CANADIAN TAX Highlights

Editor: Vivien Morgan, JD

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No Forex Gain on US-Dollar Debenture Conversion

The recent fluctuation in the value of the Canadian dollar relative to the US dollar is likely to make the tax treatment of foreign exchange gains and losses relevant for many Canadian taxpayers. The FCA decision in *Agnico-Eagle Mines Limited* (2016 FCA 130) allowed the Crown's appeal of the TCC decision (2014 TCC 324) and took an unorthodox approach in suggesting that the conversion of US-dollar-denominated convertible debentures into common shares did not result in the issuer's realization of a capital gain from currency fluctuation on the debt settlement. The decision suggests that the conversion may trigger a capital loss because the shares issued on the conversion had a higher Canadian-dollar value.

Under the general rule in subsection 261(2), a Canadian taxpayer must compute its tax in Canadian dollars (paragraph 261(2)(a)). An amount in another currency must be converted into Canadian dollars at the relevant spot rate "for the day on which the particular amount arose" (paragraph 261(2)(b)). If a taxpayer has "made a gain" or "sustained a loss" "because of any fluctuation" in foreign currency, that gain or loss is deemed (subsection 39(2)) to be on account of capital from the disposition of foreign currency (unless otherwise included in income under paragraph 3(a)).

The scope of subsection 39(2) is problematic: Parliament may not have originally intended that the provision apply to the settlement of liabilities. However, the provision is now generally considered to apply if a fluctuation in the value of the foreign currency results in a difference between the Canadian-dollar amount received from a borrowing and the Canadian-dollar amount paid to settle the indebtedness.

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CTF CANADIAN TAX FOUNDATION
FCF FONDATION CANADIENNE DE FISCALITÉ

A complication arises if the foreign-currency-denominated debt is settled by the issuance of shares. In 2002, Agnico issued US-dollar-denominated convertible debentures, whose aggregate Canadian-dollar amount was then about Cdn$228 million. Each debenture carried an annual interest rate, had a principal amount of US$1,000, and was redeemable at Agnico's option (for cash or a number of shares determined at the time of redemption) or converted at the holder's option to 71.429 common shares. In December 2005, Agnico announced that it would redeem all outstanding debentures on February 15, 2006 by the issuance of 63.4767 common shares per debenture (in lieu of cash). Obviously, most holders chose to exercise their option to convert each debenture into 71.429 shares prior to February 15, 2006. Due to an increased share value, the aggregate value of the shares issued on conversion was about Cdn$280 million, but a decline in the value of the US dollar relative to the Canadian dollar decreased the value of the principal amount of the extinguished debentures to about Cdn$166 million. The CRA assessed Agnico as having realized, under subsection 39(2), an aggregate capital gain of Cdn$62 million—that is, the difference between the debentures' principal at the times of issuance and extinguishment (Cdn$228 million less Cdn$166 million).

The TCC concluded that no capital gain arose on a conversion: that conversion merely completed the subscription for shares that arose when the debentures were originally issued. Thus, the foreign exchange gain should be computed by determining the Canadian-dollar value of the share subscription price (considered to be US$1,000) at the time when the debentures were originally issued and not at the time of conversion. The two amounts were measured on the same day, and thus Agnico did not realize a gain on the conversion. However, the TCC concluded that Agnico realized a gain on the few debentures that were redeemed (rather than converted): the number of shares issued "in satisfaction of the Redemption Price" was not determinable until the time of redemption, and the conversion rate at that time should apply.

The Crown appealed to the FCA. The FCA unanimously concluded that the TCC's interpretation of the debenture terms adopted two "different, and mutually irreconcilable, characterizations" of the debentures and that the "*ex post facto* characterization [was] the [result] of legal error" in which the FCA must intervene.

On the basis of its interpretation of the debenture terms and conditions, the FCA concluded that, on issuance, each debenture represented an indebtedness of Agnico that could be extinguished by repayment (1) in full at maturity; (2) in full at Agnico's option, by redemption; or (3) at the holder's option,

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by conversion. On conversion, the indebtedness was extinguished by the issuance of a fixed number of shares "to fully satisfy [Agnico's] obligation to repay the [principal]."

The FCA concluded that one should determine Agnico's capital gain (if any) by comparing (1) the Canadian-dollar equivalent of the debenture issue price with (2) the Canadian-dollar equivalent of the consideration given by Agnico to extinguish the debt using the spot rate relevant when the debentures were converted. In determining the second amount, the FCA, surprisingly, used not the debentures' principal amount but rather the value of the shares issued by Agnico on conversion, determined by a formula based on the shares' trading price. Although this formula was applicable under the debenture in a different context, the FCA said that "it may be readily inferred that the parties intended that this formula would apply equally to the determination of the quantum of the balance of the Repayment Amount that was paid by the issuance of a whole number of Common Shares upon each Conversion"; that inference is quite remarkable because it involved the FCA's rejection of both the Crown's and Agnico's position that the repayment amount was US$1,000.

Although not expressly stated in the decision, the logical consequence of the FCA's computational approach was that Agnico realized a capital loss on the debentures' conversion. Because the issue on appeal was limited to whether Agnico made a gain as the result of currency fluctuations, the FCA did not comment on whether there was a loss. The FCA merely concluded that no gain arose and referred the matter to the minister for reassessment in accordance with its reasons.

The FCA decision raises a number of interesting questions. The TCC suggested that Agnico suffered an economic loss because it issued shares worth more than the amount that it had received on the debenture issue. The FCA reasons suggest that that economic loss may be a loss for tax purposes. That conclusion is questionable, and it is also questionable whether Agnico suffered an economic loss at all as opposed to a dilution in share value suffered by the other common shareholders. For tax purposes, a corporation cannot realize a capital loss on its issue of shares: that event is specifically excluded from a disposition of property under subsection 248(1)—and that loss is also not deductible under paragraph 20(1)(f) (*Imperial Oil Ltd.* 2006 SCC 46). The FCA reasoning also suggests that Agnico's PUC should increase by the issued shares' FMV rather than by the amount of the liability extinguished (the debentures' principal) on the share issue: that approach is problematic under corporate legislation and may trigger a deemed dividend under subsection 84(1).

Given all of these concerns, it is unfortunate that the Crown did not seek leave to appeal. It remains to be seen whether Finance may consider legislative intervention.

Daniel Sandler and Ilia Korkh
EY Law LLP, Toronto and Vancouver

Tax Treaty Interpretation: TCC

The Canadian approach to treaty interpretation was established by the SCC in *Crown Forest Industries Ltd.* ([1995] 2 SCR 802). The TCC recently applied these interpretive principles in *Société générale valeurs mobilières inc.* (2016 TCC 131, *SGVM*), which involved the determination of the maximum Canadian foreign tax credit (FTC) allowable under the Canada-Brazil tax treaty.

Tax treaties are negotiated agreements between sovereign states. They are generally relieving in nature because they aim to prevent or avoid double taxation. Treaty language tends to be more general or abstract than the detailed technical wording often found in domestic tax legislation. The drafting style of treaties is necessary because the treaty is superimposed on two, often very different, national tax systems. Thus, treaty interpretation requires a more liberal approach whose purpose is to implement the parties' true intentions.

The taxpayer in *SGVM* was a Canco that earned interest on bonds issued in Brazil. The taxpayer claimed an FTC in Canada on the basis that the maximum credit available under treaty article XXII(2) equalled the Canadian tax rate multiplied by the gross amount of the Brazilian bond interest, not net of expenses incurred to earn the interest. The minister reassessed: the treaty limited the FTC to the actual Canadian tax payable on the net interest income derived from Brazil after expenses. The taxpayer appealed to the TCC. The Crown moved for a determination of certain questions of law under section 58(1) of the Tax Court of Canada Rules (General Procedure). These questions focused on interpreting the amount of Canadian income tax "appropriate to the income which may be taxed in Brazil" in order to establish a maximum Canadian FTC under treaty article XXII(2).

Article XXII, titled "Methods for the Elimination of Double Taxation," contains a generous tax-sparing provision. Article XXII(3) deems Brazilian tax to have been paid at 20 percent of the gross amount of interest arising in Brazil, even though article XI fixes the upper limit of Brazilian withholding tax on interest at 15 percent. The deeming rule in article XXII(3) applies solely for the purposes of determining a Canadian resident's FTC claim under article XXII(2). Generally, Canada must grant an FTC for any income tax actually or deemed paid in Brazil. However, article XXII(2) adds a further caveat: that the Canadian FTC cannot "exceed that part of the income tax as computed before the deduction is given, which is appropriate to the income which may be taxed in Brazil." These provisions depart from the standard wording in Canada's tax treaties with respect to a Canadian resident's FTC entitlement, and the Crown sought clarification in *SGVM* of the provisions' proper scope and application.

The TCC acknowledged the SCC approach in *Crown Forest* and the general rule for treaty interpretation in article 31(1)

of the Vienna Convention, which states that a treaty must be interpreted in good faith in accordance with the ordinary meaning given to the terms of the treaty in their context and in light of the treaty's object and purpose. The TCC also referred to section 3 of the Income Tax Conventions Interpretation Act, which provides that an undefined term in a tax treaty has the meaning that it has for the purposes of the Income Tax Act, except to the extent otherwise required by the context. The court observed that article III(2) of the Canada-Brazil treaty contains a similar provision.

Applying these interpretive principles, the TCC considered the plain language of article XXII(2) of the Canada-Brazil treaty. For the most part, the text of that provision was clear and its meaning was not in dispute. However, the phrase "that part of the income tax . . . which is appropriate to the income which may be taxed in Brazil" was in contention. The TCC focused on determining the plain meaning of the word "appropriate," referencing both the French and Portuguese versions of the text and various dictionary meanings, and the court agreed with the Crown that the word in this context suggests a correlation between the Canadian income tax and the income from Brazil. Thus, the amount of income tax relating to the Brazilian income must form part of the Canadian tax otherwise payable by the taxpayer as computed under the Income Tax Act and before the FTC's application. This textual interpretation leads to the conclusion that article XXII(2) limits the FTC amount to the actual Canadian tax payable on the Brazilian income, which would be calculated on a net basis under Canadian domestic law even though Brazil may tax gross interest income.

The TCC then undertook a contextual analysis of article XXII(2). The taxpayer had argued that the treaty drafters deliberately chose to deal with gross interest income without deduction for related expenses; this approach was reinforced by the gross income concept in articles XI(2) and XXII(3). The taxpayer also pointed out that the Canada-Brazil treaty is Canada's only tax treaty that does not incorporate by reference the FTC rules in Canadian domestic legislation; all of Canada's other treaties make the available Canadian FTC subject to domestic rules. The TCC reasoned, however, that the treaty's allowing Brazil to tax certain interest income on a gross basis did not mean that the treaty drafters also intended for the Canadian FTC on Brazilian income to be calculated the same way. The TCC also said that article XXII(2) referred to Canadian "income tax" and that "it would undoubtedly [have] been known to the drafters that Canadian income tax is calculated net of applicable expenses." For a departure from this basic concept of Canadian tax law, according to the court, "clear language to that effect would have been required." Thus, the reference to Canadian income tax in article XXII(2) imported the income computation rules from part I of the Income Tax Act.

The TCC then considered the purpose of article XXII(2) that was intended by the treaty drafters. The tax-sparing provision in article XXII(3), which deemed a 20 percent Brazilian tax to have been paid on gross interest income derived from Brazil, was relevant to the ascertaining of this purpose. The TCC agreed that the tax-sparing provision preserved tax incentives offered by Brazil on interest income. However, it was "unlikely that the tax sparing provision was intended . . . to shelter not only Brazilian interest income from Canadian tax, but income from other sources unrelated to Brazil as well." In the TCC's view, the result of the taxpayer's interpretation would go beyond tax sparing and amount to an additional incentive on Canada's part to invest in Brazil. Absent clear language to that effect, the TCC was not convinced that the treaty drafters intended that article XXII(2) operate in this fashion.

Moreover, the TCC referred to the 1977 OECD model treaty and commentaries for further interpretive guidance. The taxpayer had argued that these extrinsic materials should not be considered because there was no inherent ambiguity in the treaty's text and because Brazil was not an OECD member. However, the TCC affirmed that *Crown Forest* was authority for accepting model treaties and their official commentaries in the absence of a textual ambiguity. The TCC said that the 1977 OECD model treaty was a globally recognized, highly persuasive document of reference in the negotiation, interpretation, and application of tax treaties. The court also observed that the language in article XXII(2) of the Canada-Brazil treaty was very similar to the language in article 23B of the 1977 OECD model treaty: although Brazil was not an OECD member, the 1977 OECD model treaty had evidently been considered in the drafting of the Canada-Brazil treaty. The TCC therefore said that it was appropriate to consider the commentaries on article 23B of the 1977 OECD model treaty in support of the Crown's position that article XXII(2) of the Canada-Brazil treaty intended to provide an FTC equal to the actual Canadian tax paid and not provide a full credit for all Brazilian tax actually or deemed paid on interest arising in Brazil.

On the basis of textual, contextual, and purposive analyses, the TCC concluded that the limitation described in article XXII(2) restricts the Canadian FTC to the actual Canadian income tax paid on the net interest income derived from Brazil. The TCC said that the treaty drafters had left it open to Canada to determine the calculation of net income and that the treaty should not oust domestic law if the two are not inconsistent. Thus, the TCC concluded that subsection 4(1) of the Income Tax Act contained the proper test for determining amounts included in or deducted from gross interest income arising in Brazil.

This provision is unique to the Canada-Brazil treaty, and thus the TCC conclusions on the legal questions posed may not have broad implications. However, the case remains a

good exercise in tax treaty interpretation. The taxpayer has appealed to the FCA, and further refinement of the interpretive approach may be forthcoming.

Albert Baker
Deloitte LLP, Toronto

Sara McCracken
Deloitte Tax Law LLP, Vancouver

Foreign Taxes Paid in US LLC Structure: CRA Reversal

A 2015 technical interpretation (2014-0560371I7, December 15, 2015) confirms that a Canadian-resident individual (Ms. X) is entitled to a deduction under subsection 20(12) for the US tax she paid on business income earned by a US limited liability company (LLC). Similarly, a 2016 TI concerning a different LLC structure (2015-0572461I7, March 7, 2016) confirms that the taxpayer (Ms. Y) is entitled to a subsection 20(12) or 20(11) deduction for US tax on the LLC's business income paid by a US limited partnership in the structure. These TIs appear to reverse the CRA's position in two earlier TIs and to accept the TCC findings in *FLSmidth Ltd.* (2012 TCC 3; aff'd 2013 FCA 160).

Generally, section 126 allows foreign tax credits (FTCs) for two types of foreign tax: business-income tax and non-business-income tax. These terms are defined by reference to subsections 20(11) and (12), and thus the definitions must be read in conjunction with these provisions. "Business-income tax" is an income or profits tax, paid by a taxpayer for the relevant year to a foreign country, which can reasonably be regarded as paid on income from a business carried on by the taxpayer in a foreign country. "Non-business-income tax" is generally defined to mean an income or profits tax paid by the taxpayer for a taxation year to a foreign country if the tax meets all three of the following criteria: (1) it is not included in business-income tax; (2) it is not deductible under subsection 20(11) (regardless of whether it is actually deducted under subsection 20(11)); and (3) it is not deducted under subsection 20(12).

When computing his or her income from a foreign property (other than real property), the individual may, under subsection 20(11), deduct income or profits tax paid to a foreign country to the extent that it exceeds 15 percent of the foreign property income. To be deductible, the foreign tax must be reasonably regarded as paid "in respect of" an amount included in an individual's income from property for the year. The definition of "non-business-income tax" in conjunction with subsection 20(11) effectively limits an individual's foreign non-business-income tax credit under paragraph 126(1)(a) to 15 percent of the related foreign property income. The balance of the foreign tax related to the foreign property income is deductible by the individual under subsection 20(11).

Generally, subsection 20(12) allows any taxpayer resident in Canada (not just an individual) to claim a deduction from business or property income for foreign non-business-income tax paid by the taxpayer for the year in respect of that income. (No deduction is allowed for tax reasonably regarded as paid by a corporation in respect of income from an FA share.) A taxpayer may choose between claiming an FTC and a subsection 20(12) deduction: the former is generally preferable, but it may not be available. Unlike subsection 20(11), subsection 20(12) does not require that foreign property income be included in the taxpayer's income for the year when a deduction is claimed; having only a source of foreign property income is sufficient.

Both TIs consider an individual taxpayer who is resident in Canada (Ms. X and Ms. Y, respectively) and who owns an indirect interest in a US limited liability company (the US LLC) that earns active business income. In the 2015 TI, Ms. X's ownership of the US LLC is structured through a Canadian unlimited liability company (ULC), which owns an interest in a US limited liability company (Holding LLC), which owns the US LLC. ULC is treated as a Canadian-resident corporation for Canadian income tax purposes, but it is a partnership for US tax purposes. For Canadian tax purposes, Holding LLC and the US LLC are treated as non-resident corporations and are disregarded for US tax purposes.

Because the US LLC in the 2015 TI made no income distributions, Ms. X reports no income for Canadian tax purposes. However, Ms. X paid US federal income tax on her indirect share of the US LLC's active business income (ABI) as a ULC shareholder, because the partnership income reported for US purposes by ULC is allocated and taxed to the ULC members. The CRA is of the view that there is a logical connection between the US tax paid by Ms. X and the potential income that she could earn on her ULC shares. Thus, the CRA says that the foreign taxes are considered to be "in respect of" that income, a phrase in subsection 20(12) that does not require the foreign tax to be paid on the taxpayer's income from business or property.

In the 2016 TI, Ms. Y owns an interest in a Canadian limited partnership (LP), which in turn owns an interest in a US limited partnership (USLP), which owns the interest in the US LLC. USLP elected to be treated as a corporation for US tax purposes. Because, for US tax purposes, the US LLC is a disregarded entity and USLP is treated as a corporation, USLP pays US tax on income earned by the US LLC. For Canadian tax purposes, distributions made by the US LLC to USLP (treated as a partnership by Canada) are dividends that are subsequently allocated by USLP to LP and ultimately to Ms. Y. The US tax paid by USLP is also allocated to Ms. Y.

In the 2015 TI, because the US LLC did not distribute its income through to Ms. X, the issue is whether Ms. X is entitled to a deduction under subsection 20(12) for the US taxes paid by her. (On the facts in the 2015 TI, Ms. X would not be permitted to deduct any amount under subsection 20(11) because

she does not include any amount of foreign property income in her income for the taxation year.) In the 2016 TI, income is earned and distributed by the US LLC. For Canadian tax purposes, the income is treated as dividends, and successive partnerships are interposed: the issue is whether Ms. Y is entitled to deductions under subsection 20(11) or (12) for the US tax paid by USLP and allocated to her. In both TIs, the main consideration is whether the tax is "in respect of" the taxpayer's foreign-source property income. The 2015 TI says that all the conditions in subsection 20(12) are met and that Ms. X may deduct under subsection 20(12) the US tax paid by her. The 2016 TI briefly confirms that Ms. Y may deduct under subsection 20(11) or (12) the US tax paid by USLP on income earned by the US LLC and allocated to her.

The 2015 TI comments are more comprehensive. That TI concludes that Ms. X may claim a subsection 20(12) deduction because (1) she has a source of income for Canadian tax purposes (the ULC shares), and this deduction does not require that an amount actually be received from the source; (2) she paid tax to the United States; (3) the tax that she paid is not related to any business carried on by her and is thus non-business-income tax; and (4) the US tax paid was paid by an individual and not by a corporation in respect of income from an FA's share.

In considering whether the "in respect of" condition under subsection 20(12) is met, the CRA refers to the TCC decision in *FLSmidth*, which said that the phrase should be interpreted broadly: the foreign tax need not be paid on the taxpayer's income from business or property. The TCC said that a subsection 20(12) deduction is available if the foreign tax paid is "connected with or related to" the taxpayer's income from a business or property. The 2015 TI says that the deduction is in respect of Ms. X's income sourced to her shares in ULC: there is a logical connection between the two because she would not have had to pay tax to the United States if she had not owned the shares.

In the 2016 TI, the CRA confirms that Ms. Y is entitled to a deduction under subsections 20(11) and/or (12) for the US tax paid by USLP in respect of income earned by the US LLC. More generally, the CRA states that a partner's "non-business income tax . . . paid to . . . a foreign country" includes the partner's share of any non-business-income tax paid to that country by the partnership. That position confirms the CRA's longstanding treatment of foreign taxes paid by a partnership (originally stated in *Interpretation Bulletin* IT-183, October 28, 1974, now replaced by *Income Tax Folio* S5-F2-C1).

As a result, a Canadian-resident partner should be entitled to an FTC under subsection 126(1) or to a foreign tax deduction under subsection 20(11) or (12), for its share of non-business-income tax paid by the partnership, provided that all other conditions for these provisions are satisfied. The CRA supports its views in the 2016 TI by also referring to the TCC findings in *FLSmidth*, but it does not cite a specific portion of the decision.

Michael Pereira
KPMG LLP, Toronto

Contract Manufacturing in a US-Controlled Group

A Canadian tax adviser must be wary when a Canco that is owned by a US shareholder contracts with a related manufacturer to sell goods outside Canada. Recognition of the sales income may be deferred for Canadian tax purposes by placing the sales function outside Canada, but such deferral may be blocked for US tax purposes by US anti-deferral rules.

Assume that a New York private equity (PE) partnership is the sole shareholder of a Canco distributor, which is the sole shareholder of a Chinese manufacturer (Chinaco). Canco contracts with Chinaco to manufacture widgets and sells some widgets to US customers. This is not an unusual fact pattern, but the tax consequences may be less than ideal. Unless an exception applies under US tax law, the partners of the New York PE firm realize taxable income from widget sales to US customers. The inclusion occurs as and when Canco generates the income: US tax is imposed on those partners of the New York PE even if Canco does not make distributions. The same result follows for sales to customers in any non-China location.

If a foreign corporation is a controlled foreign corporation (CFC) for at least an uninterrupted 30 days in any taxable year, a US shareholder must include in its gross income a pro rata share of the CFC's subpart F income for the year. A Canco is a CFC if on any day during its taxable year its US shareholder(s) owns more than 50 percent of (1) the total combined voting power of all classes of stock entitled to vote, or (2) the total value of the Canco's stock.

For this purpose, a US shareholder is a US person—including a US domestic partnership—that owns directly, indirectly, or constructively at least 10 percent of the combined voting power of all classes of stock entitled to vote. Indirect ownership exists through a non-US corporation, partnership, or trust. Constructive ownership means actual or deemed ownership by a related party, such as a spouse or parent, or by the holding of a purchase option.

Assume that the Canco is wholly owned by the New York PE firm for the entire year and that the Canco is thus a CFC to which subpart F rules apply. The New York PE firm must include in its gross income its pro rata share of Canco's subpart F income, thus triggering taxable income for the firm's US partners.

One kind of subpart F income is foreign base company (FBC) sales income, and the underlying rule was designed to

prevent the artificial shifting of sales income between related parties. When subpart F was first enacted in the 1960s, Congress and the administration were concerned about manufacturing operations that were typically in high-tax jurisdictions but whose distribution operations may be located in low-tax jurisdictions such as the Bahamas or Switzerland. Separating the sales and manufacturing functions allowed the elimination of global tax. In a sense, subpart F was a BEPS precursor.

FBC sales income arises only if (1) the CFC is involved in the sale of tangible personal property between related parties based in different countries (Chinaco and Canco, in the example above), and (2) the property is both manufactured and sold for use outside the CFC's country of incorporation (which, in the example above, means that the property is manufactured outside Canada). The income can be the net margin from a sale or a fee for arranging the purchase or sale of inventory.

FBC sales income does not include income from a CFC that buys from and sells to unrelated persons (acting as an independent distributor), that buys and sells inventory manufactured in its country of incorporation (in the example above, Canada), that manufactures the property in country A and sells it in the same country (the manufacturing exception—see further requirements below), or that conducts manufacturing and sales operations in two or more countries whose effective tax rates are broadly comparable. In general, taxes are comparable if the effective tax rate in the country where a sales base is located (calculated by the actual tax paid) is (1) at least 90 percent of the effective rate of tax in the manufacturing country (determined by rates applicable to the same income) or (2) greater than, equal to, or less than 5 percentage points lower than a hypothetical rate.

In the example above, the New York PE firm includes in its gross income the earnings and profits that arise from trading profits from Canco widget sales to US customers (sales, less cost of goods sold, less deductible expenses computed under US tax concepts), and each partner pays tax on its respective distributive share of those earnings. In comparison, because Chinaco manufactured the widgets from a base in China, none of Chinaco's profits give rise to US tax exposure under subpart F.

Activities that qualify for the manufacturing exception must be carried out by the CFC's employees, as defined in the Code. If an employee is shared, the degree of control that exists over the individual when he or she performs the services—a question of fact—determines whether the person is an employee of the CFC. Case law concludes that more than one service recipient can exercise control over the same individual. In addition, for the manufacturing exception to be satisfied, the CFC must meet one of three tests: (1) a "substantial transformation" test, (2) a "substantial assembly" test, or (3) a "substantial contribution" test.

Under the substantial transformation test, a CFC manufactures goods if it purchases goods and then transforms them before the sale—for example, by purchasing wood pulp that is transformed into paper. Under the substantial assembly test, a CFC manufactures goods if it assembles purchased component parts into property that is later sold. To satisfy this test under a safe harbour, the cost to the CFC of converting the property must account for at least 20 percent of the total cost of the goods sold; qualified costs include direct labour and factory burden costs, but they exclude packaging costs.

Under the substantial contribution test, a CFC manufactures goods if its employees make a substantial contribution to the manufacturing process by performing important non-physical manufacturing activities, including the following:

- oversight and direction of the physical manufacturing activities or process;
- material selection, vendor selection, or control of the raw materials, work-in-process, or finished goods;
- management of manufacturing costs or capacities;
- control of manufacturing-related logistics;
- quality control; and
- development of or directing the use or development of intellectual property for the purpose of manufacturing, producing, or constructing the personal property.

Under the substantial contribution test, the CFC employees do not need to directly perform transformation or assembly activities.

In the example above, Canco does not satisfy either the substantial transformation or the substantial assembly tests because Chinaco, not Canco, actually manufactures the widgets. However, Canco's employees may carry on oversight, material selection, and control of manufacturing-related logistics, and factually those functions may amount to a substantial contribution to the manufacture of the property. The presence or absence of any factor is not determinative, and the weight accorded to the performance of any activity depends on the importance of that activity to the particular business.

Income that is subject to a foreign tax rate greater than 90 percent of the maximum US corporate tax rate (currently 35 percent) is not considered to be subpart F income. The section is elective and applies separately to each item of income received by the CFC. Thus, in the example above, if the effective rate of Canadian tax is at least 31.5 percent on an item of income, the US shareholders are not subject to tax on FBC sales income. Assuming that income and expense are computed under comparable rules for Canadian and US tax purposes, the actual effective rate of Canadian federal and provincial corporate taxes on active income is approximately 26-27 percent, depending on the province: thus, the Canadian effective tax rate may not be comparable.

Documenting the substantial assembly and substantial transformation activities can be relatively straightforward. To promote compliance with the substantial contribution test, the

practitioner should advise his or her Canco client to keep records identifying each employee, the employee's duties within the company's hierarchy, and the relative level of oversight and direction that the employee provides to the contract manufacturer. Each affected employee should keep detailed calendars, journal entries, oversight procedures, e-mails, followup reports, and agenda visits to document each time that he or she provides assistance to the manufacturing counterpart(s).

Kenneth Lobo and Stanley C. Ruchelman
Ruchelman PLLC, Toronto

Stock Options in Spinout Transactions

Employee stock options are common in many corporations' employee compensation plans, in large part because the Act affords them favourable tax treatment. Options are tax-preferred in several ways.

First, the granting of an option to an employee is not a taxable event, which occurs only when the employee exercises or disposes of the option. Second, the taxable benefit of an option granted by a CCPC may be further deferred until the employee disposes of the shares acquired thereunder. Third, the amount of any taxable benefit realized on the option's exercise or share disposition (in the case of CCPC options) may be reduced by 50 percent if certain conditions are met. The tax effect is similar to how capital gains are taxed. Generally, the taxable benefit arising from the granting of an option is the amount by which the shares' FMV, when the option is exercised or disposed of, exceeds the option's exercise price (less any amount actually paid by the employee to acquire the option).

The 50 percent benefit reduction is available only if the exercise price under the option (plus any amount actually paid by the employee to acquire the option) at least equalled the shares' FMV on the date that the option was granted or, in the case of an option granted by a CCPC, if the employee held the shares for at least two years. Different qualifying criteria exist for obtaining the benefit reduction if the employee disposes of the option.

To qualify for the benefit reduction, the shares acquired under the option must generally be plain vanilla common shares. Detailed requirements are set out in the regulations (the prescribed share rules). The prescribed share rules are complex and contain traps for the unwary. A variety of situations may be of concern, particularly a proposed takeover or merger, because employees usually want to exercise their options and sell the underlying shares to the acquiror.

For example, regulation 6204(1)(b) provides generally that a share does not qualify as a prescribed share (with the result that the employee cannot access the benefit reduction) if the corporation can reasonably be expected to redeem, acquire, or cancel the share within two years of its issue, subject to certain exceptions. The rule can give rise to surprising results in common takeovers, including in the spinouts described below.

In some corporate takeovers, the target corporation spins out certain of its assets to a Newco owned by its existing shareholders, including employees who exercised options. In the oil and gas industry, these transactions are often called Exploreco spinouts. A spinout may be achieved in a variety of ways, including through a section 86 exchange of the Targetco shares by Targetco shareholders for shares to be sold to the acquiror and Newco shares (the share exchange method). A spinout may also involve a return of capital by the Targetco by way of a distribution of the Newco shares to existing shareholders under subsection 84(2) (the return-of-capital method).

There is no apparent policy reason to treat spinout transactions differently depending on whether they are carried out by the share exchange method or the return-of-capital method, but the prescribed share rules appear to treat those transactions differently. The benefit reduction may be denied if the share exchange method is used because the transaction involves a redemption or repurchase of shares issued to the employee that does not appear to fall within any of the exceptions to regulation 6204(1)(b). On the other hand, the benefit reduction should be available to an employee if the return-of-capital method is used because a return of capital in a spinout transaction is specifically excepted from regulation 6204(1)(b).

Despite potentially adverse tax implications, many public takeovers and mergers involving spinout transactions have been structured by the share exchange method rather than the return-of-capital method. Although we are not aware of any CRA challenges to date, we would suggest that until the prescribed share rules are amended (or clarification is publicly announced by the CRA), it would be prudent to seriously consider using the return-of-capital method and not the share exchange method if share options are involved.

John McClure and Brian Kearl
Gowling WLG (Canada) LLP, Calgary

Corporate Rate Update

The federal general (and M & P) rate remains 15 percent for 2016. Provincial general (and M & P) rates increased in Alberta, New Brunswick, and Newfoundland and Labrador for December 31, 2016 year-ends.

The general (and M & P) rate in Alberta increased from 10 percent to 12 percent on July 1, 2015 (implemented by Bill 2, An Act To Restore Fairness to Public Revenue), and in New Brunswick the general (and M & P) rate increased from 12 percent to 14 percent on April 1, 2016 (implemented by Bill 18, An Act Respecting Fiscal Measures). On January 1, 2016, Newfoundland and Labrador increased its general rate from 14 percent to 15 percent (implemented by Bill 15, An Act To Amend the Income Tax Act, 2000 No. 3), and eliminated its M & P deduction: thus, the rate applicable to M & P income rose from 5 percent to 15 percent (implemented by Bill 17, An Act To Amend the Income Tax Act, 2000 No. 5).

Quebec's general (and M & P) rate decreases from 11.9 percent to 11.8 percent on January 1, 2017, to 11.7 percent on January 1, 2018, to 11.6 percent on January 1, 2019, and to 11.5 percent on January 1, 2020 (Quebec has not tabled legislation). The table shows the 2015 and 2016 combined general, M & P, and small business rates.

2015 and 2016 Federal and Combined Corporate Income Tax Rates and CCPC Small Business Taxable Income Thresholds (December 31 Year-Ends)

	General (and M & P)		CCPC small business (and M & P) up to $500,000		CCPC threshold	
	2015	2016	2015	2016	2015	2016
	percent				*dollars*	
Federal	15.00	15.00	11.00	10.50	500,000	500,000
Alberta	26.01	27.00	14.00	13.50	500,000	500,000
British Columbia	26.00	26.00	13.50	13.00	500,000	500,000
Manitoba	27.00	27.00	11.00 or 23.00[a]	10.50 or 22.50[a]	425,000	450,000
New Brunswick	27.00	28.50	15.00	14.12	500,000	500,000
Newfoundland & Labrador	29.00 (20.00)[b]	30.00[b]	14.00	13.50	500,000	500,000
Northwest Territories	26.50	26.50	15.00	14.50	500,000	500,000
Nova Scotia	31.00	31.00	14.00 or 27.00[a]	13.50 or 26.50[a]	350,000	350,000
Nunavut	27.00	27.00	15.00	14.50	500,000	500,000
Ontario	26.50 (25.00)	26.50 (25.00)	15.50	15.00	500,000	500,000
Prince Edward Island	31.00	31.00	15.50	15.00	500,000	500,000
Quebec	26.90	26.90	19.00 (15.49)[c]	18.50 (14.50)[c]	500,000	500,000
Saskatchewan	27.00 (25.00)	27.00 (25.00)	13.00	12.50	500,000	500,000
Yukon	30.00 (17.50)	30.00 (17.50)	14.00 (12.50)	13.50 (12.00)	500,000	500,000

[a] The lower rate applies as follows: (1) in Manitoba, to a CCPC's ABI up to $425,000 in 2015 and $450,000 in 2016; and (2) in Nova Scotia, to a CCPC's ABI up to $350,000 in 2015 and 2016. The higher rate applies to ABI above these thresholds and up to $500,000.

[b] Newfoundland and Labrador eliminated its M & P deduction on January 1, 2016; thus, the general and M & P rates are the same starting in 2016.

[c] Quebec's CCPC M & P rate applies to all ABI up to $500,000 if 50% or more of the CCPC's activities are attributable to M & P (based on M & P asset and labour costs). If less than 50% but more than 25% of the CCPC's activities are attributable to M & P, then the tax rate increases proportionately (straight line). If the M & P percentage is 25% or less, the combined rates are 19.00% in 2015 and 18.50% in 2016.

The federal small business rate decreased from 11 percent to 10.5 percent on January 1, 2016 (implemented by Bill C-59, An Act To Implement Certain Provisions of the Budget Tabled in Parliament on April 21, 2015 and Other Measures); as a result, all combined federal-provincial and federal-territorial small business rates decreased in 2016. The federal small business rate was set to decrease further from 2017 to 2019, but these reductions were rescinded (implemented by Bill C-15, An Act To Implement Certain Provisions of the Budget Tabled in Parliament on March 22, 2016 and Other Measures).

Provincial small business rates declined in New Brunswick and Quebec (M & P only) for December 31, 2016 year-ends. New Brunswick's Bill 32, An Act To Amend the New Brunswick Income Tax Act, decreased the small business rate from 4 percent to 3.5 percent on April 1, 2016, and an April 1, 2016 provincial news release confirmed the province's commitment to reduce the small business rate to 2.5 percent by 2018. Quebec's small business rate declined from 6 percent to 4 percent on April 1, 2015 for M & P income only (implemented by Bill 13, An Act To Give Effect to the Budget Speech Delivered on 4 June 2014 and to Various Other Fiscal Measures). Alberta's small business rate decreases from 3 percent to 2 percent on January 1, 2017 (implemented by Bill 20, Climate Leadership Implementation Act).

Small business thresholds remain unchanged in 2016 (see the table), except in Manitoba. Manitoba's small business threshold increased from $425,000 to $450,000 on January 1, 2016 (implemented by Bill 36, The Budget Implementation and Tax Statutes Amendment Act, 2015). Manitoba's December 1, 2015 news release announced that the provincial small business threshold will increase from $450,000 to $500,000, starting in 2017; however, Manitoba's 2016 budget, which was tabled by a new majority government elected on April 19, 2016, did not comment on the proposed threshold increase.

For taxation years beginning after December 31, 2016, Quebec's 2015-16 and 2016-17 budgets announced significant changes that affect eligibility for Quebec's small business rates, increasing its regular and M & P small business rates to the province's general rate in certain cases. For a discussion of these changes, see "Future Quebec CCPC Rates: 2016 Budget," *Canadian Tax Highlights*, June 2016.

Giancarlo Di Maio
PricewaterhouseCoopers LLP, Windsor

Ruby Lim
PricewaterhouseCoopers LLP, Toronto

Supplier Loyalty Payment Taxable on Receipt

A recent technical interpretation concludes that a lump-sum payment received by a taxpayer for entering into a long-term contract with a supplier should be included in income in the

year of receipt (TI 2015-0618601E5, February 16, 2016). The CRA suggests that the payment may be characterized either as an amount in respect of a "restrictive covenant" or as an inducement or assistance payment, but that the accounting treatment of deferral and amortization is not permitted for income tax purposes.

A "restrictive covenant" is defined generally to mean an agreement entered into or an undertaking made by a taxpayer—or the taxpayer's waiver of an advantage or right—that affects the taxpayer's acquisition or provision of property or services (subsection 56.4(1)). There are limited exceptions, but amounts received or receivable by a taxpayer in respect of a restrictive covenant must be included in the taxpayer's income for that taxation year (subsection 56.4(2)).

An inducement is described in paragraph 12(1)(x) and is generally taxable in the year received. An inducement includes, among other things, an amount that one receives in the year in the course of earning income from a business or property if the amount can reasonably be considered to be received as a grant, a subsidy, or an allowance in respect of an amount included in or deducted as the cost of property, or as an outlay or expense. A restricted-covenant amount included in income under subsection 56.4(2) is specifically excluded from an amount taxable under paragraph 12(1)(x).

Paragraph 18(1)(e) provides that no deduction is allowed in respect of a reserve or contingent liability, except as expressly permitted under the Act.

In the TI, a taxpayer (Canco) enters into a contract with a major supplier (A Co) and receives a lump-sum payment from A Co (the TI refers to the payment as consideration for entering into a "supplier loyalty agreement"). If Canco breaches the contract, it must repay a portion of the payment, plus interest, based on the amount of time remaining until the expiration of the contract. The TI does not provide any further details about the agreement.

For accounting purposes, the payment is amortized and included in Canco's income over the life of the contract. In considering whether, for income tax purposes, Canco can amortize the lump-sum payment over the life of the contract, the CRA acknowledges that a taxpayer is generally free to adopt any method of computing income for tax purposes that shows a true picture of income. However, this method must be consistent with the provisions of the Act, established case law, and well-accepted business principles (see *Canderel Ltd.*, 1998 CanLII 846 (SCC)).

The CRA notes that, in this instance, the contract with the supplier appears to be a restrictive covenant as defined because the payment appears to affect the acquisition or provision of property or services by Canco. Thus, the payment received (or receivable) by Canco must be included in income under subsection 56.4(2) as a lump sum. Alternatively, the CRA says that if the payment is not in respect of a restrictive covenant, it appears to meet the description of an inducement in paragraph 12(1)(x) and must be included as a lump sum in income upon receipt.

The CRA notes that paragraph 18(1)(e) expressly denies the deduction of reserves or contingent liabilities unless otherwise permitted under the Act. Because the Act does not specifically allow a taxpayer to deduct reserves relating to amounts included in income under subsection 56.4(2) or paragraph 12(1)(x), the CRA says that Canco must include the entire payment in its income without any related deduction.

Marlene Cepparo
KPMG LLP, Toronto

Canadian Foreign Tax Credit: US Inversions

A US corporate inversion is a transaction in which a USco parent restructures its corporate group so that the group's ultimate parent becomes a foreign entity. If the rules apply, that foreign entity is treated as a US domestic corporation. Surprisingly, there are several scenarios in which a Canadian may attract US withholding tax on dividends that were paid by a Canco, but without the benefit of any Canadian foreign tax credit (FTC). This article reviews three such scenarios.

Assume that a Canadian-resident individual forms a US C corp to operate a business in the United States. His Canadian tax adviser subsequently points out that the client is exposed to US estate tax, that dividends received by the individual are taxed as ordinary income in Canada (at about a 53.5 percent rate), and that the US rate of withholding tax on dividends is 15 percent. If, in the original structure, a Canadian limited liability company had owned the shares of the US C corp, there would be no US estate tax, the US rate of withholding tax would be 5 percent, and the dividends from the US C corp may be out of exempt surplus and not taxable to the Canadian corporation. Dividends paid by the Canadian corporation are eligible dividends and are taxed in Canada at the rate of 39.34 percent. (Taxes are deferred until a dividend is paid.) The effective tax rate to the individual (assuming 5 percent US withholding tax on an exempt surplus dividend paid to Canco, which is paid as an eligible dividend to the individual) is 42.37 percent.

The adviser may suggest a reorganization to insert a Canadian holdco. In the first example, the US C corp is not a real property holding company, and thus the individual may transfer his US C corp shares to the Canadian holdco without attracting US tax on any accrued gain. A section 85 tax election is filed in Canada to defer tax. Unfortunately, the transfer of the US C corp shares to a Canadian holdco results in application of the US inversion rules, which deem the Canadian holdco to be a US domestic corporation. (It is my understanding that

this applies for US income tax but not for US estate tax.) Dividends paid by the US C corp to the deemed US domestic corporation are not subject to US withholding tax. However, dividends on-paid by the Canadian holdco to its Canadian shareholder are subject to a 15 percent US withholding tax without any FTC in Canada because the dividend is not US-source. Moreover, the dividend may still be taxed as an eligible dividend in Canada at a 39.34 percent rate, resulting in a combined Canada-US tax rate of 54.34 percent.

It may be possible to effect a partial transfer of shares to the Canadian holdco in order to generate foreign-source income to support a claim for an FTC equal to some or all of the foreign withholding tax paid by the Canadian shareholder. Section 126 allows an FTC to a Canadian-resident taxpayer for dividend withholding tax paid in a foreign country, provided that the FTC cannot exceed the Canadian tax otherwise paid on that foreign-source income ("qualifying income"). The question is whether that qualifying income includes a dividend on the share of a Canadian-resident corporation that attracts US withholding tax.

In a second example, the US C corp is held by a Canadian individual and is a real property holding company for US tax purposes. FIRPTA applies to any transfer of the shares to the Canadian holdco. FIRPTA does not apply if a Code section 397(i) election is made to treat the Canadian holdco as a US domestic corporation. The US tax deferral under Code section 351 is available, and a section 85 election defers tax in Canada. However, dividends paid by the deemed US domestic corporation to the Canadian individual attract 15 percent US withholding tax, and there is no Canadian FTC. US estate tax may be avoided.

The third example involves Canadian exchangeable shares. Canada does not permit the tax-deferred exchange of shares of a Canco for shares of a US corporation. However, a structure evolved in Canada about 25 years ago that was similar to the US umbrella partnership real estate investment trust (UPREIT) structure. A Canadian vendor effects a Canadian-tax-free exchange of its shares in the Canadian target for non-voting retractable preference shares in the Canco. If the Canadian chooses to retract the shares, the Canco has the option of exchanging the preference shares for US shares; the share retraction that triggers a taxable share exchange is only exercised when the Canadian wants to sell the shares. The number of US shares to be received on the exchange is based on the relative values of the preference shares and the US shares at the original closing. The US corporation provides in a support agreement that it guarantees receipt by the Canadian shareholder of pro rata dividends from the Canco (as if the Canadian shares were actually exchanged for US shares). In addition, a US voting trust may give the Canadian shareholder voting rights in the US corporation. US authors suggest that the Canadian exchangeable shares are mirror shares to the US shares and that there is a risk that US withholding tax may apply to dividends paid by the Canco to the Canadian shareholder and relating to the exchangeable shares. If US withholding tax applies, there is no FTC in Canada.

Jack Bernstein
Aird & Berlis LLP, Toronto

Customs Administrative Practice Poses Risk

The Customs Act requires that an error in an import declaration—for example, in a tariff classification, country of origin, or value for duty—be corrected. Each correction requires the filing of a form B2 adjustment request. If the error involves a large importer with a best-selling product, hundreds or thousands of corrections must be filed, and each must be accompanied by a separate B2 adjustment request. The CBSA has an administrative practice that streamlines the procedure for an authorized importer by allowing it to file a blanket adjustment request—a single form with an attached spreadsheet—to process all the corrections. However, the Canadian International Trade Tribunal (CITT) decision in *Worldpac Canada* (AP-2014-021) demonstrates that administrative practice does not have the force of law and that a taxpayer's reliance thereon involves risk.

In September 2011, Worldpac needed to make adjustments to its import declarations and originally filed two requests for blanket authorizations. About five months later, on February 28, 2012, the CBSA issued two blanket authorization letters that allowed Worldpac to file corrections for four years back, to March 1, 2008. The letters also said that the information must be presented in the format discussed by the parties, that the authorizations might be cancelled if mutual administrative benefits were not achieved, and that the blanket authorization did not remove or adjust the legislative timelines.

Over a year later, on March 25, 2013, Worldpac had not yet submitted its blanket adjustments; the CBSA cancelled one blanket authorization because the process could not realize mutual benefits. The next day, Worldpac applied for another blanket authorization; the CBSA issued a third blanket authorization on July 12, 2013 for importations between March and December 2009.

In September and October 2013, Worldpac finally filed its blanket adjustment refund requests with the CBSA in batches, covering hundreds of corrections for the 2009 year. The CBSA ultimately rejected any blanket adjustment refund request that went back more than four years from the date of filing.

Worldpac took the position that the four-year deadline ran from the date that the blanket authorizations were first granted, not from the date that blanket adjustment requests were filed, and it requested a further redetermination of the CBSA's

decision. The CBSA declined to even consider the matter, saying that its decision not to accept blanket adjustments more than four years after the filing date was not a redetermination that could form the basis for a request for a further redetermination. Worldpac appealed to the CITT.

The CITT decision refers to Worldpac's disorganization and its "incoherent" submissions: the tribunal had to intervene merely to determine the issue under appeal. In that process, it was determined that the CITT must first consider whether it had jurisdiction. If the CBSA was correct that there had been no determination, then there could be no appeal to the CITT. The CITT concluded that the CBSA had not "decided" to reject the applications that were more than four years old: the CBSA must reject those applications under sections 59(1)(b) and 74(3)(b)(i) of the Customs Act. The CBSA had no discretion in the matter and thus did not make an appealable "decision." Thus, the tribunal had no jurisdiction to hear an appeal.

Moreover, the CITT decision not only opined on the jurisdictional issue but also touched on the substantive issue between the parties: whether the filing of a blanket authorization somehow stopped the running of the four-year limitation period in the Customs Act.

The CITT first reviewed the applicable legislation. It concluded that there were four-year limits on granting refunds and on issuing redeterminations, and that the Customs Act contained no mechanism to extend or modify these time limits. Thus the blanket authorization, merely an administrative practice, "[could] by no means modify the imperatives set out in the *Act*." The blanket authorization letters also confirmed this conclusion.

The CITT said that Worldpac could have filed a separate correction for each transaction rather than seeking blanket authorizations, particularly for transactions on the cusp of the four-year deadline. The approach would have been "time-consuming and administratively complex," but it would have ensured compliance with the Customs Act.

This case stands as an important reminder that legislative provisions cannot be modified or varied by administrative practices. Potentially, the decision has broader implications. For example, pursuant to section 32.2 of the Customs Act, importers have an obligation to make corrections to the declaration of origin, tariff classification, or value for duty within 90 days of the date that the importer has "reason to believe" that the import declaration is incorrect. If an importer wants to make its corrections by way of blanket adjustments, that 90-day period is effectively shortened by the need to apply for and receive authorization from the CBSA before proceeding (a process that can take 45 days for approval). The blanket adjustment process is the only practical solution for processing large numbers of corrections; one hopes that the CBSA's administrative process is codified to provide importers with the safety and certainty of a legislative framework.

Worldpac focused on the Customs Act and the CBSA, but numerous government entities have administrative practices and guidelines—ranging from reporting forms to instructions on appeal procedures—that are not always supported by legislation. Persons that rely on legislatively unsupported administrative practices put themselves at risk because the courts cannot grant relief except in accordance with legislation. *Worldpac* is an important lesson: always consider legislative provisions and not just administrative practices.

Robert G. Kreklewetz and John G. Bassindale
Millar Kreklewetz LLP, Toronto

Designated Member Draft Rule for SBD

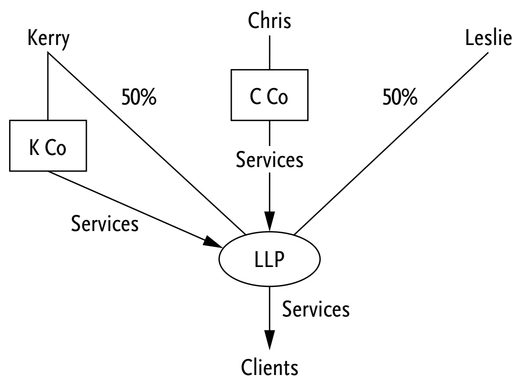
New rules in the 2016 federal budget preclude the multiplication of the small business deduction (SBD). New designated-member rules aim at partnership structures commonly used by professionals, effective for a taxation year that begins on or after budget day, March 22, 2016.

The specified partnership income (SPI) rule limits the amount of a CCPC's SBD in respect of partnership income. The CCPC's SBD for partnership income is its SBD rate times the lesser of (1) the active business income (ABI) that the CCPC receives as a partner and (2) the product of $500,000 and the CCPC's percentage share of the partnership.

In the budget documents, Finance included an example of a structure that permits a CCPC partner that receives partnership income to access the full $500,000 small business limit for that partnership income.

In the example, Kerry is the sole shareholder of a CCPC (K Co). Kerry is married to Chris and deals at arm's length with Leslie. Kerry and Leslie are 50-50 partners in the LLP. Neither K Co nor C Co is a partner. K Co provides services to the partnership as an independent contractor. Under the existing rules, K Co earns income for services rendered to the partnership, and that income is not caught by the SPI rule because K Co is not a partner. Thus, K Co can access the full $500,000 small business limit in respect of the services income earned from the partnership.

The budget's concept of a "designated member" expands the SPI rule's application to certain CCPCs that are not partners. A "designated member" is a CCPC that provides (directly or indirectly) services or property to a partnership in which it is not a partner at any time in the CCPC's taxation year but (1) one of the CCPC's shareholders holds a direct or indirect interest in the partnership or (2) the CCPC is not at arm's length with a person that holds a direct or indirect interest in the partnership and all or substantially all (generally considered to be at least 90 percent) of the CCPC's income does not arise from providing services or property to arm's-length persons



or arm's-length partnerships (except a partnership in which a direct or indirect interest is held by a person not at arm's length with the CCPC).

In the example above, K Co provides services directly to a partnership of which it is not a partner at any time in its taxation year, but K Co's sole shareholder, Kerry, holds a direct interest in the partnership. Therefore, under the new rules, K Co is a designated member of the partnership.

C Co is also a designated member of that partnership because (1) it provides services to the partnership directly, (2) a person with which it is not at arm's length holds a direct interest in the partnership (Kerry), and (3) all or substantially all of C Co's ABI does not arise from providing services to persons or partnerships at arm's length with it.

The new SPI rules limit the ability of K Co and C Co, as designated members of a partnership, to claim the small business limit for income earned from providing services to the partnership. The SPI of a designated member of a partnership is initially nil, because the designated member does not actually receive any income allocations from the partnership. However, a partner not at arm's length with the partnership's designated member can assign all or some of the partner's SPI limit to the designated member. If the partner is an individual, his or her assignable SPI is determined as if he or she were a corporation.

In the example above, Kerry is an individual partner, and thus his SPI is determined as if he were a corporation ($500,000 multiplied by his 50 percent partnership share = $250,000). Kerry can assign his SPI limit to K Co or may assign all or some of his SPI limit to C Co because Kerry and C Co are not dealing at arm's length and C Co is a designated member of the partnership.

A CCPC that is a designated member of a partnership thus has a small business limit for income earned from providing services to the partnership equal to the lesser of (1) the income from providing (directly or indirectly) services to the partnership, (2) the SPI limit assigned to the CCPC by a partner, and (3) nil, if no SPI limit is assigned to the CCPC by a partner.

The new designated-member rules also affect stacked structures if the CCPC is an actual partner and is wholly owned by another CCPC that provides professional services to the partner.

In the example above, corporations controlled by each of Kerry, Chris, and Leslie may each have a full $500,000 small business limit if they wind up the partnership and continue as a cost-sharing arrangement. However, from a commercial perspective, it may not make sense to break up the partnership, and a cost-sharing arrangement may not work if there are multiple businesses and not just one business.

Michelle Chang
Thorsteinssons LLP, Vancouver

ECP Transitional Rules and 2016 Asset Sales

The March 2016 federal budget confirmed that after 2016, the eligible capital property (ECP) rules will be repealed, and current and past ECP expenditures will be treated as depreciable property and thus as capital property. The annual deduction essentially will be the same. The main difference for a CCPC will be that the disposal of what is currently classified as ECP (for example, goodwill) will be treated as a disposal of a capital property and taxed at so-called passive income rates: the tax will thus be significantly increased. The capital dividend account (CDA) addition will continue.

Assume that, during its taxation year ending December 31, 2016, a corporation disposes of ECP such as internally generated goodwill. If the corporation has no other amounts in its cumulative eligible capital pool, the old rules trigger an income inclusion under paragraph 14(1)(b) equal to half the sales proceeds. That amount is taxed as business income, and the CDA is increased accordingly after the year-end: that increase in paragraph 89(1)(c.2) is specifically linked to the income inclusion under paragraph 14(1)(b).

Draft legislation in the budget documents repeals section 14 after 2016; the draft legislation will apply to a taxation year ending in 2017, even a year that began in 2016. A transitional rule (proposed paragraph 13(37)(d)) applies to a corporation's taxation year that begins in, but ends after, 2016. The transitional rule applies if the corporation disposed of ECP in calendar 2016, but the gain is included in the taxation year that ends after 2016. The provision treats the disposition as a capital gain, but an election is available to maintain the effect of the paragraph 14(1)(b) inclusion. Unfortunately, the rule may also generate anomalous results.

First, the preamble to the proposed transitional rule is quite restrictive: "a taxpayer has incurred an eligible capital expenditure in respect of a business before January 1, 2017 and carries on the business on that day." Therefore, both criteria must be

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Telephone: 416-599-0283
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met before the rule applies. In many cases, an affected corporation may have sold its business assets in 2016 (in its taxation year that ends in 2017) and have concurrently ceased to carry on that business. It is unclear how an income inclusion under section 14 occurs and how the related CDA addition is thus established. In informal discussions, CRA Rulings has recognized the anomaly. Following discussions with Finance, the CRA has said that this anomaly should be corrected, but because the provision interacts with many others, the solution may not be simple.

Second, the rule's application does not mean that a CDA increase is always generated. Assume that a corporation meets the conditions in the preamble of subsection 13(37). A CCPC with a January 31, 2017 year-end disposed of ECP in February 2016. Under the prior law, the CCPC had a $500 income inclusion under paragraph 14(1)(b). Under the default rule in subparagraph 13(37)(d)(ii), the CCPC is deemed to have a $1,000 capital gain and thus a $500 taxable capital gain: as discussed above, the corporate tax is nearly doubled from the prior ECP rules (but still gives rise to a $500 CDA addition). If the CCPC elects to have subparagraph 13(37)(d)(iii) apply, the $500 is included in the taxpayer's business income rather than treated as a taxable capital gain. The election achieves the lower business-income tax rates, but it seems that no CDA addition arises: that CDA addition is predicated on an income inclusion under paragraph 14(1)(b) and not under subparagraph 13(37)(d)(iii). In the informal discussion noted above, the CRA acknowledged that this unintended result will likely be corrected.

It is hoped that Finance will soon release updated draft legislation correcting these issues. A corporation that sells its business assets in 2016 in a taxation year ending in 2017 should be treated the same as a corporation whose taxation year ends in 2016: 50 percent of the gain should be included in business income and the CDA increased by the same amount.

Lorne Richter
Richter LLP, Montreal

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