TAX FOR THE Owner-Manager

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The CRA's Perspective on the New SR & ED Claim Form

Editor's note: This article is a response to "New Form T661 for SR & ED Claims" (Tax for the Owner-Manager, April 2009).

The scientific research and experimental development (SR & ED) program is a federal tax incentive program administered by the CRA, which encourages Canadian businesses of all sizes and from all sectors to conduct research and development in Canada. In 2008, about $4 billion in tax assistance was provided to over 18,000 claimants.

On November 10, 2008, the CRA launched its new Form T661, "Scientific Research and Experimental Development (SR&ED) Expenditures Claim," and Guide T4088, "Guide to Form T661—Scientific Research and Experimental Development (SR&ED) Expenditures Claim," to streamline the process and reduce the administrative burden for small and medium-sized enterprises claiming SR & ED investment tax credits. In addition, on November 17, 2008, the Honourable Jean-Pierre Blackburn, Minister of National Revenue and Minister of State (Agriculture and Agri-Food), announced the launch of a suite of new products to make it easier for all businesses to take advantage of these credits. By making it easier to apply for SR & ED tax credits, the CRA is supporting innovative businesses that are the driving force of long-term growth in the Canadian economy. To date, these new products have been well received, and the CRA has been lauded for the improvements they represent.

According to the April 2009 article, the CRA has been making significant administrative changes to the way it interprets the scientific eligibility criteria aimed at curtailing the type of work that is eligible under the program. There is also a perception among industry members that claims are being assessed more harshly. The article further states that the new term "technological obstacles" appears to have a more rigorous definition than the term "technological uncertainty," which is defined in *Information Circular* 86-4R3 ("Scientific Research and Experimental Development"). The CRA would like to assure claimants that there have been no changes to the eligibility criteria, the SR & ED program's policies, or their application as a result of the new Form T661 and Guide T4088. The SR & ED legislation and the program's application policies and other technical publications remain in force. This means that the program's eligibility and expenditure requirements remain the same, as the technical publications take precedence over the guide. The guide is meant only to be an aid to completing the form. Furthermore, the new term "obstacle" was introduced for clarity and to avoid any misunderstandings, as consultations with claimants across the country indicated that they associated the term "uncertainty" with "business uncertainty." It was noted that claimants overwhelmingly preferred the term "obstacles" to "uncertainties." Explanations in Guide T4088 have also been improved for clarity, and the CRA will be looking to further improve these explanations in the next revision of the guide.

Regarding the requirement for claimants to provide detailed project descriptions for all projects instead of the 20 projects with the largest dollar value, it should be noted that since the November 2008 launch of Form T661, the CRA has consulted widely with SR & ED claimants and other external stakeholders on this and other subjects related to the form. The vast majority of claimants have indicated that they are pleased with the CRA's undertaking to simplify and streamline the form and reduce the administrative burden related to claiming SR & ED investment tax credits. Although a large number of claimants have fewer than 20 projects,

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a small percentage of claimants with more than 20 projects have requested more time to adapt to the new requirement of submitting part 2 of the form for all projects being claimed instead of for only the 20 projects with the largest dollar value. To respond to this concern, the CRA has extended the time to comply with this requirement by an additional year for all claimants.

Therefore, claimants can continue to provide part 2 of the form for only the 20 projects with the largest dollar value for the tax years ending before 2010. However, during a CRA review of the claim, information on all projects being claimed may be required, as has always been the case.

In addition, a new five-digit code was introduced on Form T661 to help claimants identify the most appropriate field of science or technology for each project. The CRA encourages claimants to select the best overall code, which will help them provide a focused response to the questions regarding advancement at line 240 or 250 of the form. While a project may include activities in several fields, the form requires claimants to identify the primary field of science or technology that relates to the overall objective of the project. Claimants do not have to break down the project into sub-projects for each field of science or technology, and the CRA will not penalize a claimant for choosing the wrong code.

Furthermore, the 1,400-word limit on the description of a project at lines 240 to 244 of Form T661 is intended to encourage claimants to focus on the technical aspects of the project rather than describe the business aspects of the project. In general, lines 240 to 252 are designed to encourage shorter and more direct responses to help claimants provide the information needed to meet the eligibility requirements. Clear and concise descriptions will allow the CRA to speed up the review and process the claim as quickly as possible. It should be noted that the CRA will not disallow a project based on the quality or technical content of the narratives for these lines.

With respect to the compliance concerns stated in the April 2009 article, it is important to note that providing technical descriptions is not a new requirement. The technical descriptions are prescribed information and were always part of Form T661 and, by extension, part of the tax return. Therefore, the corporate officer signing the form has always been accountable for the accuracy of all the information provided with the form. On the issue of including diagrams, charts, tables, or photographs with the form, it should be noted that the CRA considers these items to be supporting evidence. Claimants can indicate on lines 270 to 282 of the form that they have these types of supporting evidence and provide them upon request or during the technical review. In addition, with respect to the perception that the CRA will be conducting more rigorous reviews as a result of the hiring of additional science reviewers, it should be noted that the intent in the 2008 federal budget of allocating an additional $10 million annually was for the CRA to implement administrative improvements aimed at increasing the SR & ED program's scientific capacity. This includes the hiring of 60 additional scientists and engineers to help strengthen service and employee-claimant interactions.

With regard to the section of the April 2009 article that states that the CRA may be considering using academic qualifications as one of its project pre-screening criteria, it should be noted that the purpose of requesting the names of the individuals directly involved in a project, as well as their qualifications and experience, on Form T661 is to help the CRA identify whom to contact if any clarification is needed during the initial review of the claim. The qualifications and experience will also help CRA staff get an understanding of the level of training and experience of the key individuals, which in turn will help the CRA get an impression of the technological context of the business, resulting in a fair and equitable review of the project. It should be further noted that the CRA does not screen files on the basis of the qualifications of individuals.

Overall, the CRA believes that the new Form T661 and Guide T4088 launched in the fall of 2008 represent positive changes that are advancing the program and are beneficial to all SR & ED claimants. For more information about the SR & ED program, services, and tools available to claimants, and to view questions and answers that provide further clarity on the new Form T661, please visit our Web site at http://www.cra-arc.gc.ca/sred.

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Characterizing Bad Loans Made to Closely Held Companies

When loans made by shareholders (or corporations they control) to closely held corporations go bad, the loss is usually characterized as an ordinary capital loss or, if the borrower is a small business corporation, perhaps as a business investment loss. However, it is worth considering whether or not such losses can be written off in their entirety. This issue is particularly important if the loss is an ordinary capital loss and there is little prospect of realizing offsetting capital gains. In this regard, it is noteworthy that the writeoff of a debt due from a corporation to a non-arm's-length corporate lender is precluded by subparagraph 39(1)(b)(iv) of the Act from being a business investment loss.

A synopsis of the principles is found in *966838 Ontario Inc. et al.* (2009 DTC 822 (TCC)). The Tax Court considered a number of different loans that had been made to an operating corporation (Opco), which later went bankrupt:

- Loan 1: loans made by its controlling shareholder (L) in his personal capacity.
- Loan 2: loans made by an investment corporation (Investco) controlled by L.
- Loan 3: loans made by a second operating corporation (Opco 2) controlled by L.

The loss on loan 2 was held to be fully deductible to Investco under subparagraph 20(1)(p)(ii) on the basis that the loan had been made in the ordinary course of Investco's moneylending business. The court observed that Investco earned interest on a number of loans—including, apparently, loans to outsiders—and that such loans constituted its most substantial assets. The court rejected the Crown's argument that a taxpayer needed to advertise publicly its intention to lend to "all and sundry," a requirement set out in some earlier Canadian jurisprudence such as *R.S. Jackson Promotions* (85 DTC 145 (TCC)) and *Consolidated Bowling* (68 DTC 357 (TAB)). It is important to note that *Consolidated Bowling* also held that making loans only to subsidiaries does not qualify as a moneylending business.

The losses on the other loans were held not to be deductible under subparagraph 20(1)(p)(ii). The taxpayers argued that those losses were fully deductible on general principles (that is, subsection 9(1)). This argument was also rejected by the court.

The court cited jurisprudence to the effect that loans made to provide working capital generally give rise to capital losses rather than business losses, as is generally the case with respect to loans made by shareholders. The court indicated that there is an exception to this rule when the loan is made for income-producing purposes related to the lender's own business rather than to the business of the borrower in which the lender holds shares. Loan 1 could not meet this exception unless the corporate veil was pierced and Opco's business was viewed as that of L.

Loan 3 also did not meet the exception, despite the fact that the Opco supplied Opco 2 with raw materials for the latter's manufacturing operation. Opco 2 contended that it had made the loans because the success of Opco would have a substantial bearing on its own success. The court rejected this argument on the basis that the loans nevertheless provided Opco 2 with an enduring advantage and were therefore capital in nature. The court also distinguished this case from earlier cases that had allowed a full income deduction for loans and guarantees that had been made to prop up arm's-length customers whose success would contribute to the lender's success: see, for example, *Jones Tobacco* (73 DTC 5577 (FCTD)) and *Lavigueur* (73 DTC 5538 (FCTD)). The court felt that those cases involved circumstances where the loans and guarantees were directly attributable to preserving a stream of income. The more recent case of *Valiant Cleaning Technology* (2008 DTC 5112 (TCC)) illustrates that bad loans to a non-arm's-length subsidiary can be written off in full if their main purpose is to protect the lender's income stream, even indirectly.

There may be circumstances in which loans are made to one's own corporation in the course of an adventure in the nature of trade, as was the case in *Freud* (68 DTC 5279 (SCC)). In such circumstances, which are rare, a full income deduction will be available if the loans should go bad. However, where an individual advances money to a controlled investment holding company for on-lending to a controlled Opco, if Opco becomes bankrupt the initial advances to the investment holding company may not be deducted in full, even where the financing is part of an adventure in the nature of trade: *Casey* (2008 FCA 299).

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Should Partnership Information Returns Be Filed as a Matter of Course?

Form T5013, "Partnership Information Return," is required to be filed pursuant to regulation 229 in respect of Canadian partnerships (and certain other partnerships). However, the minister of national revenue has the authority under subsection 220(2.1) of the Act to waive any requirement to file a prescribed form. For the time being, at least, a waiver has been granted for partnership information returns from partnerships with five or fewer members, none of which is another partnership, if the partnership has not invested in flowthrough shares and there has been no demand to file the return. (In CRA Guide T4068-1, "2007 Supplement to the 2006 T4068—Guide for the

T5013 Partnership Information Return," the CRA revoked a change to the 2006 guide, which had removed the waiver where any member of the partnership was a corporation or trust, but suggested that the filing requirements would be "re-examined" during the next revision of the guide.)

Accordingly, many partnerships are under no obligation to file the partnership information return. But should they file it nonetheless? Subsection 152(1.4) generally permits the minister to determine the income or loss of a partnership within three years after the partnership information return is filed. Therefore, until the information return is filed, the minister is free to determine those amounts at any time. When such a determination is made, subsection 152(1.7) generally permits the minister to assess any member of the partnership to give effect to the determination.

The CRA has long been of the view that if the partnership information return is not filed in respect of a particular partnership, it can assess the members of the partnership at any time in respect of partnership income or loss. If there was ever any doubt about the correctness of that position, it has been erased by paragraph 197(6)(b), which allows the minister to assess "at any time" tax payable under part I (or SIFT entity tax payable under part IX.1) to give effect to a determination under subsection 152(1.4). (Curiously, paragraph 197(6)(b) does not refer to interest or penalties, although nothing likely turns on this given that it purports to apply "for greater certainty" and subsection 152(1.7) expressly contemplates assessments of interest and penalties in addition to taxes.) The recent decision of the Tax Court in *Cummings* (2009 TCC 310) is consistent with the CRA's position, although it is not directly on point.

Irrespective of whether a partnership information return is required to be filed on behalf of a particular partnership, it is often prudent for the partnership to file the return as a matter of course in order to establish a limitation period for potential assessments in respect of members of the partnership. Even if a partnership is not required to file a return, it can do so voluntarily at any time without incurring late-filing penalties (see TI 2000-0010935 and TI 2000-0017325). It is necessary to evaluate whether or not the potential benefit of commencing a limitation period outweighs the risk of attracting heightened CRA scrutiny by filing the form late, particularly if many years of non-filing have already passed without incident.

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Legal Form Matters

In *Wabush Iron Company Limited* (2009 TCC 239), one issue decided by Paris J was whether the entire price paid by shareholders of the appellant for iron pellets was income to the appellant. Wabush Mines, an unincorporated joint venture between the appellant and other companies, operated an iron ore mine and concentrator and a processing facility where the iron ore concentrate was made into iron pellets. The joint venture arrangement involved several agreements, including a joint venture agreement (JVA) and a pellet sales agreement (PSA).

Under the JVA, each of the joint venturers was required to pay its share of the expenses, was entitled to a proportionate share of the pellets and to any income derived from the operation, and was liable for the expenses relating to the joint venture as well as investments in connected subsidiaries. Pursuant to the PSA, the appellant sold its share of the iron pellets to its shareholders in proportion to their shareholdings at a price equal to the greater of the FMV of those pellets and the shareholder's share of the costs incurred by the appellant in relation to the joint venture for the year. Under the PSA, the shareholders were still obligated to pay their proportionate share of the costs for the year even if the appellant did not produce or deliver pellets.

The costs for each of 1991 to 1994 were greater than the FMV of the pellets, so the shareholders paid their proportionate share of the costs. For financial statement purposes, the appellant recorded all amounts received from its shareholders as revenue from the sale of pellets. For income tax purposes, the appellant reported its income on the basis that the price received was the FMV of the pellets, and the excess amounts paid by the shareholders were contributions of capital to finance operations. The appellant was reassessed on the basis the entire amount paid by the shareholders was income.

The appellant, citing *Dominion Taxicab Assn.* (54 DTC 1020 (SCC)), argued that even though the payments referred to in the PSA were described as being on account of the purchase price of the pellets, that wording did not reflect the true legal nature of the payments, and the terms used by the parties to describe the payments could not override the legal character and effect of the payments.

Paris J held that the PSA set the price of the pellets, which included the excess over the FMV of the pellets, and that the relationship of the appellant and its shareholders with respect to the transfer of pellets was that of vendor and purchaser.

One of the key purposes of the PSA was found to be the provision of financing for the appellant's operations in order to protect bondholders, which was achieved by the guaranteed purchase price for the pellets. Paris J found that if the shareholders had not agreed to such pricing, the appellant would have been required to obtain additional operating capital in years in which its share of the joint venture operating costs exceeded revenues and retained earnings; nonetheless, that finding did not lead to the conclusion that payments in excess of FMV were capital contributions. Relying on *Shell Canada Ltd.* ([1999] 3 SCR 622, at paragraph 39), Paris J held that the economic effect of the payments was not determinative of their character and could not be used to recharacterize a taxpayer's bona fide legal relationships.

He also held, relying on *Friedberg* ([1991] FCJ no. 1255 (FCA)), that the parties' choice with respect to the nature of their relationship regarding the transfer of pellets must determine the tax consequences of the transactions to each party. After noting the decisions in *Hall* (90 DTC 1431 (TCC)) and *Ikea Limited* ([1998] 1 SCR 196), Paris J further held that because the payments were made as a consequence of the vendor-purchaser relationship, they would be income to the appellant rather than receipts of capital even if they were intended as reimbursements for any shortfall between its revenue and its share of joint venture operating expenses. Accordingly, the payments in excess of the FMV of the pellets issue were found to be income.

This case illustrates that the courts, in determining the tax consequences of a transaction, will respect the bona fide legal relationships between parties. It is therefore important to ensure that the words of any agreement accurately reflect the parties' intentions.

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Deductibility of Intercompany Management Fees: Still a Question of Fact

The CRA challenged the reasonableness of intercompany management fees in *Nielsen Development Company Ltd. et al.* (2009 TCC 160). At issue in the case was the deductibility of management fees paid by the taxpayer to a corporation owned indirectly by the spouse of the sole shareholder of the taxpayer corporation. The taxpayer was successful in persuading the TCC that the fees were fully deductible. The case is worth reading if one is looking for a list of the factors that will be considered by the courts in such cases.

Section 67 of the Act provides that in computing income, no deduction is to be made for an expense otherwise deductible under the Act, except to the extent that the expense is "reasonable in the circumstances." The courts have interpreted this phrase to require a factual and subjective determination. Cattanach J's statement in *Gabco* (68 DTC 5210 (Ex. Ct.)) has been frequently cited: "It is not a question of the Minister or this Court substituting its judgment for what is a reasonable amount to pay, but rather a case of the Minister or the Court coming to the conclusion that no reasonable business man would have contracted to pay such an amount having only the business consideration of the appellant in mind."

To eliminate some of the uncertainty created by section 67, the CRA has had a longstanding policy that creates a safe harbour for salaries and bonuses, provided that certain conditions are met. The CRA's policy (as set out at the Canadian Tax Foundation's 1981 annual tax conference) is that it will not challenge the reasonableness of salaries and bonuses paid to the principal shareholder-managers of a corporation when

> a) the general practice of the corporation is to distribute the profits of the company to its shareholders-managers in the form of bonuses or additional salaries; or
>
> b) the company has adopted a policy of declaring bonuses to the shareholders to remunerate them for the profits the company has earned that are, in fact, attributable to the special know-how, connections, or entrepreneurial skills of the shareholders.

In question 6 of *Income Tax Technical News* no. 22 (January 11, 2002), the CRA stated that its position on such compensation is limited to salaries and bonuses paid directly to individuals resident in Canada who are active shareholder-managers of a CCPC, and that it reserves the right to challenge the reasonableness of any intercompany management fees. The CRA's concern with such fees is likely that the arrangement may provide an opportunity to take advantage of lower tax rates within a corporate group and perhaps even permit the cascading of small business deductions.

In *Nielsen*, the taxpayer operated a hotel in Port Coquitlam. It entered into a management agreement with Mountain Tai to manage the hotel. Mountain Tai was owned by Phoebe Lo, the spouse of the taxpayer's sole shareholder. Phoebe Lo performed the management services as an employee of Mountain Tai.

In 2003, the taxpayer paid Mountain Tai $275,000 in management fees to manage the hotel. The CRA disallowed $223,330 of the fee as unreasonable in the circumstances. Similarly, in 2004 the CRA disallowed $246,749 of $300,000 in management fees. The CRA challenged the reasonableness of the management fees on the basis that Phoebe Lo was not responsible for management services such as budgeting, accounting, financial services, or overall management of the taxpayer's operations. The CRA was influenced by the fact that the hotel employed a general manager. In the CRA's view, the fees paid to Mountain Tai were based on the taxpayer's taxable income and not on the services performed by Phoebe Lo.

In allowing the taxpayer's appeal, Rossiter CJ cited the test in *Gabco*. In addition, he listed a number of factors to be considered in determining the reasonableness of the management fees in the circumstances, including the following:

- the nature of the management services (were they total or partial?);
- whether management was on site;
- how efficient the hotel operations were in comparison with similar hotel operations in similar markets;
- the effort devoted to and the responsibility for budgeting, renovations, improvements, planning and execution, finances, and staff;
- profitability;
- the presence or absence of a management services contract; and
- whether the management services company had any special expertise, training, or experience.

Rossiter CJ concluded that the management fees were reasonable. Phoebe Lo had years of experience in operating similar ventures. The evidence showed that she "[called] all the shots of the hotel." She was responsible for "the purchasing, accounting decisions, cheque signing, charitable [donations], [event attendance], room rates, discounts, equipment rates, food and beverage rates, furniture and carpet renovations, marking attendances, advertising decisions, monitoring costs, hiring and firing in conjunction with [the] general manager, budgeting in conjunction with [her husband], confirming rates and occupancy, . . . room maintenance, housekeeping, money in, money out, [and] hotel interior design."

This case is of limited precedential value because, like any section 67 case, it is primarily fact-driven. However, it provides confirmation that the CRA continues to closely scrutinize intercompany management fees, and that convincing evidence is necessary to satisfy the CRA and the courts that such fees are reasonable.

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Crown Loses Appeal in Landrus

In *Landrus* (2009 FCA 113), the Federal Court of Appeal had its first opportunity since *Lipson* (2009 SCC 1) to consider the general anti-avoidance rule (GAAR). In 1989, the taxpayer invested in a limited partnership (P1) formed to acquire and operate a residential condominium building. As a limited partner, he had the right, inter alia, to receive a particular condominium unit on withdrawing from the partnership. Subsequently, there was a significant decrease in the value of the building and in the value of an adjacent building held by a similar limited partnership (P2) with a different group of partners. In 1994, the partners of P1 and P2 agreed to implement a series of transactions that resulted in a disposition of the buildings to a third limited partnership (P3). These transactions triggered a terminal loss in each of P1 and P2, which was allocated to the limited partners of the particular partnership. Further, the limited partners ultimately received partnership interests in P3, which maintained their rights to their specific condominium units. The minister applied GAAR to deny the taxpayer's terminal loss. At the Tax Court, a tax benefit was conceded and an "avoidance transaction" was found, but GAAR was held not to apply because there was no misuse or abuse of the terminal loss rules in subsection 20(16). On appeal to the FCA, the TCC decision was upheld.

The FCA affirmed that there had been no misuse or abuse of subsection 20(16). The object, spirit, and purpose of that provision was held to be, inter alia, to allow a terminal loss when a taxpayer no longer owns or is able to use property of a particular CCA class. Because this requirement was met by P1 with respect to its disposition of the condominium building, there was no abuse of subsection 20(16). The minister had argued that the terminal loss should be denied on the ground that the partnership property, after being transferred to P3, remained available to the limited partners of P1 (for example, the limited partners retained their rights to specific condominium units). However, the FCA rejected this argument because it ignored the nature of the transactions for the purposes of the Act—namely, that the partnerships and not the limited partners disposed of the buildings.

That said, the FCA was open to the possibility of misuse or abuse if the transactions "had given rise to the tax benefit in circumstances where the legal rights and obligations of the respondent were otherwise wholly unaffected." This possibility is difficult to reconcile with the FCA's other reasons because, even if the taxpayer's rights in P3 were identical to those in P1, to find that situation abusive would be to ignore the nature of the transactions that occurred (although the foregoing quotation perhaps was a reference to the "overall result," discussed below). In any event, the FCA had little difficulty in holding that the rights and obligations of the taxpayer had been altered by the transactions (the taxpayer had acquired an undivided interest in "assets double in size," and he was entitled to share in a larger pool of rental income by virtue of his partnership interest in P3).

In keeping with *Lipson*, the FCA also considered whether the "overall result" of the transactions was abusive. The court found that the overall result did not frustrate the purpose of subsection 20(16), in part because the terminal loss resulted from a "real economic loss" (an interesting success for the taxpayer on the basis of an economic substance analysis). The FCA bolstered this finding by referring to a potential alternative transaction—a dissolution of P1 with a distribution of the partnership assets to the partners—which would have triggered the same terminal loss.

Landrus also is notable for its consideration of the interaction of GAAR and specific anti-avoidance rules in the Act. The minister had argued that certain stop-loss rules (including former subsection 85(5.1) in particular) evidenced a general policy of the Act to deny losses on transfers between persons that formed the same "economic unit." In rejecting this argument, the FCA affirmed that these detailed specific anti-avoidance rules were exceptions to a general policy of allowing losses on all dispositions of property. The court said:

> I agree with the appellant that the fact that specific anti-avoidance provisions can be demonstrated not to be applicable to a particular situation does not, in and of itself, indicate that the result was condoned by Parliament (*Canada v. Central Supply Co. (1972) Ltd.*, [1997] 3 F.C. 674 (F.C.A.)). However, where it can be shown that an anti-avoidance provision has been carefully crafted to include some situations and exclude others, it is reasonable to infer that Parliament chose to limit their scope accordingly.

This nuanced approach contrasts with what appears to be a stronger view of the TCC that GAAR should not apply when a taxpayer manages to avoid the "shoals and traps" of the various specific anti-avoidance rules (see especially *Geransky*, [2001] 2 CTC 2147 (TCC)). However, the FCA's statement arguably is more consistent with the decision in *Canada Trustco Mortgage Co.* (2005 SCC 54), which indicated that GAAR can apply when a transaction circumvents a specific anti-avoidance rule. Further, the "reasonable inference" approach should be of assistance in other cases in which the issue involves the interpretation of the object, spirit, and purpose of a specific anti-avoidance rule.

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Branch Tax Exigible When There Is No Canadian Permanent Establishment

The section 219 branch tax may be exigible in respect of Canadian-source profits of a Canadian branch in some surprising circumstances. Assume that a corporation that is carrying on business in the entertainment industry and is resident in a country that has no tax treaty with Canada enters Canada to perform one event; it is then absent from Canada for the rest of its taxation year. Its employees are in Canada for less than 10 days in the relevant taxation year in connection with the event. The non-resident corporation does not have a fixed place of business, nor does it have an office or other similar business location that would constitute a permanent establishment in Canada. Before the Canadian event takes place, the non-resident corporation obtains all of the necessary withholding waivers pursuant to regulations 102 and 105. Is the non-resident liable for branch tax on the profits attributable to the Canadian event?

To find the answer, one must look directly at Canadian domestic tax law, since the corporation is not resident in a treaty country. Subsection 219(1) of the Act generally provides that any non-resident corporation is liable for a branch tax of 25 percent on its taxable income earned in Canada after certain adjustments; it is silent on whether the liability is dependent on the existence of a permanent establishment here. Further, subsection 219(2) provides for very narrow exceptions to the Canadian branch tax, and the absence of a permanent establishment is not one of them.

The conclusion is that any corporation not resident in a treaty country that carries on a business in Canada is liable for Canadian branch tax regardless of whether it has a permanent establishment here. This makes sense from a policy standpoint because the Canadian branch tax is a proxy for the part XIII tax on dividends. The Canadian tax system should be neutral as to whether a non-resident corporation carries on business in Canada through a Canadian subsidiary or an unincorporated branch.

If the non-resident is resident in a jurisdiction with which Canada has a treaty, it is likely that the branch profits will be taxable only if the non-resident has a permanent establishment in Canada. (See article X(6) of the Canada-US tax treaty, for example.) The distinction between the effect of Canadian domestic law and the provisions of a tax treaty is subtle in this regard, but the failure to note it can have unfortunate consequences for tax practitioners.

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Canadian-Owned US LLCs More Costly After the Fifth Protocol

Many Canadian tax practitioners had hoped that the fifth protocol to the Canada-US tax treaty would address certain adverse treaty and Canadian tax issues that affect Canadian-owned limited liability companies (LLCs) that do business and invest in the United States. Although the protocol will be helpful for US residents that do business and invest in Canada through LLCs (and that satisfy certain new limitation-on-benefits provisions), it will place Canadian residents that structure their US business and investments through LLCs at an even greater disadvantage than the preprotocol law.

LLCs are popular with US persons for their tax advantages and for other reasons, and Canadians often have opportunities to invest in the United States through LLCs. For Canadian investors, however, investing through LLCs often complicates already complex arrangements. This was true even before the fifth protocol introduced the new anti-hybrid provisions in articles IV(6) and (7) (discussed in more detail below). In part, this is because under Canadian tax law the CRA views an LLC as a corporation, but a Canadian LLC member pays US tax on its allocable share of the LLC's US-source profits as a partner in the LLC (CRA doc. nos. 2001-0085845, 2003-0004415, and 2008-0272141R3).

As a result, LLCs that generate foreign accrual property income (FAPI) do not generate corresponding foreign accrual tax (TI 9613405).

Further, the CRA has ruled that a Canadian corporate LLC member (where the LLC is a foreign affiliate of the Canadian member) cannot claim a foreign tax credit under subsection 126(1) or a deduction under subsection 20(12) of the Act for US tax paid on its allocable share of LLC profits, because such tax is considered to be tax in respect of income from a share (TI 9703535 and TI 9821495). The CRA's position can have disastrous consequences for a Canadian corporation that reports income in respect of FAPI earned by an LLC: the undistributed LLC income can attract an immediate tax liability at a rate of almost 88 percent (or in some cases more).

When the LLC eventually distributes a portion of its taxable surplus, the Canadian corporate member should be allowed to claim a deduction under paragraph 113(1)(c) based on the US taxes paid on its share of the LLC's profits (TI 9703535 and TI 9821495). This deduction should be available even if the Canadian corporate recipient paid US taxes in a different year from the year of the distribution (TI 9821495). Thus, some Canadian tax relief should be available for Canadian corporate taxpayers owning LLCs that earn income from property, but only in the year in which the LLC makes a distribution.

The CRA extends more favourable treatment to corporately owned LLCs that earn active business income: those LLCs should be able to distribute that income as exempt surplus (TI 9821495). In particular, the CRA has stated that an LLC that earns \$100 of exempt earnings (and where the Canadian member pays the US tax) should have \$100 of exempt surplus to distribute to its members. Thus, although there is no credit or deduction for US taxes paid, the distribution should not result in incremental Canadian taxable income.

Individuals who own LLCs also face significant complexity. If the LLC makes a distribution, individual members should be able to claim a foreign tax credit under subsection 126(1) and deduct tax in excess of 15 percent of the dividend income under subsection 20(11). However, if the LLC does not make a distribution, the CRA allows individuals merely to deduct the tax under subsection 20(12) (TI 9641375). Thus, individuals who earn passive income through LLCs face very high tax rates, especially if the LLC does not distribute its income in the year in which it is earned.

Apart from Canada's interpretive issues, US tax law had already made LLCs an awkward vehicle for Canadian (and other non-US) investors. In 1997, Congress amended section 894(c) of the Internal Revenue Code to deny treaty benefits to items of passive income (interest, dividends, royalties, etc.) derived through hybrid entities. Thus, US-source passive income earned through Canadian-owned LLCs is subject to the US domestic withholding tax at a rate of 30 percent. The new anti-hybrid rules do not change this treatment: LLCs have been and will continue to be poor vehicles through which to derive US-source passive income.

In fact, things may be worse because new article IV(7) provides that items of income, profit, or gain are not considered to be derived by a person that is a resident of Canada if they are derived through (among other possibilities) an LLC. Practically speaking, new

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article IV(7) appears to deny a Canadian's right to a reduced rate of US branch profits tax. Non-US corporations earning income that is effectively connected with the conduct of a US trade or business must pay US branch profits tax on a dividend equivalent amount (Code section 884(a)), which is determined according to a prescribed formula (Code section 884(b)). Branch profits tax is 30 percent of the dividend equivalent amount under US tax law. Articles VII and X of the treaty generally reduce branch profits tax to 5 percent for branches of a foreign corporation. Thus, for Canadian-owned LLCs, the new anti-hybrid rules appear to increase the branch profits tax from 5 percent to 30 percent.

For Canadians, LLCs have now lost ground to state-law C corporations. Canadian corporations regularly choose to conduct business in the United States using state-law C corps (the Canco/USco structure). Before the anti-hybrid provisions existed, a Canadian corporation could conduct an active business through a US LLC (the Canco/LLC structure) and pay tax at rates identical to the Canco/USco structure (currently, about 54 percent for BC residents, calculated on the basis that all US-source income is fully distributed to the individual). The new anti-hybrid provisions now make the Canco/LLC structure unattractive for earning income of any type. The pre-fifth-protocol effective tax rate on fully distributed income, which incorporated a 5 percent branch profits tax, was approximately 54 percent. That same structure now appears to attract a 30 percent branch profits tax in the United States, resulting in a 66 percent overall effective tax rate.

There are exceptions, however. For example, an LLC wholly owned by a Canadian individual (who is not a US citizen) should incur overall tax rates identical to those that applied before the fifth protocol (approximately 60 percent) because branch profits tax does not apply to individuals. From a US income tax perspective, no withholding tax otherwise applies to business profits earned by an individual, and therefore no treaty relief should be required.

Finally, where a Canadian corporation owns a US corporation that in turn owns an LLC, payments from the LLC should not require treaty relief because they are entirely within the US tax system. However, other complexities beyond the scope of this article plague lower-tier LLC foreign affiliates.

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