Tax Topics®

December 15, 2011
Number 2075

The issues discussed at the 2011 CTF Roundtable include

CCPC Status and Options 3

Joint Ventures 3

Health Care Spending Bonus 5

Interpretation Bulletin Review 6

Convertible Debentures and Withholding Tax 7

Taxable Canadian Property 8

SR&ED 9

Non-Profit Organizations — Paragraph 149(1)(*l*) 10

Recent Cases 10

CCH a Wolters Kluwer business

2011 CANADIAN TAX FOUNDATION ROUNDTABLE

— Jesse S. Brodlieb and Timothy Fitzsimmons, Fraser Milner Casgrain LLP

On November 29, 2011, the Canada Revenue Agency ("CRA") and Revenu Québec ("RQ") participated in the Roundtable discussion at the Annual Conference of the Canadian Tax Foundation.

The discussion this year covered a wide range of issues. Interestingly, in contrast to the last few years, the CRA announced a number of substantive policy changes at the Roundtable. There was a significant focus on international issues, with multiple questions on permanent establishments ("PE") and taxable Canadian property ("TCP").

The participants were Francois Bordeleau and Jim Gauvreau from the CRA and Bernard Nolan from RQ. The Roundtable was chaired by Claude Jodoin and Pierre Bourgeois.

Services Permanent Establishments

The Fifth Protocol to the Canada–U.S. Tax Treaty (the "Treaty") brought in a concept that has few or no precedents in Canada's tax treaties: a new rule whereby the mere provision of services could, in certain circumstances, result in a resident of one country being deemed to have a PE in the other country if certain threshold tests are met.

In *Dudney* (2000 DTC 6169), a non-resident taxpayer had spent 300 days in Canada in 1994 and 40 days in Canada in 1995 providing engineering consulting services to a resident of Canada. The services were all provided at the Canadian client's premises, and the taxpayer's access thereto was restricted. The taxpayer claimed a treaty exemption on the Canadian-source income. The CRA reassessed the taxpayer on the basis that he had carried on business in Canada through a PE (fixed base) and was therefore subject to Canadian income tax. The Federal Court of Appeal found for the taxpayer, holding that there was no PE under the circumstances. The mere presence of the taxpayer in the country for a number of days, even a large number of days, could not in and of itself result in a PE where the taxpayer did not have sufficient control over the workplace.

The new services PE rule in Article V(9) of the Treaty was explicitly introduced in order to overrule the Federal Court of Appeal's decision in *Dudney*. As the services PE rule is largely unknown to Canadian tax law, a number of interpretative issues remain unresolved.

At the Roundtable, the CRA considered the application of the services PE rule in a number of scenarios involving subcontracted services.

Scenario A — Services Provided by a Related Non-Resident

The following facts were presented:

- USCo is a corporation that is a resident of the United States for Treaty purposes;
- USCo is engaged to provide consulting services to Canco, a corporation that is a resident of Canada;
- USCo subcontracts the services work to a related U.S. resident, USCo2; and
- USCo2 performs the work in Canada and its employees spend over 183 days on the project in a 12-month period.

The CRA stated that it considers this scenario to give rise to a PE of USCo as USCo is "providing" the services to Canco for purposes of Article V(9)(b) and the remainder of the requirements of that provision are met. Article V(9)(b) does not require USCo to actually perform these services in order for there to be a PE. USCo2 would also have a PE under these facts.

Interestingly, the CRA stated that its views on this matter are not influenced by paragraph 42.43 of the OECD Commentaries to Article V. The CRA noted that the different wording under consideration in that commentary means that it is not relevant in determining the scope of the services PE rule. Typically, the courts have looked to the OECD Commentaries for assistance in interpreting treaties, especially where there is little Canadian jurisprudence on an interpretive issue (see, for example, *Prévost Car Inc*. (2009 DTC 5053)).

Scenario B — Services Provided by Arm's Length Resident of Canada

The following facts were presented:

- USCo is a corporation that is a resident of the United States for Treaty purposes;
- USCo is engaged to provide consulting services to Canco, a corporation that is a resident of Canada;
- USCo subcontracts the services work out to Canco2, a resident of Canada with which USCo deals at arm's length; and
- Any services performed by USCo are performed in the United States only.

The CRA stated that this fact scenario would not result in a PE under the services PE rule, provided that there is an arm's length fee charged by Canco2 for performing the services. The CRA further stated that its views on this scenario would not change if Canco2 did not deal at arm's length with USCo.

The fee received by Canco2 is of course taxed in Canada, whereas if the services are performed by a U.S. resident otherwise than through a PE, the fees would not be subject to Canadian income tax. That being said, it is not clear under what principled basis the CRA is distinguishing between Scenarios A and B, as in each case the services are "provided" by USCo. Moreover, the CRA did not indicate how the charging of an arm's length fee is relevant for purposes of determining the existence of a services PE under Article V(9). In the related-party context, it is not clear how the CRA would assess under the services PE rule, as opposed to Canadian transfer pricing legislation, in the context of a non-arm's length fee charged between related parties.

Scenario C — Services Provided by Partnership in Canada

The following facts were presented:

- USFirm sells consulting services to Canco;
- USFirm subcontracts the provision of the services to CANFirm;
- USFirm and CANFirm are distinct partnerships, but are members of a global network;
- CANFirm employees provide all of the Canadian situs work and spend over 183 days on the project in a 12-month period; and
- USFirm does not exercise supervision and control over CANFirm and its employees.

The CRA stated that as long as CANFirm is receiving an arm's length rate for the subcontracted services, USFirm would not have a PE. Again, the relevance of the arm's length rate was not discussed.

The CRA noted that where Canco has withheld 15% of the fee due to USFirm under the services contract in accordance with section 105 of the *Income Tax Regulations*, each partner would have to file a separate Canadian income tax return in order to obtain a refund in circumstances where no final tax liability existed. The CRA stated that it was unable to provide administrative relief to simplify the refund process. RQ stated that it takes the same position with respect to the 9% withholding exigible on payments for services rendered in Quebec.

The CRA also stated that a corporation that is a member of a partnership that carries on business in Canada is required to file a Canadian tax return for the year in which the business is carried on, regardless of whether or not there is any tax payable. There is no similar obligation on a non-resident member of a partnership who is an individual where there is no tax payable.

CCPC Status and Options

A Canadian-controlled private corporation ("CCPC") is defined in the *Income Tax Act* (the "Act") as a private corporation that is resident in Canada and that is not controlled by one or more non-residents. CCPCs are provided with numerous advantages under the Act. In determining whether a particular corporation is a CCPC, paragraph 251(5)(*b*) of the Act must be considered. Pursuant to paragraph 251(5)(*b*), any right to acquire shares of a corporation is treated as though the right has been exercised and the shares acquired in determining CCPC status.

The CRA was asked how it would apply paragraph 251(5)(*b*) to a scenario where 50% of the shares of a corporation are owned by a resident of Canada and 50% are owned by a non-resident, and each shareholder has an option to acquire an additional share of the corporation.

The CRA stated that, in such circumstances, the corporation would not be a CCPC, as it applies paragraph 251(5)(*b*) on a "holder by holder" basis. Accordingly, the right to acquire an additional share held by the non-resident (despite the resident shareholder having an identical right) taints the CCPC status. The CRA stated that this position was not, in its view, inconsistent with the Federal Court of Appeal's decision in *Sedona Networks* (2007 DTC 5359).

Joint Ventures

In the 2011 federal Budget first announced on March 22, 2011 (and subsequently reintroduced on June 6, 2011), the Department of Finance announced measures that effectively eliminated the ability of a corporation that is a member of a partnership to defer partnership income where the corporation has a taxation year end that differs from the partnership's fiscal period end. As a result, the CRA announced at the 2011 Prairie Provinces Tax Conference in June that the CRA's long-standing administrative position allowing taxpayers who are participants in joint ventures to establish a separate fiscal period end for the joint venture was no longer appropriate in light of the changes to partnership taxation (see CRA Document No. 2011-0403081C6 "Joint venture administrative policy" (June 6, 2011)). At the time, the CRA announced that it would release a statement regarding the nature of the transitional relief, if any, that the CRA would provide to joint venture participants forced to accelerate the recognition of income as a result of this change in policy.

At the 2011 Roundtable, the CRA stated that it would allow, administratively, for transitional relief that "mirrored" the relief provided to members of partnerships under proposed section 34.2 of the Act. The CRA also addressed circumstances where taxpayers who wished to make an election to align the fiscal period of a joint venture with one or more of the joint venture's participants but the relevant filing deadline had passed. In such cases, the CRA stated that the taxpayer should write a letter to its Tax Centre explaining the situation and that, generally, relief would be granted.

On the day of the Roundtable, the CRA issued a technical interpretation providing additional details to its new joint venture policy (see CRA Document No. 2011-0429581E5 "Revised joint venture administrative policy" (November 29, 2011)). The document confirmed that joint venture participants will be entitled to transitional relief similar to that provided to partnerships. More particularly, the CRA indicated that: "[i]n general, and subject to the conditions as similarly stipulated under proposed section 34.2, the reserve mechanisms will effectively allow the participant taxpayer

to include 15% of additional income in 2012, 20% in 2013, 2014 and 2015, and 25% in 2016". This policy applies only to joint venture participants who previously took the position that income of the joint venture was deferred by reason of the differing year ends of the joint venture and the participants. As well, failure to report all the accrued income in a participant taxpayer's first taxation year that ends after March 22, 2011 in accordance with this administrative policy will result in the participant taxpayer's ineligibility for the administrative transitional relief.

However, the technical interpretation raised additional uncertainty with respect to participation in joint ventures going forward. Specifically, the CRA has now adopted the position that, for taxation years ending after March 22, 2011, income from a joint venture will be required to be calculated for each participant taxpayer based on the fiscal period of the particular participant taxpayer. For joint ventures that have multiple participants with different taxation year ends, this change in policy could create significant administrative difficulties. Taxpayers with joint venture interests should consider carefully whether such structures are still manageable in light of this new policy.

Rectification in Quebec

In the case of *Québec (Sous-ministre du Revenu) c. Services Environnementaux AES Inc.* (2011 DTC 5045), the Quebec Court of Appeal stated that, while the common law doctrine of rectification is not known in the French civil law, Article 1425 of the Quebec *Civil Code* provides authority for the courts to give effect to the contracting parties' intention where a written document does not reflect that intention.

In *Services Environnementaux AES Inc.*, the taxpayer had reorganized its share holdings in a subsidiary, apparently on a tax-deferred basis. The taxpayer and its professional advisers believed that the adjusted cost base of the subject shares was $1.2 million. However, they later discovered that the actual cost base was $96,000, with the result that the taxpayer was assessed for a capital gain of $840,000 on the shares. The taxpayer brought an application to the Quebec court to rectify the share exchange documents to show the correct adjusted cost base. The parties argued that they had intended that the share exchange be completed on a rollover basis with no immediate tax consequences.

In the Quebec *Civil Code*, Articles 1399 and 1400 provide that if consent to an agreement is given due to error, that error vitiates (or cancels) the consent of the parties, with the result that an agreement may be declared null and void and deemed never to have existed. For an error to vitiate consent, it must be sufficiently egregious, meaning that it must relate to the nature of the contract, or the most important element of the agreement. Further, for an error to be corrected, it must not be an inexcusable error, which means the error must not be the result of a party's negligence. Generally, the power of a Quebec court to correct an error is to simply nullify the agreement.

However, in *Services Environnementaux AES Inc.*, the Quebec Court of Appeal looked to Article 1425 of the Quebec *Civil Code*, which states that the parties' common intention shall be sought when interpreting a contract. The Court stated that implicit in Article 1425 is a court's power to make a written agreement consistent with the parties' intention. The Court of Appeal held that the share exchange agreement did not reflect the parties' intent, and the Court "rectified" the agreement to reflect the correct adjusted cost base.

At the Canadian Tax Foundation's Journees d'etude fiscale held in June 2010, RQ stated with respect to rectification that, "Québec civil law and specifically the Québec *Civil Code* provides no opportunity to 'rectify' a situation in the absence of a mistake of a material nature. When the parties have established, as a condition essential to a contract, that it has to be without tax consequences, Revenu Québec considers that the only remedy is the annulment. Thus we believe that the [Quebec Court of Appeal] misinterpreted . . . Article 1425 of the [Quebec *Civil Code*]."

The panel was asked whether this position was maintained by RQ considering that the Supreme Court has granted leave to appeal in *Services Environnementaux AES Inc.* (see Supreme Court file no. 34235).

RQ stated that, until the Supreme Court renders its judgment, RQ will maintain the position described at the June 2010 conference.

Further, RQ's position is that it must be informed of any rectification procedure. If RQ is not provided with information with respect to a rectification that is relevant to the Quebec *Taxation Act*, RQ will proceed with the appropriate judicial procedure to protect its rights (the panel did not describe the specific steps RQ may take, although presumably RQ would argue that the rectification (if successful) should be set aside because RQ had not been given notice).

Health Care Spending Bonus

The CRA has changed its administrative policy that allowed an employee to redirect a portion of his/her bonus to obtain additional flex credits in a health care spending account ("HCSA") on a tax-free basis.

The panel was asked why this change is being made, and when it comes into effect. Further, the panel was asked to describe the impact of this new position on those taxpayers who had previously sought and received advance tax rulings with respect to HCSAs.

Under subparagraph 6(1)(*a*)(i), employees are not taxed on the value of benefits (i.e., the employer's contribution to or the employee's benefit from) a private health services plan ("PHSP"), which is defined in subsection 248(1) to mean (a) a contract of insurance in respect of hospital expenses, medical expenses, or any combination of such expenses, or (b) a medical care insurance plan or hospital care insurance plan or any combination of such plans.

In Interpretation Bulletin IT-339R2 "Meaning of private health services plan" (August 8, 1989), the CRA stated that a qualifying PHSP must contain the following basic elements: (a) an undertaking by one person, (b) to indemnify another person, (c) for an agreed consideration, (d) from a loss or liability in respect of an event, (e) the happening of which is uncertain. The CRA also stated that coverage under the plan must be in respect of hospital care or expense or medical care or expense which normally would otherwise have qualified as a medical expense under the provisions of subsection 118.2(2) in the determination of the medical expense tax credit.

An HCSA plan is comprised of individual employee accounts that provide for the reimbursement of eligible medical and dental expenses as defined by the terms of the plan. An HCSA may qualify as a PHSP provided the plan involves a reasonable element of risk assumed by the employer (see Interpretation Bulletin IT-529 "Flexible Employee Benefit Programs" (February 20,1998)).

The CRA has issued a series of rulings stating that the allocation of credits to an HCSA in lieu of payment of a cash bonus would not result in employment income to the employee (see, for example, CRA Document No. 2003-0045173 "Health spending account" (2003)).

The CRA stated that the ongoing acceptability of the CRA's position was recently re-examined. In the CRA's view, the allocation of a future bonus should be taxed as employment income. The allocation of a bonus to obtain additional flex credits in an HCSA is an allocation of foregone cash remuneration. This change is to take effect on January 2, 2013. In respect of those taxpayers who had sought and received advance tax rulings on the subject, the CRA has made contact with and apprised each ruling recipient of the change in the CRA's administrative position.

Bring Your Own Device ("BYOD") Policies

The CRA addressed an increasingly common situation where employers are providing employees with technology allowances to purchase electronic devices (such as tablet computers, for example) for use in the course of carrying out employment duties, rather than the employer purchasing the device and providing it to the employee. Such policies were referred to as "bring your own device" policies, or BYOD.

The CRA stated a BYOD policy will generally give rise to a tax benefit pursuant to paragraph 6(1)(*a*) of the Act. The CRA is looking at issuing technical guidance on BYOD policies and indicated that such guidance will clarify earlier rulings on this matter. The CRA stated that the benefit could be avoided if ownership of the device, once purchased, was transferred to the employer and personal use is incidental.

Public Warehouse — Agency PE?

Subsection 124(1) of the Act allows a corporation to deduct from tax otherwise payable under Part I an amount equal to 10% of the corporation's "taxable income earned in the year in a province", which is defined in subsection 124(4) as the amount determined under the regulations.

Under Part IV of the *Income Tax Regulations*, a corporation's taxable income earned in the year in a province is determined with reference to whether the corporation had a PE in a province. Paragraph 400(2)(*b*) deems a corporation to have a PE in a place in which it carries on business through an agent who has a stock of merchandise owned by a

principal from which orders received are regularly filled. (A similar provision applies to an individual pursuant to paragraph 2600(2)(*a*) of the *Income Tax Regulations*.)

Historically, the CRA's position on agency was broad enough (i.e., an "agent" would include a commission agent, broker or other independent agent) to deem a corporation to have a PE where it uses a public warehouse to store and ship goods (see, for example, Interpretation Bulletin IT-177R2 "Permanent Establishment of a Corporation in a Province" (November 11, 2003)).

In the Federal Court of Appeal's decision in *Canada v. Merchant Law Group* (2010 FCA 206), the Court stated that, "For an agency relationship to exist . . . the agent must be able to affect the principal's legal position with third parties by entering into contracts on the principal's behalf or by disposing of the principal's property".

The panel was asked whether, in light of the Federal Court of Appeal's decision in *Merchant Law Group* and other similar cases, the CRA has reconsidered its historic position.

The CRA stated that it agreed that there is sufficient support for the use of the legal meaning of the term "agent" for provincial income tax allocation purposes. In other words, the CRA accepts the more narrow definition of the term "agent".

Aggressive Tax Planning Reporting in Quebec

On October 27, 2010, Quebec's Bill 96, *An Act to Amend the Taxation Act*, received Royal Assent. The provisions of Bill 96 implemented Quebec's new aggressive tax planning reporting regime, which had first been introduced in Quebec's 2008 Budget. The new regime introduced mandatory reporting requirements for certain transactions, expanded the scope of Quebec's GAAR, extended the assessment period for transactions subject to the Quebec GAAR, and imposed a penalty regime (subject to a due diligence defence) for transactions subject to the Quebec GAAR.

The panel was asked to provide some statistics with respect to the number of mandatory and preventative disclosures that have been made by taxpayers as a result of the recently introduced aggressive tax planning measures in Quebec. Further, the panel was asked whether a taxpayer may invoke a due diligence defence where the taxpayer has obtained a tax opinion from a tax adviser.

No statistics were provided. The panel stated that the number of disclosures was not pertinent to the determination of the effectiveness of the disclosure regime.

The panel stated that some taxpayers may not have disclosed as required, although their operations/transactions might be subject to the new reporting regime. But regardless of whether the taxpayer had received a tax opinion from a tax adviser, RQ intended to apply a penalty equal to 25% of the tax liability that arises because of the application of the Quebec GAAR.

Interpretation Bulletin Review

The CRA restated its commitment to reviewing and updating its inventory of Interpretation Bulletins ("ITs"). The focus is two-fold: format and content. With respect to format, the CRA stated that the days of printed ITs are over, and all newly updated or revised ITs will now be kept in an online "Income Tax Folio", with related documents kept together in the same folio. The ITs will be updated progressively to enhance usefulness for users. The use of the folio system will allow ITs to be updated quickly as jurisprudential developments occur.

The CRA also outlined its priorities with respect to which ITs would be updated first. The following topics will be given priority:

- health care;
- school tax refund;
- deductibility of interest;
- treatment of legal fees and accounting fees;
- residency;

- trust residency;
- options; and
- compensation of taxpayers.

The ITs bulletins will be updated after the targeted ITs are complete.

Convertible Debentures and Withholding Tax

In 2008 Canada repealed its withholding tax on arm's length interest paid to non-residents. However, interest that is "participating debt interest" is still subject to a 25% withholding tax, which may be reduced by treaty in many cases. There is generally a concern that convertible debentures may give rise to participating debt interest in respect of both the normal course interest payments and the "conversion premium" provided to holders on a conversion. The conversion premium is generally deemed to be interest for Canadian tax purposes. The CRA has previously outlined what it considers to be "traditional" convertible debt, which would not, in the CRA's view, give rise to deemed interest on conversion (see CRA Document No. 2009-0320231C6 (May 1, 2009)).

However, due to the relatively narrow requirements of so-called "traditional" convertible debentures, uncertainty remains. Issuers of convertible debt will often attempt to structure the debentures as "5/25" debt, as the provisions of now-repealed subparagraph 212(1)(*b*)(vii) as they applied to the 2007 taxation year can still be relied upon to avoid withholding tax on deemed interest arising as a result of the conversion of convertible debt. The CRA has made statements in the past that it will review its position on convertible debt and non-resident withholding tax.

At the 2011 Roundtable, the CRA indicated that it is still in the process of completing its review of the application of non-resident withholding tax to both the interest and conversion premium paid to a non-resident of Canada on convertible debentures. The CRA indicated by its comments that it did not expect to be able to release a position on the issue until 2012, and that given the complexity of the issues it would not likely be possible for its position to provide certainty in every possible situation.

Limited Partnerships and Elections

The CRA was asked whether, in the course of the acquisition of a business, a limited partnership can make an election pursuant to section 22 of the Act (or section 184 of the Quebec *Taxation Act*).

The CRA referred to subsection 96(3) of the Act, which sets out rules that apply to members of a partnership making elections under certain provisions, including section 22. An election made (including a section 22 election) will be valid if:

(1) The election was made in the name of a taxpayer and on behalf of every other member of the partnership at that time; and

(2) The taxpayer making the election has the authorization to make the election on behalf of all the other partners of the partnership.

Where these conditions are met, the election will be binding on the partnership members. The RQ indicated that, in most cases, a valid federal election will apply for Quebec tax purposes.

Pipeline Rulings Policy

Pipeline transactions were again discussed at the 2011 Roundtable (see also Timothy Fitzsimmons and Jules Lewy, "2010 Canadian Tax Foundation CRA Roundtable: Pipelines, Privilege and Working Papers (Again!)", *Tax Topics*, No. 2023-24, December 16, 2010).

In a pipeline transaction, an estate transfers shares of a corporation (Opco) to a new corporation (Holdco) in exchange for Holdco debt (taking advantage of the high tax cost in shares resulting from the deemed disposition on death to avoid triggering a section 84.1 deemed dividend) and extracts the assets of Opco on repayment of the debt.

Specifically, the CRA was asked to comment on the reasons and basis for certain conditions and timing considerations that appear in a number of recent pipeline rulings.

The CRA noted that, with respect to pipeline rulings, it will consider all of the relevant facts of the transaction and whether or not section 84.1 or subsection 84(2) should be applied. These provisions are intended to prevent surplus stripping. Of particular concern is whether subsection 84(2) can be applied to convert the otherwise tax-free repayment of the debt into a taxable dividend.

In the case of pipelines, the CRA indicated that subsection 84(2) could apply if:

(1) funds are distributed to the estate in a short time frame; or

(2) the corporation is effectively a “cash corporation” having other assets or business.

As to the timing restrictions, the CRA indicated that the ruling requests often include a condition that the operations of the corporation will continue for one year and that the property will be progressively distributed. Apparently, this is not a CRA condition, but it is generally found in pipeline ruling applications. This last statement was confusing, as it was not clear why a taxpayer would request that a distribution of assets would be delayed for a year otherwise than to satisfy the CRA that subsection 84(2) was not applicable. It is likely the case that having the ruling request indicate that the assets will not be distributed for a year or more is being included by taxpayers in order to improve the chances of having the CRA issue a favourable ruling.

Taxable Canadian Property — Fair Market Value

Generally, Canada does not tax capital gains realized by a non-resident of Canada unless the property that is disposed of is TCP. In the 2010 federal Budget, the definition of TCP was significantly narrowed to remove from the definition shares of a corporation (and trust and partnership interests) that do not derive their value principally from Canadian real property (including timber or resource property). Prior to the 2010 amendments, when determining whether shares of a public corporation were TCP (all shares of private Canadian-resident corporations were TCP), it was necessary to consider the “fair market value of all the properties of the corporation” and whether more than 50% of those properties were Canadian real property. Under the revised language, all corporations are excluded from the definition of TCP unless the “fair market value of the shares” of the corporation is derived directly or indirectly from Canadian real property.

The CRA was asked whether this change amounted to a substantive difference in determining whether the shares of a corporation are TCP of a non-resident. The CRA stated that, in its view, the new language requires that a gross asset test be applied. The debts and other liabilities of the corporation are to be ignored. According to the CRA, this is the same test that generally applies under Canada’s tax treaties for determining if a share of the capital stock of a corporation is considered real or immovable property situated in Canada (and therefore typically ineligible for treaty relief from Canadian tax on disposition).

The CRA announced that this interpretation amounted to a change in its assessing position and stated that the CRA would only apply this new position prospectively. Initially, the gross asset test will only apply to dispositions of property acquired after 2011. For 2012, taxpayers would be able to choose whichever valuation method suited them. Beginning in 2013, all non-residents disposing of property will be required to use the gross asset value to determine if the property is TCP.

In the context of a non-resident disposing of shares of a corporation that itself owns shares in one or more subsidiary corporations, the CRA stated that the August 27, 2010 draft legislation will impact the determination. This draft legislation will change the TCP definition to prevent “looking through” a corporation where the lower tier corporation is not itself TCP. Accordingly, to determine whether or not the parent corporation is TCP, each subsidiary corporation must be considered separately.

Under the proposed legislation, if a subsidiary corporation derives its value principally from Canadian real property, then the entire value of that corporation “counts” towards determining if the parent corporation is itself TCP. Conversely, where the subsidiary derives less than 50% of its value from Canadian real property, the entire value of the subsidiary is considered to be non-real property of the parent corporation.

Taxable Canadian Property — Public Company Shares

For public company shares, these shares will only be TCP of the non-resident vendor if the vendor owned 25% or more of the issued shares of any class within the preceding 60 months, and if the corporation's value is derived principally from Canadian real property. The CRA was asked whether both these elements had to occur simultaneously in order for the shares to be TCP. The example given was where one of the tests is satisfied in month 10 and the other in month 50, but at no point were both tests satisfied at the same time.

The CRA stated that the shares of a public company will only be TCP to a non-resident seller if the seller owned 25% or more of the corporation's shares within the last 60 months, and, at the same time as the seller owned 25% or more of the shares, the value of the corporation was derived principally from Canadian real or immovable property.

Questions Not Discussed at the Conference

The following questions were included in the handouts at the 2011 Roundtable, but were not discussed due to time constraints. Answers to these questions were provided in written form only following the conclusion of the Roundtable.

SR&ED

The CRA is currently reviewing its approach to the classification of activities that are considered to be Scientific Research & Experimental Development ("SR&ED") for the purposes of the Act (see CRA Document 2011-06-20C "Public Consultations — Policy on the Eligibility of Work for SR&ED Investment Tax Credits (Draft)" (June 20, 2011)).

The most recent publication of the CRA's administrative views on this subject are found in Information Circular IC86-4R3 "Scientific Research and Experimental Development" (May 24, 1994).

The CRA was asked to confirm that the statements in IC86-4R3 remain the CRA's policy and that taxpayers and the CRA can use IC86-4R3 to provide guidance on whether a particular project satisfies the eligibility criteria. Further, the CRA was asked to confirm that policies and definitions in IC86-4R3 will remain unchanged in light of the new policy documents issued under the SR&ED policy review project.

The CRA stated that the existing SR&ED policy documents and related guidance, including IC86-4R3, remain in effect until the CRA's policy review project is completed (see, for example, CRA Document 2010-11-30A "Third-Party Payments Policy-Draft" (November 30,2010) and CRA Document 2011-09-22A "Public Consultations — Total Qualified SR&ED Expenditures for Investment Tax Credit Purposes Policy (Draft)" (September 22, 2011)). Also, the principles and concepts used in existing documents will not change, and extensive public consultation has been and will continue to be undertaken.

CEE in Quebec — Qualified Corporation

Under the Quebec *Taxation Act,* the flow-through shares regime allows a "qualified corporation" to renounce its claim to its Canadian exploration expenses ("CEE") in favour of the corporation's shareholders. Additionally, the Quebec *Taxation Act* provides that an individual who resides in Quebec may claim an additional deduction of 25% for CEE incurred in Quebec and an additional deduction of 25% for surface exploration.

Generally, a "qualified corporation" is a corporation that explores for minerals, petroleum, or gas or develops a mineral resource or an oil or gas well and which does not (at the time the CEE is renounced and in the previous 12 months) operate any mineral resource or oil or gas well and the corporation neither controls nor is controlled by a corporation that operates a mineral resource or an oil or gas well.

The panel was asked whether a corporation is a qualified corporation if the corporation operates a mineral resource exclusively outside Canada.

The panel stated that the site of the operation of the mineral resource is not determinative, and thus a corporation that operates a mineral resource outside Canada will not be considered to be a qualified corporation.

CEE in Quebec — Expenses Incurred in Quebec

Under section 726.4.10 of the Quebec *Taxation Act*, only CEE incurred in Quebec are eligible for the additional deduction.

The panel was asked whether expenses would be considered to be incurred in Quebec where a geophysical air survey over a property located in Quebec is carried out by a qualified corporation using the services of a person who is not subject to the Quebec *Taxation Act*.

The panel stated that, generally, such an expenditure would be eligible under section 726.4.10, provided the other conditions of the section are met.

Non-Profit Organizations — Paragraph 149(1)(*l*)

The CRA was asked to address four questions concerning the application of paragraph 149(1)(*l*) of the Act, which exempts from tax non-profit organizations ("NPOs").

First, the CRA was asked to provide an update on the status of the NPO risk identification project. The written answers did not provide any information on this project. Second, the CRA was asked whether, as a result of the project, it had identified any recommended legislative changes. The written response indicates that there may be certain issues that the CRA will share with the Department of Finance.

Third, the CRA was asked whether IT-496R "Non-Profit Organizations" (August 2, 2001) continued to reflect the CRA's views. The CRA confirmed that IT-496R continues to "generally reflect" the views of the CRA. It was not indicated what priority the review of IT-496R has been given in the context of the IT updating project described above.

Finally, the CRA was asked in what circumstances is profit considered to be incidental to an organization's exclusive not-for-profit purposes. There was no detailed response to this question in the published materials.

— *Jesse S. Brodlieb and Timothy Fitzsimmons are Tax Associates in the Toronto office of Fraser Milner Casgrain LLP.*

A number of tax lawyers from Fraser Milner Casgrain LLP write commentary for CCH's Canadian Tax Reporter *and sit on its Editorial Board as well as on the Editorial Board for CCH's* Canadian Income Tax Act with Regulations, Annotated. *Fraser Milner Casgrain lawyers also write the commentary for CCH's* Federal Tax Practice *reporter and the summaries for CCH's* Window on Canadian Tax. *Fraser Milner Casgrain lawyers wrote the commentary for* Canada–U.S. Tax Treaty: A Practical Interpretation *and have authored other books published by CCH:* Federal Tax Practice; Charities, Non-Profits and Philanthropy Under the Income Tax Act; Corporation Capital Tax in Canada; *and* Canadian Transfer Pricing. *Tony Schweitzer, a Tax Partner with the Toronto Office of Fraser Milner Casgrain LLP, and a member of the Editorial Board of CCH's* Canadian Tax Reporter*, is the editor of the firm's regular monthly feature articles appearing in* Tax Topics.

RECENT CASES

Value of shares of two subsidiaries of Bermudian corporation properly included in taxpayer's income as dividends in kind

During a reorganization, a Bermudian corporation, Tyco, spun off two of its corporate subsidiaries into separate publicly traded corporations ("Covidien" and "Electronics"). As a shareholder of Tyco, the taxpayer received shares of Covidien and Electronics (the "Spin-off Shares"). On reassessment, the Minister included the fair market value of the Spin-off Shares in the taxpayer's income for 2007 as a dividend in kind. The taxpayer appealed to the Tax Court of Canada.

The taxpayer's appeal was dismissed. A parent corporation's distributions of shares of a wholly owned subsidiary to its shareholders are dividends in kind. The Spin-off Shares in this case, therefore, were dividends in kind that were required to be included in the taxpayer's income under s. 12(1)(*k*) and 90 as dividends from a non-resident corporation. The rules about exempt foreign spin-offs in s. 86.1(2) were also inapplicable in this case, since the corporations involved

were not resident in the United States or in a country with which Canada had a tax treaty. The Minister's reassessment was affirmed accordingly.

¶47,896, *Marshall*, 2011 DTC 1353

Trustee of estate not personally liable for non-resident tax on dividend to beneficiary

The taxpayer was a trustee of the J.J. Herbert Family Trust #1 (the "Trust") in 2001, when the Trust received a dividend of over $2 million. The beneficiary of the trust was a non-resident. On September 11, 2011, the Trust adopted a resolution that the dividend be paid to the beneficiary of the Trust and that the beneficiary "shall have the right at any time to require payment of the amount of the dividend by the Trust to himself at any time." In its 2001 income tax return, the Trust calculated Part XIII tax payable in the amount of $550,000.75, for the amount that had become payable to a non-resident beneficiary in the year. This Part XIII tax was never withheld or remitted to the Receiver General. On January 12, 2002, the appellant resigned as a trustee of the Trust. On January 18, 2002, the Trust paid an amount of $2,206,042 to the beneficiary. The Minister assessed the taxpayer on the basis that he was personally liable as trustee for tax on amounts paid from a trust to a non-resident. The taxpayer appealed to the Tax Court of Canada.

The taxpayer's appeal was allowed. The Trust was not liable for Part XIII tax in 2001, because the resolution did not result in the dividend amount being paid or credited to the beneficiary in that year; it resulted in the amount becoming payable. However, payable should not be held to be equivalent to paid or credited. The taxpayer should not be held to be personally liable for the unremitted Part XIII tax, because the resolution did not authorize that the dividend amount be paid. At the time the amount was paid, in 2002, the taxpayer was no longer a trustee of the Trust and was not in a position to directly or indirectly cause the amount to be paid to the beneficiary.

¶47,897, *Lewin*, 2011 DTC 1354

Legal expenses incurred by taxpayer to defend herself from claims in divorce proceedings not deductible

The taxpayer's children remained with her former husband, H, after their separation. H asked her for child support payments, which she refused. As a result, H instituted divorce proceedings against the taxpayer, coupled with demands for child support and joint custody. On reassessment for 2006 and 2007, the Minister disallowed the taxpayer's deduction of legal expenses incurred in those divorce proceedings. The taxpayer appealed to the Tax Court of Canada.

The taxpayer's appeal was dismissed. Legal expenses incurred to obtain child support are deductible. Child support is also income, and the expenses associated with obtaining it are deductible under subdivision b of the *Income Tax Act*. However, in this case, the taxpayer's legal expenses were not incurred to obtain child support but to defend from claims made by H in the divorce proceedings, and therefore were not deductible. The Minister's reassessments were affirmed accordingly.

¶47,900, *Mercier*, 2011 DTC 1359

Net worth assessments modified in part

Using the net worth approach, the Minister added unreported business income, rental income, and capital gains to the taxpayer's income in the combined amounts of $3,274 for 2002, $20,801 for 2003, and $13,860 for 2004, and imposed penalties for gross negligence. On appeal to the Tax Court of Canada, the taxpayer: (a) contested the Minister's actual calculations of his unreported business income, rental income, capital gains, and personal expenses; and (b) alleged that the Minister failed to take into account his business expenses, a $41,000 sum received from the Quebec Commission on Health and Safety, and the $10,000 proceeds of sale of a vehicle.

The taxpayer's appeal was allowed in part. The majority of the taxpayer's arguments were unsupported by adequate corroborative evidence, and the penalties were justified in light of his grossly negligent conduct. However, some adjustments to the Minister's calculations were required. The amounts added to his income for 2002, 2003, and 2004,

therefore, should be reduced by $1,263, $2,648, and $1,673, respectively, and the penalties, while justified, should be reduced accordingly.

¶47,901, *Dompierre*, 2011 DTC 1360

Arrears of child support received taxable

The taxpayer and her former spouse were divorced in 1982, and her husband was ordered to pay support for their child. The support order was varied in 1988. The husband was in arrears of nearly $40,000 by 1994. Subsequent court orders required him to pay these arrears, of which certain amounts were paid in 2005, 2006, and 2007. The Minister included these amounts in the taxpayer's income, and the taxpayer appealed to the Tax Court of Canada.

The taxpayer's appeal was dismissed. The Court found that the payments of the arrears were payments of amounts that were required to be made under the support order, not the enforcement orders. The last child support order fixing the child support amount payable was the 1988 order. The relevant date for the determination of the commencement day was the date the child support amount was payable and receivable, not the date when it was paid and received. If the payments had been made on a timely basis, they would have been taxable. That they were late and enforced by new court orders did not change that result.

¶47,902, *DeHart*, 2011 DTC 1361

TAX TOPICS

Published weekly by CCH Canadian Limited. For subscription information, see your CCH Account Manager or call 1-800-268-4522 or (416) 224-2248 (Toronto).

For CCH Canadian Limited

Susan Peart, C.A., LL.M.
(416) 224-2224, ext. 6434
email: Susan.Peart@wolterskluwer.com

Natasha Menon, Content Product Manager
Tax, Accounting and Financial Planning
(416) 224-2224, ext. 6360
email: Natasha.Menon@wolterskluwer.com

Notice: *Readers are urged to consult their professional advisors prior to acting on the basis of material in Tax Topics.*

CCH Canadian Limited
300-90 Sheppard Avenue East
Toronto ON M2N 6X1
416 224 2248 · 1 800 268 4522 tel
416 224 2243 · 1 800 461 4131 fax
www.cch.ca

PUBLICATIONS MAIL AGREEMENT NO. 40064546
RETURN UNDELIVERABLE CANADIAN ADDRESSES TO CIRCULATION DEPT.
330–123 MAIN ST
TORONTO ON M5W 1A1
email: circdept@publisher.com

© 2011, CCH Canadian Limited

CCH a Wolters Kluwer business

Tax Topics is a registered trademark of CCH Canadian Limited.