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## Subsection 162(2.1) and the Meaning of “Liable To A Penalty”

By: Marisa Wyse, Goodmans LLP

The imposition of late-filing penalties under subsection 162(2.1) of the *Income Tax Act* (Canada) (the “Act”) has been the subject of uncertainty for non-resident corporations that carry on business in Canada. In particular, taxpayers have questioned whether a subsection 162(2.1) penalty could be imposed where there is no amount of unpaid tax. The Tax Court of Canada was asked to consider this issue in two 2009 cases: *Goar, Allison & Associates Inc. v. the Queen*<sup>1</sup> and *Exida.com Ltd. Liability Co. v. The Queen*.<sup>2</sup> Unfortunately, within a period of approximately seven months, the Tax Court of Canada rendered conflicting judgments on substantially similar facts.

### Legislative History of Subsection 162(2.1)

Subsection 150(1) of the Act<sup>3</sup> sets out which taxpayers must file Canadian returns of income under Part I of the Act, as well as the time limits applicable to such filings. For taxation years up to and including 1998, paragraph 150(1)(a) provided that every corporation was required to file a return, regardless of whether the corporation had any connection to Canada.<sup>4</sup> Every corporation that failed to file a return for a taxation year as and when required by paragraph 150(1)(a) was liable to a penalty under subsection 162(1). The amount of such penalty was based entirely on the amount of unpaid tax when the return was required to be filed. As a result, where there was no amount of unpaid tax at the filing deadline, no penalty was imposed.

For taxation years after 1998, paragraph 150(1)(a) was amended to narrow the circumstances in which a non-resident corporation was required to file a Canadian income tax return. The amended provision imposed a filing obligation on a non-resident corporation if (i) at any time in the year the corporation carried on business in Canada, had a taxable capital gain, or disposed of a taxable Canadian property; or (ii) tax under Part I of the Act was, or but for a tax treaty, would have been, payable by the corporation for the year.<sup>5</sup> In all other cases, no filing obligation existed. In conjunction with such amendments, subsection 162(2.1) was added to the Act. New subsection 162(2.1) provided that notwithstanding subsection 162(1), where a non-resident corporation was “liable to a penalty” under subsection 162(1) of the Act for failure to file a return of income for a taxation year, the amount of the penalty would be increased to the greater of (a) the amount computed under subsection 162(1); and (b) an amount equal to the greater of (i) \$100, and (ii) \$25 for each day the return is not filed, to a maximum penalty of \$2,500.

The Technical Notes that accompanied the introduction of subsection 162(2.1) provide:

New subsection 162(2.1) thus operates to subject non-resident corporations to the effect of the “regular” penalties under subsections 162(1) and (2) in respect of a failure to file an income tax return and, consistent with the role of that tax return as an information return for those corporations that claim an exception from Canadian tax as a result of the application of a tax treaty,<sup>6</sup> to the alternative penalties that would apply under subsection 162(7) of the Act if a separate information return had been required in respect of those corporations.<sup>7</sup>

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## Interplay of Subsections 162(1) and 162(2.1)

Taxpayers have questioned whether a subsection 162(2.1) penalty could be imposed in a situation where there is no monetary penalty under subsection 162(1) because there is no amount of unpaid tax. The answer turns on the proper interpretation to be given to the words “liable to a penalty under subsection 162(1)” in subsection 162(2.1). It has been the Canada Revenue Agency’s view that a corporation is still considered “liable to a penalty” under subsection 162(1) even though the calculated amount of the penalty under that subsection may be nil.<sup>8</sup> The Tax Court of Canada was asked to consider this issue in two 2009 cases: *Goar* and *Exida.com*.

### *Goar, Allison & Associates Inc. v. The Queen*

In *Goar*, the appellant was a non-resident corporation that carried on business in Canada during its 2005 taxation year. Pursuant to paragraph 150(1)(a), the appellant was required to file a return of income within six months following the end of the taxation year. The appellant filed this return late. No federal tax was assessed, but the Minister of National Revenue (the “Minister”) assessed a late-filing penalty pursuant to subsection 162(2.1) in the amount of \$2,500. C. Miller, J., for the Tax Court of Canada allowed the appellant’s appeal, finding that subsection 162(2.1) did not apply.

In an oral judgment, C. Miller, J. stated that the words in subsection 162(2.1) “mean exactly what they say; that is, where the taxpayer is liable to a penalty”. C. Miller, J. held:

The Appellant was not liable to a penalty as it had no income. The words of subsection 162(2.1) are not where the taxpayer files late, in which case clearly the taxpayer would be subject to the monetary penalties imposed under subsection 162(2.1). But the words do not say that. They say the Appellant must be liable to a penalty equal to a monetary amount. So, what penalty is the Appellant liable to under subsection 162(1)? Nothing. Zero. No income, no penalty. That being the case, the prerequisite for subsection 162(2.1) has simply not been met, and no penalty under subsection 162(2.1) can be imposed.

C. Miller, J. was not swayed by the Minister’s argument that the Technical Notes explain that the non-resident return is to be treated as an information return for purposes of the penalty. C. Miller, J. responded that “while this may have been the legislator’s intention”, more direct and unambiguous language could and should have been used. C. Miller, J. concluded: “if the non-resident does not owe tax, the non-resident is not subject to the subsection 162(2.1) penalty”.

## ***Exida.com Ltd. Liability Co. v. the Queen***

*Exida.com* was heard together with *Tonoga Inc. v. the Queen*. The appellants were non-resident corporations that carried on business in Canada in particular taxation years. Pursuant to paragraph 150(1)(a), the appellants were required to file returns of income within six months following the end of each of those years. The appellants filed these returns late. No federal tax was assessed in respect of either appellant, but the Minister assessed late-filing penalties pursuant to subsection 162(2.1) in the amount of \$2,500 for each taxation year. Woods, J., for the Tax Court of Canada, dismissed the appellants' appeals, finding that the subsection 162(2.1) penalties applied.

Woods, J. considered the issue from a textual, contextual and purposive approach to statutory interpretation. Citing *The Oxford English Dictionary* and the earlier decision of the Federal Court of Appeal in *The Queen v. National Trust Co.*,<sup>9</sup> Woods, J. noted that the ordinary meaning of the word "liable" is quite broad. Applying a contextual approach, Woods, J. stated that the term "liable" has a different meaning than the term "payable", and therefore any argument that essentially equates these terms must be rejected. Finally, Woods, J. considered the purpose of the introduction of subsection 162(2.1) in conjunction with the narrowing of the tax return filing requirements for non-resident corporations in subsection 150(1). Woods, J. noted that if the appellants' interpretation is accepted, the limited effect of subsection 162(2.1) would be to provide for a small increase to the minimum penalty imposed on non-resident corporations that have some unpaid tax at the filing deadline. In contrast, if the Minister's interpretation is correct, the effect of subsection 162(2.1) would be to impose a minimum penalty whenever a non-resident corporation fails to file an income tax return on time, regardless of whether there is any unpaid tax. Comparing these interpretations, Woods, J. stated:

In my view, it is unlikely that Parliament enacted subsection 162(2.1) for the modest objective that is inherent in the appellants' position. It is more likely that the objective was to put teeth into the more restrictive filing requirements for non-resident corporations in paragraph 150(1)(a). Further, as noted in *Goar*, this objective is reflected in the technical notes published by the Department of Finance at the time that the legislation was introduced.

Woods, J. concluded that subsection 162(2.1) should apply if a non-resident corporation is potentially subject to a penalty under subsection 162(1) because it failed to file a Canadian tax return on time.<sup>10</sup>

## **Conclusion**

The decisions in *Goar* and *Exida.com* leave taxpayers with two conflicting judgments of the same Court on sub-

stantially similar facts. Since each case was decided under the Tax Court of Canada's informal procedure, neither has precedential value.<sup>11</sup> Fortunately, the taxpayers in *Exida.com* have appealed the decision of Woods, J.<sup>12</sup> and a decision of the Federal Court of Appeal will provide important and much needed guidance. It remains to be seen which decision the higher Court will follow.

### **Notes:**

<sup>1</sup> *Goar, Allison & Associates Inc. v. The Queen*, 2009 DTC 1125 (TCC).

<sup>2</sup> *Exida.com Ltd. Liability Co. v. the Queen*, 2009 DTC 1234 (TCC). This appeal was heard together with the appeal in *Tonoga Inc. v. the Queen*.

<sup>3</sup> Unless otherwise noted, all statutory references herein are to the *Income Tax Act*.

<sup>4</sup> Certain Canadian cases have upheld the principle that the Act does not apply to non-residents who have no connection with Canada.

<sup>5</sup> Paragraph 150(1)(a) has been further amended. Paragraph 150(1)(a) currently imposes a filing obligation on a non-resident corporation if (i) at any time in the year a corporation carries on business in Canada (unless the corporation's only revenue from carrying on business in Canada in the year consists of amounts in respect of which tax was payable by the corporation under subsection 212(5.1)), has a taxable capital gain (otherwise than from an excluded disposition), or disposes of a taxable Canadian property (otherwise than in an excluded disposition); or (ii) tax under Part I of the Act is, or but for a tax treaty, would be, payable by the corporation for the year (otherwise than in respect of a disposition of taxable Canadian property that is treaty-protected property of the corporation).

<sup>6</sup> The concept of an information return where a non-resident corporation claims a treaty-based exemption from tax under Part I of the Act on its Canadian-source business income was introduced by the Department of Finance in the 1998 federal Budget. This reporting requirement was intended to assist the Canada Revenue Agency in the administration of treaty-based claims.

<sup>7</sup> Subsection 162(7) provides that every person (other than registered charity) or partnership that fails to file an information return as and when required by the Act or the regulations or to comply with a duty or obligation imposed by the Act or the regulations is liable in respect of each such failure, except where another provision of the Act (other than certain listed provisions) sets out a penalty for the failure, to a maximum penalty of \$2,500. The penalty in subsection 162(7) is equivalent in amount to the penalty in subsection 162(2.1).

<sup>8</sup> See Technical Interpretation 2006-0195531E5, "Subsection 162(2.1)", (October 3, 2006) and Technical Interpretation 2000-0055775, "Non-Resident Penalty Failure to File" (June 1, 2001).

<sup>9</sup> *The Queen v. National Trust Co.*, 98 DTC 6409 (FCA).

<sup>10</sup> The Minister raised an alternative argument that if subsection 162(2.1) does apply, then subsection 162(7) would apply since no other provision of the Act sets out a penalty for the failure to file on a timely basis. Woods, J. dismissed this alternative argument, stating that the penalty for failure to file was set out in subsection 162(1), notwithstanding that the penalty under that subsection could be nil.

<sup>11</sup> Section 18.28 of the *Tax Court of Canada Act*.

<sup>12</sup> Subsection 27(1.3) of the *Federal Courts Act* sets out limited grounds for an appeal from a decision under the Tax Court's informal procedure.

## An Economics Perspective on the GE Canada Decision

By: *Stéphane Dupuis, KPMG LLP, Montréal and Michael Hoffman, KPMG LLP, Calgary*<sup>1</sup>

### Introduction

The *General Electric Capital Canada*<sup>2</sup> case concerns the payment of a guarantee fee by a Canadian subsidiary (“General Electric Capital Canada Inc.” or “GE Canada”) to its U.S. parent. The Minister of National Revenue disallowed the deduction of the fee in each of the 1996 to 2000 taxation years on the grounds that the fee was not warranted due to the creditworthiness of GE Canada. In the Crown’s view, GE Canada had the same credit rating as its parent (the guarantor). On December 4, 2009, in a landmark decision, the Tax Court of Canada allowed GE Canada’s appeal, and ordered the reassessments vacated.

This article provides a summary of the case, the Court’s decision, and some observations regarding the Court’s interpretation of the arm’s length principle.

### Facts

GE Canada obtained the substantial capital it required to carry out its business by issuing third-party debt in the form of commercial paper and unsecured debentures. GE Canada’s parent company, General Electric Capital Corporation (“GE U.S.”), began guaranteeing the debt after a corporate reorganization in 1988. The guarantee was unconditional and was printed on the debt instruments. In 1995, GE U.S. began charging a guarantee fee equal to one per cent of the principal amount of the outstanding debt.

As noted above, the Crown disallowed the deduction of the guarantee fee by GE Canada for its 1996 through 2000 taxation years, and reassessed GE Canada accordingly. The reassessment, which increased GE Canada’s income by \$136 million, was based on the view that GE Canada, as a core subsidiary of GE U.S., was entitled to the implicit support of GE U.S. and, therefore, the guarantee provided no benefit to GE Canada.<sup>3</sup>

### The Issue Before the Court

The Crown argued that, in the absence of a guarantee arrangement, the credit rating of GE Canada should be equalized with that of GE U.S. due to the parent–subsidiary relationship. The position was allegedly based upon paragraph 7.13 of the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (the “OECD Guidelines”) which states that:

Similarly, an associated enterprise should not be considered to receive an intra-group service when it obtains incidental benefits attributable solely to its being part of a larger concern, and not to any specific activity being performed. For example, no service would be received where an associated enterprise by reason of its affiliation alone has a credit rating higher than it would if

it were unaffiliated, but an intra-group service would usually exist where the higher credit rating were due to a guarantee by another group member, or where the enterprise benefited from the group’s reputation deriving from global marketing and public relations campaigns. In this respect, passive association should be distinguished from active promotion of the MNE group’s attributes that positively enhances the profit-making potential of particular members of the group. Each case must be determined according to its own facts and circumstances.

The Crown maintained that GE Canada could have borrowed the same quantum of funds at the same interest rate with or without the explicit guarantee of GE U.S. and that the guarantee arrangement was simply a clearer indication of the implicit support<sup>4</sup> that already existed for the benefit of GE Canada.

The core economic issue before the Court can be simplified to the issue of the credit rating of GE Canada in the absence of the guarantee. The Crown maintained that GE Canada would have a credit rating of AAA and, therefore, no benefit was received from the guarantee of its parent. GE Canada maintained that its credit rating would have been well below its parent’s AAA rating such that the benefit to GE Canada of the guarantee was at least one per cent of the outstanding loan balances.

### The Decision

The Court noted that market participants will seek out all relevant information, including information that helps them to understand their counterpart’s motivation to enter into the transaction.<sup>5</sup> The Court concluded that it is necessary to identify the economically relevant characteristics of the transaction that may influence the arm’s length parties in their negotiations. Essentially, the dispute between GE Canada and the Crown became a disagreement over the economically relevant characteristics of the guarantee arrangement that should be considered in determining an arm’s length price for a guarantee.<sup>6</sup>

Paragraph 1.15 of the OECD Guidelines states:

Application of the arm’s length principle is generally based on a comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises. In order for such comparisons to be useful, the economically relevant characteristics of the situations being compared must be sufficiently comparable.

While the case specifically addresses guarantee fees, the interpretation of the economically relevant characteristics of the transaction is fundamental to all transfer pricing transactions.

The Court concluded that the starting point of the analysis is a stand-alone rating of the subsidiary, as this approach allows the analyst to gauge the ratings gap between the parent and the subsidiary before considering any notching to improve the rating. This is an important outcome as this is the common approach taken by tax-

payers and transfer pricing professionals. Many transfer pricing analyses start with the stand-alone credit rating, determine the corresponding interest rate, and compare that rate to the guaranteed rate. Therefore, the Court's approach validates this stand-alone credit rating approach.

In assessing if any rating uplift should exist due to the implicit support of the parent, the Court concluded that GE Canada's credit rating would be two or three notches higher. While the Court gave some rating uplift for the implicit support of the parent, the Court determined that GE Canada would not get a rating uplift of the 12 or 13 notches required to get to the AAA rating of GE U.S.

Based on the evidence provided, the Court concluded that the GE Canada rating was BBB/BB+. The Court concluded that the interest rate benefit was equal to 183 basis points.<sup>7</sup> Therefore, the Court concluded that the one per cent guarantee fee was equal to or below an arm's length price. It is interesting that the Court did not conclude the rate was in the range. In fact, it noted that "the net economic benefit exceeds the 183 basis points calculated under the yield approach" due to the significant net economic benefit from the transaction.<sup>8</sup>

## Observations

The Court arrived at the same conclusion as the great majority of commentators on the case:<sup>9</sup> conceptually, an explicit parental guarantee provided a benefit for which a fee was justifiably chargeable and deductible under the Act.

On the road to what we consider to be the appropriate result for GE Canada, the Court had to determine whether, in the circumstances, the arm's length price of the explicit guarantee had been exceeded. For that, the Court had to decide which relevant economic factors should be taken into account in the determination of an arm's length price for the guarantee. In particular, in determining the arm's length price for an explicit guarantee, the Court had to decide how much value, if any, should be attributed to implicit support that might exist (for which nothing could be charged), and how much value should be attributed to the explicit guarantee.

The answers provided by the Court in respect of these economic factors raise important issues. Notwithstanding its overall positive outcome, in that the Court upheld the deductibility of the entire fee as charged, it can be argued that the decision may contain some deviations from economic theory that could lead to problems for the application of the arm's length principle in transfer pricing in Canada.

### Explicit Parental Guarantee has Value

The Court's decision demonstrates that the Canada Revenue Agency's standing position to reassess based on the notion that an explicit parental guarantee provides no benefit to the related-party borrower is inappropriate. Parental guarantees on loans have value for at least two reasons: (1) the interest rate benefit received through a lower cost of borrowing; and (2) the negative impact of

removing such a guarantee. This judgment is a significant win for GE Canada and other companies that use intercompany guarantees.

### Economically Relevant Characteristics of the Transaction and Implicit Support

On many occasions in the judgment, the Court indicated that implicit support cannot be enforced and third parties would not consider it. Yet the Court concluded that the credit rating would be notched up for the implicit support.

The reasons for any notching uplift are important. A credit rating summarizes a variety of information into one measure. The fundamental purpose of a credit rating is to provide a signal to the market about the probability of default. Factors that affect the probability of default have a direct effect on the credit rating. This credit rating signal helps address information asymmetries that exist between the borrower and the holders of the debt.

If there are specific activities that reduce the probability of default, the argument for the rating uplift would exist. If Canco were exceptional at managing its debt, it may be that the probability of default is lowered, and the credit rating may be increased. If Canco contracted this service out to another service provider – related or unrelated – and the debt management services were exceptional, then some ratings uplift may exist. Unlike the implicit support argument, in this case, the better credit rating is due to an explicit activity performed for which compensation is owed.

According to the Court, third-party guarantors assuming the default risk of GE Canada could, and should, ask for a higher guarantee fee because, unlike GE U.S., they would not assume the cash management function of GE Canada and would have less clear information on GE Canada. Basically, the Court concluded that the arm's length price for the guarantee has to take into account the fact that, on the one hand, GE U.S. takes charge of the cash management function of GE Canada and that, somewhat concurrently, GE U.S. has a level of information about GE Canada that any third party could not have. In other words, there is no asymmetry of information between GE U.S. and GE Canada in contrast to what would be the case between GE Canada and any third-party guarantor. For these two factors, the Court inferred that the guarantee fee that GE U.S. could charge to GE Canada was lower than what would be charged by any other third-party guarantor.

One might call into question the validity of that conclusion. To the extent the money management activities of GE U.S. provides it with better information and allows it to reduce a lender's estimation of GE Canada's default risk (and as a result augment the credit rating of GE Canada), these benefits result from GE U.S.'s activities. Accordingly, in the very logic of paragraph 7.13 of the OECD Guidelines, these benefits could attract a charge and are not appropriable by GE Canada as the Court's reasoning suggests. Rather, these benefits are appropriable by GE U.S. as the performer of the money management activities and unique possessor of superior information. Otherwise, it

might be seen as contradicting the economic principle of opportunity cost.

When it comes to implicit support (where it is clear that GE U.S. did not perform any specific functions), the linkages to a lower probability of default are less clear. For example, the Court took issue with the Crown's suggestion that GE U.S. could have injected capital into GE Canada to improve Canada's debt-to-equity ratio.<sup>10</sup> If additional capital was provided, the probability of default would decline, thus raising the credit rating. The Court noted that considering this possible capital injection would contradict the well-accepted principle that a corporation is a separate person whose very existence provides limited liability protection to its shareholders. Also, it was noted by the Court that "creditors have no recourse against the parent if they rely on the expectation that the parent will come to the rescue of its subsidiary and it fails to do so".<sup>11</sup> Again, there is doubt as to whether the market would consider the potential rescue by the parent as reducing the probability of default.

The reasoning of the Court in respect of the effects of the removal of the explicit guarantee opens the door to concluding that, following that removal, the value of the implicit support would be nil. Indeed, based on the idea at the heart of the Court's reasoning itself, in terms of the signal provided to the market, should the impact of the explicit guarantee removal on the information sets of the borrower and lenders not be such that, in their minds, the probability of GE U.S. providing implicit support would be nullified?

The Crown's position, as summarized in paragraph 168 of the decision, is very telling in this respect: "the guarantee arrangement was simply a clearer indication of the implicit support that already exists in favour of [GE Canada]". Would the removal of the guarantee not be a clear indication that no support would be provided following that removal – otherwise, why would a parent have put in place an explicit guarantee at all?

In that sense, one may question the Court's conclusion that, in addition to the explicit guarantee to be charged, there would remain at equilibrium some implicit support, the value of which could not be charged. Again based on the idea at the heart of the Court's reasoning, this result seems to contradict economic principles. Following the removal of an explicit guarantee, why would GE U.S. decide not to monetize and appropriate the totality of any apparently measurable economic benefit associated with its brand and reputation that is used by GE Canada?

If the parent company did not monetize the entire economic benefit and left some residual creditor's and debtor's moral hazard in the form of unpaid implicit support, suboptimal risk-taking decisions on the part of both the subsidiary and its creditors could exist. For example, a subsidiary, knowing there is implicit support upon which it can rely and not paying for the benefit received, could be less concerned about the impact its decisions could have on the probability of default, thus creating suboptimal behaviour that leads to disequilibrium. For the lenders, if they considered the implicit support to exist, they could be

less concerned about the operations and financial performance of the borrower, again creating suboptimal behaviour and disequilibrium. The removal of the guarantee would lead us to conclude that implicit support no longer exists and the guarantor would monetize the entire economic benefit associated with an explicit guarantee.

We note that the same argument would hold in the case whereby implicit support was initially offered and it was subsequently converted to an explicit guarantee – the implicit support would have no value in the market. The Court's conclusion suggests that equilibrium in that situation would include a value for any implicit support and an explicit guarantee. This contradicts economic principles just as much as it means that the guarantor would decide not to monetize and appropriate all the measurable economic benefits it generates, knowingly and against its own self-interest leaving the subsidiary and its creditors with suboptimal risk-taking incentives.

### Other Potential Applications for Implicit Support

Given the Court's acceptance of some level of implicit support notwithstanding the explicit guarantee, there are transactions in respect of which the arguments of implicit support could be used to eliminate or alter transfer prices on other transactions. The use by a foreign subsidiary of the trademark of its parent company is a case in point. Third parties will pay more for products because the third parties recognize and value the group's name and the underlying brand. Could one use implicit support arguments based on the *GE Canada* case and paragraph 7.13 of the OECD Guidelines to argue that no payment is required for the subsidiary's use of the trademark? Presumably the subsidiary could expect the implicit support of the parent in that the parent would not be expected to sue the subsidiary for trademark infringement and the parent would want to continue to distribute its products in the local market.

## Conclusion

The OECD Guidelines are based on the widely accepted "separate legal entity" approach. The Court found its way to the appropriate answer in determining that the fee charged for the explicit guarantee was reasonable. Although the Court somewhat recognizes the separate legal entity approach, it appears to have overextended the concept of implicit support and the ambit of the factors to take into account. It remains to be seen what impact the Court's reasoning and the related economic implications will have on the interpretation of transfer pricing in Canada.

### Notes:

<sup>1</sup> The opinions expressed in this article are those of the authors and do not necessarily reflect the opinions of KPMG LLP (the Canadian member firms of KPMG International, a Swiss cooperative) and other member firms of KPMG International. The authors wish to thank François Vincent, Mary Furlin, Paul Hickey, and Clark Chandler for their comments and suggestions, along with all our colleagues who willingly had discussions with us while we sorted through the economic arguments in the case. Any errors and omissions are attributed solely to the authors. Comments may be addressed to the authors at [stephanedupuis@kpmg.ca](mailto:stephanedupuis@kpmg.ca) and [mdhoffman@kpmg.ca](mailto:mdhoffman@kpmg.ca).

<sup>2</sup> *General Electric Capital Canada Inc. v. The Queen*, 2010 DTC 1007 (TCC).

<sup>3</sup> We note that, in its Reply to the Notice of Appeal, the Crown also put forth a recharacterization argument, asserting that the guarantee arrangement was not entered into for *bona fide* purposes other than to obtain a tax benefit. During the trial, the Crown abandoned this argument and agreed that the guarantee was entered into for legitimate business reasons.

<sup>4</sup> The Court uses the term *implicit support* as an equivalent to *implicit guarantee*. In the context of the case, the two terms are interchangeable, but we will use in this article the term *implicit support* as the Court, except in rare instances, used that term when referring to the concept of implicit guarantee.

<sup>5</sup> *Supra* note 2, paragraph 197.

<sup>6</sup> The adjustments for 1996 and 1997 were based on subsection 69(2) of the *Income Tax Act* (the “Act”), while the adjustments for 1998, 1999, and 2000 were based on subsection 247(2). Neither GE Canada nor the Crown agreed that the wording differences between these two subsections were not meaningful for the purposes of the appeal.

<sup>7</sup> The Court rejected the two pricing methods proposed by GE Canada and adopted the method proposed by the Crown, yet the Court used the Crown’s method to support the position of GE Canada.

<sup>8</sup> *Supra* note 2, paragraph 305.

<sup>9</sup> See, for example, Hoffman, Michael, Stephane Dupuis, and Kirsty Rockall. “Is the CRA Abandoning the Arm’s-length Principle? Potential Implications from *GE Canada v. The Queen*.” *BNA Tax Management Transfer Pricing Report*. September 6, 2007.

<sup>10</sup> *Supra* note 2 paragraph 268.

<sup>11</sup> *Ibid.*, paragraph 267.

## Tax Aspects of Commencing and Ceasing To Use Property in a Canadian Branch

By: Ken Snider, Cassels Brock & Blackwell LLP<sup>1</sup>

### I. Introduction

There is a general proclivity of non-residents to use a Canadian subsidiary (“Canco”) rather than a branch to carry on business in Canada. There may, however, be a number of tax-related reasons why a non-resident (a “NR”) may decide to carry on a branch business in Canada rather than use a Canco. For example, using a branch may be more beneficial: i) if there are start-up losses arising in Canada that the NR can utilize for its domestic tax purposes and that would otherwise be trapped in a Canco, or ii) if the NR can make use of foreign tax credits if the NR pays the Canadian taxes itself. Moreover, potential transfer pricing issues that might arise in respect of transactions between a Canco and its NR shareholders may be avoided by using a branch. In addition, in view of changes to the *Canada–U.S. Tax Convention* (the “Convention”), there may be benefits under the Convention available to a U.S. resident carrying on business in Canada through a branch, such as a reduced rate of branch tax (5%). In contrast, if the U.S. resident instead used a fiscally transparent unlimited liability Canco to carry on business in Canada, benefits under the Convention such as a 5% rate of withholding tax

on dividends would not be available on dividends paid from Canco to its U.S. parent.<sup>2</sup>

The *Income Act* (Canada) (the “Act”) contains “fresh start” rules that apply when a Canadian branch starts to use property in Canada, and a deemed disposition and ensuing tax consequences when a Canadian branch ceases to use property in Canada. Subject to treaty protection, if any, the resulting income and gain from a deemed disposition on cessation of use of property by the branch would be subject to Part I tax and potentially branch tax in Canada.

This article begins with an overview of the general Canadian federal income tax treatment of a Canadian branch when it commences or ceases to use property in Canada, and a more specific explanation of how Canadian branches are treated in respect of commencing or ceasing to use the following types of property in Canada: capital property, depreciable property, inventory and eligible capital property. It then sets out Canadian branch tax implications. Finally, this article briefly comments on the application of treaty benefits in respect of Canadian tax liabilities arising on commencing or ceasing to use property in a Canadian branch.

## II. Canadian Income Tax Treatment

### A. General

As discussed below, immediately before a branch starts to use property in Canada, various provisions in Part I of the Act provide for a “fresh start” – a deemed disposition of capital property, depreciable property, eligible capital property and inventory, followed by a deemed acquisition at fair market value (“FMV”) at the time of commencement of use of the property.

Similarly, when a branch ceases to use property in Canada (other than as a result of an actual disposition), there is a deemed disposition followed by a deemed acquisition of the property at FMV under the Act. This would arise not only on cessation of the branch itself, but also when the NR withdraws the property from use in Canada, such as by removing equipment and inventory from Canada.

In general, the “fresh start” rules for using property of the NR in a branch are expected to produce the same tax consequences as transferring the same property to a Canco. If a Canco were used, there would be an acquisition of the property by Canco at a cost equal to FMV if FMV consideration were paid by Canco. Conversely, if Canco was wound up and all of its property distributed to its NR parent, there would be a deemed disposition at FMV, and a deemed dividend. However, there are no symmetrical rules dealing with a Canco commencing to use property for the purposes of earning income from a business outside Canada, or if there is a proportionate change in business use between Canada and elsewhere.

Absent these rules, the historical cost of property acquired prior to commencement or use in the branch would generally form the basis of computing deductions and gains. This would distort an accurate picture of Canadian-source income. Also, on cessation of use in Canada there would not be recapture or an income inclusion in respect of goodwill even though deductions were claimed under the Act.

### B. Capital Property

Section 45 of the Act provides “change-in-use” rules that set out the tax consequences when the taxpayer’s use of property changes from income-producing purposes to non-income-producing purposes and *vice versa*. Paragraph 45(1)(d)<sup>3</sup> provides the effective rule in applying the section 45 rules to an NR. Generally, the change in use rules apply to an NR as follows:

1. *Starting to use property in a branch* – If the NR had acquired property for some other use, such as use in a foreign business, and, at a later time, starts to use the property for the purposes of “gaining or producing income from a source in Canada”, there will be a deemed FMV disposition of the property at that later time followed by a deemed acquisition at FMV. This would occur when the branch commences operations in Canada, and can occur subsequently as well. Consequently, for the purpose of determining a future capital loss (or capital gain) on the actual or deemed disposition of the capital property, the FMV at the time of the commencement of the use of the property would be used.
2. *Ceasing to use property in a branch* – If a taxpayer has acquired property for the purpose of gaining or producing income from a source in Canada by a deemed acquisition or an actual acquisition, and has commenced at a later time to use it for some other purpose, there will be a deemed disposition and acquisition at that later time for proceeds equal to its FMV. Note that section 116 would apply to the deemed disposition.<sup>4</sup>
3. *Changing the regular use of property* – Where any time after an NR has acquired the property (whether on a deemed acquisition or later), there has been a change in the relation between the use regularly made by the NR of the property for gaining or producing income from a source in Canada and the use regularly made of the property for other purposes, then, if the use regularly made for those other purposes has increased, the NR is deemed to have disposed of the property at the time for proceeds equal to the proportion of the FMV of the property at the time that the amount of the increase in the use regularly made by the taxpayer of the property for those other purposes is of the whole use regularly made of the property. Theoretically, there could be a deemed disposition of capital property if the other use was a business use outside Canada. If a Canco was used rather than a branch, this deemed disposition would not arise if the property was always used for the purpose of

earning income from property or business. This difference makes sense insofar as Canada would tax the worldwide income of Canco, but not that of an NR.

### C. Depreciable Property

There are similar rules in subsection 13(9)<sup>5</sup> with respect to depreciable property. Specifically, in applying paragraphs 13(7)(a) to (d) in respect of a NR, the Act provides that a reference to “gaining or producing income” in relation to a business is to be read as a reference to gaining or producing income from a business wholly carried on in Canada, where such part of a business is wholly carried on in Canada. The practical effect of these provisions is to permit an NR that brings equipment into Canada for the purpose of using it in a business carried on in Canada to claim capital cost allowance based upon a capital cost equal to the FMV of the equipment at the time it begins to be used in the Canadian branch business.<sup>6</sup> The change-in-use language is similar to that used in respect of capital property. Interestingly, other provisions of section 13 are not incorporated by reference by subsection 13(9) principally because they are applicable in any event to the NR carrying on a branch business.

### D. Inventory

There are similar rules for inventory in subsections 10(12) and (13).<sup>7</sup> Consequently, if at any time a property becomes included in the inventory of a business that an NR carries on in Canada after that time, the NR is deemed to have acquired that property at a cost equal to the FMV at that time. Conversely, if at any time an NR ceases to use in connection with the business or part of a business carried on in Canada immediately before that time, property that was immediately before that time described in inventory of the NR, the NR is deemed to have disposed of the property immediately before that time for proceeds equal to the FMV at that time, and to have received those proceeds immediately before the time in the course of carrying on a business.

Subsection 10(14) provides that, for the purposes of these rules, property will be included in inventory of the NR, assuming paragraph 34(a)<sup>8</sup> does not apply. Section 34 provides an exemption to accrual accounting for certain professional services without taking into account any professional work-in-progress at year end. Therefore, any work-in-progress that would normally be included in inventory will be subject to these deemed disposition and acquisition rules.

### E. Eligible Capital Property

There are similar rules in respect of eligible capital property found in subsections 14(14)<sup>9</sup> and (15):

1. *Starting to use eligible capital property in a branch* – If at a particular time an NR ceases to use, in connection with a business or part of a business carried on by the taxpayer outside Canada immediately before the particular time, and begins to use, in connection with a business or part of a business carried on by the NR in Canada, a property that is an eligible capital property of the NR, the NR is

deemed to have disposed of the property immediately before the particular time and to have reacquired the property at the particular time for consideration equal to the lesser of the cost to the taxpayer of the property immediately before the particular time and its FMV immediately before the particular time. Note that the deemed disposition and reacquisition of eligible capital property does not necessarily result in a FMV “fresh start” as is the case in inventory and capital property.

2. *Ceasing to use eligible capital property in a branch* – If at a particular time, an NR ceases to use, in connection with a business or part of a business carried on by the NR in Canada immediately before the particular time, a property that was, immediately before the particular time, eligible capital property of the NR, the NR is deemed to have disposed of the property, immediately before the particular time, for proceeds of disposition equal to the amount determined by a formula outlined below:

The FMV of the property immediately before the particular time less:

- Where at a previous time before the particular time the NR ceased to use the property in connection with a business or part of a business carried on by the taxpayer outside Canada and began to use it in connection with a business or part of a business carried on by the taxpayer in Canada, the amount, if any, by which the FMV of the property at the previous time exceeded its cost to the NR at the previous time; and
- in any other case, nil (this would apply where the inventory was purchased after commencing business in Canada).

Given the somewhat amorphous nature of goodwill, interesting questions may arise in respect of the cessation of use of eligible capital property in the branch. It may be an imprecise art, to say the least, to allocate an initial FMV and an increase in the FMV of goodwill on a geographic basis. Accordingly, there could be an exposure to tax in Canada on the increase in FMV of goodwill owned by an NR that was used in a business that is partly carried on in both Canada and the United States.

### III. Branch Tax Implications

In addition to the Part I implications discussed above, branch tax implications of a cessation of use of property in a branch could be significant, particularly if it occurred where there was a cessation of the branch operations altogether. As a result of ceasing the operations of a Canadian branch in a particular taxation year, there would not be a deduction in computing the amount subject to branch tax in respect of an allowance in investment property in Canada pursuant to paragraph 219(1)(j). In addition, there would be an inclusion in such taxation year of the amount claimed pursuant to paragraph 212(1)(f) in the previous

taxation year pursuant to paragraph 219(1)(g). Consequently, it would not be surprising to have a branch tax liability in the taxation year of cessation of the branch.

### IV. Treaty Protection

Whether there are treaty benefits in respect of any income or gains arising from the deemed disposition of property of an NR will require a review of the type of income, and the particular treaty that may apply to the NR. In respect of inventory and recapture, it is generally expected that the deemed income would be attributable to a permanent establishment and taxable under the Act. “Profit” must be interpreted under Canadian law and would include income resulting from a deemed disposition for purposes of paragraph 1 of Article VII of a Canadian tax treaty.

Paragraph 2 of Article VII attributes to a permanent establishment those business profits which an NR might be expected to make if it were a distinct and separate person engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the resident and with any other person related to the resident (within the meaning of paragraph 2 of Article IX (Related Persons)). A question that arises is whether paragraph 2 excludes the attribution of the deemed income. It might be argued that it would not be expected to make such business profits under the similar conditions if the appropriate reference were a Canadian person because the rule deeming there to be a disposition would not apply. It is beyond the scope of this paper to explore this question.

As far as personal property is concerned, gains from dispositions of personal property forming part of the business property of a permanent establishment in Canada would not be treaty-protected pursuant to paragraph 1 of Article XIII.

### V. Conclusion

As a tax practice matter, given the potential Canadian Part I tax and branch tax liabilities discussed above, it is recommended that where a branch is used to carry on a business in Canada:

- all property of the NR to be used in the branch at the commencement of the branch and thereafter be identified and their tax attributes noted; and
- prior to the cessation of use of property, an estimate of Part I tax and branch tax<sup>10</sup> should ideally be prepared.

In some instances, it may be possible for the potential tax exposure in respect of these rules to be reduced if the NR carrying on business in Canada leased or licensed the property from an affiliate rather than owned it. It is also important to get foreign tax advice, as Canadian Part I tax and/or branch tax may not give rise to an effective tax credit in a foreign jurisdiction because the cessation of a foreign branch likely would not create a taxable event in the foreign jurisdiction.

**Notes:**

<sup>1</sup> I would like to express appreciation for the helpful comments from Tricia Thompson.

<sup>2</sup> At the 2009 CTF Roundtable, the CRA provided a favourable response in respect of obtaining treaty benefits for a U.S. member of a ULC in respect of a deemed dividend.

<sup>3</sup> Paragraph 45(1)(d) was added by S.C. 2001, c. 17, s. 30(1), applicable after October 1, 1996.

<sup>4</sup> See CRA documents 9134055 and 2005-0113981E5.

<sup>5</sup> Subsection 13(9) was amended by 1988, c. 55, subsection 6(15), applicable with respect to changes in use occurring after April 1988. Subsection 13(9) formerly read as follows:

(9) “Business” defined – In applying paragraphs (7)(a) to (d) in respect of a non-resident taxpayer, a reference to a “business” shall be read as a reference to a business wholly carried on in Canada or such part of a business as is wholly carried on in Canada.

Subsection 13(9) was formerly identical with s. 20(7), R.S.C. 1952, c. 148.

<sup>6</sup> See *Cudd Pressure Control v. The Queen*, 98 DTC 6630 (FCA). See David Ward, “Attribution of Income to Permanent Establishments”, 2000 CTJ 3 559 for a very insightful discussion of these provisions.

<sup>7</sup> Subsection 10(12) was added by S.C. 2001, c. 17, s. 4(1), applicable after December 23, 1998.

<sup>8</sup> Section 34 provides:

In computing the income of a taxpayer for a taxation year from a business that is the professional practice of an accountant, dentist, lawyer, medical doctor, veterinarian or chiropractor, the following rules apply:

(a) where the taxpayer so elects in the taxpayer’s return of income under this Part for the year, there shall not be included any amount in respect of work in progress at the end of the year; and

(b) where the taxpayer has made an election under this section, paragraph (a) shall apply in computing the taxpayer’s income from the business for all subsequent taxation years unless the taxpayer, with the concurrence of the Minister and on such terms and conditions as are specified by the Minister, revokes the election to have that paragraph apply.

<sup>9</sup> Subsection 14(14) was added by S.C. 2001, c. 17, s. 7(7), applicable after June 27, 1999 in respect of an authorized foreign bank, and after August 8, 2000 in any other case.

<sup>10</sup> See Schedule 20 to the T2 which sets out the branch tax calculation.

## A Suitable Remedy? *Morris and Smith v. M.N.R.*

By: Christopher J. Steeves, Fasken Martineau DuMoulin LLP and Timothy Fitzsimmons, Fraser Milner Casgrain LLP

Should a capital gain realized by a trust be taxed in Barbados or in Canada? That is the relatively simple question that was before the court in *Morris and Smith v. M.N.R.* (the “RCI Trust” case).<sup>1</sup> Upon closer inspection, however, the Court’s decision regarding this simple matter was layered with nuance and procedural knots, which have left the underlying issues in the case unresolved.

The facts in the case are not complicated – a trust realized a \$145 million capital gain on the sale of shares of a Canadian company. The trust sought a certificate from the Canada Revenue Agency (the “CRA”) that, under the

*Canada-Barbados Income Tax Convention* (the “Treaty”),<sup>2</sup> the capital gain was not taxable in Canada on the basis that the trust was resident in Barbados for purposes of the Treaty. Notwithstanding the provision to the CRA of all documentation that would have enabled it to determine the applicability of the Treaty exemption, the CRA had still not decided on the Treaty issue (and thus had not yet issued the certificate) after more than 16 months. The trust brought an application to the Federal Court (the “FC”) for judicial review of the CRA’s actions (or inactions), and sought a declaration that the capital gain was not taxable in Canada. The FC decided in favour of the taxpayer and ordered the CRA to decide on the Treaty exemption issue within a specified time.

The CRA appealed the FC’s decision to the Federal Court of Appeal (the “FCA”), which overturned the FC’s decision. The CRA argued that the trust could not seek relief by way of judicial review, but had to instead avail itself of the appeal procedures under the *Income Tax Act* (Canada) (the “Act”).<sup>3</sup> To many observers, this result was not unexpected. However, the FCA’s decision, and the CRA’s actions, are examples of the obstacles facing certain non-resident trusts in Canada – obstacles that have created a great deal of uncertainty in respect of the Canadian tax status and treatment of such non-resident trusts.

### The Facts

On February 28, 1995, North West Investments settled a trust in the Cayman Islands (the “Cayman Trust”). The beneficiaries of the Cayman Trust were the two children of Lucien Rémillard, all of whom were residents of Canada.

In 1997, two waste management companies were formed under the *Canada Business Corporations Act* (the “CBCA”)<sup>4</sup> – RCI Environnement Inc. (“RCI Environnement”) and Centre de Transbordement et de Valorisation Nord-Sud Inc. (“CTVNS”). The two companies were wholly owned by Montreal lawyer Paul Biron in trust for a trust to be settled under the laws of Barbados. Mr. Biron held 100 shares valued at \$1 per share in each of RCI Environnement and CTVNS. Lucien Rémillard was the sole director of each company.

On July 9, 2002, North West Investments settled a second trust – this one in Barbados (the “Trust”) – the beneficiary of which was the Cayman Trust. On the same day, Mr. Biron conveyed the shares of RCI Environnement and CTVNS to the Trust for \$200.

On January 31, 2006, RCI Environnement and CTVNS were amalgamated to form New RCI Inc. (“New RCI”).

On May 5, 2006, the Trust agreed to sell its 200 shares of New RCI (the “RCI Shares”) to Les Investissements Historia Inc. (“Historia”), a Canadian corporation, for \$145 million. Historia was incorporated under the CBCA, and one of its shareholders was Lucien Rémillard, who was also its sole officer and director. The effective date of the sale was May 31, 2006, and the purchase price was to be paid by December 31, 2011.

By letter dated May 4, 2006, the Trust filed an application (Form T-2062) with the CRA for a certificate pursuant to section 116.

## Section 116

Section 116 requires non-residents of Canada that dispose of “taxable Canadian property”<sup>5</sup> to notify the CRA of the disposition, either before the disposition or within 10 days thereafter. Additionally, section 116 imposes a 25% withholding obligation<sup>6</sup> on the purchaser on account of the potential Canadian tax liability of the non-resident vendor (the “Vendor”) arising from the disposition,<sup>7</sup> unless the Vendor has been issued a “certificate of compliance” under section 116 (a “Certificate”). Where withholding is required, the purchaser must remit the withheld amount to the Receiver General no later than 30 days after the end of the month in which the purchaser acquired the property in question (the “Remittance Date”).

A Certificate is granted where the Vendor has paid an amount equal to 25% of the amount by which the proceeds of disposition exceed the Vendor’s adjusted cost base in the taxable Canadian property,<sup>8</sup> or has provided security acceptable to the CRA. Additionally, the CRA has stated in Information Circular IC72-17R5<sup>9</sup> that where the Vendor claims an exemption from tax based on a tax treaty and has provided to the CRA certain required information (i.e., proof of residency, or proof that the gain has been or will be reported in the Vendor’s country of residence), the CRA will grant an administrative exemption and will issue a Certificate without requiring payment of the 25% withholding tax.<sup>10</sup>

In recent years, however, because of increasing processing delays in issuing Certificates, the CRA has adopted an administrative procedure whereby a Vendor may request a “comfort letter,” which is then delivered to the purchaser and which administratively relieves the purchaser from its obligation to remit the withheld funds by the Remittance Date. If the Certificate is delivered after the Remittance Date but within the extended time period set out in the comfort letter, the purchaser can pay the withheld amount to the Vendor. However, if the Certificate is not provided within the foregoing extended time period, or if the comfort letter is revoked, the purchaser is required to remit the withheld amount to the Receiver General.

The requirements of section 116 can cause significant concerns to a Vendor entitled to treaty relief in respect of the gain realized on the disposition of the taxable Canadian property. This is so because the Vendor can be without a portion of its sale proceeds for a considerable amount of time, particularly where the withheld amount is remitted to the Receiver General. That is, once the amount is remitted, the Vendor must wait until the commencement of the next taxation year to file a Canadian tax return and claim the treaty exemption and refund of the remitted tax. The CRA must then process the return and issue the refund (assuming it determines that the refund is due).

In the *RCI Trust* case, in the absence of a section 116 certificate, Historia would have been required to withhold and remit to the CRA 25% of the purchase price for the RCI Shares – approximately \$36 million. The Trust therefore applied for the Certificate, claiming an exemption under the Treaty on the basis that the capital gain realized on the

sale of the RCI Shares was taxable only in Barbados under the Treaty. Notwithstanding such application, however, and until such time as the CRA issued the Certificate, Historia faced a potential liability of \$36 million if it did not comply with the withholding and remittance requirements of section 116. If it did so comply, however, the Trust would be without a portion of its proceeds until the CRA issued the Certificate or processed a Notice of Assessment.

In response to the Trust’s section 116 application, the CRA requested additional documents, which were apparently provided by the Trust. The Trust claimed that by September 2007 – 16 months after the application was made – the CRA had still not decided on whether the Treaty exemption was available in the circumstances.

Accordingly, on November 1, 2007, the trustees of the Trust brought an application to the FC pursuant to sections 18 and 18.1 of the *Federal Courts Act*<sup>11</sup> for declaratory relief and judicial review of the Minister’s decision (or lack thereof) of the Minister of National Revenue (the “Minister”) on the Trust’s section 116 application. Specifically, in their Notice of Application to the FC, the applicants requested:

- a declaration that subsections 116(1) to (5) did not apply to the disposition in question because, under the Treaty, the gain was taxable only in Barbados;
- a declaration that section 116 and the Treaty had to be read together, the effect of which was to compel the Minister to issue the Certificate without requiring payment of the withholding set out in subsection 116;
- a declaration that the Minister had withheld the Certificate for an improper purpose;
- a declaration that the Minister had unduly delayed delivering a decision on the Certificate application and the question as to the applicability of the Treaty to the disposition for an improper purpose, and an order requiring the Minister to render a decision on these two questions forthwith; and
- an order requiring the Minister to issue the Certificate.

The Trust argued that section 116 did not apply to its disposition of the RCI Shares because the shares were “treaty-exempt property”,<sup>12</sup> or, in the alternative, that the Trust had satisfied all the requirements of section 116 and was thus entitled to a Certificate forthwith. In response, the CRA argued that the issuance of a Certificate was a matter of discretion and that the onus was on the Trust to satisfy the CRA that the Treaty applied to the disposition. In the absence of all required information, the CRA could refuse to issue the Certificate. Further, the CRA argued that the Trust may have been a dual resident under the Treaty as a result of section 94.<sup>13</sup> Finally, the CRA raised the issues as to whether the Trust and Historia were dealing at arm’s length, and whether the purchase price reflected the fair market value of the RCI Shares.

## The FC’s Decision

The FC decided in favour of the Trust.<sup>14</sup> In its reasons, the FC stated that sections 94 and 116 “predated” the

Treaty. Accordingly, if those sections of the Act had been intended to apply notwithstanding the Treaty, the FC would have expected the Treaty to deal expressly with the interaction between those provisions and the provisions of the Treaty. In the absence of such express statements, the FC concluded that the Treaty was paramount and that the determination of the residency of the Trust – a key fact for the purpose of section 116 – was to be based solely on the language of the Treaty.

Against this background, the FC stated there were four issues to be determined:

- Where was the Trust resident?
- Who had the authority to tax the Trust?
- What was the import of the CRA's administrative position on section 116?<sup>15</sup>
- What was an appropriate remedy for the Trust in the circumstances?

In respect of the Trust's residence, the FC stated that the CRA had acknowledged that the Trust was *prima facie* resident in Barbados, and further that the Trust had met the physical criteria described in Article IV(1) of the Treaty (domicile, place of management, or criterion of similar nature),<sup>16</sup> which dealt with residency under the Treaty. The FC then considered whether the provisions of the Treaty allowed the Court to conclude that the Trust was also resident in Canada. The FC stated that it could not so conclude because Article IV(3) of the Treaty required that a finding of dual residence be based on actual physical factors and no such factors existed on the facts of the case. Accordingly, the Trust was resident only in Barbados.

Turning to the issue of the taxing authority, the FC stated that, pursuant to Article XIV(4) of the Treaty, gains on the disposition of property were to be taxed only in the country in which the Vendor was resident. The Trust was resident in Barbados, and thus the gain on the disposition of the RCI Shares were taxable only in the Barbados (which did not tax capital gains at the time of the transaction).

In respect of section 116, FC stated that the CRA should not use the section to accomplish enforcement and collection objectives. The CRA had purported to extend its powers under section 116, as the section makes no reference to exemptions under tax treaties. Further, the FC was supported in this view because of subsequent amendments to section 116 that made it clear that the section did not apply to "treaty-exempt property."

In conclusion, the FC stated that the applicants were entitled to a written decision from the CRA as to whether the RCI Shares were "treaty-exempt property" in accordance with FC's decision. Such a decision was to be issued by the CRA by June 30, 2009.

The CRA appealed the decision to the FCA, and the FC's order was stayed pending the outcome of the appeal.

## The FCA's Decision

At the hearing of the appeal, the CRA argued that its role under the Act was to determine in the first instance whether the Trust was resident in Canada for income tax purposes, and whether and to what extent the Trust was taxable in Canada or entitled to the benefit of the Treaty. If the Trust did not agree with the CRA's determination, the Trust could file an income tax return for the taxation year and appeal the resulting assessment to the Tax Court of Canada (the "TCC"), which has exclusive original jurisdiction to deal with such appeals. The CRA argued that the FC should not have intervened to determine the residency of the Trust before the CRA had done so in the context of assessing an income tax return filed by the Trust.

The availability of this option – filing an income tax return and appealing an assessment to the TCC – was something that was of particular interest to the FCA during the hearing of the appeal. The FCA repeatedly questioned counsel for the Trust on this issue. Not surprisingly then, the FCA's reasons focused on this point and allowed the CRA's appeal, set aside the judgment of the FC, and dismissed the Trust's application for judicial review.

The FCA stated that, while the FC had the jurisdiction to entertain an application for judicial review of a refusal by the Minister to issue a Certificate, it should not have exercised that jurisdiction where the person seeking the Certificate can appeal to the TCC. The FCA also stated that this conclusion was consistent with the decision of the Supreme Court of Canada (the "SCC") in *Addison & Leyen Ltd. v. Canada*,<sup>17</sup> in which the SCC held that judicial review in tax matters was available provided the matter was otherwise not appealable:

11. Reviewing courts should be very cautious in authorizing judicial review in such circumstances. The integrity and efficacy of the system of tax assessments and appeals should be preserved. Parliament has set up a complex structure to deal with a multitude of tax-related claims and this structure relies on an independent and specialized court, the Tax Court of Canada. Judicial review should not be used to develop a new form of incidental litigation designed to circumvent the system of tax appeals established by Parliament and the jurisdiction of the Tax Court. Judicial review should remain a remedy of last resort in this context.<sup>18</sup>

The Trust argued that it was not required by the Act to file an income tax return (and to thus start the process that would ultimately allow it to appeal to the TCC). However, the FCA stated that the mere possibility that this appeal route existed required the Trust to file a return and proceed by way of its objection and appeal rights to the TCC.

## Analysis

The FCA's decision will have a significant impact on judicial review of the CRA's discretionary powers under section 116. In our view, the decision is problematic because it has left unanswered several questions with respect to the jurisdiction of the FC to grant relief on a judicial review application, the effect of deemed residency for the purposes of Canada's tax treaties, and the alleged remedy available to a taxpayer where the CRA has refused to issue a Certificate.

## Jurisdiction

Discretionary decisions of the CRA have, in recent years, been increasingly challenged through the use of judicial review in Canada's Federal Court system. Under Canadian law, there is no question that a discretionary decision of the CRA (or the Minister, who is often the named party in tax litigation) is a reviewable decision by the FC.<sup>19</sup> As noted above, the authority of the FC to review discretionary decisions of the CRA is found in sections 18 and 18.1 of the *Federal Courts Act*. Under section 18, the FC has jurisdiction to issue an injunction, writ of *certiorari*, writ of prohibition, writ of *mandamus* or writ of *quo warranto* against the CRA (or any federal board, commission or other tribunal), or to grant declaratory relief against these bodies. On the other hand, the TCC has exclusive jurisdiction to hear and determine references and appeals on matters arising under the Act.<sup>20</sup> An assessment of tax against a taxpayer cannot be reviewed by the FC in its exercise of its judicial review jurisdiction.<sup>21</sup> An appeal from a decision of the TCC is taken to the FCA.<sup>22</sup>

As noted above, in *RCI Trust*, the Trust had brought an application for declaratory relief and a writ of *mandamus* compelling the CRA to issue the section 116 clearance certificate. The FC is not a court of inherent jurisdiction (as opposed to the Canadian provincial superior courts, which have the inherent jurisdiction to hear any matter not specifically ascribed to the jurisdiction of another court) and the *Federal Courts Act* contains specific provisions that describe the FC's power to grant relief on a judicial review application.<sup>23</sup> Additionally, there is case law on the power of the FC to grant *mandamus* orders.

In *Apotex Inc. v. Canada (A.G.)*,<sup>24</sup> the FCA set out eight conditions that must be met before *mandamus* will issue:

- a public legal duty to act;
- a duty owed to the applicant;
- a clear right to performance of that duty;
- the exercise of discretion by the decision-maker in a manner that is "unfair", "oppressive" or demonstrates "flagrant impropriety" or in "bad faith";
- unavailability to the applicant of another adequate remedy;
- some practical value or effect to the order being sought;
- no equitable bar to the relief being sought; and
- "balance of convenience" that the *mandamus* order should (or should not) issue.

However, the FC in *RCI Trust* did not consider the *Apotex* decision, but instead focused on the Trust's residency and issued the *mandamus* order compelling the Minister to provide a written decision to the Trust as to whether the RCI Shares were "treaty-exempt property". It is not clear from the FC's reasoning how the duties of the Minister under section 116 satisfied the requirements of the *Apotex* test. Further, the FCA did not specifically discuss this issue, deciding the matter on the narrow basis that an alternative remedy was available to the Trust. The existence of such a remedy – or, importantly, the lack thereof – is a prerequisite for the issuance of a *mandamus* order, but, again, this was not explicitly addressed in the reasons of the FCA. Even though it is far from clear that all the *Apotex* requirements would have been satisfied in the context of a judicial review of the CRA's actions under section 116, we suggest that taxpayers would have been well served by a discussion of the principles, as they apply to applications for *mandamus* relief for actions (or inactions) of the CRA.

## Non-Resident Trusts and Deemed Residency

The larger background to this dispute was the ongoing "back-and-forth" between taxpayers and the CRA in respect of non-resident trusts. As described above, section 94 contains rules addressing non-resident trusts and the situations in which certain non-resident trusts will be deemed resident in Canada.

The state of Canadian law in respect of a trust's residency is currently in flux. Previously, it seemed well-established, based on the decision in *Thibodeau Family Trust v. The Queen*,<sup>25</sup> that, under Canadian law, a trust was resident where its trustee(s) resided. The CRA stated in Interpretation Bulletin IT-447<sup>26</sup> that it accepted this approach to determining the residence of a trust.

However, in the recent case of *Garron Family Trust v. The Queen*,<sup>27</sup> the TCC stated that the holding in *Thibodeau* was confined to its facts, and instead applied a "central management and control" test to determine the residency of the trust in that case. This decision of the TCC has been appealed to the FCA.<sup>28</sup>

Additionally, *RCI Trust* is not the first judicial review case in the context of non-resident trusts. In *Perry v. M.N.R.*,<sup>29</sup> a U.S.-resident trust asked the CRA Competent Authority to settle the residence of the trust pursuant to Article IV(4) of the *Canada-U.S. Income Tax Convention*.<sup>30</sup> The trust was concerned that, under the proposed amendments to section 94, it would be deemed resident in Canada because it had acquired property from a Canadian resident. The trust brought an application for judicial review of a decision of the CRA refusing to determine the residency of a trust, and sought a *mandamus* order that the CRA settle that residence question. The FCA held that the trust was seeking an order based on the wording of proposed section 94 (and not the legislation as it was then currently in force), and thus it was too early for the trust to seek relief by way of a judicial review application.

### Alternative Remedy

The CRA argued before the FCA that the combined effect of paragraph 150(1)(c) and subsection 150(1.1) was to require the Trust to file an income tax return in the year it disposed of the RCI Shares. The CRA likely also relied on subsection 104(2), which deems a trust to be, in respect of trust property, an individual for the purposes of the Act.

Paragraph 150(1)(c) requires that a trust file an income tax return for the year within 90 days of the end of its taxation year. Subsection 150(1.1) states that the filing requirements in subsection 150(1) do not apply where the taxpayer is an individual, unless certain conditions are met – one of which is that the individual has disposed of taxable Canadian property.

In comparison, paragraph 150(1)(a), which applies to corporations, is more limited in scope and generally requires non-resident corporations to file a Canadian tax return only where the corporation carries on business in Canada, has a capital gain that is taxable in Canada, or disposes of taxable Canadian property.<sup>31</sup> Administratively, the CRA has crafted a similar regime for trusts. The CRA has stated that it will generally require a trust to file an income tax return if the trust has tax payable, is a Canadian resident and has disposed of capital property or has a taxable capital gain, is a non-resident and has a taxable capital gain or has disposed of taxable Canadian property, is a deemed resident trust, holds property that is subject to subsection 75(2), has distributed certain amounts to beneficiaries, or receives from the trust property any income, gain or profit that is allocated to one or more beneficiaries.<sup>32</sup> However, this is only an administrative practice and these limitations are not codified in the Act.

Based on the text of paragraph 150(1)(c), there are seemingly no limits on the trusts to which this would apply (i.e., any trust anywhere in the world). However, it seems reasonable that the requirement must be geographically limited in some way. In *Holiday Luggage Manufacturing Co. v. Minister of National Revenue*,<sup>33</sup> the FCA gave the word “corporation” a geographically restricted meaning not otherwise found in the statutory definition, and held that “corporation” did not bring a non-resident corporation not doing business in Canada within the ambit of the Act so as to trigger a deeming provision in section 256. We suggest the same reasoning likely applies to the interpretation of “trust” under paragraph 150(1)(c).

Nevertheless, in *RCI Trust*, the FCA stated that the Trust must file an income tax return to obtain the relief it sought. However, we suggest that, if Parliament had intended that a trust be required to file a tax return upon the disposition of taxable Canadian property, it would have clearly provided for such a requirement. As it is, that requirement is made explicit in the Act only for corporations and individuals. Further, we note that subsection 152(7) states that the CRA is not bound by the return filed by the taxpayer and may issue an assessment even where no return has been filed.<sup>34</sup> We are puzzled then that the FCA determined that the onus lay on the taxpayer to file a return, but did not find fault with the CRA's refusal or failure to issue an assessment in the absence of a return filed by the taxpayer. In other

words, we wonder if it would have been just as fair to require the CRA to issue an assessment of the taxpayer under subsection 152(7) once the CRA had determined that it could not within a reasonable time issue a decision under section 116.

This raises the question as to whether the possibility that the taxpayer may file a tax return – which may be an “alternative” remedy – should be considered an “adequate” remedy for the purpose of either the *Apotex* test for *mandamus* or the question of the FC's jurisdiction under section 18.5 of the *Federal Courts Act*. In *Addison & Leyen*, where the CRA had been exceptionally delayed (11 years after the transaction) in issuing a section 160 assessment,<sup>35</sup> the FCA<sup>36</sup> stated that none of the following were adequate remedies for the taxpayer: the right to appeal to the TCC, the right to ask the CRA for a discretionary waiver of interest, or the right to bring an action for damages against the CRA. However, the SCC reversed the FCA on this point and stated that, as a threshold issue, there could be no judicial review where the matter is otherwise appealable. Interestingly, the SCC stated that, “delay . . . does not suffice as a ground for judicial review, except, perhaps, inasmuch as it allows for a remedy like *mandamus* to prod the Minister to act with due diligence once a notice of objection has been filed”. This raises another important issue. Under the Act, the Minister is required to act “with all due dispatch” upon receipt of a taxpayer's tax return<sup>37</sup> or Notice of Objection.<sup>38</sup> However, “all due dispatch” has been interpreted to include a delay of up to eight years where the delay can be reasonably justified.<sup>39</sup>

The potential results are striking. For example, where a transaction involving the disposition of taxable Canadian property occurs on January 1, the non-resident that has disposed of the treaty-exempt property is required to wait until January 1 of the following year before it can even file a tax return and begin the process of obtaining a refund of any amounts withheld and remitted by the purchaser. If the CRA can establish reasonable grounds for not assessing, it can delay for years before issuing an assessment and refunding the withheld amount.

This is not mere conjecture. In *Merlis Investments Ltd. v. M.N.R.*,<sup>40</sup> a non-resident corporation had disposed of taxable Canadian property in November 1998. The non-resident corporation sought a certificate, but, in December 1998, the CRA indicated that it would not issue the certificate. The purchaser remitted approximately \$5 million in accordance with the requirements of section 116. In March 1999, the non-resident corporation filed a tax return and claimed a refund of the entire remitted amount. As of September 2000, the CRA had still not assessed the taxpayer or refunded the amount withheld. The taxpayer brought an application for judicial review of the CRA's failure to assess “with all due dispatch” under subsection 152(1). The FC held that the CRA's delay had not been unreasonable (there was evidence that the CRA was considering applying the general anti-avoidance rule in section 245) and dismissed the judicial review application.<sup>41</sup>

The potential for significant economic prejudice being visited on a taxpayer is evident in *Merlis* and, we suggest, could now be more likely after *RCI Trust*. In situations like the *RCI Trust* case, this would mean the Trust would be denied 25% of the purchase price (approximately \$36 million) for at least one year, even if the CRA ultimately concludes that no Canadian tax is owing. Thus, can the option to file a tax return be considered an adequate remedy?

## Conclusion

The law in Canada in respect of the residence of certain trusts is in flux. *Garron* established a new test for determining the residency of a trust, and the appeal of that case has not yet been heard. Further, proposed section 94 of the Act is administered by the CRA in a manner as though it had the force of law, but, in *Perry*, the FCA has stated that taxpayers cannot seek judicial review of a decision in respect of the proposed provisions because they have not yet been enacted. And the result of the decision in *RCI Trust* appears to be that taxpayers are now entirely prohibited from seeking judicial review of the CRA's decision (or refusal) to issue a Certificate because there will always be the possibility that a taxpayer may file an income tax return and contest the CRA's resulting assessment.

In our view, these technical hurdles – the requirements of section 116 and now the requirement to file a tax return – are clear examples of the procedural difficulties that many foreign investors have voiced as key reasons as to why they may hesitate to make investments in Canada.

## Notes:

- <sup>1</sup> 2010 DTC 5013 (FCA), rev'g 2009 DTC 6066 (FC).
- <sup>2</sup> *Agreement Between Canada and Barbados for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital* (22 January 1980).
- <sup>3</sup> R.S.C. 1985 (5th Supp.) c. 1. All statutory references herein are to the Act.
- <sup>4</sup> R.S.C. 1985, c. C-44.
- <sup>5</sup> "Taxable Canadian property" is defined in subsection 248(1) of the Act and includes, *inter alia*, real property in Canada, certain property used in carrying on a business in Canada, and certain shares of corporations that are not listed on certain public stock exchanges or which own taxable Canadian property.
- <sup>6</sup> The 25% rate of withholding is increased to 50% for certain types of property. See subsections 116(5.2) and (5.3).
- <sup>7</sup> The amount withheld is credited against any Part I tax liability of the Vendor.
- <sup>8</sup> Subsection 116(5).
- <sup>9</sup> "Procedures concerning the disposition of taxable Canadian property by non-residents of Canada – Section 116" (15 March 2005). See specifically paras. 25–29.
- <sup>10</sup> In 2008, section 116 was amended to exclude certain transactions from the reporting and withholding requirements for dispositions of property where the gain in question is treaty-exempt. These amendments apply to dispositions of taxable Canadian property that occur on or after January 1, 2009.
- <sup>11</sup> R.S.C. 1985, c. F-7.
- <sup>12</sup> See subsections 116(6) and (6.1).
- <sup>13</sup> Section 94 addresses the residence of certain trusts. Additionally, in 1999, the Canadian government proposed significant amendments to section 94, the effect of which would be to deem certain non-resident trusts to be resident in Canada where a Canadian resident has transferred or loaned property to a non-resident trust. The provisions have never been enacted, but the CRA has administered the Act as though the proposed provisions have the force of law. At the 2009 Canadian Tax Foundation Conference, the Department of Finance indicated that it expected that the revised draft legislation on proposed section 94 would be included in the 2010 federal Budget.
- <sup>14</sup> For a discussion of the FC decision see John Unger, "The Case of *Morris v. MNR: Dual Residency, Treaty-Exempt Property and Section 116 Certificates*", *CCH International Tax*, Report #47, August 2009.
- <sup>15</sup> See Information Circular IC-72-17R5, *supra*.
- <sup>16</sup> This would include *indicia* of actual physical presence and not simply deemed residence.
- <sup>17</sup> 2007 DTC 5365 (SCC).
- <sup>18</sup> See also *Ogden Palladium Services (Canada) Inc. v. Canada* (2001 DTC 345 (TCC)), *aff'd* 2002 DTC 7378 (FCA), *Domtar Inc. v. Canada* (2009 FCA 218), *Reza v. Canada* ([1994] 2 S.C.R. 394), and *Chrysler Canada Inc. v. Canada* (2008 DTC 6452 (FC), *aff'd* 2008 DTC 6654 (FC)).
- <sup>19</sup> See, for example, *M.N.R. v. Parsons*, 84 DTC 6345 (FCA) and *Addison & Leyen Ltd.*, *supra*.
- <sup>20</sup> *Tax Court of Canada Act*, R.S.C. 1985, c. T-2, at section 12.
- <sup>21</sup> See section 18.5 of the *Federal Courts Act*. See also section 169 of the Act. See also *Parsons*, *supra*, and *Addison & Leyen Ltd.*, *supra*.
- <sup>22</sup> Subsections 27(1.1) and (1.2) of the *Federal Courts Act*, *supra*.
- <sup>23</sup> See subsection 18.1(4) of the *Federal Courts Act*, *supra*.
- <sup>24</sup> 51 C.P.R. (3d) 339, 18 Admin. L.R. (2d) 122, 69 F.T.R. 152 (FCA), *aff'd* [1994] 3 S.C.R. 1100. See also *Djokich v. Canada (Attorney General)*, 95 DTC 5623 (FC); *Bumet v. Minister of National Revenue*, 97 DTC 5346 (FC); *Nautica Motors Inc. v. Minister of National Revenue*, 2002 GTC 1145 (FC); *Re Humby Enterprises Ltd.*, 2007 DTC 5729 (FCA); and *Zins v. Canada Revenue Agency*, 2008 DTC 6057 (FCA).
- <sup>25</sup> 78 DTC 6376 (FC).
- <sup>26</sup> "Residence of a Trust or Estate" (30 May 1980).
- <sup>27</sup> 2009 DTC 1568 (TCC). See also Heather Evans, Marsha Reid, and Hamid Djebelli, "*Garron: Barbados or Canadian Trust?*", *CCH International Tax*, Report #48, October 2009.
- <sup>28</sup> Court File No. A-419-09. As of the publication of this article no hearing date had yet been set.
- <sup>29</sup> 2008 DTC 6623 (FCA), *aff'g* 2007 DTC 5625 (FA). See also Timothy Fitzsimmons, "Too Late and Too Early: No Relief for NRTs", *Tax Topics*, No. 1915, November 20, 2008.
- <sup>30</sup> *Canada–United States Convention with Respect to Taxes on Income and on Capital signed at Washington on September 26, 1980, as amended by the Protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007*.
- <sup>31</sup> We note that prior to 1998 paragraph 150(1)(a) was almost identical to the current paragraph 150(1)(c).
- <sup>32</sup> See the CRA's T3 Guide (T4013) (2009).
- <sup>33</sup> 86 DTC 6601 (FCA). See also *Office Overload Co. v. M.N.R.*, 65 DTC 690 (Tax A.B.); *Lea-Don Canada Ltd. v. M.N.R.*, 70 DTC 6271 (SCC); *Allied Farm Equipment Ltd. v. M.N.R.*, 73 DTC 5036 (FCA); *The Queen v. Canadian Pacific Ltd.*, 77 DTC 5383 (FCA); and *Oceanspan Carriers Ltd. v. The Queen*, 87 DTC 5102 (FCA).
- <sup>34</sup> See also subsection 227(10), which states, *inter alia*, that where an amount is owing by a resident of Canada under Part XIII (tax on

non-resident's income from Canada) the CRA may assess the taxpayer at any time and in such a case certain additional provisions apply, including subsection 152(7).

<sup>35</sup> Generally, section 160 imposes a tax liability on a person (the transferee) where the person has received property from a non-arm's length person (the transferor) for less than fair market value and the transferor has a tax liability at the time of the transfer.

<sup>36</sup> 2006 DTC 6248 (FCA).

<sup>37</sup> Subsection 152(1).

<sup>38</sup> Subsection 165(3).

<sup>39</sup> See, for example, *Ginsburg v. The Queen*, 96 DTC 6372 (FCA); and *Hutterian Brethren Church of Wilson v. The Queen*, 79 DTC 5052 (FC), aff'd 79 DTC 5474 (FCA), where the Court held that a delay of eight years fell within the ambit of assessing "with all due dispatch".

<sup>40</sup> 2000 DTC 6634 (FC).

<sup>41</sup> Interestingly, the FC noted that the CRA had assured it that the assessment would be issued forthwith, and the FC went so far as to say that it expected that the assessment would be issued within 30 days of the decision. This was likely cold comfort to the taxpayer.