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Recent Corporate Tax Issues

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Daishowa-Marubeni International Ltd. v. R.

"*If a tree falls in the forest and you are not around to replant it, how does it affect your taxes?*"

Ryan Rabinovitch

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I. Facts:

- Taxpayer was a lumber company with three operating divisions in Alta.:
  - "High Level" and "Peace River" – Taxpayer entered into a forestry management agreement (FMA) with province.
  - "Brewster" – Taxpayer had a timber quota.
- Both the FMAs and timber quota constituted "timber resource properties" for the purposes of subsection 13(21) of the ITA.
- In 1999-2000, Taxpayer decided to sell High Level and Brewster.
- *Timber Management Regulations* (Alberta) required that the consent of the province be obtained prior to an assignment of an FMA or quota.
- As a matter of practise, Alberta refused to consent to assignments unless purchaser agreed to assume all of vendor's "reforestation obligations."

I. Facts:

- High Level:
  - Sold to Tolko Industries ("**Tolko**").
  - In parties' agreement:
    - Purchase price was defined as $169 million plus working capital (assumed obligations <u>not</u> formally part of purchase price).
    - "Free-standing" clause pursuant to which Tolko agreed to assume all of High Level's obligations, including reforestation obligations.
    - Indicated that parties "<u>estimated in good faith</u>" that the value of High Level's reforestation liabilities was $11M. Estimate was to be audited after closing, and an adjustment payment made by Taxpayer or Tolko.
    - Only $169M (and not $180M) was allocated to High Level's assets.

I. Facts:

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- Brewster:
  - Sold to Seehta Forest Products Ltd. ("**Seehta**").
  - According to Taxpayer's financial statements, amount of reforestation obligations was $3M.
  - In parties' agreement:
    - Purchase price was defined as $6.1M plus working capital adjustment (assumed obligations not formally part of purchase price).
    - "Free-standing" clause pursuant to which Seehta agreed to assume all of Brewster's obligations, including reforestation.
    - Unlike in the case of High Level, no estimate of amount of reforestation obligations or adjustment payment mechanism was provided for.
    - Only $6.1M (not $9.1M) was allocated to Brewster's assets.
- Both High Level and Brewster reforestation obligations related to trees already cut.
- Taxpayer filed on basis that assumed obligations did not form part of its proceeds.

II. Federal Court of Appeal:

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- Nadon J.A. (majority): Assumed obligations must be included in Taxpayer's proceeds:
  - Assumption of obligations formed part of the consideration given for Taxpayer's assets;
  - Taxpayer would have demanded a higher price if reforestation obligations had not been assumed.
  - Key factor seemed to be that in case of High Level, parties had valued amount of obligations assumed at $11M in their agreement. Suggested that outcome for Brewster might be different for this reason (there did not appear to have been any attempt to value the obligations assumed in that case). Did not feel that trial judge had dealt adequately with facts in the case in order to conclude. Ordered new trial regarding Brewster.
  - Rejected argument that assumed obligations did not form part of proceeds because amount not ascertained/ascertainable (i.e. based on analogy with "quality of income" case-law). Case-law was irrelevant where parties agree upon a value in their agreement.

II. Federal Court of Appeal:

- Rejected argument that Taxpayer was entitled to an offsetting deduction because it had "paid" purchasers to assume its reforestation obligations (i.e. by transferring them assets with a value equal to the value of the obligations assumed). Amount "paid" to the purchasers for the assumption was on capital account (para. 18(1)(b)). It produced an enduring benefit and was part of a capital transaction.
- Mainville J.A. (dissenting) – Assumed obligations did not need to be included in Taxpayer's proceeds:
  - Viewed transaction as a sale of assets with a "defect" for a net purchase price (e.g. sale of High Level assets for $169M).
  - Assumed obligations were "inextricable linked" with transferred assets. You could not transfer assets without reforestation obligations as a practical matter.

III. Supreme Court of Canada:

- Rothstein J.: Assumed obligations did not need to be included in Taxpayer's proceeds:
  - Adopted similar reasoning to Mainville J.A.
  - Held that assumed liabilities can form part of a Taxpayer's proceeds.
  - Reforestation obligations, however, "were not appropriately characterized as the assumption of an existing debt". Rather, the obligations were "a future cost embedded in the forest tenure" that "depress[ed] the tenure's value at the time of sale (para. 29)."
  - Taxpayer's situation was analogous to sale of a building in need of repair. Obligation to make repairs simply decreases FMV of building.
  - Distinguishes sale of property subject to a mortgage. If mortgage were assumed, value would form part of Taxpayer's proceeds.
  - Key factor in determining whether obligation is "embedded" in an asset appears to be level of attachment to the asset. Mortgaged property can be sold without an assumption of mortgage by the purchaser. Forestry tenures, however, could not be sold without assumption of vendor's reforestation obligations.

III. Supreme Court of Canada:

- Rothstein J.:
  - Not necessary for there to be a legal requirement for obligations to be assumed in order for them to be "embedded" (NB – but does not indicate what the standard is where there is no such requirement).
  - Suggests that mining reclamation obligations assumed upon the sale of mineral resource properties would not constitute proceeds.
  - Chooses not to deal with question of whether contingent obligations assumed by a purchaser should be excluded from proceeds on the basis of "quality of income" case-law.
  - Notes that result reached prevents asymmetry, as CRA's position is that assumed contingent liabilities do not form part of a purchaser's cost (see e.g. CRA View 2002-0164607).
  - States explicitly that fact that assumed obligations are valued by parties in their agreement or for accounting purposes is not relevant in determining whether they must be included in proceeds.

IV. Where are we?

- Assumed obligations:
  - Will form part of a taxpayer's proceeds unless they are "embedded" in property sold with the result that they reduce property's FMV.
  - What obligations will be considered "embedded"? Not 100% clear:
    - Not bank debt/mortgages;
    - Reforestation obligations;
    - Other obligations that must be transferred with business as a matter of law;
    - Mining reclamation obligations;
    - Future obligations?
    - Other obligations intimately linked with business that do not have to be transferred as a matter of law (e.g. supply/hedging contracts, etc.)?
  - Contingent obligations: Still no answer.
- General approach to statutory interpretation:
  - "An interpretation of the Act that promotes symmetry and fairness through a harmonious taxation scheme is to be preferred over an interpretation which promotes neither value (para. 43)."

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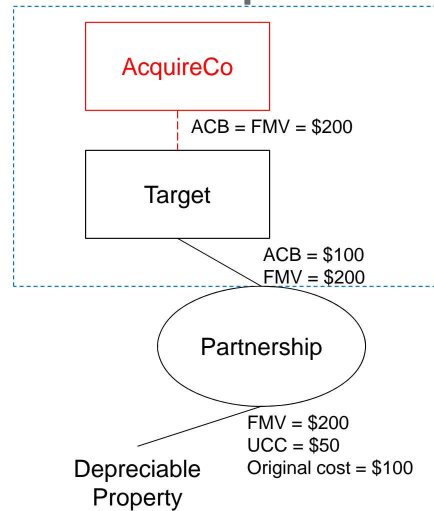
Update on Transactions Involving Partnerships

Elaine Buzzell

2012 Federal Budget

- Amendments to ss. 88 and 100 announced in “Tax Avoidance Through the Use of Partnerships” section
- Concern with transactions structured to prevent recognition of full accrued gain on income assets of partnership

Bump Rules: Example



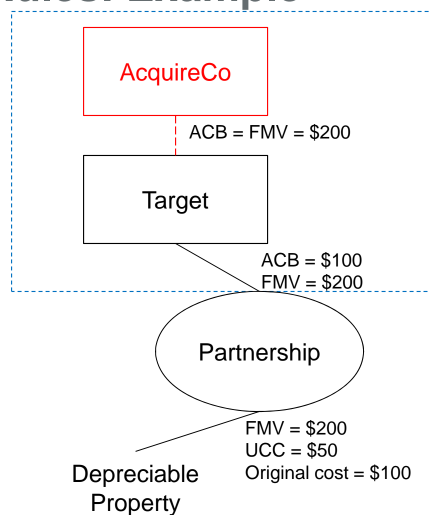
Amendments to Bump Rules

- Under current 88(1)(d)(ii), cost of a particular property of subsidiary distributed to parent on winding-up cannot be increased beyond FMV of property at time parent last acquired control of subsidiary

New subparagraph 88(1)(d)(ii.1)

- 88(1)(d)(ii.1) deems FMV of partnership interest to be reduced by portion of accrued gain on interest that "may reasonably be regarded as being attributable" to:
  - Depreciable property: excess of FMV over cost amount
  - Canadian resource property or foreign resource property: FMV of property
  - Any other property (other than capital property): excess of FMV over cost amount

Bump Rules: Example



Anti-Avoidance Rules

- Paragraph 88(1)(e) – transfer of property to partnership, or transfer of partnership interest, on rollover basis prior to acquisition of control of subsidiary
- Subsection 97(3) – transfer of property to partnership on rollover basis after acquisition of control of subsidiary
- Proposed amendments to 88(1)(d)(ii)

Subsection 100(1)

- Applies where taxpayer disposes of partnership interest and partnership interest acquired by “bad person” (see ss. 100(1.1))
- Deems taxpayer’s taxable capital gain from disposition of interest to be the total of:
  - half of gain that “may reasonable be regarded as attributable to” increases in value of capital property (other than depreciable property) owned by partnership
  - entire amount of balance of gain

"Bad" Transferees: subsection 100(1.1)

- Person exempt from tax under section 149
- Non-resident person
  - See ss. 100(1.3) exception
- "Look-through" rules for partnerships and trusts
  - See ss. 100(1.2) exception

Anti-Avoidance Rule

- Rule in ss. 100(1.5) applies where:
  - It is "reasonable to conclude that one of the purposes of a dilution, reduction or alteration" of a taxpayer's interest in a partnership is to avoid ss. 100(1), and
  - As part of series, "bad" person under ss. 100(1.1) acquires, or has an increase in or alteration of, partnership interest
- Deemed disposition of partnership interest for purposes of ss. 100(1)

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Changes to the Thin Capitalization Rules

Chris Falk

Introduction - Thin Capitalization Rules

- But for the thin capitalization rules:
  - Significant incentive for non-residents investing in Canada to finance their investments with debt rather than equity
    - Interest deductibility and possible withholding tax benefits

Introduction (cont)

- The thin capitalization rules restrict interest deduction for:
  - a corporation resident in Canada (a CRIC)
  - on loans made by non-residents of Canada who are significant shareholders of the CRIC or their affiliates
- Thin capitalization rules a central concern in structuring foreign investment in Canadian subsidiaries

Introduction (cont)

- Rules expanded substantially in the last two federal budgets
- The changes are relevant in structuring new investments and in determining whether existing investments need to be restructured
- Propose to:
  - Comment briefly on how the rules apply generally; and
  - Outline the key changes introduced by Budgets 2012 and 2013

Overview – Thin Capitalization Rules

- Where they apply, the thin capitalization rules deny deduction by a CRIC of interest payable to a "specified non-resident"
- "Specified non-resident": a non-resident that is a "specified shareholder" - together with non-arm's length persons, owns shares of the CRIC representing more than 25% of the votes or value of the CRIC
  - also includes any other non-resident who does not deal at arm's length with a specified shareholder

Overview (cont)

- Rules apply to the extent that a specified debt-to-equity ratio is exceeded
  - "Debt" for this purpose is debt of the CRIC to specified non-residents (not other debt) where interest otherwise deductible
  - "Equity" is – in general terms – the total of:
    - retained earnings (on a non-consolidated basis)
    - contributed surplus to the extent contributed by a specified non-resident shareholder
    - paid-up capital (on shares owned by a specified non-resident shareholder)

Overview (cont)

- Where the rules are engaged, a proportion of the interest on "bad debts" is disallowed
  - Disallowance based upon the "excess bad debt" (i.e., amount above the ratio) compared to the "total bad debt"

Overview – (cont)

- Historically, Canada's rules were comparatively generous:
  - 3:1 debt-to-equity ratio; reduced to 2:1 (2000)
  - Generally considered not to apply to debts of partnerships with CRICs as partners
  - Not applicable to trusts or to non-resident corporations (except non-resident corporations that had elected under ITA 216 re net rental income)

Changes to Thin Capitalization Rules

- Budgets 2012 and 2013 lowered the debt-to-equity threshold and expanded the reach of the rules
- Will outline very briefly the 2012 changes and comment in more detail on the 2013 changes, with a focus on the corporate-related changes

Budgets 2012 & 2013 – Summary of Key Changes

Budget	Change	Effective Date
2012	Debt-to-equity ratio lowered from 2:1 to 1.5:1	Taxation years commencing after 2012
2012	CRICs that are partners in partnerships – income inclusion to CRIC where partner CRIC “offside”	CRIC taxation years commencing after March 28, 2012
2012	Denied interest a deemed dividend – deemed paid immediately before year-end (where not paid or credited in year)	Taxation years ending after March 29, 2012
2013	Trusts resident in Canada	Taxation years commencing after 2013
2013	Non-resident corporations and trusts operating in Canada	Taxation years commencing after 2013
2013	Changes where ITA 216 election by corporation or trust re net rental income – rules for non-resident corporations and trusts used	Taxation years commencing after 2013

Budget 2012 Changes

1. Lowered the thin capitalization ratio from 2:1 to 1.5:1
   - Under the old rules, at least one-third of the CRIC's capital (ignoring "good debt") needed to come from equity
   - Now at least 40% (i.e., 60% debt, 40% equity is 1.5:1)

Budget 2012 Changes (cont)

2. Expanded the reach of the rules to CRICs that are partners in a partnership
   - Provisions work generally not by denying interest deductibility to the partnership but by adding deemed income to partner CRICs that are over the relevant debt-to-equity ratio
     - In this regard, some but not all partners may be "offside" (so rules would not work appropriately if disallowed deductions at partnership level)

Budget 2012 Changes (cont)

3. Treats the denied interest (or deemed income in the partnership context) as a deemed dividend for withholding tax purposes (ITA 214(16))

    - Important change as interest payable to non-resident may not be subject to withholding tax (e.g., if non-participating interest payable to an arm's length lender or if treaty-exempt under the Canada-US treaty)
    - Onerous as does not require an actual payment for the withholding tax to be triggered (ITA 214(17))
        - If not paid or credited in year, deemed paid immediately before end of year

Budget 2013 Changes

- Budget 2013 further expands the rules
    - Will now apply to:
        - Trusts resident in Canada
        - Non-resident corporations and trusts operating in Canada
    - Non-resident corporations that elect under ITA 216 to pay tax on their net rental income will use the thin capitalization provisions applicable generally for non-resident corporations. Similarly now for trusts as well.

Budget 2013 – Trusts Resident in Canada

- No longer outside the thin capitalization net
- Rules look to trust beneficiaries rather than shareholders
  - Specified Beneficiary/Specified Non-Resident Beneficiary concepts
    - Analogous to the Specified Shareholder/Specified Non-Resident Shareholder in the corporate context
  - 25% FMV test
    - including interests of non-arm's length persons

Trusts Resident in Canada (cont)

- Trust's equity amount
  - Contributions to the trust from specified non-residents plus tax-paid earnings less capital distributions from the trust
- Non-deductible interest
  - Can be designated as payment of income to the non-resident beneficiary that received the interest
    - deductible therefore to the trust
  - But withholding tax (and possibly Part XII.2 tax)

Trusts Resident in Canada (cont)

- Special Transitional Rule
  - If trust elects, equity computation as at March 21, 2013 – FMV of trust assets less trust liabilities
- Provisions will also apply to trusts that are partners in a partnership

Budget 2013 – Non-Resident Corporations and Trusts

- Where carry on business in Canada
  - Canadian branch not a separate legal entity with shareholders and equity
  - Special rules regarding equity
    - 40% of the corporation’s or trust’s cost of its properties less indebtedness (other than to “specified non-residents”)

Non-Resident Corporations and Trusts (cont)

- Special rule – in effect – mirrors the 1.5:1 debt to equity ratio (i.e., 60%/40%, after backing out “good debt”)
  - Provisions not directly related to share capital, etc.
- Change to the computation of equity can be critical to corporations that have elected under ITA 216 to pay tax on net rental income
  - Can no longer “fix” their debt-to-equity ratios simply by subscribing for new shares (and circling funds if necessary), which typically had no impact from a Canadian income tax perspective

What does it all mean?

- Generally now very important to plan out of the rules
  - interest subject to the rules treated as a deemed dividend with withholding tax independent of payment
- CRICs with indebtedness to significant non-resident shareholders need to consider the application of the rules in light of the 1.5:1 debt-to-equity ratio

What does it all mean? (cont)

- Non-resident corporations that have made ITA 216 elections in respect of rental income need to consider whether they will have enough equity under the new rules (based upon the cost of the assets in question)
- Corporations that are non-residents or partners in partnerships need to review the rules to see if they now have thin capitalization concerns
- Trusts must review rules as well

What does it all mean? (cont)

- Guarantees by specified non-residents do not make loans “bad loans”

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Recent Commodity Tax Developments

Wendy Brousseau

Current Commodity Tax Landscape

- January 1, 2013 Amended QST (harmonized with the GST)
- April 1, 2013 Implementation of HST in PEI
- April 1, 2013 Re-implementation of GST and PST in B.C.
  - B.C. PST imposed under the new *Provincial Sales Tax Act*

Current Commodity Tax Landscape

¬ HST: ON, NB, NS, NFLD, PEI

¬ GST/Amended QST: QUE

¬ GST/PST: MB, SK, B.C.

¬ GST: AB

Recaptured Input Tax Credits ("RITCs")

¬ Introduced as a result of harmonization in ON and B.C. – as of April 1, 2013, only in ON and PEI (and RITRs in QUE)

¬ RITCs effectively deny ITCs for the provincial component of the HST on specified property or services

¬ Elections available to use production proxy and estimation and reconciliation method

¬ CRA will consider late filed RITC election for periods prior to July 1, 2013, on a case-by-case basis

Budget 2013 Proposed Changes to the GST/HST Rules for Pension Plans

¬ Two measures intended to simplify employer compliance

1. Election not to account for GST/HST on actual taxable supplies
2. Relief from accounting for GST/HST on deemed taxable supplies

Election Not to Account for GST/HST on Taxable Supplies

¬ Current Rules

- Employer required to account for GST/HST on “actual” taxable supplies and, on an annual basis, also on “deemed” taxable supplies
- Potential for double tax
- Tax adjustment note (TAN) mechanism to eliminate double tax

Joint Election Not to Account for GST/HST on Taxable Supplies

¬ Proposed Election
- Participating employer and a pension entity may jointly elect to treat actual taxable supplies as being made for no consideration – if employer accounts for and remits tax on the deemed taxable supplies
- Eliminates the need for TANs

Limited Relief from Accounting on Deemed Taxable Supplies

¬ Partial relief from accounting for GST/HST on “deemed” supplies where amount of the GST/HST falls below certain thresholds and no joint election

¬ Partial relief in respect of “internal pension activities” where thresholds not met

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Tender Offers

Ron Mar

Tender Offers

- Used by Canadian resident issuers of foreign denominated debt
- Allows deferral of f/x gain that could arise upon repayment

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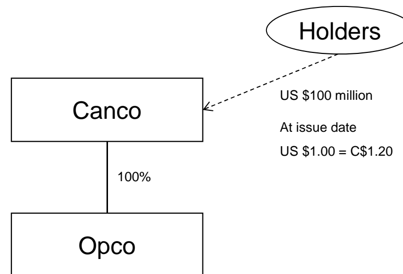
Mechanics and Structure



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Mechanics and Structure

Assumptions:

- Holders deal at arm’s length with Canco
- Holders free to sell or assign debt
- Current exchange rate is US$1.00 to C$1

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Mechanics and Structure

- Opco makes an offer to purchase in advance of maturity
- Typical amendments
  - Allow debt held by subsidiary be taken into account for future authorizations and consents
  - Extend term
- Offer to purchase is not a novation

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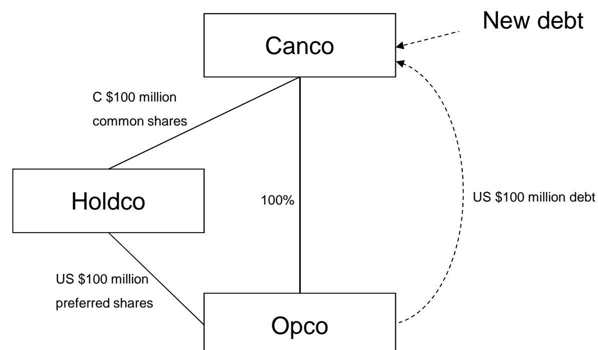
Mechanics and Structure



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Issues: Novation or Rescission

- Novation or rescission would trigger realization of the f/x gain
- Common law concept of novation is narrow
  - Tri lateral agreement
  - New debtor assumes complete liability
  - Distinct from assignment

Issues: Novation or Rescission

- Settlement will occur if original loan is terminated rather than varied or amended
- Does the change go to the very root of the agreement?
- Fundamental terms for indebtedness
  - Debtor's identity
  - Principal amount
  - Maturity date

Issues: Novation or Rescission

Application to Tender Offer?

- Canco remains fully liable
- Permitted assignment
- Maturity date is being changed
- Principal amount remains constant
- Favourable CRA rulings
- Consider governing law

Issues: Debt Parking

- Apply if specified cost to the holder is less than 80% of issue price
- Specified cost is likely Opco's C$ ACB in the notes
- Principal amount – C$ equivalent on date of issue
- Consequences
  - 80.01(11) – no f/x gain recognized
  - Forgiven amount?
  - 80(2)(k) – CRA doc # 2009 – 0347661C6

Issues: GAAR

- Object and spirit of 39(2)
  - ↳ "made a gain or sustained a loss"
  - ↳ Clear intent that realization is required
  - ↳ Pre-parking cases
- Presence of 80.01(11) + 80(2)(k)

Other Considerations

- Future Foreign Currency exposure
  - ↳ Gains and losses arise in different entities
  - ↳ Stop loss rules
- Unwinding the structure