FORWARD

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AUGUST 2016

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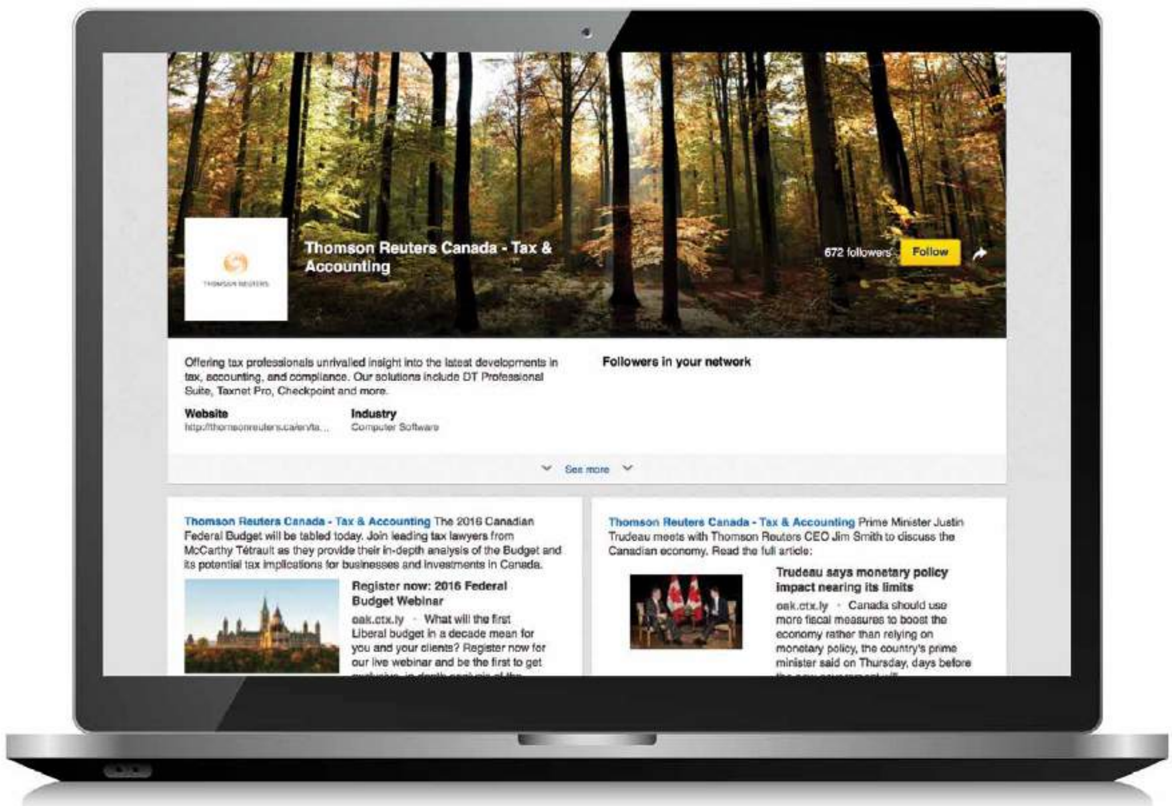

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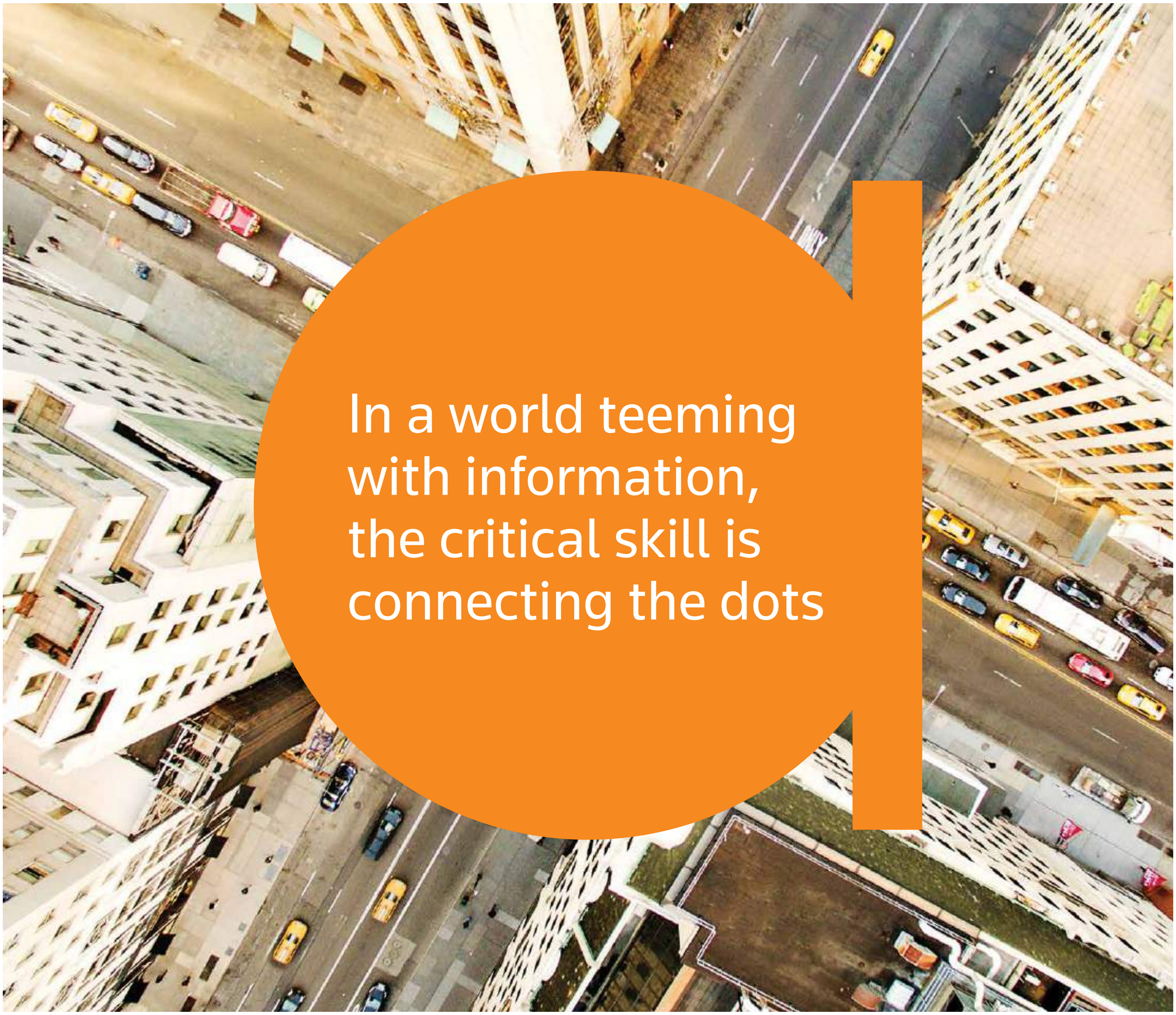

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Director's Note

Each year Thomson Reuters and McCarthy Tétrault LLP professionals attend the advanced reading of the Federal Budget in Ottawa, in what is colloquially known as "the lock-up". Isolated from the outside world – no rights of exit, no smart phones, no Wi-Fi access – and under very tight timelines, the team reviews the Budget materials, selects relevant tax measures, and prepares three valuable works for our customers: the McCarthy Tétrault in-depth Budget Commentary, the McCarthy Tétrault Federal Budget Webinar, and the Thomson Reuters Summary of Tax Measures.

We are pleased to include in this issue of *Forward* the *Thomson Reuters Summary of Budget 2016 Corporate Tax Measures*. While the McCarthy Tétrault Budget Commentary provides a full analysis, the Thomson Reuters Summary should provide a good refresher for our readers. Readers may access the Budget commentary and documents on Taxnet Pro, and view the Budget webinar by visiting www.gettaxnetpro.com/federalbudget. Incidentally, Thomson Reuters will soon release a video capturing comments from the team on their experiences in the lock-up. We know very few tax professionals have the chance to experience the lock-up and hope our video serves to give viewers a first-hand account of what it's like.

Also in this issue is an excerpt from the McCarthy Tétrault *Canada Tax Service* commentary on subsections 248(30)-(41). These sections set out what are commonly called the "split-receipting rules", which allow for the receipting for tax purposes for property transferred to a qualifying transferee even where the donee receives an advantage, provided that advantage does not exceed 80% of the fair market value of the transferred property. For example, a taxpayer makes a donation of $1,000 to a Ballet Company, which is a registered charity. In gratitude, the charity gives the donor three tickets to a show that are valued at a total of $150. The donor is considered to have received an advantage of $150. Therefore, the eligible amount of the gift is $850 ($1,000 minus $150). The commentary is interesting for its discussion on how the split-receipting rules have changed the meaning of "gift" for tax purposes, and also for its caution to donors to inform the donee of potential application of the rules and provide information before issuance of the tax receipt.

As a sign of the times, Paula Ideias provides a summary of a recent CRA Views document (2016-0633111E5) responding to a request for the proper capital cost allowance class for an aerial drone. Readers will not be surprised to hear that drone is not (perhaps yet) defined in the *Income Tax Act* or Regulations.

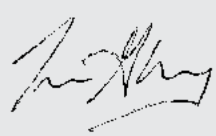
We also include William Innes' summary of the Federal Court of Appeal's decision in *TDL Group Co.* originally posted in Thomson Reuters *Tax Insight Blog* (www.gettaxnetpro.com/blog). Bill is prolific in his blogging and, apparently, prescient: in an earlier blog on the Tax Court decision, Bill wrote:

> "TDL may have some hope on an appeal, possibly by asking the Federal Court of Appeal to consider the original interest-free loan to Wendy's and the subsequent interest-bearing loan (where CRA allowed a deduction) as part of one transaction."

If this doesn't give readers a reason to follow Bill's blog, I don't know what does.

Finally, we have included a piece featuring esteemed Thomson Reuters author and tax expert, David Sherman. Readers may be interested to learn a few facts about the man behind the *Practitioner's Income Tax Act*.

As always, thank you for reading *Forward*, and please let us know what you think. You can provide your feedback to us at www.gettaxnetpro.com/forward.



Fred Glady, B.A., LL.B., LL.M.
Director, Market Segment Solutions
Thomson Reuters

ELIGIBLE AMOUNT OF GIFTS AND DONATED PROPERTY UNDER SPLIT-RECEIPTING RULES

Excerpt from ***McCarthy Tétrault's Canada Tax Service, Subsections 248(30)-(41) of the Income Tax Act***

OVERVIEW

The addition of ss. 248(30) to (41), commonly referred to as the split-receipting rules, significantly changed the meaning of a "gift" for tax purposes.

By virtue of s. 248(30), where property is transferred to a qualified donee, the existence of an "advantage" to the transferor will not in and of itself disqualify the transfer from being a gift for tax purposes provided that the amount of the advantage does not exceed 80 per cent of the fair market value of the transferred property. Where the transfer of property qualifies as a gift and an advantage has been received, pursuant to s. 248(31), the "eligible amount" of the gift in respect of which a tax credit or deduction may be claimed is the excess of the fair market value of the property (cash or other) transferred by way of the gift over the value of the advantage or benefit (if any) to which the transferor is entitled.

The addition of ss. 248(30) to (41), commonly referred to as the split-receipting rules, significantly changed the meaning of a "gift" for tax purposes.

The official donation receipt is required to be issued for the eligible amount of a gift (i.e., rather than the fair market value of a gift). According to the October 24, 2012 Technical Notes, the split-receipting rules are generally "intended to reflect the policy that the amount eligible for an income tax benefit to a donor, by way of a charitable donation deduction or credit or a political contributions tax credit, should reflect the economic impact on the donor (before considering the income tax benefit) of the gift or contribution."

Subsection 248(30) does not provide for a definition of a "gift" for tax purposes; the meaning of a gift is not defined in the Act. As discussed in the commentary to ss. 118.1(1)-(3.2) under "Meaning of a "Gift"", generally, under common law, a gift only includes a voluntary transfer of property with donative intent and with no advantage of a material character returned to the transferor. For example, in *Mariano v. R*, [2016] 1 C.T.C. 2132 (TCC), the Court stated (paras 16, 17):

> There is no dispute that the ITA does not define what a "gift" is. The definition of gift is found in established case law; namely, from the Federal Court of Appeal decision of Linden J.A. in *Friedberg v. R*, (1991) 92 D.T.C. 6031 (Fed. C.A.), at page 6032, (affirmed by the Supreme Court of Canada [1993 CarswellNat 959 (S.C.C.)]):
>
> > " Thus, a gift is a voluntary transfer of property owned by a donor to a donee, in return for which no benefit or consideration flows to the donor ... The tax advantage which is received from gifts is not normally considered a "benefit" within this definition, for to do so would render the charitable donations deductions unavailable to many donors. "
>
> The three requisite elements of a gift thus are that: 1. there must be a voluntary transfer of property; 2. the property transferred must be owned by the donor; and 3. there must be no benefit or consideration to the donor, which element has, in later jurisprudence, been taken to mean that the donor must have had 'donative intent.'

Also, in *Webb v. R*, [2005] 3 C.T.C. 2068 (TCC), Justice Bowie observed (para 16):

> " Much has been written on the subject of charitable donations over the years. The law, however, is in my view quite clear. I am bound by the decision of the Federal Court of Appeal in *The Queen v. Friedberg*, among others. These cases make it clear that in order for an amount to be a gift to charity, the amount must be paid without benefit or consideration flowing back to the donor, either directly or indirectly, or anticipation of that. The intent of the donor must, in other words, be entirely donative. "

The official donation receipt is required to be issued for the eligible amount of a gift (i.e., rather than the fair market value of a gift).

Although s. 248(30) does not provide for a definition of a "gift" for tax purposes, the provision effectively overrules the common law meaning of a gift to the extent that the receipt of any form of consideration or benefit would otherwise, in and by itself, disqualify a transfer of property from being a gift for tax purposes. The October 2012 Technical Notes state:

> " For [a] transfer of property to qualify as a gift, it is necessary that the transfer be voluntary and with the intention to make a gift. At common law, where the transferor of the property has received any form of consideration or benefit, it is generally presumed that such an intention is not present. New s. 248(30) ... allows the opportunity to rebut this presumption. "

Subsections 248(35) to (39) contain certain deeming rules with respect to determining the fair market value of a donated property. These rules are relevant for several purposes, including determining the eligible amount of a gift under s. 248(31).

The core rule in s. 248(35) deems the fair market value of certain donated property (for the purposes of s. 248(31), para 69(1)(b) and ss. 110.1(2.1) and (3) and 118.1(5.4), (6) and (13.2)) to be the lesser of the actual fair market value of the property and its cost to the donor where either: (1) the property was acquired by the donor as part of a gifting arrangement that is a tax shelter, or (2) unless the donation is made as a consequence of the donor's death, the property was acquired less than three years before the time of donation, or less than 10 years before that time if one of the main purposes of acquisition was to gift the property to a qualified donee.

Based on a December 5, 2003, Finance Press Release, these rules were primarily added with the intention of responding to concerns that various promoters were "marketing charitable gifting schemes" under which property acquired by a taxpayer would subsequently be donated to a qualified donee at a value represented to be in excess of the taxpayer's acquisition cost (commonly referred to as "buy-low, donate-high" arrangements). Subsection 248(37) provides several exceptions to the application of s. 248(35), including in respect of a donation of listed securities.

APPLICATION

Split-Receipting Rules

The eligible amount of a gift is nil if, before an official donation receipt is issued, the donor fails to inform the donee of information that would be relevant to the application of the split-receipting rules.

Eligible Amount of Gift or Monetary Contribution—Split-Receipting (subsecs 248(31), (41))

Pursuant to s. 248(31), the "eligible amount" of a gift or monetary contribution is the amount by which the fair market value of the property that is the subject of the gift or monetary contribution exceeds the amount of the "advantage" (subsec 248(32)), if any, in respect of the gift or monetary contribution. In congruence with the addition of s. 248(31), ss. 110.1(1) and 118.1(1) were amended to respectively provide that the amount deductible by a corporation in respect of a gift is generally the "eligible amount" of the gift and the amount that qualifies for a tax credit under s. 118.1(3) in respect of a gift by an individual is the "eligible amount" of the gift.

Also, s. 127(3) was amended consequentially to provide that the amount of a contribution that is eligible for the political contributions tax credit is to be reduced by the amount of any advantage or benefit to which the taxpayer is entitled in respect of the contribution. For example, a donation of $1,000 is made to the Ballet Company, which is a registered charity. In gratitude, the charity gives the donor three tickets to a show that are valued at a total of $150. The donor is considered to have received an advantage of $150. Therefore, the eligible amount of the gift is $850 ($1,000 minus $150).

Several other provisions were also added/amended in congruence with the addition of the split-receipting rules. For example, paras 38(a.1) and (a.2) provide a special inclusion rate for capital gains arising as a result of a gift to qualified donees of certain securities or of environmentally sensitive land; s. 38.2 was added to provide that, where a taxpayer is entitled to an advantage or benefit in respect of a gift, only part of the taxpayer's capital gain is entitled to the special inclusion rate. See also para 40(1.01)(c) (reserve on gift of non-qualifying security), subpara 53(2)(c)(iii) (adjustments to partnership interest cost base), para 88(1)(e.6) (wind-ups donation carryovers), and s. 143(3.1) (election in respect of gifts—communal organizations).

Subsection 248(31) applies in respect of gifts and political contributions made after December 20, 2002.

INFORMATION NOT PROVIDED

Pursuant to s. 248(41), notwithstanding s. 248(31), the eligible amount of a gift or monetary contribution made by a taxpayer is deemed to be nil if the taxpayer does not—before a receipt referred to in s. 110.1(2) (corporate donations), 118.1(2) (personal donations) or 127(3) (political contributions), as the case may be, is issued in respect of the gift or monetary contribution—inform the qualified donee or the recipient, as the case may be, of any circumstances in respect of which s. 248(31) (eligible amount of gift—advantage received), (35) (deemed FMV of donated property), (36) (non-arm's length transactions related to a donation of property), (38) (artificial transactions) or (39) (selling property and donating proceeds) requires that the eligible amount of the gift or monetary contribution be less than the fair market value (determined without reference to ss. 248(35), 110.1(3) and 118.1(6)) of the property that is the subject of the gift or monetary contribution.

In other words, the eligible amount of a gift is nil if, before an official donation receipt is issued, the donor fails to inform the donee of information that would be relevant to the application of the split-receipting rules. The qualified donee requires such information for correct preparation of the donation tax receipt.

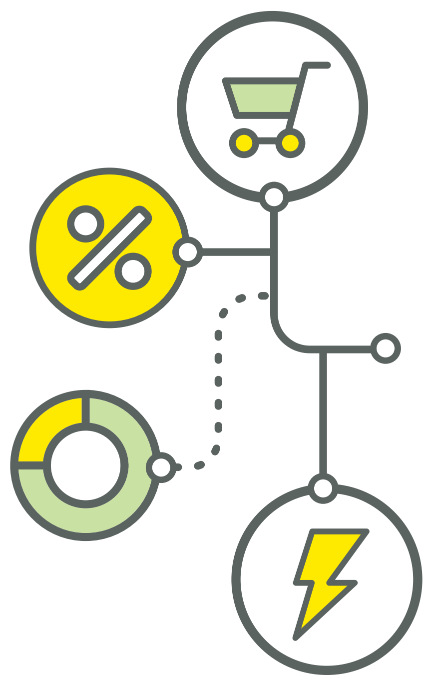
Subsection 248(41) applies in respect of gifts and monetary contributions made after 2005.

[Continued in Canada Tax Service]

About the Author

McCarthy Tétrault LLP

McCarthy Tétrault LLP is recognized as one of Canada's leading law firms, with one of the nation's most highly regarded tax law practices. The firm's tax lawyers have in-depth expertise in all areas of tax law, and provide timely, creative and practical counsel regarding domestic and international transactions and disputes.



PRODUCT AND AUTHOR SPOTLIGHT

David M. Sherman

Thomson Reuters provides professionals with the intelligence, technology and human expertise they need to find trusted answers. In Canada, Thomson Reuters delivers many leading solutions, including Taxnet Pro and Checkpoint online tax research services, DT Tax & Accounting and ONESOURCE software solutions, and many leading print publications, including *Practitioner's Income Tax Act*.

David M. Sherman is the founding author and editor of the *Practitioner's Income Tax Act*. For 25 years, David Sherman has provided valuable guidance and insight to help government departments, courts, corporations, and professional firms interpret and apply the many complex provisions of the *Income Tax Act* ("ITA"). David is especially pleased with the way tax professionals in Canada have embraced the *Practitioner's Income Tax Act*.

David M. Sherman: An author whose name is synonymous with tax law

When tax practitioners hear the word "PITA," they don't think of flatbread. They picture David M. Sherman's **Practitioner's Income Tax Act**, now in its 50th edition and 25th year of publication.

To David's amusement, loyal readers have been remarkably creative in expressing their appreciation of the *Practitioner's Income Tax Act*, applying its distinctive green, white and black colours to more light-hearted endeavours, like the cake baked for one practitioner to celebrate their birthday, and the abstract work painted by another to adorn her office.

The ITA is more than a million words long, and the vast majority of Canadian tax specialists rely on David Sherman to help make sense of it. *Practitioner's Income Tax Act* is published twice annually in both English and French (as *La Loi du Practicien – Loi de l'impôt sur le revenu*), with two supplements to bridge the editions. David Sherman's valuable Notes can now be found online on Taxnet Pro™, and in the eBook version of *Practitioner's Income Tax Act* on Thomson Reuters ProView™.

David's Notes appear throughout the book and are what distinguishes *Practitioner's Income Tax Act*. They explain the policy, application and interpretation of the ITA, and include references to court decisions, government publications and treaties, as well as his expert consideration and reflection of the legislation. David also provides many references to other publications and articles to guide the reader in a deeper analysis. *Practitioner's Income Tax Act* is like an encyclopedia of the ITA - complete, concise, and just what the busy tax professional needs to find the right answer, fast.

David has his own perspective on the popularity of *Practitioner's Income Tax Act* – it makes interpretation and application of the ITA much more manageable for tax professionals.

Even David Sherman admits the ITA is not an easy read:

1. With a few recent exceptions, every subsection is a single sentence.
2. Almost every provision contains cross-references to other provisions.
3. The words of the ITA do not, on their face, give the slightest indication as to which part of a rule is the "usual" rule and which parts are the many exceptions and special cases.
4. The Act uses many defined terms, whose definitions are found in many different places and must be referred to before any provision can be properly understood.
5. Pending amendments must always be considered – an edition that is even one year out of date is unreliable and should not be used.

> **The ITA itself is more than a million words long, and the vast majority of Canadian tax specialists rely on David Sherman to help make sense of it.**

If anyone knows the finer points of Canada's technically complex tax regime, it's David Sherman. A respected expert tax practitioner as well as author, David approaches the ITA exactly as written, relying on the legislative wording to inform his position – an approach that has helped him win many court cases and resolve disputes with the CRA. David's expertise translates clearly in the *Practitioner's Income Tax Act*, and has made him a recognized authority who is cited frequently by the Courts. His clients call him "a magician."

When provisions are amended, David explains the amendments, giving the reader a view to the revisions and the impacts of the changes that result.

To learn more about David Sherman's **Practitioner's Income Tax Act** and why thousands of practitioners choose it over any other published income act, visit www.carswell.com/pita.

The apple doesn't fall far from the tree

David Sherman – tax lawyer, consultant and prolific tax author – is carrying on a family tradition. He is the son of H. Arnold Sherman (arnoldsherman.com), a highly regarded expert in international tax and the man behind paragraph 95(2)(a) of the ITA concerning foreign affiliate property income. "I don't know anyone with as broad a knowledge as my father has of the tax systems of many different countries," David has said of his father, who was recently honoured by the Canadian branch of the International Fiscal Association.

David Sherman not only "wrote the book" on the ITA, he also writes and updates many publications on GST/HST – *Canada GST Service, Canada GST Cases, Practitioner's Goods and Services Tax Annotated, GST & HST Case Notes, GST & HST Times, GST Memoranda Bulletins Policies & Info Sheets*, and *The Lawyer's Guide to Income Tax and GST/HST.*

When asked what the future holds, David says, "Tax legislation gets only more complex, never simpler. As long as Canada has income tax and GST/HST, the profession will need help in understanding the legislation – and I'm pleased to do my part."

There is no doubt that when it comes to guiding Canadian tax professionals, David Sherman is more than playing his part.

What don't we know about you, David M. Sherman?

David's idea of taking a break during a typical 18-hour workday includes taking time to help answer questions from his many readers and colleagues.

David has raised more than $260,000 over the past 10 years doing an annual 50 k bike ride for children with special needs.

David can converse fluently in English and Yiddish, and passably in Portuguese, French and Hebrew.

David wrote his LL.M. thesis at Osgoode Hall Law School on programming a computer-based model of the *Income Tax Act*, and hasn't stopped writing about taxation since.

CAPITAL COST ALLOWANCE CLASS OF A DRONE

Paula Ideias, Thomson Reuters

CRA Views document 2016-0633111E5, dated March 11, 2016

The Canada Revenue Agency (CRA) was asked for the proper capital cost allowance (CCA) class under Schedule II of the *Income Tax Regulations* for an aerial drone. In the situation considered, the taxpayer is in the real estate business and uses the aerial drone to take aerial photographs of houses for sale.

The CRA discussed that, where the cost of a property qualifies for inclusion in the classes of property described in Schedule II of the Regulations, the specific class to which its cost is to be allocated must be determined with reference to the particular property and facts of the situation. Factors to consider include the specific functions the particular property is designed to perform and the actual use to which the property has been put by the taxpayer.

The CRA noted that the term "drone" is not defined in the *Income Tax Act* or the Regulations, and so reference must be made to the ordinary usage of the term. It is the CRA's understanding that aerial drones are considered to be a type of unmanned aircraft. *Merriam-Webster's Dictionary* defines drone as an unmanned aircraft or ship guided by remote control or onboard computers. The *Canadian Aviation Regulations* available on Transport Canada's website also describes aerial drones as a type of aircraft.

As such, and while a question of fact, it is the CRA's view that an aerial drone would generally be included in Class 9(g) of Schedule II of the Regulations, which has a CCA rate of 25 per cent.

About the Author

Paula Ideias, B.A., LL.B., LL.M. (Tax)

Paula, a Senior Tax Writer with Thomson Reuters Tax and Accounting Canada in Toronto, writes technical income tax commentary, prepares updates for existing publications, and contributes to new tax products. Previously, she was a Tax Manager at PwC LLP specializing in Canada/United States cross-border estate planning.

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Giselle Feldman, M.B.A., MTax

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SUMMARY OF BUDGET 2016 CORPORATE TAX MEASURES

Ryan Keey, Thomson Reuters

Bill Morneau, Minister of Finance, presented the new Liberal Government's first federal budget on March 22, 2016 (Budget 2016). This article summarizes Budget 2016 corporate tax proposals.

BASE EROSION AND PROFIT SHIFTING (BEPS)

Budget 2016 announced that the government plans to move forward with a number of BEPS-related changes, including introducing country-by-country reporting for large multinational enterprises (i.e., multinational enterprises with total annual consolidated group revenue of €750 million or more). The government also noted that the CRA is already applying revised international guidance on transfer pricing policies applied by multinational enterprises.

Furthermore, Canada is participating in international work to develop a multilateral instrument to streamline the implementation of treaty-related BEPS recommendations, including addressing treaty abuse. Budget 2016 also includes a commitment to implement the BEPS project's recommendation that certain forms of tax rulings be automatically exchanged between tax authorities.

ELIGIBLE CAPITAL PROPERTY

Budget 2016 proposes to repeal the eligible capital property (ECP) regime, replace it with a new capital cost allowance (CCA) class, and provide rules to transfer a taxpayers' existing cumulative eligible capital (CEC) pools to the new CCA class.

Under the proposed rules, expenditures that are currently added to CEC (at a 75% inclusion rate) will be included in the new CCA class at a 100% inclusion rate. Because of this increased expenditure recognition, the new class will have a 5% annual CCA rate. The existing CCA rules will generally apply to the new class, including rules relating to recapture, capital gains and depreciation (e.g., the "half-year rule"). CEC pool balances will be calculated and transferred to the new CCA class as of January 1, 2017. The opening balance of the new CCA class in respect of a business will be equal to the balance at that time of the existing CEC pool for that business. As a transitional measure, for the first 10 years, the depreciation rate for the new CCA class will be 7% in respect of expenditures incurred before January 1, 2017.

SMALL BUSINESS RATE

Budget 2016 proposes to maintain the small business tax rate at 10.5% after 2016, eliminating the gradual reductions that are currently legislated for 2017, 2018 and 2019 (currently, a rate of 9% would apply to taxation years after 2018). Budget 2016 further proposes to maintain the current gross-up factor and dividend tax credit rate applicable to non-eligible dividends.

PERSONAL SERVICES BUSINESSES

Budget 2016 proposes to increase the tax rate on personal services business income earned by corporations from 28% to 33%.

MULTIPLICATION OF THE SMALL BUSINESS DEDUCTION

Budget 2016 proposes amendments "to address concerns about partnership and corporate structures that multiply access to the small business deduction." According to the government, taxpayers have implemented structures to circumvent the application of the specified partnership income (SPI) rules. The Budget Supplementary Information identify as a typical structure one in which a shareholder of a CCPC is a member of a partnership and the partnership makes payments to the CCPC as an independent contractor such that the CCPC may claim the small business deduction without being subject to the SPI limit.

To address this planning, Budget 2016 proposes to extend the SPI rules to partnership structures in which a CCPC provides services or property to a partnership during a taxation year of the CCPC where, at any time during the year, the CCPC or a shareholder of the CCPC is a member of the partnership or does not deal at arm's length with a member of the partnership (essentially, where an individual is a member of a partnership and that individual provides services to the partnership through their CCPC, the CCPC will be deemed to be a member of the partnership).

Budget 2016 further states that a corporation could also be used to multiply access to the small business deduction. An example is given of a structure in which a CCPC earns active business income from providing services or property to a private corporation in which the CCPC, one of the CCPC's shareholders, or a person who does not deal at arm's length with such a shareholder, has a direct or indirect interest.

To address such structures, Budget 2016 proposes that a CCPC's active business income from providing services or property to a private corporation will not be eligible for the small business deduction if, at any time during the year, the CCPC, one of its shareholders, or a person who does not deal at arm's length with such a shareholder, has a direct or indirect interest in the private corporation, unless: 1) all or substantially all of the CCPC's active business income is earned from providing services or property to arm's length persons other than the private corporation, or 2) the private corporation assigns to the CCPC all or a portion of its business limit.

AVOIDANCE OF THE SMALL BUSINESS LIMIT AND THE TAXABLE CAPITAL LIMIT

Subsection 256(2) of the *Income Tax Act* (ITA) deems two corporations ("ACo" and "BCo") that are not otherwise associated to be associated if each corporation is associated with the same third corporation ("CCo"). However, CCo can elect not to be associated with the other two corporations for the purpose of the small business deduction. Where such an election is made, the CCo cannot claim the small business deduction; however, ACo and BCo may each claim a $500,000 small business deduction subject to their own taxable capital limit. Where the ITA 256(2) election is filed, the association exception does not apply for purposes of a separate rule that recharacterizes a CCPC's investment income as active business income eligible for the small business deduction if that income is derived from the active business of an associated corporation (ITA 129(6)).

In the government's view, certain CCPCs are "misusing" the election under ITA 256(2) to multiply their small business deductions where the small business deduction is being claimed on investment income that is treated as active business income.

Budget 2016 therefore proposes to amend the ITA to ensure that investment income derived from an associated corporation's active business will not be eligible for the small business deduction where the exception to the deemed associated corporation rule applies. Also, where the association exception applies, CCo will continue to be associated with each of the other corporations for the purpose of applying the $15M taxable capital limit.

LIFE INSURANCE PROCEEDS

Generally, life insurance proceeds received as a result of the death of an individual insured under a life insurance policy (a "policy benefit") are not subject to income tax. According to the Supplementary Information to Budget 2016, some taxpayers have structured their affairs so that the amount added to the capital dividend account of a private corporation or the adjusted cost base of a partnership interest is artificially increased by naming a person other than the corporation or partnership as the policyholder.

Budget 2016 proposes to amend the ITA to provide that the amount added to a corporation's capital dividend account will be reduced by the adjusted cost basis of a policyholder's interest in the policy, and not just that of the recipient of the insurance proceeds. A parallel change is proposed in relation to insurance proceeds received by a partnership. Budget 2016 will also introduce information-reporting requirements that will apply where a corporation or partnership is not a policyholder but is entitled to receive a policy benefit.

TRANSFERS OF LIFE INSURANCE POLICIES

If a policyholder disposes of an interest in a life insurance policy to a non-arm's length person, ITA 148(7) deems the policyholder's proceeds of disposition, and the acquiring person's cost, of the interest to be the "value" of the interest, which is in defined in ITA 148(10) as the amount that the policyholder would be entitled to receive in respect of the policyholder's interest in the cash surrender value if the policy were surrendered (or nil if the interest does not include an interest in the cash surrender value). Where ITA 148(7) applies, the amount by which any consideration given for the policy exceeds the cash surrender value is not taxed as income to the transferor. Also, this excess will ultimately be reflected in the policy benefit under the policy, and if the policy benefit is received by a private corporation, it can be paid tax-free to that corporation's shareholders. Where consideration to acquire the interest was not recognized under the policy transfer rule, the amount of the excess is effectively extracted from the private corporation a second time (i.e., once upon the purchase of the policy by the corporation and once upon the distribution of the benefit received by the corporation under the policy) as a tax-free amount.

Budget 2016 proposes several amendments to the ITA to effectively thwart this type of planning (by virtue of the proposed amendments, where the policy transfer rule otherwise applies, the fair market value of any consideration given for an interest in a life insurance policy will be included in the transferor's proceeds of the disposition and the acquiring person's cost).

DEBT PARKING TO AVOID FOREIGN EXCHANGE GAINS

A taxpayer may realize a gain or a loss on the repayment of a debt denominated in a foreign currency as a result of the fluctuation of the foreign currency relative to the Canadian dollar. To avoid realizing a gain on the repayment of a foreign currency debt (i.e., because the Canadian dollar has appreciated against the foreign currency), some taxpayers have entered into arrangements under which a related party purchases the debt from the creditor.

The government's view is that debt-parking transactions undertaken to avoid foreign exchange gains can be challenged under the GAAR. Nonetheless, Budget 2016 proposes specific measures to prevent such tax planning (the proposed rules will generally result in any accrued foreign exchange gains on a foreign currency debt being realized if the debt becomes a parked obligation).

CROSS-BORDER SURPLUS STRIPPING

ITA 212.1 provides an "anti-surplus-stripping" rule intended to prevent certain non-resident shareholders from extracting the surplus of a Canadian corporation (Canco) in excess of the paid-up capital (PUC) of its shares free of withholding tax by transferring the Canco shares to another Canadian resident corporation (Purchaser). ITA 212.1(4) provides an exception to this anti-surplus-stripping rule applicable where the non-resident shareholder of Canco is a corporation and the Purchaser controlled the non-resident shareholder before the transfer. The exception permits the unwinding of a so-called sandwich structure.

The Supplementary Information to Budget 2016 states that certain reorganizations have been implemented by non-resident corporations with Canadian subsidiaries to create a sandwich structure in order to qualify for this exception. The government intends to continue to challenge such reorganizations completed before March 22, 2016 under existing legislation (including the GAAR), and to amend to the exception in ITA 212.1(4) to prevent such planning in the future.

EXTENSION OF BACK-TO-BACK RULES

ITA 212(3.1) to (3.3) contain rules intended to ensure that Part XIII withholding tax is not circumvented by a financing arrangement in which a non-resident of Canada, instead of providing debt funding directly to a taxpayer that is a resident of Canada, provides it through an intermediary (for example, by lending funds to the intermediary on condition that the intermediary make a loan to the taxpayer).

Budget 2016 proposes a number of measures to extend the application of these back-to-back loan rules. In particular, Budget 2016 proposes to: extend the back-to-back loan rules under Part XIII of the ITA to royalty payments; extend the back-to-back loan rules to situations where such rules are avoided through the substitution of economically similar arrangements between the intermediary and another non-resident person; amend the shareholder loan rules to include provisions that are similar to the current Part XIII back-to-back loan rules; and "clarify" the application of the back-to-back loan rules in situations involving multiple intermediaries.

VALUATION OF DERIVATIVES

The Supplementary Information to Budget 2016 notes that a recent decision of the Tax Court of Canada (i.e., *Kruger Inc.*, [2015] 5 C.T.C. 2006) held that a derivative that provides rights to a taxpayer and is held on income account would be considered inventory property. From the government's perspective, "[t]he application of the lower of cost and market method to these derivatives could lead to significant tax base concerns given their potentially higher volatility and longer holding periods, as compared to conventional inventory property."

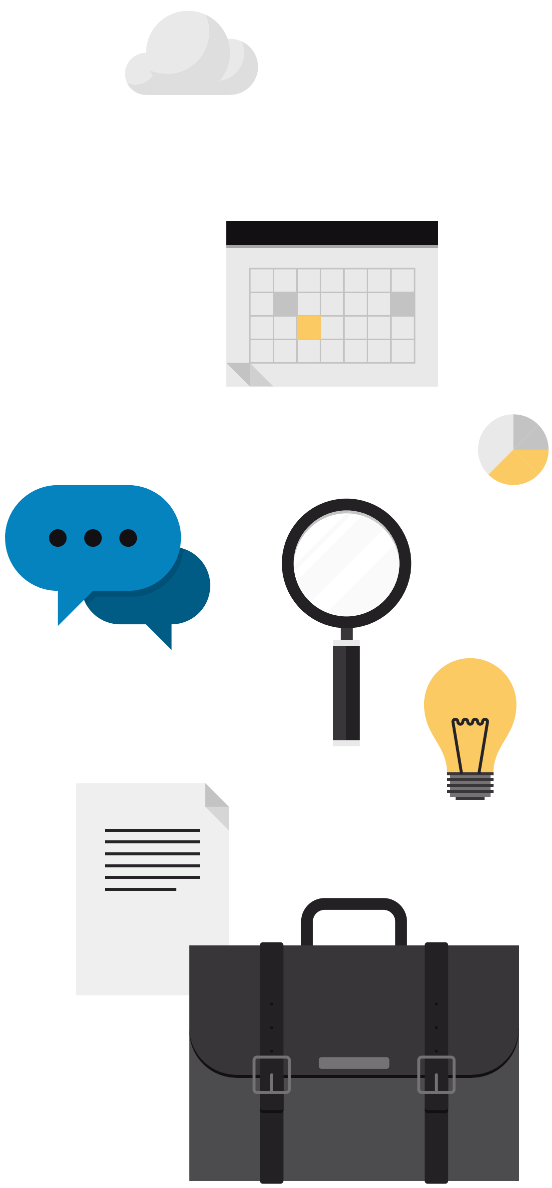
Budget 2016 therefore proposes to exclude derivatives from the application of the inventory valuation rules, while maintaining the status of such property as inventory.

CLEAN ENERGY EQUIPMENT

Budget 2016 proposes to expand Classes 43.1 and 43.2 by making electric vehicle charging stations eligible for inclusion where they meet certain power thresholds. Additionally, Budget 2016 proposes to expand the types of electrical energy storage equipment ancillary to electricity generation technologies that are eligible for inclusion in Class 43.1 and Class 43.2.

EMISSIONS TRADING REGIMES

Budget 2016 proposes to introduce rules "clarifying" the tax treatment of transactions undertaken under emissions trading regimes and eliminating the potential double taxation that could arise from the grant of emissions allowances for no consideration.



About the Author

Ryan Keey, M.Acc, CPA, CA

Ryan, a Senior Tax Writer for Thomson Reuters, has written extensive tax commentaries on all aspects of corporate taxation and has co-authored numerous books, including foreign affiliate, depreciable property, and tax elections guides. He has also published a wide variety of articles, checklists, calculators, and guides available on Taxnet Pro.

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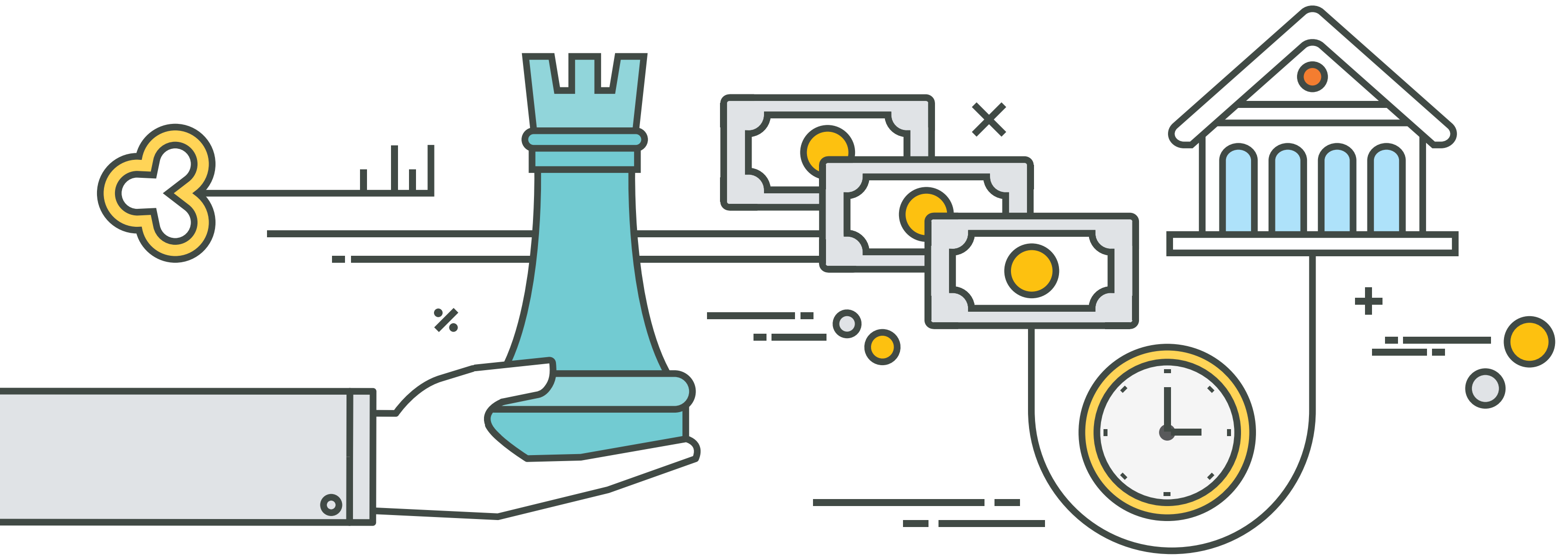

COURT OF APPEAL ALLOWS TDL APPEAL ON DEDUCTION OF INTEREST

Bill Innes, Rueter Scargall Bennett LLP
Tax Insight blog available at gettaxnetpro.com/blog

TDL GROUP CO. v. CANADA (MARCH 4, 2016 – 2016 FCA 67, DAWSON (AUTHOR), NEAR, BOIVIN JJ. A.)

Précis: In a case blogged earlier, I reported that the Tax Court denied TDL Group Co. the deduction of interest on a large loan ($234 million) for a period of seven months in 2002 on the basis that the funds (which were used to purchase shares of a U.S. subsidiary) were ultimately used to advance an interest-free loan to Wendy's International Inc. ("Wendy's"), the group parent. The loan to Wendy's was interest-free because of concerns about U.S. state taxes and the thin capitalization rule in Canada. Those concerns were resolved and in November of 2002 the loan was restructured to make it interest-bearing. CRA allowed the deduction of interest by TDL commencing in November but denied it for the preceding seven months.

The Federal Court of Appeal adopted a pragmatic, business-like approach to the issue:

> [18] Given that the appellant's purpose is to be assessed at that one point in time, an unanswered paradox runs through the reasons of the Tax Court: how is it that there was no income earning purpose during the first seven months the additional common shares were owned by the appellant, but an income earning purpose thereafter?

That paradox was resolved in favour of TDL. The appeal was allowed with costs both in the Court of Appeal and the Tax Court.

Decision:

The facts of this case were not complex:

> [4] As the Tax Court noted, most of the relevant facts are not in dispute. A series of transactions began when Wendy's International Inc. (Wendy's), the ultimate parent corporation of the Wendy's group of corporations, lent $234 million (Cdn) to a U.S. subsidiary, Delcan Inc., at a rate of interest not to exceed 7%. The same day, Delcan Inc. lent the full amount to the appellant taxpayer, at an interest rate of 7.125%. Next, the appellant used the full amount of the loan to purchase additional common shares in its wholly-owned U.S. subsidiary Tim Donut U.S. Limited, Inc. (Tim's U.S.). The next day, March 27, 2002, Tim's U.S. lent the monies received on account of the appellant's share subscription to Wendy's on an interest-free basis, evidenced by a promissory note.
>
> [5] Counsel for the appellant accurately characterized this to be another "money in a circle case." Thus, money that originated from Wendy's, and was lent out by it at a 7% rate of return, wended its way back to Wendy's on an interest-free basis.
>
> [6] Of relevance, in my view, is that the loan to Wendy's was originally intended to be on an interest-bearing basis, although no rate of interest was specified. Concerns arose, however, with respect to the impact an interest-bearing note would have on state taxes in the U.S. and on the Thin Capitalization and Foreign Accrual Property Income Rules in Canada. As a result, it was decided the loan would be advanced on an interest-free basis until these concerns could be addressed.

By November of 2002, the underlying problems were resolved and the loan to Wendy's was restructured as interest bearing. CRA allowed the deduction of interest commencing in November of 2002 but denied it in the preceding seven months.

The Court of Appeal found two fundamental errors in the Tax Court decision:

> [20] The first error resulted from the Court importing into subparagraph 20(1)(*c*)(i) a requirement that the appellant have a reasonable expectation of receiving income on account of the newly acquired shares within the first seven months of ownership of those shares. Without importing this requirement, one cannot explain how thereafter the shares carried an income-earning purpose.
>
> [21] The second legal error flows from the Tax Court's concern with tax avoidance, hence its conclusion that for the seven-month period in question (a period the Tax Court found was intended to be shorter) the "sole purpose of the borrowed funds [was] to facilitate an interest-free loan to Wendy's while creating an interest deduction for the Appellant."
>
> [22] In *Shell Canada Limited v. Canada* [1999] 3 S.C.R. 622, the Supreme Court concluded, at paragraph 47, that this Court's "overriding concern with tax avoidance not only coloured its general approach to the case, but may also have led it to misread the clear and unambiguous terms of s. 20(1)(*c*)(i) itself". In my view, the same error led the Tax Court to its conclusion with respect to the purpose for which the borrowed monies were used.

Similarly, the Court of Appeal rejected the Crown's somewhat feeble argument that the amount of interest actually paid was "unreasonable:"

> [25] In *Shell*, at paragraph 28, the Supreme Court observed that the reasonableness of the amount paid must be assessed by reference to the first three requirements of interest deductibility. That is, the reasonableness must be assessed by reference to the terms upon which the monies were lent and the purpose for which the borrower used the money.
>
> [26] I have found that the temporary use of the subscription proceeds by Tim's U.S. did not detract from the appellant's income-earning purpose behind its acquisition of additional shares in Tim's U.S. The Minister accepted that the rate of interest on the loan from Delcan Inc. was reasonable after the interest-free loan was replaced with an interest-bearing loan. On that basis, I accept that the interest paid during the period at issue was also reasonable.

As a result, the appeal was allowed with costs both in the Court of Appeal and the Tax Court.

Comment:

In my blog of the Tax Court decision, I wrote: *TDL may have some hope on an appeal, possibly by asking the Federal Court of Appeal to consider the original interest-free loan to Wendy's and the subsequent interest-bearing loan (where CRA allowed a deduction) as part of one transaction.*

TDL changed counsel for the appeal and the new counsel seems to have had the same view of the matter as the one I expressed last year.

About the Author

Bill Innes, B.Sc., LL.B., LL.M.

Bill has practised in the areas of tax litigation, taxation and estates and trusts since 1975. His practice includes all aspects of dispute resolution in taxation matters under both federal and provincial legislation, but with a special emphasis on appeals under the *Income Tax Act* (Canada). In addition, he acts as counsel in matters of estate and trust law, and serves as an advisor to large charitable and non-profit institutions on issues of trusts, estates and taxation. Bill frequently appears as counsel before the Tax Court of Canada, the Federal Court and the Federal Court of Appeal. He is also the co-author of the Thomson Reuters' work *Tax Evasion*.

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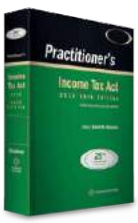

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Richard W. Pound, O.C., O.Q., Q.C., FCPA, FCA

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