Panel Discussion – Ethical and Reputational Risk Considerations in International Tax Planning: The Industry Perspective

Moderator: Lynn Moen
Panelists: Brian Levitt, Jack Mintz, Michael O'Connor
Rapporteur: Ian Caines

This panel was convened to discuss the ethical and reputational risks facing corporations in relation to tax compliance and planning, particularly in view of recent heightened scrutiny from tax authorities and the increasing focus on tax issues in the popular media and elsewhere, and addressed a number of specific questions posed by the moderators and conference attendees.

Concerning recent increased scrutiny of tax matters by government authorities

The panel agreed that populism and issues of tax justice have been coming more to the fore in recent years, with potential reputational implications for corporate taxpayers. This trend is evidenced by many examples: the controversy faced by Starbucks in the United Kingdom, the reported changes in how Amazon will be booking its European sales, Walgreens' decision to reject an "inversion" transaction (likely driven by a desire not to alienate its customer base), and statements from the U.S. president that such "inversion" transactions are unpatriotic. Effective tax rate reporting in the resource industry has been another particular factor encouraging this trend.

One panelist anecdotally remarked that the change in attitude could also be seen in professional tax literature, where, based on his own observations, aggressive tax strategies are now less openly promoted. The panelist also thought that, in addition to increased scrutiny, the rules of the tax system have in fact become tighter over time, due to changes such as the general anti-avoidance rule (GAAR) in Canada, so that many planning approaches used in the past would in fact no longer be considered appropriate today.

Another panelist remarked that in some cases increased government scrutiny was counter-productive for the governments involved. For example, the harder line against "inversion" transactions in the U.S. has simply encouraged more takeovers of U.S. companies by foreign purchasers.

Concerning the effect of recent tax developments on how companies do business

The panel felt that the most significant change resulting from the recent tax developments discussed above has been the recognition that a company's tax affairs could have reputational implications for the company impacting on the bottom line, whereas taxes had in the past been seen as simply another cost to be minimized to the extent possible.

These reputational implications are multifaceted. For consumer -facing businesses, a public perception that the company is unfairly avoiding taxes could obviously harm sales and profits. The panel felt that an even larger concern for most businesses would be the potential effects of a damaged reputation on the company's dealings with governmental authorities. The panel pointed to the situation of the financial industry following the 2008 crisis as a cautionary example of the consequences that can flow from a damaged reputation—in that case, quite apart from the direct financial cost of fines and penalties, the industry has faced "incalculable" harm due to increased regulations. Had the industry been more sensitive to that possibility, the harms may have been avoided. The panel felt that tax issues are, due to their nature, often approached with a myopic focus on

technical concerns, and that it is therefore important to put in place management systems to counteract such tendencies and guard against harm to the company's reputation.

The panel also noted that increasing government revenue needs will affect how tax authorities pursue disputes, which should be borne in mind by companies. While these concerns will often make governments take a hard line regarding tax liabilities, they may also in some cases encourage the ~~acceptances~~acceptance of settlements that allow the government to meet its immediate fiscal targets.

Concerning the handling of tax matters by company boards

In the panel's experience, taxes *per se* would not normally be a regular topic for board-level discussions, although taxes would implicitly factor into many board decisions that are based on after-tax projections of financial returns. Specific discussion of taxes might be confined to the audit committee (as part of its oversight of the financial statements) and to periodic updates from the company's tax director. The panel thought such arrangements were appropriate, given that, among other things, most board members would not have expertise in tax matters.

The panel felt that the best practice is for boards to generally focus on economic outcomes. To the extent that tax matters affect the company's performance, whether directly or otherwise, that is something that would need to be factored into the ultimate decisions. In any case, the appropriate arrangements in any particular case would depend on how important tax issues are in the overall success of the company (both reputationally and financially).

One panelist noted that some structures put in place for tax reasons have not worked out as expected, with some past structuring resulting in direct economic costs (even apart from reputational effects) that far outweighed any tax benefit that they could have generated. He felt it was important for boards to bear in mind that tax structures often carry real economic risks and be careful not to create larger business problems when attempting to solve tax problems.

Concerning ethical obligations of companies beyond mere compliance with tax laws

The panel felt that it was difficult to provide any definite and general answers regarding a company's extra-legal ethical obligations regarding taxes, given the highly subjective nature of "good corporate citizenship", and the fact that norms of acceptable behavior often differ between countries. The panel noted that these international differences are often ~~a~~ stumbling blocks for businesses expanding internationally, which may face home-country controversies from activities undertaken abroad which were entirely acceptable based on local standards. The panel felt that a clear set of corporate values can help to mitigate these problems.

Concerning the "fair" tax burden for companies

One panelist argued that it was not meaningful to consider the "fairness" of company taxes in the abstract, and what should really be considered are the ultimate burdens placed on individuals by taxes levied on companies, and whether those ultimate burdens are fair. Research suggests that company taxes are generally effectively pushed down to the immobile factors of production, such as ~~labor~~labour. Furthermore, it appears that taxes on large public companies are likely regressive, since investors will shift away from more highly taxed companies and push up their pre-tax rate of return at the expense of other stakeholders. The situation appears to be different for small private companies, where the income may be more akin to the individual entrepreneurial income of the owners.

As a practical matter, another panelist noted that, based on Canadian figures and looked at in aggregate, the tax burden on corporate income in Canada does in fact approximate the income tax paid by other, non-corporate, taxpayers.

Concerning the focus on effective tax rates for companies

It was noted that the concern about effective rates has a long history and that governments have attempted to respond to it in the past, such as in Ontario with the fair tax commission and corporate minimum tax. Based on one panelist's research, it appears that, at least in Canada, effective tax rates for companies are not in fact vastly lower than statutory rates, and much of the difference is due to intended tax incentives. It was also noted that there are problems in determining real effective tax rates given limitations in current tax accounting models.

Audience questions

In response to an audience question about how professionals could contribute to increasingly politicized tax policy debates, one panelist expressed the view that the Canadian Tax Foundation (CTF) could play a larger role in these debates (as it had done at some points in the twentieth century), and thought as an organization it should be more publicly engaged. He pointed to a CTF symposium concerning the proposed repeal of the harmonized sales tax in British Columbia as a promising step, but thought that the CTF could have attracted greater press and public involvement.

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IFA Tax Conference – LNG Rapporteur Summary

Tax Considerations for the Next Frontier – LNG Projects on Canada's West Coast

Panelists: Mary Hemmingsen, KPMG, Toronto and Chris Roberge, Deloitte, Hong Kong

Moderator: David Keane, BC LNG Alliance

Rapporteur: Sarah Chiu, Felesky Flynn LLP, Calgary

Disclaimer: This summary records the contents of a free-flowing discussion which took place on May 28, 2015. The numbers referenced herein are illustrative and have not been independently verified. Readers should independently verify any numbers and facts referenced herein rather than citing this summary as authority.

Introduction

Canada is a net producer of natural gas and has traditionally relied on pipeline networks to export its natural gas to the United States. In recent years, because natural gas production within the United States has increased dramatically as a result of improved hydraulic fracturing technology, natural gas exports to the United States have been in steady decline. Whereas traditionally 15% of US natural gas supply came from Canada, this number has fallen to 6% currently and is expected to fall further to 3% by 2020. As such, it is imperative that Canada find other export markets for its natural gas.

In order to transport natural gas to these other export markets, Canada needs to expand its markets and not solely rely on its traditional pipeline networks. Accordingly, liquefied natural gas ("**LNG**") has emerged as an alternative means to reach new markets. LNG is natural gas that is cooled to liquid form (at minus 162 degrees Celsius) in LNG liquefaction terminals to facilitate transportation. In liquid form LNG takes up one six hundredth (1/600) of the volume of natural gas (similar to reducing the volume of a beach ball to the volume of a ping-pong ball) and can be transported by specially designed ships to overseas markets in Asia and Europe.

Globally, the supply to be produced by the proposed LNG projects exceeds projected future demand. However, like most competing infrastructure projects, the market will determine which projects are built and which ones are not built as supply and demand function to keep the industry in balance. Canada lags behind other countries that are potential LNG exporters, including Australia and the United States, in securing its share of this projected future demand. LNG is typically sold through long term supply contracts. Canada will need to secure these long term supply contracts in order to economically build the LNG facilities. Canada must be able to produce LNG and deliver it to customers at globally cost competitive price. For Asian customers, the main target for Canadian LNG, this includes the cost of the gas supply (from BC and Alberta), the pipeline transportation costs to the BC coast, liquefaction costs and finally the shipping costs to the customer. Accordingly, these large scale LNG projects must be globally cost competitive or they will not be built in Canada.

The current low prices for energy commodities may be an opportunity for Canada to enter the LNG market. Canada has some of the cheapest natural gas available and this makes it more competitive relative to other countries in which low natural gas prices may lead certain projects to be put on hold or cancelled. Moreover, these low energy commodity prices could lead to the cancellation of other energy project which could also free up labour, and lead to reduced cost of materials (*e.g.,* lower steel prices), which will also help the development of Canada's LNG industry. However, in order for Canada to embrace this opportunity, it is imperative that the federal and provincial governments do what they can to support Canadian competitiveness. The Canadian federal and provincial governments must ensure that the regulatory and environmental regulations are appropriate, First Nations issues are equitably addressed, and the fiscal regime (including all taxes) is globally competitive. If the Canadian projects do not proceed, not only will Canada lose the $10 to 15 billion from the large scale investments in each of the LNG plants, it also risks losing the equally large scale investments in pipelines and natural gas production facilities. These large scale investments would contribute significant economic benefits including new taxes in development and operation, creating thousands of jobs in construction and resulting in a legacy much like the initial Canadian pipelines which have become an economic backbone of Canada. The corresponding benefits of this significant incremental infrastructure of pipelines, improved ports and enhanced skilled labour are beneficial to all of Canada.

Current State of the Global LNG Markets

The state of global LNG markets has changed dramatically in the last five years and is becoming increasingly competitive. Globally, there are proposed LNG projects all over the world including U.S, Russia, Cyprus, east Africa, South East Asia and Australia which is adding more LNG supply to the global marketplace. The growth projections of future demand are also slowing (*i.e.* demand is projected to increase at a slower pace), as the LNG market is predominantly (approximately 70%) in Asia, including China, Korea, Japan and Malaysia, which has had reduced economic growth in recent years.

The pricing for LNG is driven in part by demand in the country to which the LNG is being delivered and therefore there has been a corresponding decline in price for LNG. Demand reductions and other factors influencing pricing such as the tie to oil indexing have significantly reduced the current price of LNG. Moreover, because of the very high upfront costs associated with constructing LNG liquefaction terminals and related infrastructure, in practice, projects will not be approved (and financing for such projects will not be given) until long term (15 to 20 year) supply contracts are in place. As such, those proposed projects which are unable to secure supply contracts for the majority of their supply volumes are unlikely to reach final investment decisions and will not be approved and completed. With China and Russia recently signing a long term contract for an estimated $9 per MMBtu, more of the global demand for LNG will be served by Russia. Timing, therefore, is critical for Canada to secure a share of the projected global demand and avoid missing this LNG opportunity.

LNG in Other Countries

In addition to Russia, countries that are competing with Canada in the global LNG supply market include the Middle East (United Arab Emirates, Oman, Algeria), North Africa (Libya, Nigeria, Egypt), East Africa (Mozambique), South East Asia (Malaysia, Indonesia, Brunei), Australia, the United States and Papua New Guinea.

Australian LNG facilities are already producing and have secured a significant share of the global LNG demand. By being the first of the new wave of LNG exports to the market, Australian authorities did not have to introduce any particular tax incentives into their relatively favourable tax regime to encourage investments in LNG facilities.

The United States has also succeeded in making their investment climate more attractive for investors and it is expected that the first US LNG facility will be commissioned later this year. Many of the proposed LNG facilities in the United States also have an advantage to those proposed in Canada. The United States facilities involve converting import facilities (which were designed to import LNG from abroad) to export facilities. As such, these converted facilities generally have reduced costs as they can rely on some existing infrastructure and using these “brownfield” sites generally requires fewer governmental approvals. In contrast, the proposed LNG facilities in Canada generally involved “greenfield” sites (*i.e.*, where there are no existing facilities and no pipeline infrastructure).

There are currently a number of developments in Mozambique. The authorities in that country offered significant concessions, including dropping the royalty rates and withholding tax rates and exempting LNG projects from customs and sales taxes. These concessions were necessary to encourage investments in a region with geopolitical risks. Note that some of these concessions have since been retracted, but past investments have been grandfathered.

In Papua New Guinea, to encourage investments, the authorities have waived customs and sales taxes to encourage LNG investments. They also introduced priority treatment for work visas related to LNG projects and have waived certain local content requirements for such projects.

Tax Policy and LNG – British Columbia

Many of the LNG related taxes in British Columbia (“**BC**”) were introduced at a time when the global LNG market was comparatively less competitive and the federal and provincial governments were being motivated to get their “fair share” of LNG profits. These taxes include federal and provincial corporate income taxes, provincial sales taxes, provincial carbon taxes, and provincial LNG income taxes. In addition to taxes, electricity is also more expensive for LNG facilities than for other industries (with BC Hydro charging approximately $83 per megawatt hour rather than $55 per megawatt hour which applies for existing industries). Transportation of natural gas to the proposed LNG facilities also involves building pipelines across two large mountain ranges which poses another set of technical challenges and adds significant costs. All of these factors weigh on the overall economics of proposed LNG facilities in BC.

With Canada competing for future LNG projects, it is increasingly important for tax policy to be used as a tool to promote investment. Investment capital has become scarcer as a result of the

decrease in global energy prices. Even investment capital from foreign states has been tempered by internal anti-corruption campaigns (*e.g.*, in China) and Canada's own foreign investment and immigration rules. Moreover, the investment capital that remains available is increasingly mobile and no longer tied to any one country as investors which may have historically preferred investing in Canada are now surveying all global opportunities.

In recognition of these market challenges, the federal government has introduced a number of relieving measures, including extending export licenses for LNG (improving project economics by approximately $2 billion) and enhancing the capital cost allowance treatment for LNG facilities (that is expected to improve project economics by $750 million). Additional measures from the federal and provincial governments may still be required in order to attract this investment. Such measures could be in the form of further revisions/exemptions to the BC provincial sales tax regime, targeted and identified incentives under the current SR&ED regime,[1] further enhancements to programs assisting employers with required employee income tax withholdings,[2] and advanced discussions on the environment and native affairs matters.

The potential impact of the OECD BEPS[3] project is adding further uncertainty into an already uncertain investment climate. Investors are unclear about how they should own and finance their investments in LNG facilities which complicates the structuring of their arrangements. By its nature, LNG projects will involve agreements between related parties located in many different countries. Obtaining financing is problematic when project economics can vary drastically with uncertain future tax treatments including transfer pricing adjustments. With already tight economics, certainty of tax treatment as well as tax incentives is critical to finalizing investment decisions.

Other Factors That Impact Investment Decisions – Environment, First Nations Partnerships and Labour

Environment and First Nations. In general, the investors in the proposed LNG facilities are well equipped and prepared to meet the required environmental standards and to work with First Nations communities to develop long term partnerships.

Labour. The LNG industry is carefully examining labour supply issues as labour problems caused significant budget overruns and delays in Australia. It is estimated that between 3,000 to 7,500 workers will be required during the construction phase for each of the proposed LNG facilities; this does not include the additional 3,000 construction workers required to build each of the large pipelines. BC's labour market, which currently consists of approximately 14,000 workers in the oil and gas industry, does not have the depth required.

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1 Scientific research and experimental development credits and deductions under the *Income Tax Act* (Canada).

2 Under section 102 and 105 of the *Income Tax Regulations* (Canada).

3 The Organization for Economic Co-operation is developing a number of strategies to address “Base Erosion and Profit Shifting”.

Potential solutions include, in order of preference: training other workers in BC, seeking trained individuals from elsewhere in Canada or seeking temporary foreign workers. The LNG industry is committed to hiring British Columbians first, Canadians second and then looking abroad for any additional workers needed to build the industry. The industry is working well with labour organizations and proceeding with caution to avoid training individuals for single purpose projects who will no longer have jobs once the LNG facilities are built. Therefore, working with the federal and provincial governments to facilitate access to foreign workers to secure scarce skills that cannot be provided by Canadian workers is critical. Processes to withhold taxes on remuneration or payments for services payable to these foreign workers[4] are also cumbersome relative to other countries and could be streamlined.

Other solutions include modularized construction, which would see large modules being constructed in fabrication yards in Asia which are then shipped and assembled on site in BC. However, while this would alleviate problems with local labour shortages, modularized construction would result in additional excise taxes and provincial sales taxes which negatively affect project economics.

Conclusion

Proponents of LNG facilities in Canada continue to be optimistic that an LNG industry can be successful in Canada. Canada has all the key fundamentals - cheap natural gas, a skilled workforce, supportive governments, and quick shipping routes to Asia. With an increasingly competitive global LNG market, taxation will play a major role in project economics and in ultimately determining whether investors with mobile capital will choose to invest in LNG facilities in Canada. If investment decisions into Canada continue to be delayed, the limited number of future long term supply contracts will be signed by investors in other countries and Canada will miss this opportunity to be a supplier in the global LNG market. It is critical for all of Canada that this opportunity that materially benefits all Canadians not be missed.

[4] Under sections 102 and 105 of the *Income Tax Regulations* (Canada).

RECENT M&A AND CASE LAW UPDATE

Moderator: Ron Durand, *Stikeman Elliott LLP* (Toronto)

Presenters: Brian Bloom, *Davies, Ward, Phillips and Vineberg LLP* (Montréal)

Nancy Diep, *Blake, Cassels & Graydon LLP LLP* (Calgary)

Edward Rowe, *Osler, Hoskin & Harcourt LLP* (Calgary)

Reporter: Joanne Vandale, *Osler, Hoskin & Harcourt LLP* (Calgary)

This presentation addressed recent M&A transactions, with a focus on the following Canada-U.S. transactions: (1) acquisition of Kodiak Oil by Whiting Petroleum; (2) acquisition of Vicwest by Kingspan and sale of Vicwest's Westeel Division to AG Growth International; and (3) combination of Tim Hortons and Burger King Worldwide. In addition, the presentation gave an update on Canadian case law, including the following cases: (1) *George Weston Limited v. The Queen*; (2) *Kruger Wayagamack Inc. v. The Queen*; and (3) *TDL Group Co. v. The Queen*.

Recent M&A Transactions

Acquisition of Kodiak Oil by Whiting Petroleum – Brian Bloom

The focus of the discussion with respect to this transaction was the impact of the foreign affiliate dumping rules (FAD Rules). Whiting Petroleum, a Delaware corporation listed on the NYSE, acquired all of the shares of Kodiak Oil and Gas (a Yukon corporation) in a share exchange transaction. Kodiak was continued under the British Columbia *Business Corporations Act* (BCBCA), the purpose of which was to provide certainty with respect to the ability to undergo a survival-style amalgamation in which only one of the amalgamated corporations survives. Pursuant to the Plan of Arrangement, Whiting's subsidiary (Whiting Merger Sub) acquired all of the Kodiak shares in consideration for Whiting shares, the Whiting shares were delivered directly to Kodiak shareholders and Whiting Merger Sub issued its shares to Whiting.

It was important for the purposes of the FAD Rules that Whiting Merger Sub did not acquire the shares of Whiting and then deliver the Whiting shares to Kodiak shareholders, as the acquisition of the Whiting shares by Whiting Merger Sub would have been an "investment" in a foreign affiliate. Whiting Merger Sub was a Canadian corporation controlled by a non-resident corporation, and as such, was a "CRIC" for the purposes of the FAD Rules (s. 212.3(1)). An investment by Whiting Merger Sub in a foreign affiliate would result in the reduction of the paid-up capital of its shares to the extent thereof and any excess would be a deemed dividend from Whiting Merger Sub to Whiting. The acquisition of the Kodiak shares was treated as a direct acquisition of the shares of the US subsidiaries of Kodiak because the fair market value ("FMV") of the foreign affiliates exceeded 75% of the FMV of all asses (s. 212.3(10)(f)). As a result, the paid-up capital ("PUC") of the Whiting Merger Sub shares issued to Whiting was reduced to nil.

The issuance of Whiting shares to Kodiak shareholders likely prohibited a s. 88(1)(d) bump because the value of Kodiak appears to have represented more than 10% of the total value of the combined company. Therefore, unless there is no inherent gain in the Kodiak U.S. subsidiaries, a tax-efficient exit from Canada will not be available. The FAD Rules will need to be managed

going forward recognizing that the PUC of the shares of Whiting Merger Sub (or its successor) will be nil.

Whiting Merger Sub and Kodiak then amalgamated to form one corporate entity with the same effect as a typical amalgamation under the BCBCA except Kodiak is stated to survive the amalgamation and the separate legal existence of Whiting Merger Sub is stated to cease without the liquidation or winding-up of Whiting Merger Sub. The rules in s. 87(11) and s. 212.3(22) will apply; query whether a s. 87(3.1) election is required to clarify that a future PUC reinstatement under s. 212.3(9) can apply.

Acquisition of Vicwest by Kingspan and Sale of Vicwest's Westeel Division to AG Growth International – Brian Bloom

Vicwest is a Canadian company listed on the TSX and Kingspan is a UK public company that wished to purchase Vicwest's Business Products Division (which was operated as a partnership). AG Growth is a Canadian public company that wished to purchase Vicwest's Westeel Business (which includes the Canadian Division which was operated as a partnership and the NR Subs) The transaction was structured to use the s. 88(1)(d) bump to split the Vicwest assets between Kingspan and AG Growth on a tax-efficient basis.

Due to the restriction on bumping partnership interests, Vicwest transferred the Westeel Canadian Division to Westeel Newco on a tax-deferred basis (s. 85(1)). AG Buyco made a loan of $221M to Kingspan to AcquireCo to fund the portion of the purchase price represented by the Westeel Business. Kingspan AcquireCo then made a loan to Vicwest to fund the cash-out of options and phantom units and the repayment of amounts owed by Vicwest under a credit facility. Kinsgpan AcquireCo then acquired the Vicwest shares for cash consideration (shares of dissenting shareholders were transferred to Kingspan AcquireCo in consideration for a debt claim against Kingspan AcquireCo, which was intended to ensure that dissent rights are specified property under s. 88(1)(c.4)(ii)). The loan made by Kingspan AcquireCo to Vicwest was settled by way of a capital contribution to Vicwest. Vicwest then filed an election to cease to be a public corporation. The timing of the election and the risk that Vicwest continued to be a public corporation at the time of the amalgamation was discussed. Kingspan AcquireCo and Vicwest then amalgamated to form Amalco. Amalco will make a designation under s. 88(1)(d) to bump the tax cost of the shares of Westeel Newco and the Westeel NR Subs to their FMV (the amount being paid by AG Buyco). Amalco then transferred the shares of Westeel Newco and Westeel NR Subs to AG Buyco in repayment of the $221M loan previously advanced by AG Buyco to Kingspan AcquireCo. Provided the tax bump is available, no gain should be realized by Amalco on the disposition of the Westeel Business to AG Buyco.

The bump denial rules were designed to prohibit the use of the bump to effect a purchase butterfly, but are much broader in application. The discussion focused on the market cap of the various entities and voting agreements and their impact on the analysis of "prohibited property" under the bump denial rules.

Combination of Tim Hortons and Burger King Worldwide – Edward Rowe

Tim Hortons Inc. (THI) and Burger King Worldwide, Inc. (BKW) combined to create Restaurant Brands International (RBI), a publicly traded *Canada Business Corporations Act* parent company. This is an example of a transaction in which a U.S. corporation ends up as a subsidiary of a non-

U.S. corporation, without triggering the adverse consequences of the U.S. anti-inversion rule in s. 7874 of the Code. The anti-inversion rule, had it applied, would have deemed the new parent (RBI) to be a U.S. corporation, even though it is not a U.S. corporation in law. Another example, discussed in detail at a prior IFA seminar in 2014 was the Paladin-Endo pharmaceutical merger under a new Irish parent.

The U.S. anti-inversion rules are becoming increasingly restrictive; they apply where the shareholders of the U.S. corporation hold over 80% of the combined equity unless the merged group conducts "substantial business activities" in the home country of the new parent corporation (measured by at least 25% of employees, assets and income during the period). The THI/BKW merger was on the safe side of this shareholder limit (at 78%) and met the substantial business activity test, but that is a rare case and we have not seen any more of these transactions in Canada.

Much of the structuring was focused on maintaining rollover treatment for the U.S. shareholders of BKW, which structuring included the receipt of publicly traded partnership units by the BKW shareholders (which partnership would be a SIFT partnership for Canadian tax purposes). From a Canadian perspective, two structuring points were noted:

1. THI – there is a technical issue with making an election to cease to be a public corporation where a prior public corporation is acquired (and delisted) by a corporation that never has been and never will be a public corporation. The CRA has a relieving administrative position on this issue (CRA Ruing 2010-0355001R3), but steps were taken in the plan to de-list prior to the amalgamation and to file the election at the appropriate time so as to ensure that the technical issue did not arise.

2. BKW – a Delaware absorptive merger does not require additional shares to be issued as consideration for the issuance of equity by the parent, but for Canadian purposes the issuance of equity may be necessary both for internal Canadian rollover rules (s.87) and to ensure that there is basis in the mergerco shares from a Canadian perspective.

Recent Case Law Update

George Weston Limited v. The Queen, 2015 TCC 42 – Edward Rowe

This cases addresses the circumstances under which proceeds arising on the termination of a currency derivative (currency swap) may be treated as a capital gain. The character of the gain or loss realized on a derivative transaction is to be established through "linkage" to the item being hedged. The hedge at issue in this case related to the value of the underlying foreign affiliate group, but the hedge was taken at the parent level, and therefore, did not meet the CRA's test of what constitutes a hedge. The judge rejected the CRA's narrow application of the linkage test and rejected the CRA's default position with respect to hedges that are considered to be on account of income.

There is no definition of a hedge in the *Income Tax Act*; the key difference between a derivative transaction being speculative or a hedge is whether there is a risk that is matched. If such a risk exists, it's a hedge, but if not, it's speculation. The question before the Court was whether the risk needs to be borne by the taxpayer. In this case, the Court held as a factual matter that the parent had risk because it carried the foreign affiliates on its consolidated balance sheet. This case clarifies the items of risk that may be subject to hedge treatment for tax purposes and provides

helpful guidance regarding the criteria necessary to establish a sufficient link between an item at risk and a hedging derivative for tax purposes.

Kruger Wayagamack Inc. v. The Queen, 2015 TCC 90 – Brian Bloom

This issue in *Kruger* was whether the taxpayer was associated with its majority shareholder. This decision considers the issue of when a Unanimous Shareholders Agreement (USA) may deprive a majority shareholder of legal control of a corporation. This case also contains a discussion on the meaning of (*de jure* and *de facto*) control, which has far broader implications.

The USA at issue split the decisions relating to operations or managerial type decisions from the strategic decision, and the Court was asked to determine where control resided. The Court equated "control", both *de facto* and *de jure*, with the ability to make strategic decisions on behalf of a corporation. The Court concludes that the USA deprived the majority shareholder of de jure control of the taxpayer but that they were nevertheless associated by virtue of certain deeming rules in s. 256.

The TDL Group Co. v. The Queen, 2015 TCC 60 – Nancy Diep

The issue in this case was whether TDL's interest expense was deductible pursuant to s. 20(1)(c) during the relevant period (March – November 2002), the period during which the loan from its subsidiary (Tim's US) to its parent (Wendy's) was non-interest-bearing. The parties did not dispute the direct use of the borrowed funds, namely, the acquisition by TDL of shares in Tim's US. The issue was confined to whether TDL satisfied the "purpose test" in s. 20(1)(c). In particular, the borrowed money must be used for the purpose of earning income from a non-exempt business or property. The relevant test was set out in *Ludco*, 2001 SCC 62 as: "whether, considering all the circumstances, the taxpayer had a reasonable expectation of income at the time the investment is made."

In concluding that the purpose test had not been met, the Court focused on the words "considering all the circumstances", and concluded that the words were very broad and permitted a court to look through the direct use of the funds to the indirect use (*i.e.*, the use of the funds by Tim's US and other members of the group), including any series of transactions related to the direct use. This case is under appeal to the Federal Court of Appeal.

2015 IFA International Tax Conference – Seminar Proceedings

Transfer Pricing Update

Moderator: Stephen Bowman
Panelists: Dale Hill, Marc-André Séguin, and Givndaray Nayak
YIN Rapporteur: Jeffrey Shafer

The panel provided an update on recent global developments in transfer pricing and their implications for Canadian taxpayers and tax practitioners.

The most significant new developments in the area of international transfer pricing are the changes being proposed in connection with the OECD's base erosion and profit shifting (BEPS) initiative. Some of the BEPS "action items" that most directly impact transfer pricing are:[1]

- Action 8 – Intangibles, with the objective of developing transfer pricing rules to prevent BEPS by the moving of 'intangibles' among group members;
- Action 9 – Risks and capital, with the objective of developing rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members; and
- Action 10 – Other high-risk transactions, with the objective of developing rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties.

A common theme of the BEPS initiative is to focus the transfer pricing exercise on value creation, and to arm tax authorities with the information and analytic guidance to properly evaluate value creation within multi-national groups. The Canada Revenue Agency (CRA) spends a lot of time and money on international tax issues, so these actions present an opportunity to realize important efficiencies by improving the process and reliability of transfer pricing audits.

Of the three action items noted above, Action 8 may be the most significant from a Canadian perspective. Historically, in connection with issues relating to intangibles taxpayers have focused on legal ownership of intellectual property (IP); CRA has not always agreed with these positions. BEPS Action 8 clarifies that while legal ownership is important, one must have regard to value creation in order to reach the correct result. Indeed, the statements in Action 8 are, in some respects, consistent with the approach that CRA has taken for some time and may provide additional support for these positions. In particular, Mr. Nayak[2] emphasized that CRA has had difficulty with the transfer of legal ownership of intangible property among group members, and has therefore focused on people functions and value creation to better understand the contributions made by all relevant parties.

[1] Action 13, proposing new documentation requirements, has been covered extensively in other sessions and so is not addressed here. There are comments on Action 13 in the slides from this session.
[2] Mr. Nayak's comments are based on his personal perspective as a senior CRA transfer pricing economist but do not necessarily represent official CRA policy or viewpoints.

One aspect of the new guidance that has been criticized, or at least viewed with skepticism, is the uncertainty that it appears to create in a transfer pricing audit. One source of uncertainty could be a focus on value creation to the exclusion of external factors that impact profitability. For example, the arm's length transfer price for a good or service between related group members would not necessarily change from one year to the next, even if one of those companies saw a dramatic change in profitability that was attributable to external market factors.

Mr. Séguin provided two examples of the uncertainties that have arisen in real transfer pricing audit situations:[3]

- In one example, a German affiliate has a manufacturing function and owns IP. This affiliate earned very low, or no, profits, and so was shut down for commercial reasons. Professional third-party valuators were retained to value the IP, and the value in the middle of the range developed by the valuators was used for purposes of the transfer. On the one hand, CRA is asserting that the IP had no value; on the other hand, Germany is asserting that the value was at the high end of the range. The double taxation arising from these mutually exclusive positions is now being resolved by the competent authorities, but the case demonstrates that valuation of IP or other intangibles is a subjective exercise. This leaves taxpayers facing the prospect of adjustments regardless of any steps they take to determine and apply arm's length prices.
- The second example involves an entity engaged in pure research and development activity, but in respect of IP that is far from being commercialized. All development activity occurred in Canada. CRA is asserting that there should be a re-charge to other entities in the group in respect of the research and development activity, notwithstanding that the business people can find no commercial justification for the IP having any current commercial value. This case demonstrates that even where there may be valuable functions being performed, that does not necessarily imply that an arm's length party would pay any amount at that time in respect of that function.

Mr. Nayak pointed out that we should not assume that CRA auditors have no knowledge of taxpayers' business. Many auditors have extensive experience auditing taxpayers in specific industries and have thereby gained considerable expertise. He also explained CRA general approach to intangibles is first to confirm through investigation the existence and ownership of intangibles, and only then to evaluate the pricing of any related transactions. Finally, one step that taxpayers can take to help minimize uncertainty is to ensure that contemporaneous documentation provides the relevant details to help establish the existence and ownership of intangibles.

The hope is that BEPS can provide taxpayers with greater insight into the approach that tax authorities take towards intangibles and therefore help reduce uncertainty.

From an audit perspective in Canada, it is not clear that BEPS Action 8 will have much of an impact. This is because CRA has traditionally taken positions that are consistent with the new Action 8 guidance. It is

[3] These examples are based on real situations but the facts are abstracted to protect confidentiality.

an open question whether BEPS guidance should be applied to transactions that occurred in prior years to the extent any of the guidance represents truly new approaches.

There are several possible impacts that the BEPS work may on the competent authority program in Canada. Many suggest that the BEPS Action 8 guidance can justify more adjustments in transactions relating to intangibles, thus creating more work for the competent authorities. However, to the extent that the guidance is consistent with historical CRA approaches, it is not clear that more adjustments should be expected. On the other hand, if all tax authorities have consistent interpretations of the BEPS guidance this could facilitate easier and more efficient resolution of competent authority resolutions.

The possibility of needing to resolve inconsistent positions reinforces the need to bring forward all relevant facts to educate auditors on the relevant features of a transaction and to help reach a reasonable result. The BEPS initiatives may create a higher documentation burden on taxpayers, through country-by-country reporting under Action 13 as well as the need to address new concepts introduced in the other action items. These documentation requirements may be a burden for some taxpayers, and may extend timelines for audits as people take time to assemble and review all relevant documents. This is so even if more detailed documentation provides an opportunity to avoid misunderstandings or different views of the facts. Some are concerned that the increased volume of information may delay the competent authorities from acknowledging that a competent authority request is substantially complete so that an arbitration “clock”, if applicable, can start.

The changes currently happening in the field of transfer pricing emphasize the need for taxpayers, tax practitioners and CRA to think creatively and practically to try to arrive at reasonable, and hopefully consistent, results. This includes a focus on commercial reality in respect of inter-group transactions, the need to educate non-tax business people about the importance of complying with transfer pricing rules, and understanding the limits of information systems and finding practical ways to identify and provide necessary information. With all of the concepts and details that need to be addressed in a transfer pricing audit, it will be increasingly important to focus on identifying the real issues up front to help ensure that audits proceed efficiently.

U.S. Developments and Implications for Canadian Tax Planning

May 29, 2015

Panelists: David Forst (Fenwick & West) and Adam Halpern (Fenwick & West)

Moderator: Siobhan Goguen (Felesky Flynn)

YIN Rapporteur: Christopher Montes (Felesky Flynn)

The panelists discussed a number of recent U.S. tax developments that may be of interest to Canadian tax practitioners.

<u>Interest Deductibility</u>

Section 163(j) currently applies to limit interest deductibility where interest is paid by a corporation to a related person or on a debt guaranteed by a related person, the corporation has a debt-to-equity ratio exceeding 1.5-to-1, and the corporation has excess interest expense (which generally means net interest expense over 50% of adjusted taxable income).

The Obama Budget proposes a different kind of interest deductibility rule that potentially could apply to a U.S. entity that is a member of a multinational group, has a foreign parent, and prepares consolidated GAAP or IFRS financial statements. Under the proposed new rule, the U.S. entity's interest deduction would be limited (1) if the member has net interest expense for tax purposes, and (2) in the same proportion that the member's net interest expense for financial reporting purposes exceeds its proportionate share of the group's financial statement interest expense. The rule also applies in reverse where the U.S. entity is under-leveraged relative to the group. If the U.S. entity fails to substantiate its share of the group's interest expense, or a makes an election, the U.S. entity's interest deduction will be limited to its interest income plus 10% of its adjusted taxable income. Section 163(j) will not apply in a situation where the proposed new rule applies. Although this proposed new rule is not likely to pass in the current year, the panelists were of the view that it was difficult to predict whether the rule (or some variation of it) eventually might be passed.

<u>Anti-Inversion Rules</u>

Section 7874 currently applies to "inversions", treating a foreign corporation as a U.S. corporation generally where: (1) the foreign corporation acquires, directly or indirectly, substantially all of the assets of a U.S. corporation or the U.S. business of a domestic partnership; (2) after the acquisition, at least 80% of the foreign corporation's stock is held by former owners of the U.S. entity; and (3) after the acquisition, the expanded affiliated group that includes the foreign corporation does not have substantial business activities in the foreign corporation's country of incorporation when compared to the group's worldwide business activities. Less severe consequences apply if the former owners of the U.S. domestic entity hold between 60% and 80% of the stock of the foreign corporation. In IRS Notice 2009-78, the IRS previously ruled

that, in applying the 60% or 80% ownership tests, certain stock acquired for cash was not to be taken into account.

In January 2014, the Treasury Department introduced new temporary regulations which codify the rules in IRS Notice 2009-78, but with some changes. In applying the 60% or 80% ownership tests, the new temporary regulations disregard "disqualified stock" of the foreign corporation that was transferred for "non-qualified property" (*i.e.*, cash, marketable securities, or debt obligations of any member of the group or a related person). However, stock is not disregarded where (1) the transfer does not increase the value of the foreign corporation (*e.g.*, sales of stock by existing shareholders), or (2) former owners of the U.S. entity would otherwise hold less than 5% of the stock of the foreign corporation or any member of its group. The panelists noted that these new regulations can lead to some surprising results. For example, where shareholders of a U.S. corporation acquire more than 5% of the foreign corporation's shares and the remaining foreign corporation shares are acquired for cash in an IPO, the foreign corporation could be treated as a U.S. corporation under these rules.

Also discussed was IRS Notice 2014-52, which the panelists described as the U.S. government's well-publicized, but legally-questionable, attempt to curtail inversion transactions. The panelists discussed two of the less-well-publicized provisions of the Notice. First, in applying the "substantiality" test (*i.e.*, whether the U.S. corporation is less than a certain size relative to the foreign corporation, which is relevant for the transaction to be tax-deferred for U.S. shareholders), the Notice disregards "non-ordinary course distributions" of the domestic target corporation within the 36 months preceding the acquisition. Second, in applying the 50% taxability test in section 304(b)(5)(B) (discussed below), the Notice states that only dividends from the foreign acquiring corporation are considered; dividends from the issuing corporation are disregarded.

<u>Partnership Carrying on U.S. Trade or Business</u>

Rev. Proc. 91-32 currently applies where a partnership has a U.S. trade or business and an interest in that partnership is owned by a non-U.S. person. In that ruling, the IRS takes the position that a non-U.S. partner's sale of its partnership interest is taxable to the extent attributable to the partnership's U.S. property. This is seemingly contrary to provisions of the Internal Revenue Code. However, the Obama Budget proposes to codify this ruling. The Obama Budget also proposes to require the transferee to withhold 10% of the amount realized.

In respect of whether a U.S. trade or business exists, the panelists noted a recent IRS memorandum (CCA 201501013-ECI) where the IRS took the position that a fund with no employees that conducted lending and underwriting activities through a U.S.-based agent was carrying on a U.S. trade or business.

<u>Changes to Section 304</u>

Section 304(a)(1) applies when a person (or persons) are in control (+50% of votes or value) of each of two corporations and one of those corporations acquires stock of the other in exchange

for cash, a note or other property (other than stock of the acquiring corporation). The section recharacterizes the stock sale as (1) a transfer of the issuing corporation's stock to the acquiring corporation in exchange for deemed stock of the acquiring corporation, and (2) a redemption of the deemed stock of the acquiring corporation, which is treated as a dividend first from the acquiring corporation's E&P and then from the issuing corporation's E&P. After E&P of both entities is exhausted, basis is reduced.

Section 304(b)(5)(B), introduced in the 2010 Tax Act, states that E&P of a foreign corporation will not be taken into account if more than 50% of the dividends therefrom would otherwise not be subject to U.S. tax or taken into account in E&P of a CFC. Anti-avoidance rules were also introduced in 2012 which allow the IRS in certain circumstances to deem other corporations to be an acquiring corporation or an issuing corporation.

Triangular Reorganizations – Killer B Regulations

The Treasury Department and the IRS announced in IRS Notice 2014-32 that they will modify the "Killer B" regulations, which apply to triangular reorganizations where a corporation ("**USCo**") acquires a target using the stock of USCo's parent. Various technical changes will be made to remove the deemed contribution rule, adjust the parent's basis in USCo's stock, eliminate opportunities to avoid recognizing a gain, and clarify the anti-abuse rule. The panelists noted that the "clarifications" of the anti-abuse rule are, in fact, very unclear and could apply in a number of surprising circumstances. The panelists also noted that the Killer B regulations can be avoided by making the transaction fail to qualify as a tax-free reorganization.

U.S. Position on BEPS

The panelists observed that the U.S. has expressed concerns over a number of proposed BEPS initiatives, including: (1) "special measures" (as opposed to using the arm's length standard) for transfers of certain intangibles; (2) initiatives to reallocate profit based on risk; (3) the use of a "main purpose" clause to avoid treaty shopping; (4) the concept of a multilateral treaty; (5) the broadening of the PE concept; and (6) unconditional information sharing (which could be used for, among other things, formulary apportionment).

Revisions to the U.S. Model Treaty

Proposed changes to the U.S. Model Treaty include the following: (1) denial of treaty benefits in a triangular situation where a treaty partner has a PE in a third country and neither the treaty country nor the third country tax the PE's profits significantly; (2) imposition of a 30% withholding tax on dividends, interest, royalties paid by entities that have undertaken an inversion; (3) denial of treaty benefits with respect to payments of royalties, interest and certain other amounts to related parties who are subject to a special low-tax regime; (4) revisions to the LOB provision; and (5) denial of treaty benefits if the treaty partner country reduces its tax rate to less than 15% or makes certain other changes to its tax system. The panelists noted that changes to the U.S. Model Treaty do not have legal effect, but simply will form the basis for negotiations of new treaties.