IFA CANADA SEMINAR

ROUNDTABLE QUESTIONS

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Centre Mont Royal, Montreal

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ADMINISTRATION

Please provide an overview of the current internal structure within CRA for the administration of international tax matters including identification of the individuals in key leadership roles.

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QUESTIONS REGARDING SECTION 18.2

- Under Section 18.2 interest expense and other borrowing costs of a Canadian corporation will be denied, where the corporation uses borrowed funds (or an amount payable for property) to invest in foreign affiliates, if the debt is linked with a second interest deduction in another country resulting from an inter-affiliate loan, where the interest income to the recipient affiliate is characterized as active business income for Canadian tax purposes – so-called "double-dips".

- The legislation applies if it is reasonable to consider that the Canadian indebtedness is used in a particular taxation year, directly or indirectly, for the purpose of funding, in whole or in part, an offending inter-affiliate loan, and relies on the tracing method for this purpose. While tracing is the method used and understood in Canada for determining interest deductibility (and while the tracing method does not suffer from the even more severe distortions that inevitably result under the allocation formulae), the application of the tracing method in the context of the interest denial rules will lead to uncertainty in many circumstances, and the addition of the concept of "indirect use" adds to this uncertainty. The legislation contains no supporting or prescriptive rules, nor any specific anti-avoidance provisions.

- As Section 18.2 contains no grandfathering relief, it is critical that taxpayers entering into acquisition and financing transactions today be able to determine whether or not interest expense on indebtedness being incurred will be deductible after the year 2011.

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- We have 3 examples where we would invite the CRA to comment.

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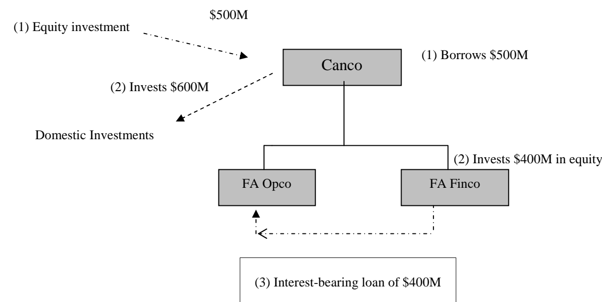
EXAMPLE 1(a) - COMMINGLING OF FUNDS IN ONE ACCOUNT



COMMINGLING OF FUNDS IN ONE ACCOUNT (Cont….)

- In this example, Canco borrows $500 million from a bank and, on the same day, receives an equity investment of an additional $500 million from its shareholders. Canco uses the cash of $1 billion to make 2 investments – it invests $400 million in a conventional, foreign affiliate, double-dip structure; and second, it invests $600 million in Canadian domestic investments.

- At the 2002 Annual Conference, the CRA indicated that, where there is a commingling of borrowed funds in a bank account together with funds from other sources, and if a taxpayer can demonstrate that the aggregate eligible expenditures from the account exceed the amount of borrowed money deposited to that account, then the CRA will generally accept, as a reasonable proxy for tracing, that the taxpayer has satisfied the test of tracing and of linking the borrowed money to an eligible use. This position was subsequently confirmed in IT 533, issued on October 31, 2003. Consistent with these comments, can Canco, in this example, "positively" trace all of the borrowed funds to the good, domestic assets, with the result that there should be no denial of interest expense to Canco?

Example 1(b) - Cash Damming

- In the comments at the 2002 Annual Conference with respect to the positive tracing of borrowed funds to eligible assets, the CRA also commented on cash damming. CRA's position was confirmed in IT 533. It noted that, in a situation involving a commingled cash account where it is very impractical to trace, cash damming may be acceptable, although the CRA did reserve on this position with respect to GAAR. Again turning to the diagram above, and if there was any uncertainty with respect to whether, in the absence of planning, Canco's borrowed funds should be positively traced first to its good, domestic assets, would the Department accept a segregation of cash from borrowed funds in one account (used to fund the investment in eligible, domestic assets), and cash from Canco's equity investment in a separate account – this for purposes of clearly identifying the use of borrowed funds first to an eligible use?

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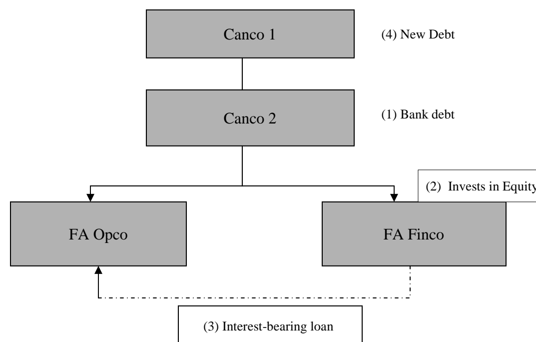
EXAMPLE 2 - PRE-EXISTING CONVENTIONAL DOUBLE-DIP



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PRE-EXISTING CONVENTIONAL DOUBLE-DIP (Cont…)

- In this example, we have a Canadian corporate group which, before the year 2012, has entered into a conventional, double-dip structure, using borrowed funds to finance the foreign affiliate investment. Canco 1 is a Canadian holding company, which owns 100% of the shares of a Canadian operating company – Canco 2. Canco 2 borrowed from a bank, and invested in equity of FA Finco, which made a loan to FA Opco. And so, after the year 2011, the interest on the bank debt of Canco 2 would be denied. (If Canco 2 refinances its bank debt with new debt, the extension of the substituted indebtedness rules in subsection 20(3) to the interest-denial rule would mean that the interest on the new debt of Canco 2 would also be denied).

- Assume that the Canadian corporate group decides to substantially refinance its Canadian domestic and foreign investments (both existing and planned) and that, in this regard, the parent company, Canco 1, obtains new debt. Canco 1 uses the proceeds from the new debt, in part, to invest in equity of Canco 2, and Canco 2 uses the proceeds to repay its old bank debt. In this example, does the CRA agree that the proceeds from the new debt incurred by Canco 1 have not been used, directly or indirectly, to fund or support, in whole or in part, the inter-affiliate debt between FA Finco and FA Opco, and that the interest-denial rule should accordingly not apply to the interest expense on Canco 1's indebtedness?

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PRE-EXISTING CONVENTIONAL DOUBLE-DIP TAKEOVER OF CANCO

Example 3

- The third example is basically the same as Example 2, with one significant difference. Assume that Canco 2 was a Canadian public company which incurred the bank debt, before the year 2012, to fund an offending inter-affiliate loan. Subsequently, and in a transaction that has no connection with the original foreign affiliate investment, there is a takeover of Canco 2, and a third-party purchaser – Canco 1 – acquires all of the shares of Canco 2, using the proceeds from new indebtedness as partial currency for the acquisition: Canco 1 also received a significant equity contribution as part of its funding for the acquisition. In addition to the acquisition of shares of Canco 2, Canco 1 uses a portion of the proceeds from the new debt and from its own equity investment, to invest in equity of Canco 2, allowing Canco 2 to repay its old debt. Does the CRA agree given the complete absence of any nexus between the takeover (and the introduction of a new shareholder group) and the transactions previously entered into by Canco 2 when it was a public company, that the new debt of Canco should not be considered to be linked with, or to be funding, in whole or in part, the inter-affiliate loan between FA Finco and FA Opco, such that the new denial rules should not apply to Canco 1's interest expense?

- In the alternative, and having regard to the fact that Canco 2 will typically have significant Canadian domestic assets in addition to its foreign affiliate investments, can the proceeds from Canco 1's new debt first be positively traced to domestic and other non-offending assets held, directly or indirectly, by Canco 2?

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GAAR

It has been argued that the decision of the Federal Court of Appeal in *MIL (Investments)* should give taxpayers and their advisors greater comfort that the GAAR will not be a significant tool for attacking the use of holding companies for investment into Canada by non-residents on the basis of a treaty shopping argument in most cases. The Court, in that case, could easily have found that the GAAR did not apply on the facts without giving any comfort of a general nature inasmuch as the Tax Court had found that no relevant series of transactions existed. Furthermore, it could have merely found no reviewable error in the Tax Court decision, leaving the range of possible interpretations open. Instead, the Court stated, as clearly as possible, that it does not accept the proposition that choice of jurisdiction for a holding company is subject to the GAAR. Would CRA please provide its reaction to this argument?

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APA rollbacks

- With the publication of TPM-10, the CRA has indicated that rollbacks would not be available with respect to taxation years for which a request for contemporaneous documentation would have been issued by the CRA prior to the taxpayer holding an APA pre-filing meeting with the CRA. Under that fact pattern, if, for instance, a taxpayer nonetheless proceeds with a bilateral APA for taxation years 2008 through 2012 with a roll back to 2006 while the CRA proceeds with an audit of the 2005 taxation year, and if the audit of the 2005 taxation year results in a reassessment, is it not likely that, if the facts and circumstances have not changed between 2005 and the subsequent taxation years, the result of the mutual agreement procedure with respect to the 2005 taxation year should be the same as the application of a rollback of the APA?

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Appeals consulting ITD economists

- There is anecdotal evidence of the CRA Appeals division consulting ITD’s economists when reviewing a notice of objection that involves a transfer pricing adjustment. Given that ITD’s economists are the ones who approved the reassessment with respect to which the relevant notice of objection has been filed, does this not affect the Appeals division’s objectiveness of the review?

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Modified - Re-characterizations

Please provide some examples where CRA has or intends to apply the 247(2) re-characterization.

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DEPARTMENT OF FINANCE OVERVIEW

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Amendments to Section 116

- Why does the “reasonable inquiry safe harbour” apply only in respect of the vendor’s residence? Could it be extended to cover the applicability of treaty benefits (including effect of the LOB provisions)?
- Could special provision be made for partnerships?
- How about limiting the purchaser’s exposure to a short (e.g. one year)
  - time period, to facilitate escrow and related arrangements?
- Would it be appropriate to eliminate all section 116 requirements where a transaction is governed by a domestic rollover?

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TIEAs

- Was the omission of a definition of "TIEA" an oversight?
- Is there an anomaly in the different treatment of affiliates in no-tax TIEA countries versus affiliates in treaty countries that have special preferential regimes?

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18.2 Double Dip Rules

- Why is the foreign tax position of the payor affiliate not taken into account? That is, why is the mere recharacterization of an amount under 95(2)(a)(ii) considered enough to warrant disallowing the deduction in Canada?

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Pending legislation

- What is likely to happen with Bill C-10 (including the FIE and NRT rules)?

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5th Protocol

General

- When should taxpayers expect the Protocol to reach the US Senate?
- When will the planned Technical Explanation be made public?
- The 5th Protocol includes a number of new provisions – some that are entirely new and unique to the Canada-US context, and others that are in the existing treaty but are being made to apply in Canada for the first time. What level of detail can taxpayers expect from the Technical Explanation in respect of these new elements?

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LOB – derivative benefits

- Should the derivative benefits rule apply to capital gains? What about guarantee fees?
- Why, if the tax rate under the source country's treaty with a third country is higher than the Canada-US rate, does that higher rate not apply (rather than the full (non-treaty) source country rate)?

Hybrid Entities

- Some commentators have suggested that new paragraph IV.7 is overbroad, in that it may deny benefits under the treaty even where income has been fully taxed in the source country. Comments?

QUESTIONS REGARDING THE 5th PROTOCOL TO THE CANADA-US TREATY

PROCEDURES

Would CRA comment on what procedures it anticipates will need to be followed by Canadians paying amounts to US residents to establish that a particular US resident is a "qualifying person" under the proposed LOB provisions. Is it expected that there will be some type of form that can be requested by the Canadian payor and relied upon? If not, what standard of due diligence must be conducted in order for a Canadian taxpayer to pay at the Treaty rate?

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THE 5th PROTOCOL TO THE CANADA-US TREATY (Cont….)

PARAGRAPH 6 LOB

A related question would be how CRA expects paragraph 6 of the LOB article to be administered (competent authority requests for determination that the Treaty benefits should be available where the recipient does not meet the test to be a "qualifying person").

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THE 5th PROTOCOL TO THE CANADA-US TREATY (Cont….)

FISCALLY TRANSPARENT ENTITY

The term “fiscally transparent” is not defined in the Protocol.

How does CRA interpret the term “fiscally transparent”?

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THE 5th PROTOCOL TO THE CANADA-US TREATY (Cont….)

S CORPORATION

It is argued that an S Corporation could be considered fiscally transparent. Under these circumstances, it appears that paragraph 6 of Article IV of the Convention as amended by the Protocol would also apply to a dividend paid from a Canadian company to a U.S. shareholder that is an S Corporation. What is the appropriate rate of withholding tax to be applied on the dividend paid to the S Corporation?

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THE 5th PROTOCOL TO THE CANADA-US TREATY (Cont….)

US PARTNERSHIPS TREATED AS CORP = RESIDENT

Does the current Treaty or the Fifth Protocol provide relief (in the form of access to treaty benefits from Canadian tax) for those US partnerships that are treated for purposes of the Code as corporations, and therefore are fully subject to US tax on worldwide income? Article III(1)(f) provides that ("[F]or the purposes of this Convention, unless the context otherwise requires") "the term 'company' means any body corporate or any entity which is treated as a body corporate. Accordingly, it appears that a US partnership that is treated for the purposes of the Code as a corporation and is subject to US tax on its worldwide income is a resident of the US within the meaning of paragraph 1 of Article IV of the Treaty because it is a person who, under the laws of the US, is liable to tax in the U.S. by reason of its "domicile, residence, citizenship, place of management, place of incorporation or any other criterion of a similar nature". Does the CRA, nevertheless, look to the partners of such partnerships as the taxpayers in respect of amounts earned or realized by such partnership, rendering useless the treatment of the partnership as a resident of the US for the Treaty? Nothing in the Protocol (e.g. Article IV(6)) addresses this matter.

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THE 5th PROTOCOL TO THE CANADA-US TREATY (Cont….)

Articles XXIX A (2)(d) & (e) (LOB) and fiscally transparent entities:

For purposes of applying the Limitation of Benefits Provision of the Canada-US Income Tax Convention, as amended by the Fifth Protocol, will Canada look through limited liability companies ("LLCs") and other entities that are fiscally transparent for US purposes, in applying paragraphs 2(d) and (e) of the definition of "qualifying person" in Article XXIX A?

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THE 5th PROTOCOL TO THE CANADA-US TREATY (Cont….)

Articles XXIX A (3) (LOB) & “incidental to or in connection with”

Paragraph 3 of Article XXIX A of the Convention, as amended by the Fifth Protocol, provides, in part, as follows:

“Where a person is a resident of a Contracting State and is not a qualifying person, and that person, or a person related thereto, is engaged in the active conduct of a trade or business in that State…, the benefits of this Convention shall apply to that resident person with respect to income derived from the other Contracting State in connection with or incidental to that trade or business…”

How will Canada interpret the reference to "in connection with or incidental to" in applying paragraph 3 of Article XXIX A - what is the required nature of the connection, and the required degree of the connection?

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THE 5th PROTOCOL TO THE CANADA-US TREATY (Cont….)

LOB Provision

Will Canada consider that capital gains can be treated as income that is “in connection with or incidental to” in applying paragraph 3?

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THE 5th PROTOCOL TO THE CANADA-US TREATY (Cont….)

Hybrid Entity Clause: Substantive/Administrative issues on the HEC

Assume USco holds LLC and LLC holds Canco. Canco pays interest or a dividend to LLC. How do Articles IV(6), X(2) and XI(1) work in practice? Who "claims" the treaty relief? Can LLC make a "claim" under the Convention given that it is not regarded as a resident for the purpose of the Convention and the benefits of the Convention accrue only to residents? If LLC makes the treaty claim, is the LLC required to establish that each of (or as many of) its members is entitled to treaty benefits?

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The 5th Protocol to the Canada-US Treaty

- There is a lot of interest in the new binding arbitration rules. One particular concern relates to the effective availability of arbitration for issues which already are stalemated at the MAP level. The issue is the coming into effect rule, which appears to require that the normal new rule (that two years must pass from the date the issue has first been submitted for MAP) will apply in such a way as to require that issues submitted long ago now await a further two-year delay from the date the Treaty comes into effect.

- Can CRA or Finance comment on the waiting period that will apply to those disputes which have been submitted for MAP at time that is prior to the coming into force of the Protocol.

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