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Government of Canada tests the limits under the Income Tax Act in 2017

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In 2017, the Canada Revenue Agency (the CRA) pursued litigation which tested the limits of its powers under the *Income Tax Act*. The landmark *Cameco* case, now on reserve before the Tax Court of Canada, was the first tax appeal involving the scope of the recharacterization provisions in Canada's transfer pricing rules for related-party international transactions. Likewise, in *BP Canada Energy Company v. Canada (BP Canada)*, the CRA pursued a test case to the Federal Court of Appeal on the limits of its power to seek production of a taxpayer's internal analysis of uncertain tax positions. On the legislative side, the Department of Finance released a package of broad proposals which many say unfairly targeted Canadian private companies and their shareholders. The measures, which were largely intended to reduce certain perceived advantages of earning income through a corporation, were widely criticized by the business community and financial advisors and several of the proposals have now been abandoned or substantially revised. This article explores each of these 2017 developments in the administration of Canada's tax system.

Tax Court hears landmark case involving transfer pricing recharacterization rule

The international tax system has been the subject of recent debate in the news with populist accusations of companies not paying their "fair share" of taxes, leaks of documents, and the fallout from the Base Erosion and Profit Shifting (BEPS) project of the OECD. While most of that debate focuses on whether new laws should be adopted, the Tax Court of Canada heard a landmark case (*Cameco*) in 2017 that may influence how Canada's existing transfer pricing tax rules are applied to multinational corporations. The trial heard from dozens of witnesses and lasted over 60 trial days.

In particular, the case presents the Court with its first opportunity to interpret the recharacterization provision of the transfer pricing rules – a provision that permits the Court to set aside the actual transactions between a Canadian taxpayer and a non-arm's length foreign person and recharacterize them in relation to the transactions that arm's length parties would have entered into.

In *Cameco*, the Canadian parent mined and sold uranium to its Swiss subsidiary under long-term contracts. The Swiss subsidiary also acquired uranium from third parties. The Swiss subsidiary sold its acquired uranium to third parties via a back-to-back contract with a related U.S. subsidiary.

The Minister of National Revenue challenged Cameco on three fronts. First, the Minister invoked the previously untested recharacterization provision in an attempt to eliminate the

subsidiary from these transactions altogether (with profits thereby accruing to the Canadian parent). The Minister's argument was based on the assumption that arm's length parties would not have included the subsidiary in such transactions.

Second, and in the alternative, the Minister argued that the Swiss subsidiary's profit should accrue to Canada under the traditional transfer pricing rule – where the actual transactions are retained but the terms and conditions are adjusted to those that would have been agreed to by arm's length persons. While the Courts have previously dealt with this rule, *Cameco* raises a number of important issues regarding how risk is treated, how the transfer pricing rules relate to other provisions in the *Income Tax Act* and, of course, how the traditional transfer pricing rule interacts with the recharacterization rule.

Finally, the Minister has also alleged that the series of transactions undertaken by the Cameco entities was a sham under common law principles.

Cameco, represented by Osler, has vigorously contested the Minister's allegations, which Cameco believes are entirely without merit. The Court's ruling is expected in 2018 and will be closely watched by the tax community.

Federal Court of Appeal defines limits of the CRA's power to demand documents

In *BP Canada*, the Federal Court of Appeal offered important guidance on the limits of the CRA's statutory powers to demand documents that relate to the taxpayer's internal analysis of uncertain tax positions. These documents are known as "tax accrual working papers," and generally refer to papers created by or for independent auditors in order to assist in the process leading to the certification of financial statements in accordance with GAAP.

In *BP Canada*, the taxpayer had been fully co-operative in providing all the facts and records that the CRA had requested on audit and had, in fact, satisfied all the CRA auditor's concerns in relation to the particular tax year. The auditor then demanded an unredacted list of the taxpayer's uncertain tax positions. The CRA auditor ultimately admitted that the purpose of this request was to use the list as a "road map" to facilitate audits of BP Canada for future taxation years.

The Court unanimously refused to grant this request, holding that the statutory regime, properly interpreted, does not make "tax accrual working papers" compellable without restriction and that the Minister cannot enlist taxpayers to reveal soft spots in their tax returns. While the tax system is one of self-assessment, the obligation to self-assess does not require taxpayers to self-audit or to perform core aspects of the CRA's audit function. The context and purpose of the statutory regime indicates that Parliament intended the document disclosure power to be used with restraint when dealing with tax accrual information and that such information is not required to be routinely provided. The Court noted that the CRA's own published policy on document disclosure states that the power to access tax accrual documents will not be used routinely. Seeking ongoing access to BP Canada's uncertain tax positions effectively turned that policy on its head.

The Court further accepted the argument that requiring tax accrual papers to be routinely provided would undermine financial reporting obligations under provincial securities legislation by creating an incentive for publicly traded corporations to refrain from documenting issues for their external auditors and to be less candid in disclosing their tax risks. In the Court's view, Parliament cannot have intended the audit powers in the *Income Tax Act* to imperil the integrity of provincial financial reporting systems.
The CRA has chosen not to appeal the *BP Canada* decision. It is anticipated that the CRA will

publish an updated policy to address when it is appropriate for CRA auditors to request this type of document. It is to be hoped that the revised policy will continue to reflect the Court's admonition that such requests not be made for purposes of scoping the CRA's audit.

Private company tax reform

In July 2017, the federal government proposed sweeping changes to the manner in which Canadian private companies are taxed. The proposals addressed four broad areas; (i) income sprinkling, (ii) the taxation of passive income held in private corporations, (iii) surplus stripping (transactions intended to convert regular income into capital gains), and (iv) limiting access to the lifetime capital gains exemption (LCGE).

As a result of significant public criticism, the government indicated that it will scale back on the passive income proposals and will not be moving forward with either the surplus stripping proposals or the proposals to limit access to the LCGE.

The government also announced that the small business tax rate would be reduced from 10.5% to 10% effective January 1, 2018, and to 9% effective January 1, 2019.

Income sprinkling

Where a child under the age of 18 receives certain taxable dividends from private corporations (or income from partnerships and trusts derived from a business or a profession), these amounts will be taxed in the child's hands at the highest personal tax rate (i.e., tax on split income). The government has proposed to expand the types of income to which the tax on split income could apply. In addition, the proposal expands the persons to whom the rules could apply to include spouses, adult children and related persons (such as aunts, uncles, nieces and nephews). Where the amount received is "reasonable" having regard to the level of contribution made by the individual to the business, the high rate of tax on split in income will generally not apply.

Draft legislation outlining the proposals and providing greater certainty for family members who contribute to the business is expected in late 2017 and is proposed to be effective for the 2018 and subsequent taxation years.

Passive income

Very generally, the aggregate amount of tax paid on investment income earned by a corporation and distributed to shareholders as a dividend is similar to the amount of tax an individual would pay on the same investment income earned directly. However, because active business income is taxed in a private corporation at a lower tax rate than the same income earned by an individual, a private corporation earning business income will generally have more "after tax" funds to invest in passive investments.

While draft legislation has not yet been released, the government has indicated it is considering ways to address this "perceived advantage." This could ultimately result in an effective tax rate of over 70% on certain passive income. However, the government has recently confirmed that new rules will not apply to past investments and income earned on past investments. The government is also proposing to introduce a $50,000 annual exemption from the higher rate of tax.

Draft legislation for these rules is expected in the 2018 federal budget.