VDP Report

On December 8, 2016, the CRA released Report on the Voluntary Disclosures Program (VDP), which sets out the recommendations of the Offshore Compliance Advisory Committee (OCAC). The report states that the 11 recommendations, which are summarized below, are designed to “enhance and improve” the VDP.

On April 11, 2016, the minister of national revenue established the OCAC to advise her and the CRA on administrative strategies to deal with offshore compliance. The minister said that the formation of the OCAC aligned with the federal government’s goal “to crack down on tax evasion and [combat] tax avoidance.” The OCAC’s first report is on the CRA’s VDP. If implemented, the OCAC’s 11 recommendations could significantly change the VDP. In particular, (1) the program may be increased as a tool to conduct more audits; (2) the result of a disclosure may be more discretionary and less certain; and (3) the increased discretion and uncertainty may lead to more tax disputes. Implementation may result in a VDP whose value may be reduced for a taxpayer that is non-compliant (whether inadvertently or intentionally), and in turn the number of disclosures may decrease.

Recommendation 1: Less generous VDP relief in certain circumstances. The OCAC recommends reducing the value of VDP relief in certain circumstances, including if (1) the disclosure involves a sophisticated taxpayer; (2) the disclosure involves a significant amount of tax; (3) the disclosure involves multiple years; (4) the disclosure involves an “avoidance transaction” that is undertaken or continued after the implementation of the common reporting standard; (5) active efforts were taken to avoid detection, such as the use of offshore vehicles; (6) deliberate or wilful default occurred or there was carelessness amounting to gross negligence; (7) the disclosure was motivated by CRA statements regarding its intended focus of compliance, or by broad-based CRA correspondence or campaigns; and (8) any other circumstance in which a high degree of taxpayer culpability contributed to the failure to comply. The OCAC suggests that relief may be reduced by increasing the period for which full interest must be paid or by denying relief from civil penalties.

Recommendation 2: Repeat users. The section of IC00-1R4, “Voluntary Disclosures Program,” that may preclude taxpayers from accessing VDP relief more than once should be reviewed and given greater prominence. In addition, the CRA should ensure that a taxpayer’s past participation in the VDP is verified. (IC00-1R4 was the point of reference for the OCAC. IC00-1R5 was issued in January 2017. Its revisions do not affect the OCAC’s recommendations.)

Recommendation 3: Payment of tax and interest. A taxpayer that has made a voluntary disclosure should be required to pay the estimated tax and interest payable as a result of the disclosure or provide adequate security within the time frame described in IC00-1R4, except in certain exceptional circumstances.

Recommendation 4: Incomplete information. IC00-1R4 should be reviewed and, if necessary, revised to clarify the circumstances in which the CRA will accommodate a taxpayer that is unable to provide full and complete information about the subject matter of a disclosure. However, a taxpayer that fails to provide full and complete information without a legitimate reason should be denied full VDP benefits. (As mentioned, IC00-1R5 was issued in January 2017. Its revisions do not affect the OCAC’s recommendations.)

Recommendation 5: Transfer-pricing penalties. The VDP should not be available for multinational enterprises seeking relief in respect of related-party transfer-pricing issues, including transfer-pricing penalties.

Recommendation 6: Disclosure of advisers. Persons making a voluntary disclosure should be required to disclose the identity of advisers that assisted with the non-compliance. The OCAC refers to “non-compliance” very broadly as including the establishment of international accounts and structures.

Recommendation 7: Level of internal approval. Consideration should be given to requiring higher-level sign-offs if substantial amounts of evaded taxes, complex arrangements, or new issues of law are involved. Currently, team-leader approval is sufficient for all VDP settlements. The CRA may also want to consider higher-level approval in high-profile cases that may undermine public confidence in the VDP.
Recommendation 8: Review by specialists. Consideration should be given to ensuring that large or complex cases are reviewed by appropriate specialists (such as offshore compliance or aggressive tax-planning specialists) before acceptance into the VDP.

Recommendation 9: Rights of objection. A taxpayer should not be allowed to object to an assessment that is based on a voluntary disclosure agreement.

Recommendation 10: Information returns. Instead of requiring taxpayers that fail to file form T1135, “Foreign Income Verification Statement,” to use the VDP, the CRA should use its audit resources to examine these taxpayers’ returns to verify their compliance with the reporting and payment of tax on the related income.

Recommendation 11: Similar VDP relief for offshore non-compliance. The OCAC considered whether offshore and onshore non-compliance should be treated differently, but it concluded that all compliance should be treated similarly.

The extent to which any of the above recommendations will be implemented is uncertain. The recommendations are of concern because they appear to be partly based on an interpretation of non-compliance that is consistent with messages given by the minister of finance, which blurs the line between legitimate tax planning (by which international businesses and investors reduce tax within the limits of tax laws) and tax evasion (which is the criminal offence of illegally underreporting income). Many of the recommendations also appear to focus on the nature of the original non-compliance rather than on the taxpayer’s desire to voluntarily come forward and comply with obligations. Implementation of the OCAC recommendations will fundamentally change the nature of the VDP.

Implementation of some of the recommendations may significantly and negatively affect the program and the taxpayers that are willing to voluntarily disclose. Several of the recommendations include an increased role for the CRA’s audit division in the VDP, a change that may create several risks and issues. For example, the auditors may review unrelated matters in the years relating to the disclosure, and this review may result in audit queries and additional information requests; an increased compliance burden would raise the cost, and reduce the value, of a disclosure. As well, if the audit team builds a case on an unrelated issue, and comes to a conclusion that differs from the taxpayer’s, the CRA may take the position that the disclosure is not “complete” and that therefore no VDP relief is available. Even if the years involved in the VDP are not challenged by the audit team, the audit team’s review of the disclosure may raise the taxpayer’s risk-assessment profile; a raised profile increases the likelihood of a subsequent audit and thus a taxpayer’s compliance costs.

With respect to recommendation 2 (repeat users), a taxpayer can currently make more than one disclosure if the issues are significantly different. Any restriction on this approach means that a taxpayer must weigh the current using-up of a disclosure versus reserving it for any subsequent discovery of a significant error. With respect to recommendation 9 (rights of objection), loss of the right to appeal any legally incorrect assessment is not appropriate for a taxpayer (or the minister), whether or not the VDP was accessed.

If implemented, the recommendations will significantly change the VDP. The recommended changes will generally reduce the value of disclosures and increase a taxpayer’s compliance costs. Also, as is consistent with the OCAC’s mandate, a VDP amended according to the recommendations will be less valuable and less predictable for a taxpayer that is viewed by the CRA as intentionally non-compliant; for example, the CRA would need to add a new step to its VDP process to review each disclosure and make a judgment about whether the non-compliance was inadvertent or intentional. If an amended VDP includes such a review, it is hoped that the process to determine intentionality, and any related harsh consequences, will be fairly and thoughtfully crafted so as not to extend to a taxpayer that is only inadvertently non-compliant.

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Editor’s note: Larry Chapman, the former executive director of the Foundation, was a member of the OCAC.

Two Cases on Privilege

Two recent decisions add some certainty in the area of privilege. Lizotte v. Aviva Insurance Company of Canada (2016 SCC 52) clarifies the difference between solicitor-client privilege (SCP) and litigation privilege (LP), and Igillis Holdings Inc. v. Canada (National Revenue) (2016 FC 1352) establishes that so-called advisory common interest privilege (CIP)—that is, privilege that protects transactional negotiations between parties with separate legal representation—does not exist in Canada. The two decisions are reminders of the scope of privilege in the tax context, and they highlight the importance of understanding the proper ambit of privilege when one is engaging in tax transactions or tax litigation.

The confidentiality of legal communications between lawyer and client is a common-law rule of English origin. That rule entered Canadian jurisprudence in the 20th century as a rule of evidence considered necessary for ensuring the proper conduct of trials. Over time, the protection of legal communications between lawyer and client grew beyond an evidentiary rule and is now understood as a “fundamental civil and legal right” (Solosky v. The Queen, [1980] 1 SCR 821). But the development of this area of law has been confusing, and indeterminate
lines have been drawn between various forms of legal privilege: SCP, LP, joint client privilege (JCP), settlement privilege, and CIP.

In Lizotte, the SCC dealt with the line of demarcation between SCP and LP. Ultimately, the court concluded that LP is distinct from SCP and that it can be abrogated only by express statutory language. On the facts, Lizotte, assistant syndic of the Chambre de l’assurance de dommages, was conducting an inquiry into an insurance claims adjuster. Lizotte asked the insurer to provide a complete copy of a particular claim file; the insurer produced the file in part, but withheld some documents on the basis that they were covered by either SCP or LP. Lizotte filed a motion for a declaratory judgment and argued that section 337 of Quebec’s Act respecting the distribution of financial products and services (ADFPS) was sufficient to lift any form of privilege because it stipulated an obligation to produce “any . . . document” concerning the activities of a professional whose conduct was under review.

At the Quebec Superior Court, Lizotte conceded that SCP could be asserted against her; thus, the only remaining question was whether LP applied. The court held for the insurer, on the grounds that LP cannot be abrogated without an express provision, and section 337 of the ADFPS did not constitute such a provision. Both the Court of Appeal and the SCC upheld the Superior Court decision.

The SCC distinguished SCP and LP on the basis that the former’s purpose is to protect a relationship, whereas the LP’s purpose is to ensure the efficacy of the adversarial process; that SCP is permanent, whereas LP is temporary and lapses when the litigation ends; and that SCP is directed at communications between solicitors and clients, whereas LP applies to unrepresented parties and to non-confidential documents. However, SCP and LP are similar because both represent a class privilege, meaning that the privilege is not assessed according to a case-by-case balancing test. LP, like SCP, is subject to only a few clearly defined exceptions: those relating to public safety, the innocence of the accused, and criminal communications.

Ultimately, the SCC found for the insurer. The court said that LP does not have the same status as SCP, but that LP is fundamental to the proper functioning of our legal system; moreover, the language of section 337 of the ADFPS was too general to justify lifting the privilege known as LP.

In Iggillis, the FC dealt with the question whether the advisory form of CIP exists in Canada. On the facts, two parties entered into negotiations regarding a corporate acquisition: Abacus Capital Corporations Merger and Acquisitions acquired the shares of two companies owned by Iggillis Holdings Inc. Abacus was a private equity company that bought shares of target corporations from their shareholders and sold the target’s assets to third parties in a tax-effective manner. The acquisition in question took place through a series of 17 transactions: ultimately, Abacus was the purchaser through a nominee corporation. During the process, there was legal consultation and cooperation between Iggillis’s lawyer and Abacus’s lawyer, and legal advice travelled in both directions between the two. The flow of legal advice culminated in the so-called Abacus memo, which was primarily the work of Abacus but included contributions from Iggillis’s lawyer.

The CRA took the view that the transactions related to the sale of the corporations were entered into in order to maximize shareholder benefits by avoiding the payment of tax on the sale of the corporate partner’s assets. The CRA asked Iggillis to disclose the Abacus memo; Iggillis claimed privilege. The FC concluded that the Abacus memo was not protected by CIP, and thus the court effectively gutted the advisory form of CIP. The FC explained that JCP is a variation of SCP and protects communications between two distinct clients and their common lawyer, but that CIP is not a variant of SCP. Moreover, the court said that Pitney Bowes of Canada Ltd. v. Canada (2003 FCT 214), which affirmed JCP, was not an appropriate precedent.

The court distinguished between litigation CIP and advisory CIP: the court accepted that litigation CIP provides some protection to communications that occur during litigation, but it rejected any application of advisory CIP. The court explained that advisory CIP is incompatible with SCP: advisory CIP undermines the administration of justice by expanding the quantity of evidence denied to the courts. Thus, allowing an advisory CIP results in increased potential for abuse. Moreover, the court said that acceptance of advisory CIP would threaten the principle of legal equality because CIP only benefits a small subset of users of advisory legal services. Furthermore, when the court considered the policy rationales proposed by Iggillis and Abacus, it rejected as entirely speculative the proposition that CIP is beneficial because it enables commercial transactions.

Iggillis filed leave to appeal in early January 2017. Thus, there may be further judicial consideration of advisory CIP.

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The Tax Lawyer’s Standard of Care

The Ontario Superior Court of Justice in Ozerdinc Family Trust et al. v. Gowling et al. (2017 ONSC 6) allowed a partial summary judgment against a law firm for the acts or omissions of one of its tax partners, who was negligent in his tax law advice. The issues of breach of fiduciary duty and damages suffered will be addressed at trial.

On February 1, 1990, the plaintiffs Grimes and Ozerdinc, a married couple, retained the defendant tax lawyer to create the Ozerdinc Family Trust No. 1 (OFT1) for the benefit of their children. The trust was to be divided and distributed when the youngest child reached age 22 or at an earlier date to be
determined at the trustees’ discretion. In 2007, Grimes contacted the defendant tax lawyer because she was concerned that the trust assets would be distributed when the children were too young. Thus, the defendant tax lawyer set up the Ozerdinc Family Trust No. 2 (OFT2) on September 28, 2007 and rolled the assets of OFT1 into OFT2 under subsection 107.4(3), which provides a rollover on a transfer of property if there has been no change in beneficial ownership. Under subsection 104(5.8), despite the rollover, the 21-year deemed disposition applies to the rolled assets.

The defendant tax lawyer and his associate did not mention the 21-year deemed disposition date for the assets rolled over from OFT1 into OFT2. On February 11, 2011, the deemed disposition occurred (subsection 104(4)), triggering a significant and apparently unanticipated tax liability of $1,870,045.22 and accrued interest of $151,483.35. (See Grimes v. The Queen, 2016 TCC 280.) The defendants admitted that the defendant lawyer was negligent but argued unsuccessfully that they were not the cause of the plaintiffs’ damages: the defendants said that the accounting firm Raymond Chabot Grant Thornton LLP should have advised the plaintiffs of the upcoming 21-year deemed disposition and of mitigation strategies for the resulting tax. The defendants’ cross-motion relating to causation and damages against the accounting firm was dismissed by the court because the defendants’ liability had to be determined first.

The court did not opine on negligence and the standard of care. However, Malton v. Atitia (2013 ABQB 642) summarizes well the nature of negligence in relation to a professional’s advice:

What is negligence? In the foundational case of Donoghue v Stevenson, Lord Atkin explained negligence as a failure to act in a reasonable manner to one’s neighbours, when these are “... persons who are so closely and directly affected by my act that I ought reasonably to have them in contemplation as being so affected when I am directing my mind to the acts or omissions that are called in question.”

An act or omission is negligent when it is conducted in breach of a person’s standard of care. The appropriate standard of care is a question of mixed fact and law.

The scope of a standard of care is a contextual question—“It is not a matter of uniform standard. It may vary according to the circumstances from man to man, from place to place, from time to time.” In other words, standard of care depends on the facts of each case.

While the standard of care is contextual, it flows from the conduct of a “reasonable and prudent man.”

The scope of what forms a standard of care is in many ways a common-sense exercise. Given the context and the facts, what would a reasonable person do? Because a standard of care is necessarily linked to the scenario in which it emerges, a different standard is applied for lay persons and those with particular expertise. For example, a doctor’s conduct is tested against the standard of care of an average doctor of his or her speciality. [Citations omitted.]

Regarding whether the defendants caused the plaintiffs’ damages, the Superior Court looked to the SCC decision in Clements v. Clements (2012 SCC 32), which identified the “but for” test as basic to determining causation:

On its own, proof by an injured plaintiff that a defendant was negligent does not make that defendant liable for the loss. The plaintiff must also establish that the defendant’s negligence (breach of the standard of care) caused the injury. That link is causation. . . .

The test for showing causation is the “but for” test. The plaintiff must show on a balance of probabilities that “but for” the defendant’s negligent act, the injury would not have occurred. Inherent in the phrase “but for” is the requirement that the defendant’s negligence was necessary to bring about the injury—in other words that the injury would not have occurred without the defendant’s negligence. This is a factual inquiry. If the plaintiff does not establish this on a balance of probabilities, having regard to all the evidence, her action against the defendant fails.

The “but for” causation test must be applied in a robust common sense fashion. There is no need for scientific evidence of the precise contribution the defendant’s negligence made to the injury.

A common sense inference of “but for” causation from proof of negligence usually flows without difficulty. Evidence connecting the breach of duty to the injury suffered may permit the judge, depending on the circumstances, to infer that the defendant’s negligence probably caused the loss. [Citations omitted.]

The Superior Court concluded that “‘but for’ the [admitted] negligence of the Defendant Siegel . . . in failing to advise the Plaintiffs of the impending deemed disposition of OFT1 and/or OFT2 and . . . of the 21-year deemed disposition rule in 2007, the tax consequences that the Plaintiffs are now facing would not have occurred.” The court granted the partial summary judgment against the defendants: “there is no genuine issue for trial in respect of the Defendant’s liability in negligence to the Plaintiffs.”

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Part-Year Residents Report Full Year’s Transactions on T1135

In a technical interpretation (2015-0611141E5, July 11, 2016), the CRA says that if an individual becomes resident of Canada during a taxation year and must file form T1135, “Foreign Income Verification Statement,” the reporting period for that form is the individual’s entire taxation year, not just the period when the individual is a Canadian resident.

The CRA also confirms that when one is determining whether an entity must file a form T1135 for a taxation year,
the only relevant time is when the entity is a resident of Canada. The period in the year during which the entity is not a resident of Canada is excluded from the analysis.

Under Canada’s tax rules, a “reporting entity” for a taxation year must file form T1135 for the year, under subsection 233.3(3). A “reporting entity” for a taxation year is defined in subsection 233.3(1) as a “specified Canadian entity” for the year if, at any time in the year (other than when the entity is non-resident), the total cost amount to the entity of specified foreign property (defined in subsection 233.3(1)) exceeds $100,000. A “specified Canadian entity” for a taxation year (defined in subsection 233.3(1)) generally includes a taxpayer that is resident in Canada during the year. An individual’s taxation year is the calendar year (paragraph 249(1)(c)).

In the TI, the CRA considers a situation in which a former resident of Canada (Ms. X) owns specified foreign property throughout 2014 with a total cost amount of $500,000. Ms. X immigrates to Canada on July 1, 2014. During 2014, but before her immigration to Canada, Ms. X acquires and disposes of another property that is specified foreign property. The CRA was asked to consider whether the reporting period for Ms. X’s form T1135 is the entire 2014 calendar year or only that part of the year during which she was resident in Canada (that is, July 1, 2014 to December 31, 2014).

In its response, the CRA indicates that Ms. X’s relevant form T1135 reporting period is the 2014 calendar year. Although the determination of whether an entity is a “reporting entity” excludes the taxation year period when that entity is a non-resident of Canada (on the TI’s facts, January 1, 2014 to June 30, 2014), the CRA says that the T1135 reporting period for an entity is the entire taxation year.

As a result, even though Ms. X was only resident in Canada in 2014 from July 1 onward, she must file a 2014 form T1135 and report all of the specified foreign property that she held throughout 2014—including any gain or loss she realized on her disposition of specified foreign property in 2014 during a period prior to immigration to Canada. Thus, reporting for the 2014 form covers dispositions of specified foreign property from January 1, 2014 to December 31, 2014.

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**Earnings of Disregarded US LLC**

In response to a question at the Canadian Tax Foundation’s November 2016 annual conference, the CRA reversed its prior position (T1 2016-0669761C6, November 29, 2016) on how to compute the active business earnings of a US LLC that is disregarded for US tax purposes. The definition of “earnings” in regulation 5907(1) contains a hierarchy of computational methods whose applicability depends on whether the FA’s income or profit must be computed under foreign law. If no foreign-law requirement exists, earnings must be computed under part I as if the active business were carried on in Canada (regulation 5907(1)(a)(iii)). A change in CRA policy regarding the computation of earnings for a disregarded US LLC creates a plethora of problems.

Technically, the calculation of earnings under the Canadian rules in part I is appropriate for a disregarded US LLC. A disregarded LLC is a passthrough entity that has not elected to be taxed as a corporation and that has only one member (shareholder). The LLC is disregarded as an entity for US tax purposes and is effectively a branch of its sole member regardless of whether it keeps separate branch books of account. If the sole member is, for example, a USCo that is an FA, that member FA must take into account the activities of the LLC when computing its profits for US tax purposes. The LLC, however, does not compute its profits.

Notwithstanding technical support for the regulation 5907(1)(a)(iii) method, at the 2011 International Fiscal Association (IFA) conference the CRA said that the regulation 5907(1)(a)(i) method applied; thus, a disregarded US LLC’s earnings were its income or profits under US tax law. Generally, US tax law does not give a taxpayer discretion regarding, or provide a minimum and maximum range for, tax deductions: US tax law generally mandates a specific deduction. It is assumed that the CRA began to favour US tax law under the regulation 5907(1)(a)(i) method when it became aware that some taxpayers were operating US active businesses through disregarded LLCs and were taking less than the maximum permissible Canadian deductions in computing earnings under the regulation 5907(1)(a)(iii) method. The result was viewed as a purposeful inflating of surplus, and the CRA indicated that it would challenge such a taxpayer position. The lack of technical clarity about the appropriate method seems to have led to Finance’s promulgation of regulation 5907(2.03), effective for FA taxation years ending after August 19, 2011; that provision required that the maximum permissible Canadian deductions be taken when earnings are computed under regulation 5907(1)(a)(iii).

At the Foundation’s 2016 annual conference, the CRA was asked whether, in light of the implementation of regulation 5907(2.03), it was still taking the position that the regulation 5907(1)(a)(i) method applied to a disregarded US LLC. The CRA responded that it had changed its position: retroactive to all FA taxation years ending after August 19, 2011, a disregarded US LLC must apply the regulation 5907(1)(a)(iii) method. The CRA also said that if a taxpayer was switching methods, the CRA would accept deductions claimed under US tax law as deductions claimed under the Act. It is not clear whether the CRA will view the US deductions claimed as the maximum permissible Canadian deductions. No further elaboration was made regarding prior US claims, and it is therefore unclear whether—if the Act provided for a larger deduction
than US tax law did for the years in question—the shortfall leads to a retroactive downward adjustment to the earnings computed under regulation 5907(1)(a)(ii); regulation 5907(2)(a)(ii) deems maximum deductions to have been claimed in prior taxation years. In a separate part of the question, the CRA confirmed that the regulation 5907(1)(a)(i) method continues to apply for a US passthrough LLC that has two or more members that are taxed as partnerships for US tax purposes.

For practical and cost-efficiency reasons, many taxpayers chose US tax law instead of Canadian tax law to compute an LLC’s earnings; this practice was accepted and has been a CRA requirement since the May 2011 IFA conference. A taxpayer must switch to Canadian tax law retroactive to 2011; for this reason, if the taxpayer paid dividends out of what was previously thought to be exempt surplus, it may discover that it has an unjust shortfall of surplus when it recomputes earnings for post-2010 taxation years. At the very least, the CRA should have made its new position retroactive at the taxpayer’s option.

The new CRA position of using Canadian tax law creates a whole host of practical problems, including the need to maintain another set of accounts to track tax attributes and the lack of reliable information required, and the difficulty of allocating actual tax paid to address timing differences that are exacerbated when applied to a US consolidated group and tax-sharing payments within the group. Using Canadian tax law may trigger early recognition of income or gain for surplus purposes but without corresponding US tax: subsequent US tax will be paid by a different FA and is ignored in the computing of the first FA’s surplus. For example, if under US rules an LLC rolls its asset to a related FA and US tax law is used to compute its earnings, no income or gain is recognized for the purposes of the LLC’s surplus; when the related FA sells the asset, the related FA recognizes the deferred income or gain and pays tax thereon, for both its US tax and surplus purposes.

There is no compelling reason for the CRA to require a taxpayer who has been using US tax law to switch to Canadian tax law for computing the disregarded LLC’s earnings. A taxpayer should be allowed to maintain its current method; new taxpayers and new LLCs should be able to choose either method, if it is applied consistently.

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Year-End US Regulations

At the end of 2016, the Treasury and the IRS published various regulations that may affect both a US person that invests in a Canadian company and a Canadian person that owns a US entity that is disregarded for US income tax purposes (typically, a single-member limited liability company). New passive foreign investment company (PFIC) regulations affect a US shareholder of a PFIC; new disregarded entity (DRE) regulations require the filing of an annual form with the IRS by a Canadian (or another non-US person) that owns at least 25 percent of a US entity that is disregarded for US income tax purposes.

New PFIC regulations. The new PFIC regulations provide (1) some clarifications to the definitions of “shareholder” and “indirect shareholder” in the PFIC context, and (2) clarification of and additional exceptions to form 8621 (“Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund”) reporting.

(1) Definitions.

The final regulations adopt the 2013 temporary regulations’ definition of “shareholder,” and they revise and clarify the term “indirect shareholder.” First, they provide that a US person is not treated as a PFIC shareholder to the extent that such a person owns PFIC stock through a tax-exempt organization or account.

Second, the new regulations include a non-duplication rule to ensure that the prior regulations are not interpreted so as to create overlapping ownership in a PFIC (which is taxable under section 1291) by two or more US persons. Thus, solely for the purposes of determining whether a person owns at least 50 percent of the stock value of a foreign corporation that is not a PFIC, a person that directly or indirectly owns at least 50 percent in value of a domestic corporation’s stock is considered to own a proportionate amount (by value) of any stock owned directly or indirectly by the domestic corporation. However, the non-duplication rule states that a US person is not treated as owning the stock of a PFIC that is directly owned or considered owned indirectly by another US person.

Third, the new PFIC regulations revise the prior regulations in relation to when a US person is considered to be an indirect shareholder as a result of attribution through a domestic corporation.

Finally, the new PFIC regulations make two additional clarifications with respect to the rules discussed above. One clarification is that the attribution rules do not apply to stock owned directly or indirectly through an S corporation; the second clarification is that the domestic-corporation attribution rule applies for all PFIC purposes, not just to a PFIC that is taxable under section 1291.

(2) Reporting (filing) requirements.

Unless an exception applies, a direct PFIC shareholder must file form 8621, “Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund.” The reporting rules for an indirect shareholder depend on whether the shareholder owns the PFIC through foreign or domestic entities.
The new regulations provide several exceptions to reporting, followed by specifics for filing form 8621. Eight general categories of exceptions exist: (1) if a shareholder is a tax-exempt entity; (2) if the aggregate value of the shareholder’s PFIC stock is no more than US$25,000; (3) if the value of the shareholder’s indirect PFIC stock is no more than US$5,000; (4) for PFIC stock marked to market other than under section 1296; (5) for PFIC stock held through certain foreign pension funds; (6) for certain domestic partnerships; (7) for certain short-term ownership of PFIC stock (30 days or less); and (8) for certain bona fide residents of certain US territories.

Form 8621 must be filed whether or not the shareholder files a US federal income tax return. The statute of limitation period to assess additional tax does not begin to run on the failure to file the form. Importantly, a protectively filed form 8621 does not trigger the beginning of the limitation period to assess additional tax. The Treasury relies instead on reasonable-cause statements to provide relief. Moreover, if a shareholder holds interests in multiple PFICs, the shareholder must file a separate form 8621 for each PFIC and cannot consolidate the forms for filing purposes.

**New DRE regulations.** An entity, such as a US LLC, that has a single owner and is not classified as a corporation is generally a DRE and disregarded as separate from its owner under other regulations. A DRE is generally not subject to US tax-filing requirements and thus generally does not need to obtain an employer identification number (EIN) unless it files an entity classification election. If an entity must obtain an EIN, it should file form SS-4, “Application for Employer Identification Number,” and therein identify a responsible party (generally, the individual with control over, or entitlement to, the entity’s assets); this method applies unless the sole reason for applying for an EIN is to make an entity classification election and the entity is foreign-owned.

A domestic corporation, a domestic partnership, and a foreign corporation engaged in a trade or business in the United States must—unlike a DRE—file an annual income tax return. A domestic corporation that is at least 25 percent foreign-owned has additional information-reporting and record-maintenance requirements, including the filing of an annual return on form 5472, “Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business,” for each related party with which it had any “reportable transactions.” These corporations must also keep records sufficient to establish the accuracy of the return, including any relevant information regarding related parties.

Generally, a foreign-owned US DRE does not have US reporting obligations unless it is engaged in a US trade or business or has certain types of US-source income. However, solely for the purposes of the reporting requirements, a US DRE that is wholly owned by one foreign person is treated under the new DRE regulations as a domestic corporation separate from its owner: thus, such a DRE is subject to the reporting and record-keeping requirements currently applicable to a 25 percent foreign-owned US corporation.

For the purposes of the new DRE regulations, a foreign person is considered to wholly own a domestic DRE if the foreign person has direct or indirect sole ownership of the entity. To that end, indirect sole ownership means “ownership by one person entirely through one or more other [DREs] or through one or more grantor trusts, regardless of whether any such [DRE] or grantor trust is domestic or foreign.”

The new DRE regulations do not affect an entity’s classification for other purposes. Consequently, the DRE must file IRS form 5472 and maintain related records for reportable transactions with the entity’s foreign owners or other foreign related parties. To complete this filing, an entity must also obtain an EIN by filing a form SS-4 with responsible-party information, including the responsible party’s social security number, and the party’s individual taxpayer identification number (ITIN) or EIN.

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### Limited Liability Partnerships

Limited liability partnerships (LLPs) have become more frequently used as vehicles to structure business activities. Some provinces—for example, Alberta—restrict the use of LLPs to self-governing professionals such as accountants and lawyers; other provinces, such as Ontario, allow an LLP to be formed for any business activity whose practice is, inter alia, governed by legislation that allows an LLP to practise as a profession. In 2006, the Ontario Partnerships Act was amended to allow so-called full-shield protection for a limited partner of an LLP governed by that act.

A main reason for the use of LLPs is the access to the customary benefits of limited partnerships and the limitation on personal liability. A limitation of liability may be either full-shield or partial-shield protection. Partial-shield protection limits liability from certain types of obligations and liabilities: generally, only those arising from the negligence of another partner or an employee. An LLP with partial-shield protection closely resembles a general partnership, because all partners may take part in the management of the partnership and its business and each partner has the authority to bind the partnership. Full-shield protection generally protects a partner against most partnership liabilities. Exceptions include those that arise from the partner’s own professional negligence or misconduct.

The rule in subsection 40(3.1) of the Income Tax Act provides that if a limited partner (defined in subsection 40(3.14)) or another specified member of the partnership incurs a
negative ACB (calculated under subsection 40(3.11)), the partner realizes an immediate capital gain. A general partner is excluded from that rule (paragraph 40(3.14)(a)). An LLP that is granted partial-shield protection, similar to that of a general partnership, does not fall within the scope of paragraph 40(3.14)(a), because each partner’s liability is limited only vis-à-vis the negligence of another partner or employee. As a consequence, such a partner’s ACB may become negative without that partner realizing a deemed capital gain.

Legislative changes in 2006 to Ontario’s Partnerships Act (pursuant to section 19 of the Ministry of Government Services Consumer Protection and Service Modernization Act, 2006) granted full-shield protection for an LLP governed by that act. An LLP partner with full-shield protection falls within the meaning of a limited partner under paragraph 40(3.14)(a). Thus, an LLP partner in Ontario is subject to subsection 40(3.1), because the LLP partner’s liability, like that of a partner in a limited partnership as defined in paragraph 40(3.14)(a), is protected against most partnership liabilities except those that arise from the partner’s own negligence.

Subparagraphs 53(1)(e)(i) and 53(2)(c)(i) do not add to or subtract from a partner’s interest’s ACB any current-year income or loss, respectively, in the calculation of the gain under subsection 40(3.11). However, amendments to subsection 40(3.11)—subclauses 40(3.11)(A)(b) and 40(3.11)(B)(c)—allow current-year income or loss to be included in the ACB calculated for the year for a member of a “professional partnership.” For the purposes of subsections 40(3.1) and 40(3.11), that phrase is defined in subsection 40(3.111) to mean a partnership through which one or more persons carry on the practice of a profession that is governed or regulated under a law of Canada or a province. This rule partly remedied the deficiency caused by the fact that a draw on income is usually made before an LLP’s income is allocated. Thus, a partner in an LLP formed in Ontario must take these rules into account when computing the ACB of the partner’s partnership interest, especially if a professional corporation is used as a corporate partner: unintended tax consequences can reduce the main source of cash flow for ultimately personal purposes.

The evolution of partnership legislation has allowed professionals to use more favourable business structuring than previously. As professional partnerships continue to grow, it is essential that a practitioner correctly distinguish and identify the type of partner involved and the partner’s level of liability. Each jurisdiction that governs LLPs—including countries other than Canada that have LLPs—offers either partial-shield or full-shield protection, and it is thus necessary to fully analyze the governing statute in each applicable jurisdiction to determine whether subsection 40(3.1) applies.

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Cash Consideration on Share-for-Share Exchange

A recent technical interpretation (2015-0614981E5, August 23, 2016) says that a foreign share-for-share exchange must satisfy the same requirements as a domestic exchange in order to qualify as a rollover if both non-share and share consideration are received for each exchanged share. The CRA says that its allowance of a rollover exchange if non-share consideration is received on a domestic share-for-share-exchange extends to a foreign share-for-share exchange and that the same requirements apply.

The TI considers a situation in which the taxpayer receives newly issued shares of the foreign purchaser corporation and also non-share consideration in exchange for each share held by the taxpayer in another foreign corporation. In the TI, the CRA says that the purchaser’s offer must indicate (1) the fraction for which each exchanged share is exchanged in consideration for a newly issued share, and (2) the fraction exchanged for non-share consideration: it is not sufficient to state the amount of cash or other non-share consideration to be received. If the requirements are not met, there can be no rollover for any portion of the exchanged share. If the requirements are met, the vendor must report any gain or loss from the disposition of the fraction of each exchanged share for which non-share consideration was received. However, the CRA says that a rollover is available for the portion of each exchanged share that was exchanged for shares of the foreign purchaser.

A share-for-share exchange that meets certain criteria is eligible for rollover treatment (section 85.1). Generally, under a domestic share-for-share exchange, a taxpayer (the vendor) is entitled to a tax-free rollover if it holds shares in a taxable Canadian corporation (exchanged shares) and exchanges them for newly issued shares of a particular class of the capital stock of another Canco that purchases the exchanged shares (subsection 85.1(1)). The rollover applies automatically unless the vendor includes in income any portion of the gain or loss on the disposition of the exchanged shares. However, the vendor can receive as consideration for the exchanged shares only shares of the particular class of the capital stock of the purchaser corporation (paragraph 85.1(2)(d)).

A similar tax-free rollover in subsection 85.1(5) is available to a vendor that exchanges shares in a corporation that is resident in a country other than Canada for newly issued shares of another foreign corporation (the foreign purchaser) that purchases the exchanged foreign shares. Legislative arm’s-length requirements and other applicable conditions are similar (but not identical) to those for a domestic share-for-share exchange. In particular, under paragraph 85.1(6)(c), subsection 85.1(5) does not apply where the vendor also receives consideration that is other than shares of the foreign purchaser.
The CRA’s administrative position is that subsection 85.1(1) may apply where a vendor receives newly issued shares of the purchaser and non-share consideration for each exchanged share, if certain conditions are met. As outlined in point 2 of paragraph 1.7 of Income Tax Folio S4-F5-C1, “Share for Share Exchange,” the CRA’s position is that the purchaser’s offer must clearly indicate (1) the fraction of each exchanged share that is exchanged in consideration for the newly issued shares of the purchaser, and (2) the fraction exchanged for non-share consideration. The folio also states that the vendor must report any gain or loss from the disposition of the fraction of each exchanged share for which non-share consideration was received.

In the TI, the CRA considers a situation in which a taxpayer owns shares of a foreign public company. The vendor sells all of its foreign target shares to another foreign public company in exchange for newly issued shares of that foreign purchaser and for cash. The transaction meets all of the conditions required for the application of subsection 85.1(5), except that a portion of each exchanged (foreign target) share was disposed of for cash.

On the facts, the foreign purchaser’s offer did not clearly specify the fraction of each foreign target share that was disposed of for cash; instead, the offer quantified the actual amount of cash paid for each foreign target share. The fraction of the total exchange consideration represented by cash could not be determined until the date of the exchange, because the total exchange consideration depended on the average trading price of the foreign purchaser’s shares (within a fixed range) immediately before the exchange.

In its response, the CRA confirms that the requirements of the subsection 85.1(5) rollover are not met if a vendor receives newly issued shares of the foreign purchaser and non-share consideration for each exchanged share and the purchaser’s offer does not clearly specify the fractional information set out in the folio (point 2 of paragraph 1.7). As a result, the subsection 85.1(5) rollover is not available to the vendor for the portion of each foreign target share that was exchanged for shares of the foreign purchaser. Thus, the vendor must report any gain or loss from the disposition of each exchanged share.

The CRA notes that the folio is written in the context of domestic share-for-share exchanges. However, the CRA says that its administrative position applies equally to a foreign share-for-share exchange, as mentioned in TI 2000-0000765 (June 2, 2000). The CRA says that, regardless of whether a purchaser’s offer is foreign or domestic, it must clearly indicate (1) the fraction of each exchanged share exchanged in consideration for a newly issued share, and (2) the fraction exchanged for non-share consideration.

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Anti-Intermediary Rules in Section 125

The new section 125 small business deduction (SBD) rules, applicable to tax years beginning after March 21, 2016, ended most, if not all, traditional SBD multiplication planning. The new rules contain certain measures to prevent the new specified partnership income (SPI) or specified corporate income (SCI) rules from being circumvented by the insertion of an intermediary between the true transacting parties. This article highlights the operation of these anti-intermediary rules and their impact on some common business arrangements.

Income qualified for the SBD, which must be active business income (ABI) (paragraph 125(1)(a)) of a corporation, is now subject to three carve-outs under the new rules:

- ABI earned from a partnership in which the corporation or its shareholder holds a direct or indirect interest, or a person that holds such an interest is not dealing at arm’s length with the corporation, which does not earn all or substantially all of its income from arm’s-length customers (clause 125(1)(a)(i)(A); “the clause A carve-out”);
- ABI earned from another corporation in which the corporation, its shareholder, or a person not at arm’s length with either holds a direct or indirect interest, and the corporation does not earn all or substantially all of its income from arm’s-length customers (clause 125(1)(a)(i)(B); “the clause B carve-out”); and
- deemed ABI under subsection 129(6) that is earned from a non-CCPC or a CCPC that elected under subsection 256(2) not to be associated (clause 125(1)(a)(i)(C)).

Generally, clause A or B carve-outs are prima facie not entitled to the SBD, unless another entity assigns business limit (subsection 125(3.2)) or “specified partnership business limit” (subsection 125(8)). Subsection 125(10) also excludes most transactions between associated corporations because those corporations must already share the $500,000 business limit.

Specified corporate income. To protect the integrity of the clause B carve-out and the SCI regime, anti-intermediary measures in new section 125 may invalidate the subsection 125(10) associated-corporation exception and limit the business limit assignment under subsection 125(3.2). Assume that Mrs. A wholly owns ACo, an opco that earns $800,000 per year selling widgets to arm’s-length customers. Mr. A wholly owns SpouseCo. SpouseCo’s sole source of income is the provision of administrative services to ACo. SpouseCo planned to charge $300,000 this year for those services. However, the new clause B carve-out would have prevented SpouseCo from claiming an SBD on the $300,000 unless ACo surrendered $300,000 of its business limit to SpouseCo (subsection 125(3.2)). The arrangement is restructured so that ACo does not receive services directly from SpouseCo, but instead contracts with
IntermediaryCo (wholly owned by Mr. A) for $300,000 worth of administrative services. IntermediaryCo in turn subcontracts with SpouseCo to provide the subject services for $299,999.

Without the anti-intermediary measures, the SBD entitlement increases: ACo and SpouseCo are not associated, and each is entitled to $500,000 of business limit. ACo can claim the SBD on $500,000 of net income. The income earned by IntermediaryCo is subject to the clause B carve-out, but its income is only $1. SpouseCo can also claim the SBD on the $300,000 of subcontracting income (subsection 125(10)), because the income is earned from providing services to an associated corporation, IntermediaryCo. Thus, ACo and SpouseCo can claim an aggregate SBD of $800,000, contrary to the policy intent of new section 125.

To prevent this result, paragraph 125(10)(b) disallows the associated-corporation exception if the associated corporation that receives the service or property may deduct the amount in respect of income that is subject to a clause A, B, or C carve-out. On the facts, IntermediaryCo deducts SpouseCo’s subcontracting services against its income from ACo; that income is subject to the clause B carve-out because ACo’s shareholder does not deal at arm’s length with IntermediaryCo, and IntermediaryCo does not earn all or substantially all of its income from arm’s-length customers. Thus, the subsection 125(10) exception is disallowed between IntermediaryCo and SpouseCo.

However, barring further scope in the anti-intermediary rules, the family could still achieve the same result—contrary to the policy intent—by causing IntermediaryCo to assign $300,000 of its business limit, which it does not need, to SpouseCo under subsection 125(3.2). Therefore, paragraph 125(3.2)(c) prevents IntermediaryCo from assigning its business limit to SpouseCo to the extent that it has deducted amounts against income subject to the clause A or B carve-out. As a result, SpouseCo cannot claim any SBD on its $300,000 of income; the only SBD entitlement in the group is the $500,000 claimed by ACo.

**Multiple PC structures.** The anti-intermediary measures may also apply to relatively common business arrangements. For example, a professional partnership has professional corporate partners (PCPs), and each professional individual involved also owns a service professional corporation (ServicePC) that provides services to his or her PCP. Such a structure regularly preserves SBD entitlement under the old SPI rules, which forced partners to share pro rata a $500,000 notional business limit. By charging services against PCP’s partnership income, that income was diverted to ServicePC: ServicePC was entitled to claim the full $500,000 SBD on income otherwise subject to the old SPI rules.

This structure fares poorly under the new rules. The subsection 125(10) exception does not apply to the service income earned by ServicePC, because it is deductible by PCP against the partnership income allocated from the partnership and that latter income is subject to a clause A carve-out, which applies to any partnership income earned by a partner. Thus, all of ServicePC income may be carved out by clause B, and ServicePC may bring that income back into paragraph 125(1)(a) only if PCP assigns business limit to it under subsection 125(3.2). However, PCP is barred from assigning any business limit (paragraph 125(3.2)(c)), because the services that it receives from ServicePC are deductible against partnership income that is subject to the clause A carve-out. Therefore, if the service arrangement has diverted all of PCP’s income to ServicePC, there is no SBD entitlement for either corporation—a harsh result.

To avoid this outcome, businesses and professionals in these structures should consider a restructuring that leaves income in PCP. As a result of this restructuring, PCP may at least be entitled to the SBD to the extent of its specified partnership business limit, which is a pro rata allocation of a notional $500,000 business limit among the partners.

**Supply chain structures.** The anti-intermediary measures may also apply to a structure in which SBD preservation or multiplication was never a primary motivation, such as a corporation carrying on business in a supply chain that has common or non-arm’s-length shareholders. Assume that FishingCo sells raw fish to FilletCo. FilletCo processes the fish and sells fish fillet to RestaurantCo, which in turn cooks fillet and serves it to arm’s-length customers. The three corporations are owned by separate shareholders not dealing at arm’s length. If FishingCo does not earn all or substantially all of its income from arm’s-length customers, FishingCo’s income earned from providing raw fish to FilletCo is subject to the clause B carve-out, and paragraph 125(3.2)(c) prevents assignment of business limit by FilletCo. In contrast, FilletCo and RestaurantCo can effectively share up to a $500,000 business limit through the subsection 125(3.2) assignment mechanism. The outcome is unfair to the owner of FishingCo and may reduce the aggregate SBD entitlement to less than $500,000. The policy rationale for denying FishingCo an SBD is unclear.

**Specified partnership income.** An anti-intermediary measure for the SPI rules is set out in paragraph A(c) of the SPI definition. The underlying concept is similar to the SCI anti-intermediary rules, but the outcome is harsher: the CCPC may lose access to the SPI rules entirely without regard to the quantum of the offending income. This result was set out in a CPA-CBA joint committee submission of August 25, 2016.

Arguably, the policy objective may substantially be achieved without these complicated anti-intermediary rules by a broad interpretation of the phrase “directly or indirectly, in any manner whatever” in the clause A and B carve-outs. Ultimately, the cost of compliance with the new SBD rules falls on the intended beneficiaries of the SBD program: the small business owners.

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