

Corporate Tax - Canada

Reviewing the significant tax developments of 2012

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January 25 2013

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The year 2012 brought significant Canadian tax developments in several areas.

Legislation

The 2012 federal budget strengthened Canada's thin capitalisation rules by:

- reducing the debt-to-equity limit from 2:1 to 1.5:1 (effective January 1 2013);
- including debt incurred by a partnership of which a Canadian corporation is a member; and
- treating disallowed interest as a dividend for Canadian withholding tax purposes.

New foreign affiliate dumping rules apply to investments by foreign-controlled Canadian corporations in foreign group members that are or become foreign affiliates. Secondary transfer pricing adjustments affecting a non-arm's-length non-resident are now deemed dividends (triggering non-resident withholding tax). Starting in 2013, reduced benefits under the scientific research and experimental development regime will be phased in, while some resource sector investment tax credits will be phased out (subject to transitional relief).

Draft legislation was released to deny the deduction of amounts paid by the issuer of a stapled security (ie, debt and equity that trade as a unit) in some circumstances.

The non-resident withholding tax rules were amended so that trust income made payable (but not paid or credited) to a non-resident beneficiary is deemed paid or credited for withholding tax purposes before a trust's emigration from Canada.

A comprehensive technical bill introduced on October 24 2012 implements (and in many cases revises) several outstanding legislative proposals going back many years, including:

- long-awaited amendments to Canada's foreign affiliate regime (including upstream loan rules);
- amended rules regarding non-resident trusts, offshore investment fund property, real estate investment trusts, foreign tax credit generators, aggressive tax avoidance transaction reporting and restrictive covenant rules;
- expanded shareholder benefit and debt rules addressing partnerships and issues arising from foreign spin-offs; and
- amended rules regarding the treatment of non-residents with Canadian service providers.

Canada signed tax treaties with Serbia and Hong Kong, updated its treaties with New Zealand and Poland and signed protocols with Austria and Luxembourg. Canada's treaty with Colombia and the protocol to the Canada-Singapore treaty entered into force.

Canada's tax information exchange agreements with Costa Rica, the Dominican Republic, the Netherlands (in respect of Aruba) and Saint Lucia entered into force. Canada also began negotiating an information exchange agreement with the United States.

Jurisprudence

General anti-avoidance rule

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The Supreme Court of Canada dismissed the taxpayer's appeal in *Copthorne Holdings Ltd v The Queen*. An internal reorganisation carried out before a horizontal amalgamation in order to preserve the paid-up capital of both amalgamating corporations' shares on the amalgamation was subject to the general anti-avoidance rule (GAAR).

The government has sought leave from the Supreme Court to appeal the Alberta Court of Appeal's decision in *The Queen v Husky Energy Inc*. In that and a similar case, *The Queen v Canada Safeway Limited*, the provincial version of the GAAR was not applied to inter-provincial tax planning that exploited differences (now eliminated) between Ontario and Alberta's corporate tax rules.

The Federal Court of Appeal applied the GAAR in *Triad Gestco Ltd v The Queen, Ontario Ltd v The Queen* and *Global Equity Fund Ltd v The Queen*, in which a loss was manufactured through a series of transactions to offset a previously realised gain.

Other Supreme Court cases

The Supreme Court dismissed the taxpayer's appeal in *Garron Family Trust (Trustee of) v The Queen*, upholding the use of a central management and control test to determine that a Barbadian trust was resident in Canada for tax purposes.

The Supreme Court dismissed the government's appeal and the taxpayer's cross-appeal in *The Queen v GlaxoSmithKline Inc*. The Tax Court of Canada must now reconsider, based on a related licence agreement, whether the taxpayer paid a reasonable price to a related non-resident for the supply of an active ingredient in a brand-name medication manufactured and sold in Canada.

The taxpayer was granted leave to appeal the decision in *Daishowa-Marubeni International Ltd v The Queen* requiring it to include in its taxable sale proceeds the non-cash consideration it derived from transferring a reforestation obligation attached to the timber property it sold.

The taxpayer in *Envision Credit Union v The Queen* was granted leave to appeal the decision that the amalgamating corporations' tax attributes flowed through to the amalgamated corporation on a non-tax-deferred amalgamation.

Other decisions

In *FLSmith v The Queen* the Tax Court held that the taxpayer could not deduct taxes paid by a US hybrid entity involved in a cross-border financing structure.

The Tax Court in *Velcro Canada Inc v The Queen* held that a Dutch intermediary holding company was entitled to a treaty-reduced rate of Canadian royalty withholding tax because it beneficially owned the royalties and was not a conduit.

In *Sommerer v The Queen* the Federal Court of Appeals held that a non-resident trust's gains from a sale of property could not be attributed to the person who sold the property to the trust and that the gains were exempt from Canadian taxation under the Canada-Austria tax treaty. In *McPeake v Canada (Attorney General)* the British Columbia Supreme Court rectified a trust deed to reflect the taxpayer's tax avoidance intent. In *Twomey v The Queen* the Tax Court held that the taxpayer could correct clerical errors in corporate share transactions without a court-ordered rectification.

Commodity tax

Persons doing business in Canada were busy preparing for significant commodity tax changes in 2013. The federal goods and services tax is a value added tax levied in Alberta, Saskatchewan, Manitoba, Nunavut, the Northwest Territories, Quebec and Prince Edward Island. Saskatchewan, Manitoba and Prince Edward Island levy an additional provincial sales tax that is not a value added tax. British Columbia, Ontario, Nova Scotia, New Brunswick and Newfoundland and Labrador levy a harmonised sales tax (provincial sales tax harmonised with the goods and services tax). Effective April 1 2013, British Columbia will cease to levy harmonised sales tax and reintroduce a provincial sales tax, while Prince Edward Island will implement a harmonised sales tax. Quebec also levies a provincial sales tax – the Quebec sales tax – which is mostly harmonised with the goods and services tax.

Effective January 1 2013, Quebec has fully harmonised its Quebec sales tax with the goods and services tax:

- The Quebec sales tax rate has increased to 9.975% and will be calculated on a base that does not include goods and services tax;
- Suppliers of financial services can no longer claim input tax refunds;
- Non-residents can no longer register for Quebec sales tax to avoid the drop shipment rules; and
- Registered non-residents must cancel their registrations.

Much of the implementing legislation has not yet been released, complicating

businesses' preparations for the changes.

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An earlier version of this update first appeared in *Tax Notes International*, December 24 2012, p1191.

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