



2011 TRENDS

Blakes
CANADIAN LAWYERS

INCOME TAX AND TAX CONTROVERSY AND LITIGATION

TWO BUDGET BILLS ENACTED

Continuing a pattern that has been exhibited over the past several years, 2010 saw the federal government pass multiple bills enacting several, but by no means all, of the measures announced in the March 4 budget.

Bill C-9, which became law on July 12, enacted a welcome and significant narrowing of the definition of “taxable Canadian property” (TCP). Previously, the definition of TCP included shares of private corporations, the sale of which by a non-resident of Canada would attract the cumbersome and time-consuming “section 116” certification process, which generally required purchasers to withhold 25 per cent of the purchase price for several months and (for those non-residents without tax treaty protection) attracted Canadian tax on the sale. The changes brought into law under Bill C-9 generally removed shares of corporations, partnership interests and trust interests from the TCP definition, except where those shares, partnership interests or trust interests are a real property interest or where certain tax-deferred transactions in respect of those shares, partnership interests or trust interests occurred in the five years prior to the disposition.

Bill C-47 became law on December 15. This bill enacted significant changes to the stock-option taxation regime that were announced in the March budget. For a detailed discussion of these changes, please see our “Pension & Employee Benefits – 2011 Trends” publication.

A number of measures announced in the 2010 budget, including changes to the rules governing non-resident trusts and foreign investment entities and legislation aimed at curbing foreign tax credit “generators”, along with numerous previously announced technical amendments, were released in 2010 but not introduced into Parliament. It is expected that 2011 will see many of these amendments passed into law.

SIFT GRANDFATHERING EXPIRES

On October 31, 2006, in response to the perceived threat to the Canadian tax base from the proliferation of income trusts, the Government of Canada announced an entity level tax on publicly-traded business trusts and partnerships. This tax on “specified investment flow-through” entities (SIFTs), was grandfathered for existing trusts and partnerships (provided they did not issue equity in excess of permitted thresholds under the “normal growth guidelines”). That grandfathering period expired on December 31, 2010.

Accordingly, all trusts and partnerships meeting the definition of a SIFT under the *Income Tax Act* are now subject to entity level tax. REITs (discussed below) are excluded from this regime. 2010 saw a number of trusts that would have become subject to the SIFT tax on January 1, 2011, convert to corporations to prevent the application of the SIFT tax. Of course, these corporations are subject to entity level tax; however, perceived benefits of a corporate structure such as greater flexibility in the use of cash flow, simplicity of structure, greater comparability to corporate peers and better access to capital likely encouraged the rush of conversions.

A handful of income trusts decided not to convert, meaning that they will be liable to pay the SIFT tax beginning in 2011. The SIFT regime subjects certain trust income to entity-level tax at rates approximating corporate tax rates. However, there are subtle differences in the SIFT tax regime from the general corporate tax regime that in some cases may make the SIFT regime preferable. As an example, these trusts may anticipate making distributions to unitholders in the form of tax-free returns of capital, which is generally not possible for publicly traded corporations without triggering a deemed dividend. These trusts may have resisted converting to a corporate structure for non-tax reasons as well.

RELIEF FOR REITS

On December 16, 2010, proposed amendments affecting the treatment of real estate investment trusts (REITs) under the *Income Tax Act* were released for public comment. These changes, while still falling short in some respects, will generally make it easier to qualify as a REIT and thereby be exempt from entity-level taxation under the SIFT rules (discussed above under the heading “SIFT Grandfathering Expires”).

These proposed changes generally take effect for the 2011 tax year, although an election can be made to apply the rules to prior years. The new rules enable REITs to hold up to 10 per cent of their “non-portfolio property” (a term that generally covers most property held by a typical REIT) in the form of property that is not “qualified REIT property”. Previously, if a REIT had any non-portfolio property that was not qualified REIT property, that REIT would be subject to tax as a SIFT for the entire year, even if the REIT only held the property for a very brief period or in *de minimis* quantities. Other welcome changes, including a relaxing of certain revenue tests, rules enabling subsidiaries of REITs to hold certain property for resale and rules preserving the characterization of income received from flow-through REIT

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subsidiaries (trusts or partnerships) were also included in the package of amendments.

Unfortunately, the ability of a REIT to own a taxable REIT subsidiary, a concept permitted under U.S. REIT legislation, was not included in the proposed amendments. In many cases, this will make it difficult for REITs that concentrate on senior housing or hotels to qualify for the exemption from entity-level tax under the SIFT rules.

ANTI-HYBRID RULES COME INTO FORCE

In September 2007, Canada and the United States signed a protocol to the Canada-U.S. Tax Treaty (5th Protocol), which entered into force on December 15, 2008. Significant measures impacting the treatment of so-called “hybrid entities” were delayed, coming into force on January 1, 2010. These rules can have significant practical implications on inbound investment into Canadian unlimited liability companies (ULCs).

ULCs are generally subject to different treatment under Canadian and U.S. tax law. In Canada, ULCs are taxed as ordinary corporations; whereas in the U.S. such entities are presumptively treated as either disregarded entities or partnerships, depending on the number of shareholders (unless a contrary election is made). This so-called “hybrid” treatment was in several instances beneficial.

The anti-hybrid measures in the 5th Protocol deny treaty-reduced rates of withholding tax on items of income paid by fiscally transparent (for U.S. purposes) ULCs to U.S. treaty residents where certain conditions are met. Unfortunately, the broad language used by the drafters of the 5th Protocol to achieve this objective has resulted in considerable uncertainty as to the application of these rules. The rules basically deny Treaty benefits on payments from a ULC to a U.S. resident if the “treatment” of the item in the hands of the recipient is not “the same” as the hypothetical treatment that would have been obtained had the ULC not been fiscally transparent for U.S. tax purposes.

In 2010, the Canada Revenue Agency (CRA) released some helpful technical guidance on the application of the anti-hybrid rules to payments made by ULCs. Several advance income tax rulings endorsed a contrived, yet permissible, two-step process for achieving a treaty-reduced rate of withholding tax when a ULC wishes to make a dividend distribution.

The CRA has also acknowledged that the zero rate of withholding tax on related-party interest may apply to interest payments made by a ULC to a related U.S. corporation that is not the direct shareholder of the ULC (e.g., a “grandparent” corporation), even where the U.S. “grandparent” corporation is the parent entity of a U.S. consolidated group. If the grandparent lends money to the

ULC, the CRA has confirmed that interest paid by the ULC will generally not be subject to the anti-hybrid rule; this is because the treatment of the item (recognition as interest income) is the same as it would have been had the ULC been non-transparent. The fact that the geographic source of the interest differs was not considered problematic.

Despite these welcome clarifications, numerous issues surrounding cross-border payments made by ULCs remain unresolved. In particular, where the immediate shareholder of a ULC is a fiscally transparent U.S. limited liability company, the ability to obtain treaty protection remains uncertain. Hopefully, additional clarifications from the CRA will be forthcoming in 2011.

PROCEDURAL DISPUTES IN TAX DISPUTE RESOLUTION PROCESS

2010 witnessed the continued escalation of a trend impacting taxpayers involved in the tax dispute resolution process: the increasing number of protracted procedural disputes impacting the court process. Indeed, a significant number of Canadian tax court decisions on motions concerning largely procedural matters were handed down in 2010. This trend signifies an increasingly adversarial process that can only be more costly for taxpayers and the government alike.

One example of this trend was discussed in a decision released by the Tax Court of Canada on December 30, 2010 (*Cameco Corporation v. The Queen*). In that case, the court criticized both parties in a somewhat direct and unprecedented manner.

Procedural disputes of the sort involved in this case seem likely to continue, if not increase, in 2011.