

Court Overturns \$1.3 Million Damages Award Against the CRA

In *Neumann v. Canada (Attorney General)* (2011 BCCA 313), the BC Court of Appeal unanimously overturned an award of \$1.3 million in damages against the CRA for causing harm to a taxpayer, Mr. N, in the execution of a search warrant at Mr. N's residence. The award had been of considerable concern to the CRA because some observers had cited it as an example of anti-taxpayer attitudes and behaviour. The damages had been awarded in 2009 by a BCSC judge and jury on the basis that agents of the CRA had violated the section 8 Charter right of Mr. N to be secure against an unreasonable search or seizure and had negligently caused him harm while executing a search of his residential premises (2009 BCSC 324). (The tort of "negligent investigation" on the part of police was recognized in *Hill v. Hamilton-Wentworth Regional Police Services Board*, 2007 SCC 41.)

At trial, Mr. N testified that CRA agents, accompanied by two uniformed and armed police officers, arrived at his home unannounced and demanded to examine documents and files. The purpose of the search was to obtain business documents relating to an Alberta resident, Ms. B, who was under criminal investigation by the CRA for tax evasion.

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Mr. N had paid commissions totalling \$400,000 to Ms. B in his capacity as president of a company that sold used mining and construction equipment. The company's registered and records office was also Mr. N's residence.

At trial, a psychiatrist testified that Mr. N had been profoundly affected by the search, and that he was suffering from depression and post-traumatic stress as a result of the suddenness of the event and his feeling of lack of control and distrust of the government searchers. The court noted that Mr. N had been born under a dictatorship in East Germany and had escaped to West Berlin with his family at the age of four.

The BCCA acknowledged that the execution of a search warrant at one's home is "doubtless an upsetting and frightening event for anyone who experiences it." Nevertheless, the court said, the search warrant is an important and accepted tool in the fight against crime. When a warrant is lawfully obtained and executed, those subject to it cannot seek compensation for intrusive investigations and searches.

The court concluded that the execution of a search warrant was necessary in this case because the commissions paid to Ms. B were substantial, and thus Mr. N and Ms. B could be presumed to have a close business relationship. Even though Mr. N may have been cooperative with CRA audits up to the time of search, a search warrant was necessary to ensure that all of the evidence available to support the criminal case had been obtained. Further, nothing in the conduct of the search suggested that the CRA was unreasonably intrusive. When a search warrant is served, the CRA requests that police officers accompany their agents to keep the peace; in this case, the police officers left when it was evident that there was going to be no trouble.

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Moving Expenses: A Broadened Definition?

An unheralded 1998 amendment to section 62 may have broadened the definition of eligible moving expenses, according to *Vickers v. The Queen* (2011 TCC 2, informal procedure).

The pre-1998 version of subsection 62(1) limited the amounts that could be claimed to "moving expenses incurred

in the course of moving.” The new wording allows for the deduction of “moving expenses incurred in respect of an eligible relocation.” In *Vickers*, the court noted (citing *Nowegijick v. The Queen*, [1983] 1 SCR 29) that “in respect of” has “probably the widest scope of any expression intended to convey some connection between two related subject matters.” The court concluded that “Parliament’s intent was to broaden significantly the potential scope of section 62.” While this is true for most of the specific deductions permitted, it does not apply to paragraphs 62(3)(a) and (b), since the phrase “in the course of” still appears in each of those paragraphs.

In *Vickers*, the taxpayer, an investment adviser, testified that when he moved to Ottawa to begin his job at a new employer, he had to start work immediately in order to continue to serve his existing clients. However, his family was unable to move for four months. Therefore, he argued, it was necessary for him to travel between Toronto and Ottawa, incurring significant hotel and meal expenses, including expenses incurred on 44 days for which there was no employer reimbursement. The court held that those expenses were incurred “in respect of” the taxpayer’s eligible relocation, and thus 15 days of expenses were deductible under the new interpretation of paragraph 62(3)(c). In addition, 3 days were deductible under paragraph 62(3)(a).

The court found that the most logical result is derived from “interpreting paragraph 62(3)(a) as allowing the deduction of all travel expenses incurred in the actual move, and 62(3)(c) as allowing further and other meal and lodging expenses incurred near either the old or new residence, expenses such as are often incurred in scouting for a new residence or in setting up in or leaving a residence before the actual move takes place.” Although this interpretation avoids the potential redundancy of paragraph 62(3)(c), the first example cited conflicts with the common justification for denying house-hunting expenses—namely, that one cannot be said to be staying near a new residence until the new residence has been acquired.

This interpretation also may have implications for the jurisprudence that was decided under the pre-1998 wording. In particular, *Séguin v. R* (1997 CanLII 5524 (FCA)) held that deductible moving expenses are limited to those incurred for physically changing one’s residence and those directly related to the actual move. This holding may now apply only to paragraphs (a) and (b).

It is interesting to note that the taxpayer in *Vickers* did not raise an alternative means of broadening the moving expense definition—that, as mentioned in *Séguin* and in *Trigg v. The Queen* (2009 TCC 194), the use of the term

“includes” in the preamble to subsection 62(3) suggests a non-exhaustive definition.

The CRA’s position on *Vickers* (which was decided in January 2011), and in particular on the question whether house-hunting costs are still viewed as non-deductible (*Interpretation Bulletin* IT-178R3, “Moving Expenses,” paragraph 12(f)), is unknown, and the court’s interpretation of the amendment has yet to be considered in other cases.

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Capital Gains Deduction Planning for Family Farm Partnerships

Upon the incorporation of a family farm partnership or a family fishing partnership, it may be possible to convert, on a tax-free basis, the accrued capital gain on the partnership interest into a shareholder loan owing to the taxpayer from the corporation. The shareholder loan can then be repaid, allowing the owner to receive retained earnings in non-taxable form. This distribution of income is more tax-effective than either salary or dividend distributions because it is taxed at the corporate rate (currently 14 percent in Alberta, where the small business deduction applies). This strategy exploits the fact that interests in family farm partnerships and family fishing partnerships qualify for the capital gains deduction. Unfortunately, partnership interests in other types of businesses do not qualify.

Consider a farm partnership with two equal individual partners (partner 1 and partner 2). The interests in the partnership constitute “qualified farm property” for the purposes of each partner’s capital gains deduction. The value of each partnership interest is \$500,000, and the ACB of each interest is a negative \$50,000.

Partner 1 transfers his partnership interest to the corporation in exchange for a shareholder loan credit in a principal amount of \$500,000 and one share. He does this through subsection 85(1), electing fair market value as the transfer price in order to recognize a \$550,000 capital gain (to be sheltered by the capital gains deduction). Partner 2 makes the same transfer, leaving the corporation as the sole partner.

Following partner 2’s actions, the partnership dissolves by operation of law; a partnership cannot exist with a single partner. This dissolution and exchange of the partnership interest for the corporate share takes place on a tax-free basis, according to subsection 98(5). However, for that subsection

to apply, the actions of partner 1 and partner 2 must occur on separate days.

Other tax implications of the partners' actions are as follows:

- 1) Each partner must submit form T2057 to the CRA for the subsection 85(1) election on or before the applicable deadline. The proceeds of disposition, amount of shares, and the shareholder loan received are to be reported.
- 2) For GST purposes, the corporation is considered to acquire the partnership assets at fair market value upon the dissolution of the partnership. GST will likely apply to this transaction unless an exemption is available (for example, if the requirements for form GST 44, "Election Concerning the Acquisition of a Business or Part of a Business," are satisfied).
- 3) Section 84.1 does not apply because the transferred property is a partnership interest, not shares.
- 4) If the tax cost of the assets to the corporation is greater than the ACB of the corporation's interest in the partnership, there will be a capital gain in the corporation. In the reverse situation, it may be possible to bump the ACB of any non-depreciable property received during the windup. To make the ACB of the corporation's interest in the partnership as large as possible, the corporation should assume all debts of the partnership as a contribution of capital. This must happen before partner 2 makes the transfer, because after that point the partnership does not exist.

As noted above, the main benefit of this method of transferring a family farm partnership to a corporation is the creation of a shareholder loan account balance that can later be repaid on a tax-free basis. However, it is important to note that the incorporation also allows access to the small business deduction. Thus, the business can reinvest earnings in the business in a more tax-effective way than it previously could as a partnership.

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CRA Confirms Luxco Financing Structure

Consider a Canadian company with a foreign operating subsidiary in a country with which Canada has a tax treaty. Dividends paid by the subsidiary to the Canadian parent will generally be considered to be paid out of the subsidiary's

available exempt surplus, and thus will be effectively tax-free in Canada. One way to improve the tax result for the foreign operating subsidiary while preserving the favourable Canadian tax treatment of the parent company is to finance the foreign operating subsidiary through a Luxembourg entity. In a recent advance tax ruling (2010-0375111R3), the CRA confirms the commonly understood Canadian tax consequences of such treaty-based Luxembourg financing structures.

The ruling involves a Canadian public corporation (Pubco) with two wholly owned foreign subsidiaries: an operating company (Opco) in country A and a Luxembourg financing entity (Luxco). In the proposed transaction, Pubco was to transfer to Luxco certain interest-bearing debt instruments issued by Opco in exchange for Luxco issuing mandatory redeemable preferred shares to a Luxembourg branch of Pubco.

The non-Canadian tax aspects of this structure are outside the scope of the ruling, but generally Opco would obtain a tax deduction in country A for interest payments (withholding taxes may apply), and Luxco would only be subject to tax in Luxembourg on the financing margin for the interest income on the debt.

The financing structure results in a reduction in Opco's tax payable in country A; the interest payments made under the structure are generally deductible to Opco, while the dividend payments they replace are not. As discussed below, the favourable Canadian tax treatment of the parent company—that is, the tax-free receipt of dividends—continues under the financing structure.

The ruling concerns the tax consequences to Pubco. It confirms that the interest income earned by Luxco for the debt would be included in computing Luxco's income from an active business under clause 95(2)(a)(ii)(B) because the interest would be deductible by Opco in computing its earnings from an active business other than a business carried on in Canada. Accordingly, such income would be added to Luxco's "exempt earnings" and "exempt surplus," as those terms are defined in regulation 5907(1), presumably on the basis that Opco was resident in a country with which Canada either has entered into a tax treaty or has a TIEA. Therefore, pursuant to subsection 113(1), Pubco would not be taxable on dividends distributed by Luxco out of its exempt surplus.

The ruling also says that subsection 95(6) (a specific foreign affiliate anti-avoidance rule) and subsection 245(2) (GAAR) would not apply as a result of the proposed transactions. Specifically, the CRA had suggested at the Canadian Tax Foundation's 2004 annual conference that it might consider applying subsection 95(6) when a taxpayer transfers an interest-bearing loan from Canada to a foreign affiliate

financing structure. Therefore, the CRA's ruling on the application of subsection 95(6) and GAAR is welcome, and it should provide comfort for those dealing with treaty-based financing structures in general.

The CRA also commented on the situation in which the debt had a value below its principal amount, perhaps because Opco was in financial difficulty. The ruling notes that paragraph 40(2)(e.1) would apply to deem the loss on the transfer to be nil, with a corresponding addition to the ACB of the debt transferred to Luxco.

The logic of the ruling appears to suggest that similar Canadian tax results would result from treaty-based financing structures in other countries, such as Switzerland, Barbados, and the Netherlands.

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Asserting Privilege over Third-Party Communications: The "Essential Function" Test

Case law has established that when a taxpayer consults with a lawyer for the purpose of obtaining legal advice, communications between the taxpayer and the lawyer in respect of that advice are generally subject to solicitor-client privilege and thus are protected from disclosure to the rest of the world (for example, the CRA). However, if the lawyer consults with an accountant or other third-party adviser in connection with providing that legal advice, there is some uncertainty about whether those third-party communications are subject to privilege. The recent decision in *Bank of Montreal v. Tortora* (2010 BCSC 1430) arguably may benefit practitioners by increasing the likelihood that privilege will attach to those communications.

The landmark case in this area is *General Accident Assurance Company v. Chrusz* (1999 CanLII 7320), in which the Ontario Court of Appeal confirmed that when a third party acts as a messenger who conveys information between a client and its lawyer, any communications between the third party and the lawyer or client are privileged (provided that those communications would have been privileged if they had been made directly between the client and the lawyer). In addition, privilege may apply if the third party is retained to perform "a function which is essential to the existence or operation of the client-solicitor relationship," which must be more than information gathering from a source extraneous to the client.

Welton Parent (2006 FC 67), a tax case, cast doubt on the "essential function" test. The court held that privilege did not apply to communications between lawyers and actuaries retained by those lawyers; unfortunately, there was little discussion about why the third-party actuaries did not satisfy the test.

In *Tortora*, a bank (BMO) was involved in a lawsuit alleging fraud against former employees. Prior to filing the lawsuit, BMO's lawyer hired a fraud analyst to investigate some of its employees, including the defendants. It also retained a consulting company to handle its human resource matters, including those related to the fraud allegations. Legal opinions were provided to the consulting company because it was involved with the termination of the defendants' employment with BMO. The defendants brought an application to the court for the production of certain communications between BMO's lawyer and both the fraud analyst and the consulting company.

Boyd J, applying *Chrusz*, held that the fraud analyst had been "empowered" by BMO's lawyer and BMO to perform a function integral to the solicitor-client relationship, and that the fraud analyst was not merely collecting and passing on information to BMO's lawyer. The court stated that the analyst used his expertise in collecting relevant information from BMO and explaining that information to BMO's lawyer to help facilitate the providing of legal advice to BMO. Similarly, the court determined that the consulting company was "intimately involved" in the defendants' potential termination, and thus the consulting company was essential to the solicitor-client relationship. As a result, privilege applied to the communications between BMO's lawyer and both the fraud analyst and the consulting company.

Tortora appears to be consistent with *Chrusz*, and the two cases provide support for tax practitioners who attempt to assert privilege based on the "essential function" test where the third party provides some expertise or skill in assembling and explaining to the lawyer the information that it collects from the client. For example, practitioners might rely on this test when a tax lawyer retains an accountant to prepare a report to assist in providing legal advice, and the accountant collects information from the client. Thus, *Tortora* offers needed guidance in this area after the decision in *Welton*. (For further analysis of this issue, see Brian R. Carr, "Solicitor-Client Privilege," in the 2010 Conference Report, forthcoming.)

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Responding to Questions Taken “Under Advisement”

Examination for discovery is a pre-trial question-asking procedure used in Tax Court general procedure cases for gathering information, narrowing the issues, obtaining admissions and commitments to facts or positions, and gauging the strength of a witness. In discovery, the witness’s counsel sometimes takes a question “under advisement” in order to gain time in which to determine whether to refuse to answer, and on what basis (for example, solicitor-client privilege). Tax Court judges appear to accept this widespread practice (for example, in *Piersanti v. The Queen*, 2010 TCC 430; *Labow v. The Queen*, 2008 TCC 511; and *Rezek v. The Queen*, 2000 CanLII 138 (TCC)) even though the Tax Court rules are silent on the topic.

The rules require a witness to answer any proper question relevant to any matter in issue (rule 95(1)). Procedures and sanctions are engaged if the witness fails or refuses to do so (rules 96, 107, and 110; rule 116 for written examinations). The only recognized categories under the rules are proper (versus improper) questions and full answers (versus failures or refusals to answer). Taking a question under advisement must be categorized, if it can be categorized at all, as a failure or refusal, albeit a temporary one.

Faced with a question taken under advisement, the examiner has two immediate options. First, she can press for an answer or explicit refusal on the spot on the basis that no “under advisement” category is recognized by the rules, and she can state on the record that the witness has failed or refused to answer. Second, she can accept the response and wait to see whether the question is answered in a reasonable time. In either case, the only way to compel a witness to answer after that time is to move in court for an order compelling an answer or requesting other relief (rule 110). Given the Tax Court’s apparent acceptance of the “under advisement” practice, an immediate move in this regard is likely to be poorly received by the judge. Some waiting time for a response is difficult to avoid; accordingly, it may make sense to accept the “under advisement” answer and provide time for a response. If no response is forthcoming, opposing counsel can be reminded by letter that the question is proper but has not been answered. A deadline can be set, after which the witness will be treated as having refused to answer the question.

The case law provides no specific guidance on how long an examiner should wait before moving for relief. A reasonable approach might be to use the date for completion

of undertakings (usually 30 or 60 days following the deadline for discoveries). Section 31.07 of the Ontario Rules of Civil Procedure suggests that 60 days is a reasonable maximum. (Note that Ontario is the only jurisdiction to have codified the practice of taking questions under advisement.) Ultimately, it is up to the examiner to determine whether and when to force the issue.

Counsel for both the examiner and the examinee should be aware that a refusal cloaked “under advisement” comes at a price: if no answer is given within 10 days of the matter being set down for hearing, the examinee may not introduce the information refused on discovery (rule 96). Further, if the examiner moves for relief, she can request any of the relief set out in rule 110, which includes allowing the taxpayer’s appeal.

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Income Attribution Rules and Trusts

The decision in *Sommerer v. The Queen* (2011 TCC 212; under appeal, court file no. A-188-11) canvasses several interesting legal issues, including the application of the income attribution rules in subsection 75(2). In *Sommerer*, the taxpayer immigrated with his family to Canada from Austria in 1978. Almost two decades later, the taxpayer’s father, an Austrian, established a private foundation pursuant to Austrian legislation. The taxpayer, along with his wife and their children, were named beneficiaries. The foundation purchased from the taxpayer, at fair market value, shares in two Canadian corporations. It later sold the shares and realized capital gains.

Miller J determined that the foundation was a trustee of a properly constituted non-resident trust settled by the taxpayer’s father for the benefit of the taxpayer and his family. (Miller J also recently considered the issue of trust settlement in *Antle v. The Queen* (2009 TCC 465).) He further held that the foundation was not an agent for the taxpayer.

Miller J focused much of his attention on the application of the income attribution rules to the trust. Generally speaking, subsection 75(2) applies with severe consequences whenever a person transfers property to a trust on the condition that (1) the property may revert to the person, (2) the person may determine who can receive the property, or

(3) the property cannot be dealt with without the person's consent or must be dealt with only on the instructions of the person. If the provision is triggered, any income, losses, capital gains, and capital losses related to the transferred property (or property substituted therefor) are attributed to the transferor.

The minister, relying on *Interpretation Bulletin* IT-369R ("Attribution of Trust Income to Settlor," March 12, 1990), asserted that the "person" referred to in subsection 75(2) need not be the settlor of the trust; instead, the person could be any contributor to the trust, including a beneficiary of the trust who was also a vendor of property to it. Thus, capital gains realized on the disposition of the shares ought to be attributed to the taxpayer.

Following a detailed analysis of subsection 75(2), Miller J disagreed with the minister's position, holding that the trust was not a trust to which subsection 75(2) applied. He concluded that "subsection 75(2) of the Act does not apply to a beneficiary vendor of property at fair market value to a trust, but only to a settlor or subsequent contributor, who could be seen as a settlor."

Given the court's decision on the application of subsection 75(2), Miller J did not need to address the taxpayer's contention that Canada was prohibited from taxing any portion of the capital gains having regard to the provisions of the Canada-Austria income tax convention. Nevertheless, Miller J noted that he agreed with the taxpayer's position on this issue. (For further analysis of this case, see "Trust Not Revocable," *Canadian Tax Highlights*, July 2011.)

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The GST/HST Treatment of a Trust as a Separate Legal Person

Applying the GST/HST rules to trusts can be complicated. At common law, a trust is not a separate legal person; rather, "trust" refers to the relationship between a trustee and beneficiary in relation to trust property. In contrast, subsection 123(1) of the Excise Tax Act defines a "person" to include a trust, thereby conferring a separate identity on trusts for GST/HST purposes. This mismatch has sometimes caused uncertainty about how the legislation applies.

Deeming a trust to be a separate person does not fit particularly well within the GST/HST regime. The GST is a transactional tax—it generally requires a "supply" of

property and services, a "supplier," and a "recipient." But a trust, at law, acts only through its trustees; the trust itself is incapable of entering into contracts or otherwise incurring liabilities. So how can a trust make or receive a supply?

For the tax to be legally levied, the "statutory fiction" needs to be complete—that is, all of the elements required to trigger the tax must also be deemed by the legislation. As stated in *W.R. McRae Company Limited v. The Queen* ((1994), 2 GTC 7131 (FCTD)), "[I]n order to levy a tax on the basis of a deeming provision, the legislator must effectively deem every event the occurrence of which is in fact required to trigger the tax." A similar principle was expressed by the court in *State Farm* ([2003] GSTC 35 (TCC)): while a deeming provision (such as the deeming of a trust to be a person for GST/HST purposes) "creates a statutory fiction, or, if you will, an artificial presumption . . . it does not direct us to pursue that presumption to its logical (or illogical) conclusion." Thus, one must still determine whether all the elements required to trigger the tax are present.

Paragraph 267.1(5)(a) attempts to fill in this gap by deeming anything done by a trustee to be done by the trust. For example, if a trustee enters into an agreement to receive supplies, the trust is deemed to be the person receiving the supplies under the arrangement and is liable for any applicable GST/HST.

What if there is no arrangement with the trustee for supplies? So far, the legislative approach has been to create a special rule to fill the gap in each circumstance where this situation arises. In particular, if an employer acquires supplies or incurs internal expenses in relation to its registered pension plan and that plan is governed by a trust, new section 172.1 deems the employer to have made a supply of services to the trust. Similarly, if an insurer deducts an amount from its segregated fund (which is deemed to be a trust), section 131 deems the insurer to have supplied services to the fund (*The Maritime Life Assurance Co.*, 2000 CanLII 16374 (FCA)).

Who is the "recipient" of a supply? The answer may be relevant in determining the supply's GST/HST status—for example, certain supplies to non-residents are zero-rated, and supplies to provincial Crowns and agencies are eligible for a GST/HST rebate. If payments are made out of trust funds, taxpayers must consider whether the true "recipient" of the supply is the trust as a separate person or some other person.

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Litigating Ontario Shuffles

Recent taxpayer victories in *Husky Energy Inc. v. Alberta* (2011 ABQB 268) and *Canada Safeway Limited v. Alberta* (2011 ABQB 329) suggest—subject to the outcome of appeals filed by the tax authorities—the continued viability of tax-planning strategies based on inconsistencies between provincial statutes resulting in an avoidance of provincial tax. However, the situation in Quebec may be different.

The decisions concerned a type of transaction colloquially referred to as an “Ontario shuffle” or “Finco,” which was based on an opportunity afforded by sections 2(2) and 27(1) of the Ontario Corporations Tax Act prior to 2005 amendments. In a nutshell, those sections provided that a corporation resident in Ontario but incorporated in another jurisdiction would not be liable to tax on interest income in Ontario. As a result, corporations in a number of provinces avoided the provincial tax by setting up structures that allowed interest income to be earned in Ontario rather than in another province. In *Husky Energy* and *Canada Safeway*, the Alberta provincial tax was being avoided; consequently, the Alberta government reassessed the taxpayers.

In both cases, the court found that the Alberta GAAR did not apply on the basis that it was not abusive for the taxpayers to reorganize and refinance their operations in order to take advantage of the Ontario tax regime available at the time. In *Husky Energy*, the court said, “There is no principle, constitutional or otherwise, that says that a province may prevent corporations doing business within the province from taking advantage of another province’s tax policy. The reassessments of the Husky from [sic] entities attempt to do precisely that.”

Similarly, in *Canada Safeway*, the court held that “[t]he reduction of tax payable in a province through the use of *bona fide* commercial transactions that transfer income from one province to another to take advantage of a lower tax rate or of a different tax base is not abusive tax avoidance. As noted by the Safeway Group, the free flow of capital across Canada is constitutionally protected and choosing where to employ capital in order to obtain the most favourable provincial tax result is legitimate tax minimization.”

With these decisions, the Alberta Court of Queen’s Bench has sent a strong signal that taxpayers can structure their affairs to benefit from opportunities in other jurisdictions, to the extent that such opportunities can be found.

One caution: as a result of a 2010 amendment, the definition of “avoidance transaction” for the purpose of the Quebec GAAR (unlike similar provisions in other provincial legislation and the federal Act) encompasses the reduction, avoidance, or deferral of tax under a statute of Canada or

of another province. Thus, any future strategy implemented by a Quebec taxpayer and based on non-Quebec legislation could be challenged under the Quebec GAAR, instead of the GAAR of the province whose tax is being avoided. Many questions are raised by this amendment, including whether Quebec has the constitutional jurisdiction to oversee the application of federal legislation or the legislation of another province.

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Alberta Printed Circuits: Basic Transfer-Pricing Concepts

The taxpayer’s appeal was partly allowed in *Alberta Printed Circuits Ltd. v. The Queen* (2011 TCC 232), a lengthy decision that provides guidance on subsection 247(2) of the Act, the OECD transfer-pricing guidelines (1995-2010), and *Information Circular 87-2R*, “International Transfer Pricing.”

The appellant is a Canadian company that produces custom prototype circuit boards, a process that entails setup operations and the manufacturing of the boards. In 1995, the setup operations were moved to Barbados to be carried on by APCI, which provided services to the appellant by performing setup functions, software and website development, and maintenance services. Under the terms of the agreements, APCI charged the appellant a fixed fee for the setup services and a square-inch fee for non-setup services. The appellant charged the same fee for the same services to third-party customers. The CRA asserted that the appellant overpaid APCI \$3.4 million because the terms and conditions of the agreements differed from those that would have been entered into by persons dealing at arm’s length.

The appellant provided evidence of internal comparable transactions between itself and third parties; the transfer prices were determined by the comparable uncontrolled price (CUP) method. The court held that the price paid to APCI for the setup fees was arm’s-length. It allowed the appeal for those amounts but found that the appellant failed to establish that it did not overpay for the non-setup services.

The court relied on the OECD guidelines to interpret section 247 of the Act, as has been done in other cases (for example, *Smithkline Beecham Animal Health Inc. v. Canada*, 2002 FCA 229; *GlaxoSmithKline Inc. v. The Queen*, 2008 TCC 324; and *General Electric Capital Canada Inc. v. The Queen*, 2009 TCC 563). However, the court used the 1995 version of the guidelines for this purpose, since the “update

[was] well beyond the taxation years in issue.” With respect, this conclusion is not in line with current jurisprudence, in which Canadian courts have applied the most recent version of the OECD guidelines or the commentary on the OECD model income tax convention, even if the version was published after the taxation years in issue (see *General Electric Capital* and *Prévost Car Inc. v. Canada*, 2009 FCA 57).

The court strongly disagreed with the CRA’s application of the transactional net margin method. The TCC judge instead accepted the hierarchy of methods established in the 1995 OECD guidelines, which shows a preference for traditional transaction methods and cites the CUP method as providing the highest degree of comparability. Thus, the court preferred the appellant’s internal comparable transactions.

Moreover, the court differed with the CRA’s view that the setup fees included some or all of the square-inch fees, concluding that the transfer-pricing analysis should be made on a transaction-by-transaction basis in most cases, as stated in the OECD guidelines and the information circular.

The decision reiterates the importance of unbundling transactions and studying comparables, but it also demonstrates that internal comparables are the best way to document transactions for transfer-pricing purposes. (For further analysis of this case, see “Transfer-Pricing Update,” *Canadian Tax Highlights*, June 2011.)

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Elimination of Tax Deferral for Corporate Partnerships

The federal budget of March 22, 2011, as reintroduced on June 6, 2011, was minimal in scope, so it is easy to forget the one significant item—the end of the tax deferral for corporate partnerships. As a reminder, this note sets out the main provisions of those proposals. Draft legislation has yet to be released, so changes may still be forthcoming.

Previously, partnerships could be structured with a year-end that would fall shortly after the year-end of a corporate partner, providing almost a year of tax deferral. In addition, declining corporate tax rates produced absolute savings. The budget proposals, which end both tax benefits, are expected to reduce the cash flow of corporate partners (and increase federal revenues) by \$2.8 billion over a five-year period. The proposals are a followup to the 1995 budget, which proposed to end the tax deferral for sole proprietorships

and for partnerships with individuals and professional corporations as members.

The 2011 budget proposals will apply to a corporate partner (other than a professional corporation) for a taxation year ending after March 22, 2011 if (1) the corporation is a member of a partnership at the end of the taxation year; (2) the partnership’s last fiscal period that began in the taxation year ends in a subsequent taxation year of the corporate partner; and (3) the corporation, together with affiliated and related parties, was entitled to more than 10 percent of the partnership’s income (or assets, in the case of a windup) at the end of the last fiscal period of the partnership that ended in the taxation year.

Affected corporations must accrue a notional income amount from the partnership for the portion of the partnership’s fiscal period that falls within the corporation’s taxation year. The income inclusion will be based on a formula that takes the corporation’s actual partnership allocation for the partnership’s fiscal year that ends in the corporation’s taxation year and then prorates that allocation for the stub period, which is the number of days remaining in the corporation’s tax year. This income inclusion is deducted in the subsequent year and a new notional accrual is calculated for that year. The accrual cannot be negative, so a partner cannot accrue partnership losses.

The corporate partner may instead designate any amount above zero for the income inclusion. However, if this designated amount is subsequently found to be less than the lesser of the amount determined by the accrual formula and the actual stub period income of the partnership, the partner will be subject to an additional income inclusion in the subsequent taxation year.

The simplest way to avoid all of the calculations and confusion is to cause the partnership to change its fiscal year-end to coincide with that of the corporate partners. A one-time election is available, provided that certain conditions are met. The election must be made on or before the earliest of all the filing-due dates of any corporate partner.

Significant income inclusions will occur whether or not the election is made. Without the election, the most significant effect is in year 1; with the election, there will be two partnership fiscal years within one taxation year of the corporate partner. The additional income can be recognized gradually over five taxation years: 15 percent in 2012, 20 percent in each of 2013 to 2015, and the remaining 25 percent in 2016.

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The Hardly Simple Tax: Problems in Implementing the New Place-of-Supply Rules

The GST/HST place-of-supply rules provide a framework for determining the province in which a good or service is supplied and thus the applicable tax rate. With the addition of Ontario and British Columbia to the HST system, it has become increasingly important that these rules work properly. Accordingly, new place-of-supply rules were enacted on May 31, 2010 under the New Harmonized Value-Added Tax System Regulations (SOR/2010-117).

The guiding principle of the place-of-supply rules is simple—the HST is a consumption tax; therefore, the appropriate rate should be based on the place where the consumption occurs, not on the place where the supplier is located. This principle is important for equity: two consumers in a province should pay the same tax rate, irrespective of the province in which their goods are purchased. It is also important for neutrality: a vendor in Alberta should not be able offer purchasers in Ontario lower tax-included prices than an Ontario-based supplier could offer.

On the basis of this guiding principle, the new rules have in many cases shifted the place of supply from the supplier's location to the recipient's. The new rules primarily affect supplies of services and intangible personal property (IPP); no significant changes were made to the rules for tangible personal property (TPP) and real property.

One drawback of the new rules is that they may make it difficult for a supplier to determine the tax rate to be charged on a particular transaction.

- Consider, for example, a transaction consisting of varying types of properties or services supplied together. Assume that in a single deal an Ontario-based corporation purchases both TPP and IPP (with a value of over \$300) from an Alberta-based corporation. The particular IPP has no intrinsic restrictions on where it can be used. (The province of “use” is a factor in determining the place of supply of IPP.) In this case, the place of supply of the TPP will be Alberta (where the property is ordinarily located), and the place of supply of the IPP will be Ontario (where the recipient's business is located), unless it is reasonable to characterize the entire transaction as a single supply—not always an easy determination.

- Assume that the recipient in the example above is licensed to carry on business only in the province in which the IPP rights are to be used (Alberta). Should Alberta be considered the place of supply, since use by the recipient is limited to that province?
- Assume that a service is provided in relation to both real property and TPP. Should the supply be considered to have been made in the province where the TPP is located, in the province where the real property is located, or in the province where the recipient is located?

In some instances, the new rules offer ease of implementation at the possible expense of fairness. For example, when a corporation without a Canadian address purchases IPP usable throughout Canada, the supply defaults to the province with the highest provincial component of the HST, irrespective of the actual province in which the property is to be used. Similarly, when services are provided in relation to the supply of various real properties, the supply generally will be considered to be in the province where the bulk of the real property is located. For example, if an Ontario-based real estate lawyer provides legal services to an Ontario corporation in relation to the acquisition of numerous real properties in various provinces, the supply will be made in the province where most of the properties are located. A rule that considered the relative value of the properties in the different provinces might have been more equitable.

Further revisions to the rules are expected to be announced in a new version of *GST/HST Technical Information Bulletin* B-103.

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