general anti-abuse rule aimed at arrangements where one of the main purposes is to obtain treaty benefits is contained in the discussion draft.

- **Determining treaty residence:** The discussion draft proposes removing the place of effective management tie-breaker clause for determining treaty residence (where different domestic rules would treat an entity as resident in two countries). This would be replaced by a requirement that the competent authorities of the two countries endeavour to determine residence, by reference to place of effective management, place of incorporation/constitution and any other relevant factors.

- **Minimum shareholding period re dividends:** It is proposed that the reduced rates of withholding tax applicable to non-portfolio dividends be restricted to shareholdings that are owned throughout a period of months that includes the dividend payment. Comments are sought on what the number of months should be.

- **Withholding taxes on payments to permanent establishments (PE):** A new treaty clause is proposed to restrict relief from withholding taxes on payments to a third country PE, which would apply where the combined rate of tax paid by the recipient in the PE and residence countries is less than 60% of the tax rate of the residence country.

March 19, 2014 release of two discussion drafts on BEPS Action 3 – Hybrid mismatch arrangements

The discussions drafts covered domestic law and treaty issues requiring consideration in the area of hybrid arrangements and focus on unilateral solutions to neutralize undesired results.

The recommendations in the discussion draft addressing domestic law issues target three categories of hybrid mismatch arrangements:

- Hybrid financial instruments (including transfers)
- Hybrid entity payments
- Reverse hybrid and imported mismatches

The recommendations in the discussion draft address treaty issues related to dual resident entities and hybrid entities, and discusses the interaction between the recommendations in the first discussion draft and tax treaties. Two main recommendations are:

1. The OECD Model Convention should be amended to resolve dual residency issues on a case-by-case basis rather than on the basis of the place of effective management. In addition, countries should include provisions in their domestic law, as Canada does, to deem an entity that is not a resident of the particular country under a tax treaty not to be a resident under domestic law.
2. A new OECD Model Convention provision should be introduced which sets out that an entity that is fiscally transparent under the tax laws of either country will be treated as if it is resident in the recipient country for the purpose of accessing the treaty, but only to the extent that the recipient country, in its domestic law, treats the entity as a resident in respect of the income concerned (and therefore taxes it).

March 24, 2014 release of discussion draft on BEPS Action 1 – Digital economy

On March 24, 2014, the OECD released a discussion draft on the digital economy, identifying the policy challenges. The discussion draft examines the evolution over time of information and communication technology, including examples of new business models, and identifies the key features of the digital economy. It identifies the challenges of segmenting the digital economy and confirms that treating digital business as separate from more traditional businesses for tax purposes would be difficult, if not impossible. The conclusion reached was that the development of the other Actions in the BEPS Action Plan will be relied on to help to address concerns regarding the digital economy.

April 2, 2014 update on BEPS Action 13: Transfer pricing documentation and country-by-country reporting

On April 2, 2014 the OECD announced in a webcast that was open to the public that tentative decisions have been taken to streamline the initial proposals that were contained in the BEPS Action 13 discussion draft that had been issued on January 30, 2014 relating to country-by-country information and transfer pricing master file documentation. This revised approach was in response to public feedback received in respect of the discussion draft.

BEPS Release of September 16, 2014

On September 16, 2014, ahead of the Cairns, Australia September 20-21, 2014 meeting of G20 Finance Ministers and Central Bank Governors, the OECD published seven BEPS papers which addressed the following:

- The digital economy
- Hybrid mismatch arrangements
- Harmful tax practices
- Tax treaty abuse
- Transfer pricing for intangibles
- Transfer pricing documentation and country-by-country reporting, and
- The development of a multilateral instrument to amend bilateral treaties to facilitate the BEPS changes

The digital economy report analyzed the key features of business in the evolving digital economy. Four main policy challenges are identified: (1) Nexus - The reduced need for extensive physical presence in order to carry on business; (2) Data - The increasing ability for companies to gather and use information raises the issues of how to attribute value created from the generation of data through digital products and services, and how to characterize it for tax purposes; (3) Characterization of payments - New digital products create uncertainties in relation to the characterization of payments made in the context of new business models; (4) VAT collection - Cross-border trade in goods and services creates challenges for VAT systems like the Canadian GST and HST regimes, particularly where transactions are between private consumers and foreign suppliers. The report identified the challenges of segmenting the digital economy and concluded that treating “digital” as separate from more traditional businesses for tax purposes would be difficult, if not impossible. Instead, it is anticipated that the work on the other BEPS actions address many of the concerns in relation to the digital economy.

The hybrid mismatch arrangements report targeted the following types of transactions: (1) deduction/no inclusion outcomes – including hybrid financial instruments, disregarded hybrid payments, and reverse hybrids; (2) double deduction outcomes – including deductible hybrid payments and deductible payments made by dual residents; and (3) indirect deduction/no inclusion outcomes - including imported mismatch arrangements. Specific rules are recommended to address each of these arrangements. The recommendations are in the form of domestic “linking rules”. To avoid double taxation, a hierarchy would operate to “switch off” the effect of one rule where there is a rule in the counterparty jurisdiction which addresses the mismatch. Further changes to domestic law are recommended: restricting dividend exemptions for deductible payments; limiting tax credits for taxes withheld at source; improving controlled foreign company (CFC) and other offshore investment regimes; restricting the tax transparency of reverse hybrids that are members of a controlled group; and adjusting information reporting requirements. Each hybrid mismatch rule has its own defined scope. Broadly, the rules target structured arrangements and related party/controlled group transactions. In response to concerns regarding obtaining information from minority stakeholders, a 25% (rather than

10%) investment threshold applies. A new model treaty provision is recommended which sets out that a recipient entity that is fiscally transparent under the tax laws of either country will be treated as if it is resident in the recipient country for the purpose of accessing the treaty, but only to the extent that the recipient country, in its domestic law, treats the entity as a resident in respect of the income concerned (and therefore taxes it). Further work is required in a number of areas, including imported mismatch arrangements, the treatment of income taxed under a CFC regime, the application of the rules to hybrid regulatory capital issued intra-group.

The harmful tax practices report followed up on previous work done by the OECD's Forum on Harmful Tax Practices. It is an interim report which focused on two issues: the compulsory spontaneous exchange of information between tax authorities and the definition of "substantial activities" in determining whether or not an incentive regime is harmful. There was a particular focus on so-called IP boxes/patent boxes and whether or not the income eligible for these regimes should be based on transfer pricing principles (a so-called "transfer pricing" approach) or based on R&D spent in the country with the patent box (a so-called "nexus" approach). More work is required before conclusions are reached on these issues and a late breaking development is discussed below.

As discussed above, the issue of tax treaty abuse was the subject of a discussion draft issued on March 14, 2014. The proposals contained in the September 16, 2014 report are more flexible than the original proposals, providing that at a minimum, tax treaties should include either: (1) a broadly drafted principal purposes test (PPT), which would be a general purpose test aimed at removing treaty benefits where one of the principal purposes of arrangements or transactions is to obtain treaty benefits; (2) a specific anti-avoidance rule based on the limitation on benefits (LOB) rule contained in many US treaties, supplemented by a mechanism to deal specifically with conduit arrangements. Such a rule would be broadly designed to limit treaty benefits to companies with sufficient presence in the relevant country, based on their legal nature, ownership and activities; or (3) a combined approach (i.e., include both PPT and LOB rules). Certain targeted anti-avoidance clauses were also proposed, including a 365-day shareholding period for non-portfolio dividends to be eligible for reduced withholding tax rates. As well, changes to the OECD model treaty were included, to indicate that the prevention of tax evasion and avoidance, specifically including but not limited to treaty shopping, is one of the purposes of a double tax treaty. Further work will be undertaken in 2015 to refine the proposals and, in particular, to further develop them in respect of the treatment of collective investment vehicle (CIV) and non-CIV funds and to further address the availability of so-called "derivative benefits".

The report on transfer pricing for intangibles recommended revisions to Chapter VI of the OECD transfer pricing guidelines. This report is a work in progress, as several important sections will only be finalized in 2015. The report adopted a broad definition of intangibles to preclude arguments that valuable items fall outside the scope of the definition. An intangible was defined as something (1) that is not a physical asset or a financial asset; (2) is capable of being owned or controlled for use in commercial activities; and (3) whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances. The report also began to address the difficult question of how to allocate profits attributable to an intangible when ownership of the intangible is separated, in whole or in part, from activity that relates to the development, enhancement, maintenance, protection, or exploitation of that intangible. The report indicates that while more work in this area will be done, the method to be applied to value intangibles will likely be the transactional profit split, and the use of discounted cash flow techniques by requiring consideration of both parties' realistic alternatives. In particular, the report specifies the difficulties, in many circumstances, of finding suitable comparables for the use of the comparable uncontrolled price method.

The report on transfer pricing documentation and country-by-country reporting contained final revisions to Chapter V of the OECD transfer pricing guidelines which reduce the documentation burden contemplated in the January 30, 2014 discussion draft and modified in the April 2014, OECD webcast discussed above. It is clear that the new guidance will change the documentation process fundamentally. The report provides a three-tiered approach to documentation that includes: (1) the country-by-country reporting template, which is intended to provide a financial picture of a company's global operations; (2) the master file, which is intended to provide a high-level view of a company's business operations, along with important information on a company's global transfer pricing policies on intangibles and financing; and (3) the local file, which is intended to provide information and support of the intercompany transactions that the local company engages in with related parties.

The report on the development of a multilateral instrument confirmed the OECD's view that such a vehicle is feasible from a legal and a practical perspective, and is the most effective way of implementing treaty outcomes under the BEPS project, given that there exist more than 3,000 bilateral tax treaties (varying widely in their details) that may be affected by any BEPS changes. A number of areas in which a multilateral instrument may be useful are identified in the report. They include addressing abuse in cases of dual residence, transparent entities (hybrids), and

"triangular cases" of payments to permanent establishments from third countries. The report concluded that the multilateral instrument should be negotiated through an international conference of OECD, G20 and other interested counties.

BEPS Release of October 31, 2014 – Action 7 on PE

On October 31, 2014, the OECD released a discussion draft on Action 7 in relation to preventing the artificial avoidance of permanent establishment (PE) status. As part of this work, the OECD is considering modernizing the PE threshold address digital cross-border business, in line with BEPS Action 1.

***Commissionnaire* arrangements and similar strategies:** The OECD proposes changes to the current rules on dependent and independent agents. Activities performed by an intermediary in a sales country that are intended to result in the regular conclusion of contracts by a foreign entity will in future create an agency PE (taxable presence) of the foreign entity. The exception for independent agents remains, but the discussion draft proposes tightening the rule to make it clear this will not apply to an agent acting only for a group of companies. Four alternate proposals are noted.

In addition, the OECD proposes to strengthen the requirements (in Article 5(6) of the model treaty) for an agent to be considered "independent" such that it does not create a PE of a foreign entity. The exemption would only apply where the agent is acting on behalf of "various persons" and specifically clarifies that acting "exclusively or almost exclusively on behalf of one enterprise or associated enterprises" will not be sufficient to be considered an independent agent.

Specific activity exemptions: The OECD proposes changes to the list of exceptions for specific activities (such as the maintenance of stocks of goods for storage, display, delivery or processing and purchasing) under which a fixed place of business is treated as not creating a PE (Article 5(4) of the model treaty). This proposal modernizes the exemptions for activities such as warehousing that would have been considered preparatory or auxiliary when the model treaty provisions were originally negotiated. Modern ways of doing business - and in particular internet sales - have made warehousing in the form of sophisticated logistics centres a key part of the value chains of many businesses; it the current exemption is perceived by many governments as being too wide. The discussion draft considers possible alternative proposals.

In addition, the OECD has proposed alternative approaches to address situations where activities are "fragmented" between related parties in order to meet the requirements for activities to be preparatory or auxiliary.

Splitting up of construction contracts: The OECD is considering proposals to deal with the splitting up of contracts between related parties,which may affect the application of the 12-month time period for creating PEs for building sites, construction or installation projects (Article 5 (3) of the model treaty) (and also non-OECD model services PE articles for countries that have adopted them).

Insurance: The discussion draft addresses – through proposed alternatives - a concern that has been identified that insurance companies may do large-scale business in a country without having a PE. It also raises the question of whether reinsurance causes specific concerns related to the avoidance of PE status.

Transfer pricing: The need to coordinate the work on thresholds for PEs with the BEPS work on transfer pricing (particularly on interest deductions and other financial payments, intangibles and risks and capital) is recognized. The discussion draft comments that the preliminary work by the OECD to date has not identified changes that would be required in relation to the attribution of profits to a PE (although some additions and/or clarifications would be useful). The OECD acknowledges, however, that work on other areas, in particular risks and capital, might involve a reconsideration of some aspects of the existing rules.

BEPS Release of November 3, 2014 – Action 10 on Transfer Pricing and Intra-Group Services

On November 3, 2014, the OECD released a discussion draft on Action 10, relating to Chapter VII of the Transfer Pricing Guidelines and low value-adding intra-group services. The principal change included in the proposals is the addition of an elective, simplified approach also known as a safe harbour for determining the intra-group charge for low value-adding services. Taxpayers not electing to apply the simplified approach would still be able to choose to price low value-adding intra-group services using the general guidance included in Chapter VII of the OECD Guidelines, consistent with historical practice.

These proposals are the first new safe harbour proposals by the OECD since the May 2013 revision to Chapter IV, showing the OECD's continued confidence in the potential benefits that can, in theory, be obtained from safe harbours. Such benefits include simplifying compliance and providing some level of assurance for eligible taxpayers as well as streamlining the audits of eligible transactions, allowing tax administrators to focus on higher risk and more complex transactions.

The safe harbour essentially supersedes the arm's length principle; a principle that is deeply rooted in OECD guidance and is the international standard that OECD member countries have agreed should be used for determining transfer prices for tax purposes.

The proposals contain specific rules, where the simplified approach is elected, such as applying the same markup for all categories of services and applying mark-ups of between 2% to 5%. Thus, the low value-adding intra-group services safe harbour would save administrative time and effort by removing the fundamental requirement to consider what would be agreed to by arm's length parties and instead apply a prescribed elective approach.

BEPS Release of November 21, 2014 – Action 6 on Treaty Abuse continued

On November 21, 2014, the OECD released another follow-up discussion draft on Action 6 in relation to preventing treaty abuse. This follow-up discussion draft invites comments on a number of areas which were not addressed or fully addressed in the September release.

Comments are invited on the following in respect of the LOB rule:

- **Widely held CIVs:** Whether the recommendations of the 2010 OECD Report, 'The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles' are adequate or whether improvements could be made.

- **Non-widely held CIVs:** This could include, for example, sovereign wealth, alternative and private equity funds. These funds may not qualify as residents and, even if they do, may fail to meet the current draft of the LOB rule.

- **Pensions:** The residence of pension funds, the exemption of income where both states generally exempt from tax the investment income of domestic pensions, the 50% ownership test and the definition of pension funds.

- **Competent authority discretionary relief:** The factors that competent authorities should take into account when determining whether relief should be available.

- **Derivative benefit provisions/ equivalent beneficiaries:** Possible ways in which a derivative benefits test could be included to allow intermediate companies used for valid commercial reasons to access treaty benefits. This is tied in with other BEPS Actions.

- **Timing issues:** In particular how to treat a company which becomes or ceases to be publicly-listed during a taxable period.

- **Small countries with non-substantial stock exchanges:** Modifying the publicly-listed provision to reflect the fact that listings may not be sought in smaller local markets, while ensuring that an entity has sufficient nexus to warrant the application of the treaty.

- **Interpretation of the active business provision:** Head office operations, and the combination of different activities (for example, manufacturing and investment) carried on in the same country should be considered.

Comments in respect of the PPT are invited on:

- **Extending the list of examples** in the PPT commentary;

- **Alignment with LOB commentary,** in particular, in respect of the competent authority discretionary LOB rule which also considers purpose;

- **Availability of discretionary relief:** As currently drafted, if the PPT applies, the relevant income would be taxable under domestic law without any treaty benefits. In some cases, however, it may be appropriate to provide some form of treaty relief. The example given is a transaction which transforms dividends into a capital gain on shares. Tax authorities may consider it appropriate to apply the relief provided under the dividends article;

- **The alternative "conduit-PPT rule":** This alternative to the PPT may be used by states to address treaty-shopping conduit strategies that would not be caught by the LOB rule. The commentary could include possible examples, which could be taken from the exchange of notes between the United Kingdom and United States in respect of the conduit arrangement rules in the 2001 treaty.

Other issues to be addressed as part of the follow-up work on Action 6 include:

- **New treaty tie-breaker rule:** The possible encouragement of competent authorities to address as quickly as possible requests that will be made under the new rule.

- **Triangulation/permanent establishment in third state:** Comments are invited on whether the rule should be extended to situations beyond where the profits of the permanent establishment are exempt, and whether the exemptions from the rule are broad enough.

Late breaking developments

Some countries have introduced unilateral anti-avoidance measures that are addressing the same issues as BEPS, but in an uncoordinated manner that increases the exposure to double-taxation. Other countries are proceeding with unilateral measures that are directionally aligned with the preliminary recommendations coming out of the BEPS work thus far, while others are continuing make legislative changes that may or may be aligned with the ultimate BEPS recommendations. While it is beyond the scope of this article to address all of the unilateral legislative changes that we are seeing around the world that are related to BEPS, a couple of late breaking ones are worthy of mention:

- Subsequent to the September 16, 2014 release on harmful tax practices described above, Germany (which had previously been opposed to patent boxes) and the United Kingdom (which has a "transfer pricing" type of patent box) negotiated an agreement regarding patent boxes and adopted a "nexus" type patent box as the framework for the agreement. This means that the United Kingdom will be changing its current regime and it is understood that Germany will be introducing a patent box. This agreement is perhaps illustrative of both the spirt of cooperation that exists regarding the BEPS project and the fact that the dynamic between countries remains competitive. This will likely influence the OECD's final recommendation on patent boxes.

- As part of its December 3, 2014 Autumn Statement, the UK government announced a Diverted Profits Tax regime. Further details were released on December 10, 2014. It is scheduled to apply as of April 1, 2015, at a rate of 25%, to profits of corporations that are artificially diverted from the UK. It is separate from corporation tax (which has a rate of 20%).The UK government is of the view that it will be outside of the scope of existing tax treaties .It is not targeting financing.

There are two targets: artificial avoidance of a permanent establishment (PE) in the UK; and/or where a group has a UK company (or UK PE of an overseas company) and there is a "tax advantage" as a result of an entity or transactions that lack economic substance. In both cases there is a requirement that there be activity (people) in the UK. The rules focus on profit that would have arisen in the UK if the arrangements had not been implemented. It is not intended to apply to activities carried on by persons in other countries. In general, a "tax advantage" will be deemed to arise where the overseas tax is less than 80% of the UK tax that would have applied.

There are exemptions for small and medium sized businesses and where the UK sales do not exceed £10 million.

The draft legislation is complex, a full analysis of which would be beyond the scope of this summary. It is surprising that the UK is releasing this unilateral measure before the OECD's BEPS work is completed.

The OECD will be continuing its work on the BEPS actions. At the time of writing, OECD releases on VAT B2C guidelines, interest deductions, risk recharacterization, commodity transactions, profit splits and dispute resolution are anticipated in December, 2014. In 2015, we will see new reports on strengthening CFC rules, collecting BEPS data, disclosure of aggressive tax planning arrangements and making dispute resolution mechanisms more effective along with a finalization of current drafts. As a result, proposed solutions are not yet finalized and may be affected by decisions and future work on BEPS in 2015. It is also important to remember that the OECD's work will result in recommendations - it will then be up to each country to decide if, when and how it will implement a particular recommendation.

B. Country Specific Initiatives

United States - Restrictions on 'Inversion' Transactions

On September 22, 2014, the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) released Notice 2014-52 (the Notice) indicating their intention to issue regulations to address inversion transactions and certain post-inversion transactions that would be characterized as tax avoidance transactions. A corporate inversion may occur when a US corporation becomes a foreign corporation or a subsidiary of a foreign corporation.

The Notice proposes to limit for ten years after the inversion the new foreign parent's ability to access earnings of existing controlled foreign corporations (CFCs) by:

- Preventing inverted companies from accessing a CFC's earnings while deferring US tax through the use of certain loans.

- Preventing inverted companies from restructuring a CFC in order to access its earnings tax-free by way of 'de-controlling' transactions.

- Limiting the ability of inverted companies to transfer cash or property from a CFC free of US tax.

Moreover, the Notice seeks to broaden the application of the inversion rules by:

- Limiting the ability to rely on passive assets that are not part of daily business functions in order to inflate the new foreign parent's size.

- Preventing US companies from reducing their size pre-inversion by making extraordinary dividends.

- Preventing a US company from inverting a portion of its operations by transferring assets to a newly-formed foreign corporation that it spins off to its shareholders.

The Notice is generally applicable to transactions completed on or after September 22, 2014. The Treasury Department and the IRS expect to issue additional guidance to further limit inversion transactions, which will be applied prospectively and only to groups that completed inversion transactions on or after September 22, 2014. They are also looking at ways of reducing the tax benefits of inversions by reviewing US tax treaties and international commitments.

Switzerland - Swiss Corporate Tax Reform III
On September 19, 2014, the Swiss Federal Council adopted the draft legislation of the Federal Law on Measures to Maintain the Competitiveness of Business Location Switzerland (Law on Swiss Corporate Tax Reform III or CTR III). The proposals seek to maintain Switzerland's competitiveness as a business location despite the upcoming repeal of privileged cantonal tax regimes, namely holding, administrative, and mixed company regimes, as well as the federal-level principal taxation and Swiss Finance Branch regimes. CTR III foresees the following tax measures:

- Existing privileged cantonal tax regimes will be replaced with more internationally accepted measures, such as a Swiss Patent Box at the cantonal level and an interest-adjusted profit tax (i.e. a notional interest deduction) on surplus equity at the federal and cantonal levels.

- Cantonal income tax rates shall be decreased at the discretion of the cantons.

- Where there is a change of status, entrance or exit of patent box, transfer of seat or place of effective management from abroad to Switzerland, hidden reserves will be taken into consideration at the time of the change of status or arrival in / exit from Switzerland. Hidden reserves (including goodwill) will be deemed realised for tax purposes and give rise to higher tax deductible depreciation. Adaption of annual capital tax (reduction of taxable equity basis related to participations, intangibles and group loans).

- The issuance stamp tax on equity capital shall be abolished.

- The unrestricted use of tax loss carry forwards (currently limited to 7 years) shall be permitted up to 80% of annual taxable income.

- The indirect participation relief shall be replaced with a direct participation exemption without minimum participation quota and without minimum holding period requirements.

- The partial taxation of individuals on dividend income shall be reduced to 70% and extended to portfolio investments.

- A capital gains tax on privately held investments in participations by individuals shall be introduced.

- The current system of financial equalisation among cantons shall be adopted.

The consultation process on the CTR III began on September 22, 2014 and will extend to January 31, 2015. Based on the consultation input, the Swiss Federal Council is expected to release an updated version of the proposals with an explanatory federal report for parliamentary debates by June 2015. The final reform will likely be subject to popular vote. The new measures are not expected to enter into force before 2018 to 2020. Until the effective date of CTR III, the current tax law remains applicable.

Ireland – Finance Bill 2014
On October 14, 2014, the Irish Minister for Finance released the 2015 Budget along with a policy statement titled "A Road Map for Ireland's Tax Competitiveness," offering an update on Ireland's international tax strategy. The announcements are intended to ensure that Ireland will remain competitive and attractive as a location in which to align intellectual property, profits and substance. The Government also confirmed its strong commitment to maintaining the 12.5% corporate tax rate.

Ireland's Finance Bill 2014 was published on October 23, 2014 to bring into effect the 2015 Budget. Significant changes are as follows:

- Companies incorporated after January 1, 2015 will be regarded as defacto Irish tax resident and the only exemption to this will be under a tax treaty tie breaker. The legislation provides that any companies incorporated prior to January 1, 2015 should be able to avail themselves of "grandfathering" provisions which will continue to apply until 31 December 2020.

- Under the current Irish IP regime, tax depreciation on the cost of qualifying IP acquired is available to offset against qualifying profits. Previously a limitation was included on the amount of taxable income that could be sheltered in any one year through use of this tax depreciation and financing. This threshold of 80% has been removed. The minimum effective tax rate on IP-related profits is therefore reduced from 2.5% to 0%. In addition, the definition of qualifying intangible assets is expanded to include certain acquisitions of customer lists as of January 1, 2015; customer lists acquired, directly or indirectly, as part of a transfer of a business as a going concern are not eligible.

- The 25% refundable R&D credit is presently computed in respect of incremental expenditures incurred over and above a company's R&D expenditures from 2003. The base year limitation from 2003 is being removed from January 1, 2015, with the R&D tax credit being calculated entirely on a volume basis.

- The Special Assignee Relief Programme (SARP) is being extended to the end of 2017. This program aims to attract executives from abroad to work in Ireland by offering tax incentives. Changes to the program including removing the upper salary threshold and reducing the period of employment abroad before moving to Ireland to six months.

The 2015 Budget also proposed the introduction of a "knowledge development box" regime for intangible assets in 2015. This will be open for public consultation and is not expected to be introduced until the current EU review of patent box/IP box regimes is completed.

France: New Hybrid Mismatch Rule
The 2014 Finance Act, enacted on December 30, 2013, introduced a new hybrid mismatch rule pursuant to which related-party interest is deductible only if the French borrower demonstrates that the lender is, for the current tax year, subject to corporate income tax on the interest income that equals 25% or more of the corporate income tax that would be due under French tax rules. When the lender is a foreign tax resident, the corporate tax determined under French law equals the tax liability that the lender would have owed had it been tax resident in France. The hybrid mismatch rule applies to tax years ending on or after September 25, 2013.

Final guidelines released by French tax authorities on August 5, 2014 on the application of the hybrid mismatch rule include the following clarifying remarks:

- The rule is concerned only with the taxation of gross interest income, regardless of any expenses or deductions which would reduce the lender's taxable income.

- The French borrower must demonstrate that the gross interest income is subject to a statutory rate of at least 25% of the standard French tax rate applicable to the lender. The standard French tax rate is the standard tax rate plus applicable surtaxes, such that the minimum local tax rate for purposes of this test would range from 8.33% to 9.5%.

- The interest income inclusion by the lender need not trigger an effective payment of tax. A lender in a loss position can be in compliance with the rule if the gross interest income is included in its tax base.

- The rule focuses on the tax treatment of the amount owed by the French borrower and not the legal characterization of the interest income to the lender.

The final guidelines confirm that interest disallowed as a result of the hybrid mismatch rule should not be treated as a deemed distribution and therefore should not be subject to French dividend withholding tax and distribution tax.

Overall, the hybrid mismatch rule confers upon the French borrower the burden of providing documentation to support the corporate tax calculation. The analysis of the lender's tax rate must be available for each tax year in which the French borrower is claiming an interest deduction.

China: Public Notice 72
On December 12, 2013, the State Administration of Taxation (SAT) released a tax circular, Public Notice 72, which provides new technical and procedural guidance relevant for Non-Chinese tax resident enterprises (Non-TREs) when applying for Special Tax Treatment (STT), essentially a tax deferral, in respect of gains arising on the transfer of equity interests (shares) in Chinese tax resident enterprises (TREs). In the past, STT for cross-border intra-group equity transactions for foreign invested groups has rarely been approved by the Chinese tax authorities due to a lack of detailed guidance on how to determine whether a transaction satisfies STT criteria. With Public Notice 72, effective December 12, 2013, Chinese tax authorities are expected to become more receptive to STT applications for cross-border intra-group restructurings.
Specifically, Public Notice 72 sets out the following clarifying remarks:

- The equity in a Chinese TRE will be deemed to have been transferred in the context of a spin-off or merger of the Non-TRE shareholder(s).

- When the Non-TRE transferor and Non-TRE transferee are tax resident in different jurisdictions,

dividends paid by the Chinese TRE to the Non-TRE transferee after the transfer from retained earnings generated prior to the transfer will not be eligible for the lower withholding tax rate under the double tax treaty (DTT) between the Non-TRE transferee's jurisdiction and China.

- Applications for STT are currently required to be approved by the Chinese tax authorities. This approval requirement is replaced with a record filing procedure, although such transactions will remain subject to review and assessment by the Chinese tax authorities on whether the STT criteria have been satisfied.

CANADIAN INTERNATIONAL TAX DEVELOPMENTS: YEAR IN REVIEW

A. Legislative Developments

Not surprisingly, as we are less than a year from a federal election, we saw quite a lot of activity in personal tax announcements. However, the legislative branch at the Department of Finance has also been quite occupied in their continuing efforts to address perceived tax abuse in the international forum as well. As stated by the Department of Finance, their goal with respect to tax legislation is to release smaller technical packages on a more frequent basis.

On a somber note, this year we also lost a very revered and respected Finance Minister, the Honorable Joe Flaherty. He was a very active advocate for tax fairness and will be missed by many of us in the tax community.

FATCA/IGA – February 5th
The much anticipated intergovernmental agreement ("IGA") between Canada and the U.S. to address the U.S. reporting requirements under the Foreign Account Tax Compliance Act (FATCA) was released on February 5th.
In addition to requiring the IRS to provide the CRA with information on certain accounts of Canadian residents held at U.S. financial institutions and the exemption of deferred plans such as RRSPs, RRIFs, RDSPs and TFSAs, the IGA allows the following:

- Financial institutions in Canada will not report any information directly to the IRS but to the CRA instead. This includes information on accounts held by U.S. residents and U.S. citizens (including U.S. citizens who are residents or citizens of Canada). The CRA will then exchange the information with the IRS through the existing provisions of the Canada-U.S. Tax Convention, which is consistent with Canada's privacy laws.

- Smaller deposit-taking institutions with assets of less than $175 million will be exempt.

- If the Canadian financial institution is compliant, the 30% FATCA withholding tax will not apply to clients of Canadian financial institutions.

Budget 2014 – February 11th
The following is a summary of some of the announcements in the Budget or the "Economic Action Plan 2014":

- The non-resident trust rules will be tightened to eliminate the exemption extended where a beneficiary became a Canadian resident within the past 60 months.

- Specific legislation is proposed to address the use of "insurance swaps" that may circumvent the FAPI rules for companies that are insuring Canadian risks through foreign insurance subsidiaries and will apply where the insured risk in Canada is connected or tracked to other risks that are insured by other parties. These arrangements had previously been addressed under the GAAR, but this was considered to be time-consuming and ineffective.

- The use of regulated foreign financial institutions for investment accounts of the Canadian parent or related entities (rather than financial transaction for customers) was proposed to be curtailed by restricting the use of these entities to regulated Canadian financial institutions that have either $2 billion or more in equity OR more than 50 per cent of the total taxable capital of the entity (and all related Canadian corporations) in Canada is attributable to taxable capital employed in Canada of regulated Canadian financial institutions.

- "Back-to-back" loan rules were introduced to address perceived abuses regarding the use of intermediaries to reduce the effect of the thin capitalization rules relating to interest paid to non-residents (see additional discussion below).

- Consultations were requested from taxpayers regarding Tax Planning by Multinationals, asking specific questions surrounding base erosion and international tax planning.

- Additional consultations were requested surrounding Treaty Shopping, in particular, four elements of a proposed rule were identified:

    - A "Main purpose provision" where a benefit would not be provided under a tax treaty if it

is "reasonable to conclude" that the main purpose was to obtain a benefit;

* A "Conduit Presumption" where it is presumed that one of the main purposes for entering into a transaction is to allow a person to receive a benefit indirectly through a tax treaty where they would not have received that benefit directly;
* A "Safe Harbour Presumption" where it is presumed that none of the main purposes for entering into a transaction was to gain a benefit from a tax treaty where a certain test is met. These tests relate to active business, ownership or publicly traded company status; and
* A "Relieving Provision" where, in cases where the "Main Purpose" provision applies, the benefit under the tax treaty would still be allowed if it is reasonable in the circumstances. A number of examples were provided and consultations were requested.

Interestingly, on August 29, Finance announced a suspension of the domestic treaty shopping initiative pending the OECD's BEPS Action Item on Anti-Treaty abuse. (See discussion on page 4)

Technical Amendments - February 27th

Certain amendments relating to the taxation of Canadian banks with foreign affiliates were released for consultation on November 27, 2012. Additional proposals were released February 27, 2014 that address some of the comments received, dealing with "base-erosion" rules in the FAPI regime. The draft legislation includes modifications to the November 27, 2012 proposals.

Technical Amendments – August 29th, October 10th and October 20th

Draft legislation was release for consultation on August 29th and followed up with further legislation on October 10th and October 20th. It largely implements tax measures from the 2014 budget and also included relieving legislation addressing "non-qualifying countries" to allow certain countries to be qualifying countries for the purposes of calculating FAPI where that country is one for which the Convention on Mutual Administrative Assistance in Tax Matters is at that time in force and has effect.

The October 10, 2014 release also contained the following amendments:

- A relieving amendment to section 17 to ensure that an amount is not included in that section if it had already been included as FAPI under section 91;
- New legislation surrounding a special regime for Australian trusts in which a foreign affiliate had a beneficial interest. In certain circumstance, this trust will be deemed to be a non-resident corporation in order to allow the foreign affiliate regime to apply;
- Certain provisions of the foreign affiliate rules are amended to address the applicability of the rules to partnerships and the "same country" requirement rule in clause 95(2)(a)(ii)(D) has been removed. In addition, an easing of the income from services rules was implemented to not include as FAPI the income from services performed outside of Canada by non-residents;
- Rules regarding the foreign affiliates of Canadian-based banks to help alleviate the tax burden of using excess liquidity of their foreign operations in their Canadian operations.

Back-to-Back Loans

The back-to-back loan legislation includes some amendments that were requested through submissions from interested parties. These rules address circumstances where taxpayers have borrowed funds and the following four conditions are met:

1. The taxpayer has borrowed an amount from an intermediary that can be a resident or non-resident;
2. The intermediary is not a Canadian resident that does not deal at arm's length with the taxpayer AND is not a person identified in the definition "outstanding debts to specified non-residents" in subsection 18(5) (the "connected non-resident");
3. The amount owing by the intermediary to the connected non-resident meets one of certain conditions that are related to the terms of the loan such as the loan having limited recourse or it can reasonably be concluded that all or a portion of the debt owing by the taxpayer to the intermediary was permitted because of another amount owing by the intermediary to the connected non-resident. In addition, if the intermediary has a "specified right" (such as a right to assign or pledge property) that is granted by a connected non-resident, the condition would be met. Note that this "specified right" does not include cash that may be used in a cash pooling arrangement, which is a relieving provision that was later included in the draft legislation;
4. The total of all amounts outstanding to the intermediary is equal to at least 25% of the total of the particular debt AND the amount that the taxpayer has outstanding as debt to the intermediary under the agreement where the intermediary was granted security on the intermediary debt and this security also secures the payment of every debt.

In cases where these conditions apply, the taxpayer will be deemed to owe the amount (and applicable interest) to the non-resident person instead of the intermediary. This amount is limited to the fair market value of the pledged/secured property or the outstanding amount of the debt for which recourse is limited or the loan made on condition, depending on the circumstances surrounding the loan.

In addition, the interest deemed to be paid or payable to the non-resident will be subject to withholding tax under Part XIII. Certain provisions in section 212 have also been amended to address these amounts and to be congruent with the changes to section 18. However, one additional condition applies in that the interest would only be subject to tax under Part XIII if the tax that would be payable under this part, if the loan were made by the connected non-resident, is greater than the tax that is payable under Part XIII to the intermediary.

This legislation also outlines an exemption from the rules where a corporation resident in Canada (“CRIC”) lends the borrowed funds to a foreign affiliate, electing to be subject to the pertinent loan or indebtedness (“PLOI”) rules instead. If the PLOI rules apply, it is unnecessary to also apply the back-to-back loan rules.

Foreign Affiliate Dumping Rules

There were some relieving amendments to the foreign affiliate dumping rules that were released this year, including the following:

- Requiring the corporation resident in Canada (“CRIC”) to be controlled by the non-resident corporation immediately after the time the investment is made instead of at the time to ensure the condition is not met at the time of the investment, thereby addressing the situation where the transaction cause the CRIC to not be controlled by the non-resident corporation after the transaction;

- Where the CRIC is not controlled by the non-resident corporation immediately after the investment is made, but is later controlled, through a series of transactions or events that includes the investment, the rules may apply;

- A Safe Harbour provision has been added to address issues surrounding corporate takeovers where the non-resident corporation does not own more than 25% of the votes or value of the CRIC, subject to a rule regarding the risk of loss or opportunity for gain or profit with respect to the property (for example, a preferred share investment that may have limited risk may allow the CRIC to accommodate a transaction prior to the acquisition of control by a non-resident corporation);

- Amending the “dividend substitution election” in the foreign affiliate dumping rules to limit the scope of the election (for example, it is no longer required for the PUC offset as this is now an automatic calculation);

- Adding a new section to address indirect investments made after direct investments in a subject corporation to ensure that a deemed dividend is not calculated and included twice for the same investment;

- Substantially amending the way the PUC is reduced and reinstated and implementing an anti-avoidance rule to address situations where the investment has been structured to inappropriately reduce the effect of the PUC reduction;

- The exception from the rules for a “more closely connected business activity” has been expanded to allow the principal decision-making officers to be satisfied where they are officers of a corporation resident in Canada that does not deal at arm’s-length with the CRIC. In addition, further exceptions to the rules for corporate reorganizations have been allowed.

B. Case Summaries

***Sifto Canada Corp. v. MNR*, 2014 FCA 140**

Sifto Canada is the first significant judicial review case since *JP Morgan Asset Management (Canada) Inc. v. MNR*, 2013 FCA 250. In *JP Morgan*, the Federal Court of Appeal sternly warned against the "flow of unmeritorious applications for judicial review in the area of tax" (para. 29). The Court ultimately held that judicial review of CRA’s conduct in issuing an assessment is a tool of last resort. Fortunately for the taxpayer in *Sifto Canada*, the Court in this case was able to distinguish *JP Morgan* and it was allowed to proceed to a hearing on the merits.

The available facts were straightforward. *Sifto Canada* made a disclosure in 2007 under the CRA's Voluntary Disclosures Program ("VDP") dealing with the transfer price of rock salt that *Sifto Canada* sold to a related U.S. company during its 2004 to 2006 tax years. The CRA accepted that the disclosure met the requirements of the VDP. Thereafter, the CRA entered into an agreement with *Sifto Canada* to settle its tax liability for the years at issue, based on a mutual agreement reached by Canada and the U.S. tax authorities under the *Canada-U.S. Tax Treaty*. However, when the CRA ultimately reassessed *Sifto Canada*, it seems that CRA had a change of heart. It informed the taxpayer that it did not consider itself bound by the agreement and that the reassessments would reflect a different tax liability. It also informed *Sifto Canada* that the reassessments would include penalties under subsection 247(3) of the *Income Tax Act* (the "Act"). The CRA ultimately followed through on these statements and issued corresponding reassessments in 2012.

Sifto Canada brought two applications for judicial review before the Federal Court. The first application sought a declaration that the imposition of penalties was "invalid and unenforceable", since the imposition of penalties directly contradicted the CRA's published policy for voluntary disclosures that meet the requirements of the VDP. The second application sought a declaration that the Minister was bound by the terms of the settlement agreement with the U.S. tax authority by virtue of subsection 115.1(1) of the Act. In response, the Minister brought motions to strike both applications, arguing that they were clearly improper and "bereft of any possibility of success" in light of *JP Morgan.* Ultimately, the second application was discontinued by the taxpayer, so the sole issue before the Federal Court of Appeal was whether the first application (dealing with the imposition of penalties) would be permitted to continue.

In a relatively brief judgment, Justice Sharlow (on behalf of a unanimous Court) held that the essential question raised by the taxpayer in the remaining judicial review application was whether the Minister properly exercised his or her jurisdiction to waive or cancel the penalties under subsection 220(3.1) of the Act. Since this question is not within the jurisdiction of the Tax Court, and any challenge to that determination must instead be made in the Federal Court, the application did not have to be struck out. While the Court acknowledged that this could result in parallel proceedings in both the Federal Court and the Tax Court (where proceedings were also commenced in relation to the reassessments), this was a case management matter rather than a substantive issue going to the propriety of the application itself. Accordingly, the Crown's motion to strike the judicial review application dealing with the imposition of penalties was dismissed and the taxpayer's case was permitted to proceed.

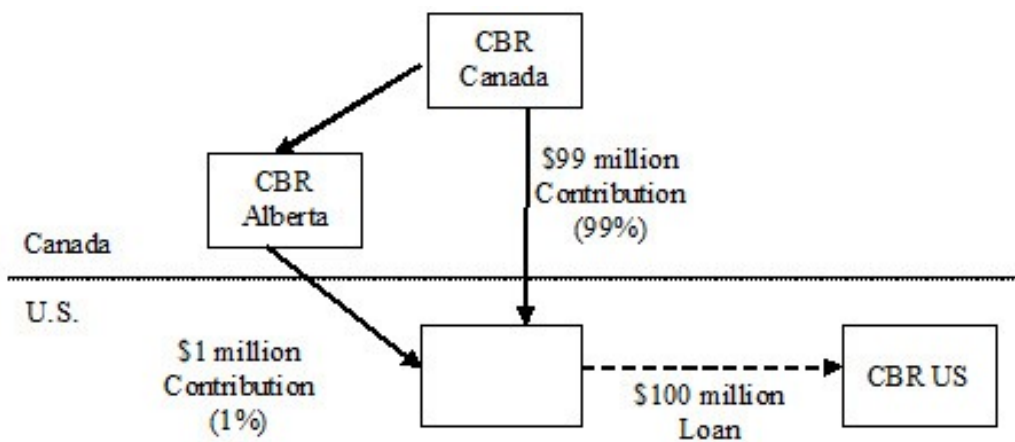
***Lehigh Cement Limited v. The Queen*, 2014 FCA 103**

This case dealt with paragraph 95(6)(b) of the Act and dealt a decisive blow to the Crown's long-standing position on the scope of that provision.

The facts in Lehigh were not controversial. CBR Canada and CBR Alberta were two Canadian corporations controlled by a multinational group headquartered in Belgium. The two corporations entered into a series of transactions whereby they established a Delaware LLC (a hybrid entity), with a 99% and 1% interest, respectively. As part of the series of transactions, a total of US$100 million was borrowed by CBR Canada, contributed as equity to the Delaware LLC and then loaned from that Delaware LLC to another US entity, CBR US. CBR US ultimately used the funds in its active business.

From a Canadian tax perspective, the series of transactions was designed to create an interest deduction for CBR Canada on the US$100 million borrowing, while the dividend income received by CBR Canada and CBR Alberta from its controlled foreign affiliate, Delaware LLC, would be sheltered by offsetting deductions under section 113. The Minister challenged this result under paragraph 95(6)(b), denying the section 113 deduction on the basis that the taxpayers' principal purpose in acquiring their shares in the Delaware LLC was to avoid taxes that would otherwise be payable under Part I of the Act. The effect of paragraph 95(6)(b) was therefore to deem the Delaware LLC shares not to have been issued and thereby denying the section 113 deduction on the inter-corporate dividends received by CBR Canada and CBR Alberta.

At trial, the Tax Court held that paragraph 95(6)(b) could apply to any acquisition of shares that was principally intended to reduce or avoid Canadian tax, whether or not such avoidance was abusive or involved the manipulation of share ownership. However, on the facts of the case, the Tax Court found that the acquisition of the Delaware LLC shares was implemented to reduce US tax rather than Canadian tax. Consequently, paragraph 95(6)(b) did not apply. Further, the Court found that paragraph 95(6)(b) required a comparison of the Canadian tax results otherwise achieved with an alternative arrangement in which no shares of the Delaware LLC were acquired. Since the Canadian tax results in that case would have been identical, the provision again could not apply.



On appeal, the Crown argued for a broader interpretation of paragraph 95(6)(b), which was based on the purpose of the overall series of transactions rather than simply the acquisition of the Delaware LLC shares. That argument

was unsuccessful. The Federal Court of Appeal unanimously held that the words of paragraph 95(6)(b) were "precise and unequivocal" and focused on the principal purpose of the acquisition of the shares at issue, not the overall series of transactions of which it was a part. The Court was clearly uncomfortable with the sweeping implications of the Crown's position on a rule that seemed, on its face, to be targeted at a definite and specific type of abuse. Further, the Court found no reason to disturb the lower court's finding that the primary purpose of that share acquisition was to minimize U.S. tax. The Crown's appeal was therefore dismissed.

Leave to appeal to the Supreme Court was not sought in this case.

***Inter-Leasing Inc. v. Ontario (Revenue),* 2014 ONCA 575**

The Inter-Leasing case from the Ontario Court of Appeal reverses a troubling judgment from the Ontario Superior Court of Justice dealing with the "Ontario Finco" strategy. In doing so, the Court of Appeal has clarified not only the application of the Ontario GAAR, but the more fundamental principles of income characterization as well.

The taxpayer was a member of a group of companies in the oil and gas business. The group carried out a reorganization culminating in the conversion of over $500 million from non-interest-bearing debt to interest-bearing debt. The debt (structured as "specialty debt") was held by the taxpayer, a special-purpose corporation incorporated under the laws of the British Virgin Islands but with common law residency in Canada and a permanent establishment in Ontario. The taxpayer was fully taxable federally, but since it was incorporated outside Canada it was liable to tax in Ontario (under Ontario law during the period in question) only on certain enumerated sources of income, including "income from a business carried on in Canada". The taxpayer took the position that the interest income it earned on the specialty debt in question did not so qualify. Rather, it constituted income from property and therefore was not taxable under Ontario law.

The Ontario tax authority assessed tax and interest totaling $55 million on the basis that the income earned by the taxpayer was income from a business. Alternatively, it argued that the Ontario GAAR applied to deny the tax benefit.

At trial, the judge found that although income received on investments (such as the specialty debt) was generally considered income from property, the income here constituted income from a business and was therefore taxable in Ontario based on existing rules. Despite the passive nature of the taxpayer's investment and operations, the trial judge found that the nature of the taxpayer's business was to assist group members in attempting to reduce their after-tax cost of capital. In this regard, the judge relied upon the presumption that the taxpayer carried on a business in pursuit of its objects, the existence of a permanent establishment in Ontario and the fact that the earning of interest income was the main part of its core activity. Accordingly, the income was taxable in Ontario.

While the trial judge was not required to rule on the Ontario GAAR, he made clear that he would have found it applicable, noting "the Minister would likely have no difficulty meeting the onus of establishing that such tax avoidance is inconsistent with the object and purpose of the particular legislative provision in issue. When it comes to charging provisions the object and purpose is to raise revenue…" (at para. 42).

In a succinct and unanimous judgment, the Ontario Court of Appeal reversed the lower court's decision for two reasons. First, the trial judge's analysis of the "income from property" versus "income from a business" question was not supported by the facts or the law and "undercut the well-established jurisprudence that taxpayers may arrange their dealings and structures to reduce taxes" (at para. 40). Second, the Ontario GAAR could not apply since the transactions were not abusive. On this latter point, the Court made special note of the fact that it must reject the lower court's approach to the interpretation of Ontario's GAAR, since that approach would effectively mean that abusive tax avoidance will always be found in any case where provincial revenue is diminished.

An application for leave to appeal to the Supreme Court of Canada from this judgment was filed by the Ontario Minister of Finance on October 6, 2014. As of the date of writing, no decision has been rendered on the leave application.

***Zellstoff Celgar Limited v. British Columbia,* 2014 BCCA 279**

In this decision, the British Columbia Court of Appeal was faced with the old "fixture versus chattels" chestnut in the context of certain machinery and equipment used in a pulp mill. The question was relevant as it affected the amount of property transfer tax payable under BC law. If the machinery and equipment were fixtures, and therefore part of the land, the property tax payable was in excess of $4.5 million. If they were chattels, and not part of the land, the tax payable was only $286,000.

On the facts, the pulp mill was constructed in the 1960s and most of the machinery and equipment was installed in the 1990s. Some of the machinery and equipment in question (which included specialized and adapted pulp and paper equipment and standard industrial equipment) was very large and almost every item was affixed to the buildings. However, the evidence suggested that almost all of the machinery could be dismantled and removed, and that there was a secondary market for it, although the removal of larger pieces would be expensive and may not have been an economically viable option.

Following the hearing that included the introduction of expert evidence, the trial judge considered numerous authorities and concluded that the machinery and equipment constituted fixtures, relying in particular on the case of Stack v. T. Eaton Co. (1902), 4 OLR 335 (Div. Ct.). The judge's key findings were that the degree of annexation was "substantial" and that "the true object of annexation of the machinery is for the better use of the land for the purpose of its use as a pulp mill" (paras. 45 and 76). As a result, the machinery and equipment formed part of the land and its fair market value was taxable upon transfer.

On appeal, the taxpayer argued that the trial judge erred in failing to apply the correct test. In particular, the taxpayer argued that the trial judge erred in taking into account the use of the land as a pulp mill when determining whether that the equipment was affixed for the better use of the equipment as chattels or the better use of the land. The British Columbia Court of Appeal rejected this argument and held that there was nothing in the existing jurisprudence that prevented the consideration of the use of the lands when determining the object of the annexation. Further, the Court noted that the fact that the machinery and equipment had been affixed for "a very long time" suggested that there was an objective intention of permanent affixation despite the fact that it could be dismantled and sold on a secondary market. As such, the taxpayer was unsuccessful and its appeal was rejected.

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