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International Tax

Report No.: 103

Date: December, 2018

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NOW IT'S "EXCLUDED PROPERTY", NOW IT'S NOT

- –Marc André Gaudreau Duval and Michael N. Kandev, Davies Ward Phillips & Vineberg LLP

INTRODUCTION

The notion of "excluded property" is a key concept within Canada's foreign affiliate system. Generally, where a foreign affiliate of a taxpayer resident in Canada disposes of excluded property, any resulting gain or profit can enjoy deferral and, potentially,[1] tax-free repatriation to the Canadian corporate parent. Conversely, income from the disposition of non-excluded property is included in foreign accrual property income ("**FAPI**").

This article discusses a recent internal technical interpretation[2] (the "**TI**") issued by the Canada Revenue Agency ("**CRA**"), which dealt with the qualification of a partnership interest as "excluded property" and certain related issues. While some of the points discussed in the TI are of historical relevance only, as they have been superseded by legislative amendments, the TI discussed a number of other important concepts that are reviewed below.

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BACKGROUND

Where a non-resident corporation is a controlled foreign affiliate ("**CFA**") of a Canadian-resident taxpayer at the end of a taxation year of the CFA, the taxpayer is required to include in computing its income its "participating percentage" of the FAPI of the CFA for that taxation year. FAPI is calculated on an affiliate-by-affiliate basis and as such, foreign accrual property losses ("**FAPL**") of a CFA of a taxation year may only be used to reduce the FAPI of such CFA.

FAPI is defined in subsection 95(1) of the *Income Tax Act* (Canada) (the "**Act**")[3] to include income from property, income from businesses other than active businesses, as defined, and taxable capital gains from dispositions of property other than "excluded property".[4] The term "excluded property" refers to property of a foreign affiliate that is principally used in an "active business",[5] shares of a foreign affiliate where all or substantially all of its assets are "excluded property", property all or substantially all of the income from which is deemed to be income from an active business,[6] and certain partnership interests.

Against this background, the questions discussed in the TI arose out of the unwinding of a financing structure of a Canadian multinational group where the taxpayer seems to have identified an opportunity to generate a FAPL that it tried to offset against FAPI of another CFA.

SUMMARY OF THE TI

We understand that this internal TI was issued at the request of the Compliance Programs Branch of the International and Large Business Directorate with respect to an audit of the dismantlement (and likely migration) of the financing structure of a Canadian multinational group that conceivably was a result of the changes to the income tax treaty between Iceland and the United States.

The starting structure considered by the CRA was as follows:

- A Canadian-resident corporation ("**Parent**") owned all the issued and outstanding shares of two Canadian corporations ("**Canco1**" and "**Canco2**") as well as a non-resident subsidiary that qualified as a CFA of Parent ("**NR Sub**").
- Canco1 owned all the issued and outstanding shares of a non-resident corporation that qualified as a CFA of Canco1 and Parent ("**NR3**").
- Canco2 owned all the issued and outstanding shares of two non-resident corporations that qualified as CFAs of Canco2 ("**NR1**" and "**NR2**").
- NR1 and NR2 established an Icelandic Sameignarfelag ("**FORP**"), which was viewed by the CRA as a partnership.[7]
- FORP used capital contributions from NR1 and NR2 to make loans within the affiliated group of Parent, the income from which was recharacterized as income from an active business pursuant to subparagraph 95(2)(a)(ii) (the "Loans").

The transactions that were considered by the CRA were as follows:

(1) NR1 purchased an additional interest in FORP from NR2;
(2) FORP sold its Loans to another member of the affiliate group of Parent in exchange for cash;
(3) FORP distributed the cash proceeds from the sale of the Loans as a returns of capital;
(4) NR1 distributed the cash received to Canco2 by way of return of capital and by way of dividend;
(5) Canco2 sold its shares of NR1 to NR3;
(6) Canco2 sold its shares of NR2 to NRSub;
(7) FORP distributed all of its remaining assets to its members;
(8) FORP was liquidated and dissolved; and
(9) NR1 was liquidated and dissolved into NR3.

The taxpayer took the following principal positions regarding the above transactions:

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a. at the time it was disposed of, the partnership interest was not excluded property and, therefore, the capital gain or loss from the disposition was included in FAPI/FAPL in respect of Canco1; and
b. as the gain or loss was to be included in FAPI/FAPL, pursuant to paragraph 95(2)(f.14) , it was computed in Canadian currency; therefore, the computation of the ACB of NR1's partnership interest in FORP, pursuant to paragraph 95(2)(j) of the Act and subsection 5907(12) [now 5908(10)] of the Regulations, was to be computed in Canadian currency, including each capital contribution and reduction, earnings pick up, and distribution.

The CRA proceeded to analyze the following principal issues.

Partnership Interest Ceases to Qualify as "Excluded Property"

For certain purposes relevant to the definition of "excluded property", where a foreign affiliate has an interest in a partnership, the partnership is deemed to be a non-resident corporation having a single class of 100 issued shares of which the foreign affiliate is considered to own that proportion which reflects the fair market value of the FA's interest in the partnership. As a result, an interest in a partnership can qualify as "excluded property" if the requirements in the definition are met. The determination is to be made at "a particular time".

The CRA stated that it had not previously commented on the meaning of "a particular time" in the context of "excluded property", but that it had already considered it in the context of determining whether property deemed disposed of under subsection 88(3) would qualify as "excluded property".[8]

The CRA followed by indicating that it was not necessary to provide its views on whether the partners disposed of their partnership interest on the final distribution date pursuant to subsection 98(2) or on the formal dissolution date, as the result would be the same under the two alternatives. Under the first alternative, FORP would not have held any property on the final distribution date. Under the second alternative, it would only have held cash proceeds that could not be seen as used in a continuation of the active business undertaken by FORP (as it had never carried on an active business) and the income from which would not be recharacterized as active business income under paragraph 95(2)(a). Thus, the CRA concluded that the partnership interest in FORP no longer was "excluded property" when it was disposed of.

Canadian Currency to be Used Even if it Has Never Been Relevant Before Disposition

Unlike active business income which is computed pursuant to applicable foreign tax law in the applicable foreign currency, FAPI is computed under the rules of the Act using the Canadian currency.[9] Paragraph 95(2)(f.14) specifically requires that the capital gain or loss from the disposition of property that is not "excluded property" be computed using Canadian currency. Paragraph 95(2)(j) further provides that the ACB of a partnership interest to the foreign affiliate must be computed according to the rules of subsection 5908(10) of the Regulations.[10] As a result, both the proceeds of disposition and each component of the ACB are to be calculated in Canadian currency by converting any amount denominated in a currency other than Canadian using the relevant spot rate for the day on which the amount arose.[11]

Given that the ACB of the partnership interest in FORP did not qualify as "excluded property" at the time it was disposed, the CRA viewed that each adjustment to the ACB of the partnership interest in FORP that may be required by subsection 5908(10) of the Regulations will need to be computed in Canadian currency as of the date they arose. It essentially becomes irrelevant that for most of its existence FORP held "excluded property" for which the calculation currency of its partners was to be used. The CRA added that it understands that "a number of the amounts relevant to an ACB adjustment in respect of a partnership interest that is not "excluded property" may have been initially calculated in a foreign affiliate`s calculating currency", but that "in these circumstances, paragraph 261(2)(b) would apply to convert the amount to Canadian currency using the relevant spot rate of the day on the amount arose".

Carryback of FAPL

Subsection 5903(5) of the Regulations essentially provides, for specific purposes, that upon a designated liquidation and dissolution of a foreign affiliate under paragraph 95(2)(e), the parent foreign affiliate is deemed to be the same corporation as, and a continuation of, the disposing affiliate.

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The CRA accepted that paragraph 5903(5)(b) provides for a flow-through of FAPL. As a result, the CRA opined that the FAPL of NR1 for a pre-dissolution taxation year will be available to reduce the amount of NR3's FAPI for a post-dissolution taxation year; and a FAPL of NR3 for a post-dissolution taxation year may be available to reduce the amount of NR3's FAPI for a pre-dissolution taxation year.

However, the CRA made it very clear that, in its opinion, the deeming rule of 5903(5)(b) does not permit the use of a FAPL for a pre-dissolution taxation year of a dissolved company (such as NR1) to reduce the FAPI of a parent (such as NR3) for one of its pre-dissolution years. This position is based on the following:

- the use of the word "continuation of" by the legislator makes it clear that the deeming rule does not operate retroactively;
- permitting the use of a subsidiary's FAPL against the FAPI of the parent for a pre-dissolution taxation year goes against the principle that the calculation of FAPI is done on an affiliate-by-affiliate basis; and
- the interpretation of 5903(5)(b) must be consistent with the application of the equivalent rules that apply in respect of corporations residents in Canada (i.e., subsections 88(1.1) and (1.2) in the context of wind-ups and subsections 87(2.1) and (2.11) in the context of vertical amalgamations does not permit, in the view of the CRA, the application of any losses of the subsidiary to the parent's previous taxation year).

COMMENTARY

The primary issue considered by the CRA in the TI highlights that, for good or bad, excluded property status is determined on a snapshot point-in-time basis. This is particularly relevant where a foreign affiliate either sells its business or, in the context of the dismantlement of a financing structure, disposes of its paragraph 95(2)(a) asset. Where a foreign affiliate structure is liquidated or reorganized after the underlying excluded property has been disposed of, the non-excluded property nature of the shares or partnership interests in the chain of entities may give rise to unexpected exposure to FAPI,[12] which must be carefully considered and managed.

The related point of computation of FAPI on non-excluded property, shows that where a foreign affiliate has been emptied out of its excluded property content, the requisite recomputation of the ACB may prove to be arduous, especially in the context of a partnership of foreign affiliates as demonstrated by the TI.

Finally, the portion of the TI dealing with the carryover of FAPL is only of historical relevance. The foreign accrual capital loss (FACL) notion was included as part of Part 3 of the 2002-2013 technical bill[13] for taxation years of a foreign affiliate that end after August 19, 2011, in order to segregate the utilisation of FAPLs and FACLs in a conceptually similar fashion to that of non-capital losses and net capital losses in a domestic context. In other words, the scenario discussed in the TI would, under current law, give rise to a FACL that would not offset FAPI other than FAPI from capital gains.

In conclusion, while the TI seems to have arisen out of a tax-saving opportunity identified by the taxpayer, current law has largely eliminated such opportunity while still potentially exposing foreign affiliate groups to FAPI in the context of reorganizations or liquidations that follow the disposition of the excluded property underlying the structure.

THE TRACKING INTEREST RULES

- –Peter Lee and Annika Wang, Blake Cassels & Graydon LLP

In its 2018 budget released on February 27, 2018 (the "**Budget**"), the federal government proposed rules to prevent the use of "tracking interests" to circumvent certain elements of the foreign accrual property income ("**FAPI**") regime, in particular by avoiding controlled foreign affiliate ("**CFA**") status. The proposals will apply to taxation years of a taxpayer's foreign affiliate that began on or after February 27, 2018. Draft legislation to implement the proposals was released on July 27, 2018 and, following a period of public consultation, a Notice of Ways and Means Motion with revised language was released on October 25, 2018. This article will

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introduce the concept of “tracking interest” and the motivation behind it, and summarize the progression of the government’s proposals.

BACKGROUND: UMBRELLA FUNDS, SERIES LLCS, AND SEGREGATED ACCOUNT COMPANIES

The late 1990s saw the emergence of a new form of corporate vehicle, consisting of a single legal entity with multiple legally separate accounts (also referred to as “series”, “cells”, or “compartments”). Underlying assets are pooled in one entity, but investors invest in specific accounts within the corporate entity, may retain control over the related assets and liabilities, and are exposed to the opportunity for gain and risk of loss only in respect of those assets and liabilities. The accounts themselves are not considered separate legal entities.

An example of such vehicles is the “umbrella fund” available in a number of European jurisdictions.[14] Similar vehicles are available in the form of the “series limited liability companies” (or “**series LLCs**”) of various US states, including Delaware and Illinois, and of the “segregated account companies”[15] of Bermuda and certain other jurisdictions (umbrella funds, series LLCs, segregated account companies and related vehicles will generically be referred to as “SACs”). A key benefit of using a SAC (rather than incorporating separate corporate entities) is the ease of registering and administering a single corporate entity and the attendant cost efficiencies. In a related vein, pooling various sub-funds within a single umbrella fund may generate efficiencies in terms of regulatory compliance and securities law disclosure, where applicable.

There are many uses of umbrella funds and SACs including:

- the offering of multiple investment sub-funds, whose assets and liabilities are segregated from one another, within a single umbrella fund;
- the provision of employee retirement benefits, death benefits, and other benefits to multiple participating employers, who subscribe for separate sub-funds of an umbrella fund;
- serving as a securitization vehicle for multiple issuers; and
- serving as a captive insurance vehicle to reinsure risks of multiple unrelated insured parties, who reinsure risks with and pay premiums to separate cells of a SAC.

In each case, the cost efficiencies and administrative convenience of using a shared vehicle are a key attraction.

While umbrella funds are relatively common in Europe, SACs and related vehicles appear to be less common in the United States,[16] and Canadian law does not currently include an analogous concept at all. Indeed, the closest form of Canadian vehicle may be the mutual fund corporation (“**MFC**”). However, while MFCs may offer different “classes” of shares which in principle track different pools of underlying investments (and may be treated as separate investment funds under securities law), a key distinction is that the classes are not legally segregated. That is, from a legal perspective assets of one class may be used to satisfy liabilities of another class.

While the treatment of SACs from a legal or commercial perspective is beyond the scope of this article, it is worth mentioning that there appears to be little North American jurisprudence dealing with such entities. However, a key preliminary question would seem to be to confirm whether creditors of a particular series of an SAC would in fact be precluded from making claims against assets of another series. While the legal segregation of different series or cells may seem to be fundamental to these vehicles, there may be a valid question as to whether a jurisdiction other than the jurisdiction of formation must recognize that segregation, particularly if the corporate law of that other jurisdiction does not have an umbrella fund or SAC concept. A related question is whether the question of legal segregation should be determined under the laws of the particular entity or under the laws governing any agreement under which a claim may be made.[17]

Similarly, there has been very little literature on the use of SACs from a Canadian tax planning perspective. As in the commercial context, however, a key question is whether the corporation should be treated as a single entity or whether each series or cell is a separate entity for Canadian tax purposes. Although at that level of generality the question remains unresolved, the Budget proposed the tracking interest

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rules to generally treat each series or cell as a separate corporation in certain circumstances where the federal government perceived that SACs or similar vehicles could be used to circumvent the FAPI rules, as described below.

BUDGET 2018

In the Budget, the federal government expressed two concerns about "tracking interest" arrangements: (1) potential undue avoidance of CFA status; and (2) aggregating full-time employees of multiple series or cells to more easily pass the "six employees test". These points are considered in greater detail below.

Avoiding CFA Status

A CFA is, essentially, a foreign affiliate of a taxpayer which is controlled by the taxpayer (either alone, or together with any four other Canadian residents[18] and persons not dealing at arm's length with them or the taxpayer). CFA status is generally adverse, and in particular any FAPI of the CFA (including income from property as discussed further below, but excluding income from an "active business") is included in the income of the taxpayer on an annual "accrual" basis, whether distributed to the taxpayer or not.

The Department of Finance ("**Finance**") appears to be concerned that a taxpayer could invest in or reinsure risks through a particular series or cell (in which the taxpayer may have a controlling or even 100% interest), while remaining a non-controlling shareholder of the SAC as a whole, such that the SAC would not be a CFA of the taxpayer. That is, the SAC may be sufficiently large that the investor (together with other relevant persons) would not have a controlling interest overall for the purposes of the CFA definition, despite the fact that it may have control over its individual cell.

"Six Employee Test"

As noted, the income from property of a CFA of a taxpayer (and all other FAPI) is included in the income of the taxpayer on an annual "accrual" basis. For these purposes, a CFA's "income from property" includes its income from an "investment business". Generally speaking, income from an "investment business" includes income from a business the principal purpose of which is to earn income from property (including interest, dividends, rents, royalties, or similar returns), with some exceptions.[19]

In particular, an investment business does not include:

(a) a business that is:
  (i) a business carried on by it as a foreign bank, a trust company, a credit union, an insurance corporation, or a trader or dealer in securities or commodities, the activities of which are regulated under the laws of the country in which the business is principally carried on;[20] or
  (ii) the development of real property for sale, the "lending of money", the leasing or licensing of property, or the insurance or reinsurance of risks; and

(b) the foreign affiliate employs more than five employees full time in the active conduct of the business (the "**six employee test**").[21]

Thus, income from a business that satisfies the six employee test should not be included in a CFA's FAPI. The investment business definition applies on a business-by-business basis, which means that each business of the foreign affiliate must meet the six employee test on its own in order to be excluded from being an investment business.

Finance appears to be concerned that investors in a SAC may ostensibly pool their assets and take the position that the activities of the different cells constitute a single business. As a result, the SAC as a whole may meet the six employee test, even if the employees devote very little of their time to any individual cell. Investors whose activities would not otherwise be significant enough to meet the six employee test may thus be able to do so, while still obtaining the same economic return (and being subjected to the same economic risk) as though they had carried out their activities in a separate (smaller) legal entity.

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LEGISLATIVE PROPOSALS AND PUBLIC CONSULTATION

The Budget did not include specific legislative language to implement the tracking interest proposals but, as noted earlier, legislative proposals in this regard were released on July 27, 2018. The main thrust of the proposals was to introduce a definition of "tracking interest" and two independent operative provisions to address the two concerns discussed above.

New subsection 95(8) provided that a property was a "tracking interest" in a person or partnership (the "tracked entity") if:

(a) all or part of the fair market value of the property (or of any payment or right to receive an amount in respect of the property) could reasonably be considered to be determined, directly or indirectly, by reference to one or more of the following criteria in respect of property or activities of the tracked entity ("tracked property and activities"):

- (i) the fair market value of property of the tracked entity,
- (ii) any revenue, income, or cash flow from property or activities of the tracked entity,
- (iii) any profits or gains from the disposition of property of the tracked entity, and
- (iv) any similar criteria in respect of property or activities of the tracked entity; and

(b) the tracked property and activities represent less than all of the property of the tracked entity.

Thus, if a taxpayer holds shares of a non-resident corporation that confer only an interest in the property or activities of a particular cell, the shares may be a tracking interest in the foreign affiliate.

The first operative provision was in new subsection 95(9): if a taxpayer held a tracking interest in a foreign affiliate, the tracked property and activities would be deemed, for the purposes of the definition "investment business", to be a separate business carried on by the foreign affiliate. This provision may effectively prevent the aggregating of full-time employees of a SAC across multiple cells of the SAC to more easily pass the six employee test.

The second operative provision was in new subsections 95(10)–(12). In particular, pursuant to a default rule in subsection 95(10), if a taxpayer held a tracking interest in a foreign affiliate, and the affiliate had FAPI for the year, then the affiliate was to be deemed to be a CFA of the taxpayer. We note that the application of this default rule could have seemingly anomalous results. For instance, shareholders of a particular cell could be required to recognize FAPI of the SAC as a whole, whether or not the particular cell had FAPI. Relatedly, FAPI in one cell could be "offset" by FAPI loss[22] in another cell; if the SAC as a whole had no net FAPI, no FAPI would need to be recognized by the Canadian taxpayer, even if it was invested in a cell with positive FAPI.

Taxpayers could make an election under subsection 95(11) to opt out of the above default rule if, essentially,

(i) the affiliate would otherwise be a CFA of the taxpayer because of subsection 95(10) ,
(ii) the taxpayer holds a tracking interest in the affiliate, and
(iii) the tracking interest is shares of a class (referred to as the "tracking class") of the affiliate the fair market value of which can reasonably be considered to be determined by reference to the tracked property and activities.

The result of the election was that the tracked property and activities would be deemed to be property and activities of a separate corporation that is a "non-resident corporation without share capital", and the tracking class was deemed to represent equity interests in the separate corporation. The intent was that the share structure of the separate corporation would be determined under the rules in section 93.2 relating to non-share capital corporations, for the purpose of ascertaining CFA status and of attributing the appropriate amount of FAPI to the taxpayer (where applicable).

In particular, the shares of the tracking class are deemed to be "equity interests" (as defined in section 93.2) of the separate corporation, and would have attributes similar to those of the tracking class.[23]

This election was intended by Finance to address two problems with the default rule: (1) taxpayers may lack the information required to compute FAPI for the foreign affiliate overall (for example, where the taxpayer

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controls one cell of many in a large SAC and has no control over or visibility into the operations of the SAC generally); and (2) a taxpayer that has a minority interest in tracked property could be deemed to have a CFA, even though the tracked property would not be a CFA of the taxpayer if was a separate entity.

A period of public consultation followed the legislative proposals, ending September 10, 2018. On that date, the Joint Committee on Taxation of the Canadian Bar Association and Chartered Professional Accountants of Canada (the "**Joint Committee**") made a submission in response to the proposals. The Joint Committee raised a concern that although the tracking arrangement rules had an anti-avoidance purpose, the purely mechanical nature of the proposed language could capture a wide array of benign situations that have no tax avoidance intent. In addition, the Joint Committee pointed out two specific issues with the way in which the language was drafted.

First, the Joint Committee pointed out that the default rule in proposed subsection 95(10) has potentially significant adverse consequences (in addition to the anomalous results noted above). For instance, an umbrella fund may offer several sub-funds and different classes or series of shares of each sub-fund denominated in different currencies, with the expectation, for example, that Canadian investors would invest in a Canadian dollar-denominated series. In such cases, because an investor in the Canadian-dollar denominated series of a particular sub-fund would not have an interest in the property of the other sub-funds, the investor's interest would be a tracking interest. In addition, although the umbrella fund or the particular sub-fund may be large, there may not be many Canadian or other investors in the Canadian dollar-denominated series of the particular sub-fund. As a result, investors in the Canadian dollar-denominated series may hold more than 10% of the series even if their investment in the sub-fund overall is not particularly large. Hence, the umbrella fund could be a foreign affiliate of a Canadian investor in the series, and under proposed subsection 95(10), the entire umbrella fund would be deemed to be a CFA of the Canadian investor. This would not seem to be an appropriate result.

Although this treatment could be averted if the taxpayer made the election contemplated in proposed subsection 95(11), it is unrealistic to expect the typical investor (including in particular retail investors) to be aware of making such an election.[24] The Joint Committee recommended that the current opt-in election in subsection 95(12) be made the default rule, with an election available for those investors who wish to have the treatment provided for in subsection 95(10).

Second, the Joint Committee pointed out that, even if the election in subsection 95(12) is made, the resulting deemed separate corporation could still be a CFA in inappropriate situations. Using the same example, if the sub-fund hedges its non-Canadian dollar exposure with respect to the Canadian dollar series back to the Canadian dollar, then the property attributable to that series may be deemed to be tracked property. In the words of the Joint Committee, the interests in the Canadian dollar series may be seen as a separate tracked interest from the other interests in the particular sub-fund. As noted above, in general there would not be many holders of the Canadian-denominated series, and therefore holders of that series could readily be deemed to hold more than 10% of the shares of the related separate corporation. In addition, since most holders of the Canadian-denominated series can be expected to be resident in Canada, it would be easy for the separate corporation to be deemed a CFA pursuant to the "relevant Canadian shareholders" rule.[25] Such a result does not seem appropriate, since if the sub-fund (rather than just the series) had been a separate legal entity, the Canadian investor typically wouldn't be subjected to the CFA regime in such circumstances.

NOTICE OF WAYS AND MEANS MOTION

On October 25, 2018, the government released a Notice of Ways and Means Motion with amended language for the tracking interest proposals.

There were no material changes in the definition of "tracking interest" in new subsection 95(8) and in the deemed investment business rule in new subsection 95(9). A key change however is that the elective procedure in the previous version of the rules is made to be the default rule, as recommended by the Joint Committee. More specifically, if the taxpayer holds: (1) property that is a tracking interest in an affiliate; and (2) shares of a class of the affiliate's capital stock that have a fair market value that may reasonably be

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considered to be determined by reference to the tracked property in respect of the tracking interest, then subsection 95(11) will deem the tracked property to be property of a separate corporation, much as under the old elective procedure.

In particular, the separate corporation is deemed to have 100 issued and outstanding shares of a single class, but now each shareholder is deemed to hold their "aggregate participating percentage"[26] of the shares of the separate corporation.[27]

There is effectively a *de minimis* rule whereby the taxpayer will not have any shares of the separate corporation attributed to it if FAPI in the relevant cell or compartment does not exceed $5,000. In such cases the taxpayer's "aggregate participating percentage" in the compartment (per the existing definition) would be nil, and no shares of the separate corporation would be attributed to the taxpayer. As a result, it appears the separate corporation should not be a CFA in that year, regardless of whether the separate corporation would otherwise be treated as being controlled by the taxpayer.

Where applicable, this appears to have the effect of not requiring the taxpayer to report *de minimis* amounts of FAPI pursuant to the tracking rules. However, it may also imply that the taxpayer may not get the benefit of any FAPL that might otherwise arise in a particular year, unless the cell or compartment is net FAPI-positive in that year (more accurately, FAPLs would not arise as the cell or compartment would not be a CFA). It seems inappropriate to impute FAPI of a deemed CFA to the taxpayer but deny the taxpayer the benefit of any FAPLs of the CFA.

In addition, new subsection 95(12) is a residual rule that applies where the rules in new subsections 95(10) and (11) do not apply (e.g., because the taxpayer does not hold shares of a corporate affiliate). In such cases, if the taxpayer holds a tracking interest in respect of the affiliate, subsection 95(12) will deem the entire affiliate to be a CFA (similar to the old default rule).

While it is helpful that the new proposals adopt the Joint Committee's suggestion of making the former elective procedure apply by default, the new proposals could still result in a deemed CFA in the second hypothetical considered by the Joint Committee and, as noted above, appear to deny access to FAPLs. In addition, in situations where a cell is not actually controlled by a holder of an interest in the cell, the holder may have difficulty obtaining the information necessary to determine whether the cell is a CFA. For example, Canadian investors in a compartment of a publicly offered umbrella fund will not in general know whether there are "relevant Canadian shareholders" and hence whether the CFA test is met.

CONCLUSION

In conclusion, Finance seems intent on pursuing measures aimed at curbing perceived use of umbrella funds or SACs to avoid CFA status or to circumvent the six employee test. Although in substance the rules are anti-avoidance rules, as noted earlier they are mechanical in their application, with no requirement of an actual avoidance motive. Since there are often many excellent commercial reasons for Canadian investors to invest in a cell of a SAC or a compartment of an umbrella fund, it remains to be seen whether these new rules will have a significant effect on taxpayers' international investment strategies.

THE CANADA REVENUE AGENCY'S INTERPRETATION OF THE 2017 OECD TRANSFER PRICING GUIDELINES

- –Matias Milet and Jennifer Horton, Osler, Hoskin & Harcourt LLP

INTRODUCTION

At the 2018 Annual Canadian Tax Foundation Conference's CRA Roundtable (the "**CRA Roundtable**"), the Canada Revenue Agency (the "**CRA**") was asked to comment on the new 2017 OECD Transfer Pricing Guidelines[28] (the "**2017 Transfer Pricing Guidelines**") and the Discussion Draft on Financial Transactions (the "**Discussion Draft**").[29] Of particular note, the representatives of the CRA were asked to articulate

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the agency's position on the potential application of the 2017 Transfer Pricing Guidelines on a retroactive basis.[30]

In response, the CRA indicated that it is still of the view that the 2017 Transfer Pricing Guidelines do not represent a significant change to the analysis that should be conducted in respect of transfer pricing issues. More specifically, the CRA stated that the 2017 Transfer Pricing Guidelines simply clarified the appropriate interpretation and application of the guidance that was already in place, as opposed to establishing new standards for a transfer pricing analysis. As a result, the CRA indicated that it will apply the 2017 Transfer Pricing Guidelines to pre-2017 taxation years, as well as to the interpretation of treaties entered into post-2017. However, the CRA does not consider such an application to be retroactive, due to its characterization of the 2017 Transfer Pricing Guidelines as merely an elaboration on the prior guidance.

The CRA's position that the 2017 Transfer Pricing Guidelines may be applied to pre-2017 years, if the new guidelines do in fact only constitute an elucidation of the previous guidelines, is in accordance with the applicable judicial guidance. As noted by the Federal Court of Appeal (the "**FCA**") in *Prévost Car Inc v. R*,[31] later guidance from the OECD can be helpful to the interpretation and application of existing bilateral tax treaties, when it "represent[s] a fair interpretation" of the OECD Model Tax Convention (the "**Model Treaty**")[32] and does not conflict with the guidance that was in place at the time a specific treaty was entered into:

> [t]he worldwide recognition of the provisions of the Model Convention and their incorporation into a majority of bilateral conventions have made the Commentaries on the provisions of the OECD Model a widely-accepted guide to the interpretation and application of the provisions of existing bilateral conventions […].
>
> The same may be said with respect to later commentaries, when they represent a fair interpretation of the words of the Model Convention and do not conflict with Commentaries in existence at the time a specific treaty was entered and when, of course, neither treaty partner has registered an objection to the new Commentaries. […] The Introduction [to the Income and Capital Model Convention and Commentary (2003)] goes on, at par. 35, to note that changes to the Commentaries are not relevant "where the provisions... are different in substance from the amended Articles" and, at par. 36, that "many amendments are intended to simply clarify, not change, the meaning of the Articles or the Commentaries".

Since the FCA rendered its decision in *Prévost Car*, Canadian courts have continued to accept and affirm the principles articulated in that case when tasked with assessing the relevance of different iterations of various publications from the OECD. Recently, the Tax Court of Canada (the "**TCC**") in *Elliott v. R*[33] and *McKesson Canada Corp v. R*,[34] cited *Prévost Car*, as quoted above, in support of the appropriate approach to take when determining how much weight should be given to guidance from the OECD. Although the CRA's understanding of the judicial guidance set out above is correct, it is not clear that the CRA's position that the 2017 Transfer Pricing Guidelines do not represent a significant change to the transfer pricing analysis is also accurate.

CHANGES IMPLEMENTED BY THE 2017 TRANSFER PRICING GUIDELINES

The content of the 2017 Transfer Pricing Guidelines can generally be divided into two categories. The first category includes documentation and process-oriented clarifications — that is, clarifications regarding transfer pricing documentation and administrative approaches to resolving transfer pricing disputes, which cover matters such as audit practices, corresponding adjustments and the mutual agreement procedure, simultaneous transfer pricing examinations, and advance pricing agreements. Generally, these do not represent significant changes and it is not objectionable as a general matter for the CRA to be applying such changes to pre-2017 years. However, the second category relates to more fundamental shifts in how the arm's length principle is to be interpreted and applied when conducting a transfer pricing analysis. Such shifts in the fundamental building blocks of transfer pricing analysis, as it is understood by the OECD, include (but are not limited to) the new concepts of "value creation" and "accurate delineation".

a) Value Creation

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The OECD has reoriented transfer pricing as revolving around the concept of value creation. For example, actions 8 to 10 of the Base Erosion and Profit Shifting project were subsumed under the rubric *Aligning Transfer Pricing Outcomes with Value Creation*, which was used as the subtitle for the final report on those action items (the "**2015 BEPS Report**").[35] The new "value creation" criterion was first introduced in the 2015 BEPS Report and subsequently incorporated into the 2017 Transfer Pricing Guidelines. That criterion is intended to ensure that profits are taxed where economic activities take place and value is created.[36] In the 2015 BEPS Report, the OECD presented its new emphasis on value creation as a "clarification and strengthening" of the guidance on the arm's length principle, rather than a change in core transfer pricing objectives, concepts or methodologies:[37]

> [W]ith its perceived emphasis on contractual allocations of functions, assets and risks, the existing guidance on the application of the principle has…proven vulnerable to manipulation. This manipulation can lead to outcomes which do not correspond to the value created through the underlying economic activity carried out by the members of an MNE group. Therefore, the BEPS Action Plan required the guidance on the arm's length principle to be clarified and strengthened… [Emphasis added]

Despite the implicit assumption by the OECD that the concept of "value creation" accords with the arm's length principle, "value creation" is a new test. In fact, the "value creation" test is not mentioned in any of the following: Article 9 of the Model Treaty, the prior Commentary on Article 9, or in either of the 1995 and 2010 Transfer Pricing Guidelines.[38] Nevertheless, the OECD presents this new test as the primary objective of transfer pricing, and attempts to position "value creation" as having always been at the core of transfer pricing analysis.

The OECD's attempt to deemphasize contractual allocations of functions, assets and risks represents a significant change in approach to transfer pricing — particularly if it were to be applied in countries such as Canada, that generally respect the legal form of transactions (rather than allowing a recharacterization in accordance with underlying economic substance). Recently, the Crown's approach in *Cameco Corporation v. The Queen*,[39] was, in essence, congruent with the "value creation" concept. Its argument that the TCC should disregard contractual allocations of risk and "award" income to the performance of services — irrespective of what compensation those services would garner in arm's length transactions — was rejected. More generally, the thrust of the BEPS project itself was to effect fundamental changes to the international tax system, which appears inconsistent with attempting to now characterize the resulting BEPS-related changes as being mere "clarifications" of prior practices.

b) Accurate Delineation

The 2017 Transfer Pricing Guidelines also introduce the concept of "accurate delineation", which essentially proposes that in order to compare a transaction between associated enterprises with a comparable transaction entered into between independent parties, it is necessary to first "accurately delineate" the former transaction in light of "economically significant characteristics". However, such economically significant characteristics are not limited to the applicable contractual terms. Instead, they also include the conduct of the associated parties, the functions they perform, the assets they actually use and the risks they actually assume.

If an analysis of the above enumerated economically significant characteristics results in a delineation of a transaction that differs from that entered into under the contract between the associated enterprises, the accurate delineation principle would then ignore the contractual transaction in the comparability analysis, instead focusing on the "accurately delineated" transaction. In essence, this would recharacterize the contract prior to engaging in a comparability analysis for transfer pricing purposes. Recharacterization at this fundamental initial step of the transfer pricing analysis represents a significant departure from the 1995 Transfer Pricing Guidelines.

The 1995 Guidelines do indicate that, in some circumstances, it may be appropriate to determine whether a purported allocation of risk is consistent with the economic substance of the transaction by examining the actual conduct of the parties. However, the 1995 Transfer Pricing Guidelines note that these situations are limited to instances where the parties are effectively engaged in window dressing or a sham, that is, where

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the parties do not act in accordance with the terms of the underlying agreements. As has been noted in comments made to the OECD,[40] the reference to the transaction as “accurately delineated” in the 2017 Transfer Pricing Guidelines can be regarded as allowing for recharacterization of a transaction before taxpayers and tax authorities reach the stage of determining whether legal form and substance should be disregarded, as would be the case under Canadian domestic transfer pricing rules (in particular, paragraphs (*b*) and (*d*) of subsection 247(2) of the *Income Tax Act* (the “**ITA**”)).

c) Delineation of Capital Structure

To provide a sense of how far from legal form “accurate delineation” of transactions can take one, it is helpful to consider the approach to delineating a corporation’s capital structure, in terms of the relative mix of debt and equity, as described in the OECD’s recent Discussion Draft. In the Discussion Draft, the OECD considers how the accurate delineation of the actual transaction, as set out in the 2017 Transfer Pricing Guidelines, can relate to the capital structure of an entity within a multinational group. The Discussion Draft echoes the 2017 Transfer Pricing Guidelines in stating that the accurate delineation of the actual transaction ought to begin by identifying the economically relevant characteristics of the transaction – consisting of the commercial or financial relations between the parties and the conditions and economically relevant circumstances attaching to those relations – including: an examination of the contractual terms of the transaction, the functions performed, assets used, risks assumed, the characteristics of the financial products or services, the economic circumstances of the parties and of the market, and the business strategies pursued by the parties. Those general statements are then followed by an illustration of what would be useful indicators in identifying the economically relevant characteristics in accurately delineating a debt-funded capital structure:

> the presence or absence of a fixed repayment date; the obligation to pay interests; the right to enforce payment of principal and interest; the status of the funder in comparison to regular corporate creditors; the existence of financial covenants and security; the source of interest payments; the ability of the recipient of the funds to obtain loans from unrelated lending institutions; the extent to which the advance is used to acquire capital assets, and the failure of the purported debtor to repay on the due date or to seek a postponement.[41]

That list looks much like the types of factors that are relevant under U.S. tax law in determining whether a financial instrument is debt or equity. To illustrate this approach, an example is then given of a purported loan being accurately delineated as equity, chiefly because of a low likelihood of repayment within the specified term. However, under Canadian law, the nature of an instrument as debt or equity is determined by general legal principles, pursuant to which the form or label attached to an instrument can be overturned only if the legal substance of the arrangement is clearly different, not because the economics are such that an arm’s length party might have chosen to subscribe for shares rather than make a loan.

The TCC recently applied the leading Canadian case on debt versus equity characterization, *Canadian Deposit Insurance Corp. v. Canadian Commercial Bank*,[42] in the context of a hybrid instrument in *Barejo Holdings ULC v. The Queen*.[43] The question before the TCC was whether two non-interest bearing “Notes” that, upon maturity, would pay the value of a specified pool of investment assets, were debt or equity. The TCC noted that the Notes had both debt-like and equity-like features, including a specified interest rate (of zero) and the possibility of a nil return upon maturity. The TCC concluded that the Notes were closer to being debt based on their features and the parties’ intention (including the fact that the instruments were called “Notes”, referred to a “Principal Amount”, had a maturity date, and ranked *pari passu* with other debt).

Assuming that a debt is a debt as a matter of legal substance, and subject to the potential application of the recharacterization rule in paragraphs 247(2)(b) and (d) of the ITA), there is no support for the recharacterization of debt as equity in Canadian law. As held by the TCC in the *Barejo* decision, if the instrument has the core essential characteristics of debt, it is debt for purposes of the ITA.

In *Barejo*, the TCC listed the following essential characteristics of a debt for purposes of the ITA:

(i) an amount or credit is advanced by one party to another party;

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(ii) an amount is to be paid or repaid by that other party upon demand or at some other point in the future set out in the agreement in satisfaction of the other party's obligation in respect of the advance;
(iii) the amount described in (ii) is fixed or determinable or will be ascertainable when payment is due; and
(iv) there is an implicit, stipulated, or calculable interest rate. There was no reference to several of the "economically relevant characteristics" that the OECD suggests may be useful indicators in accurately delineating a loan including, for example, the source of the interest payments and default of the debtor on the due date. In short, form largely governs.

d) Inconsistency with Canadian Transfer Pricing Law

Not only do these new concepts in the 2017 Transfer Pricing Guidelines depart from the 1995 Transfer Pricing Guidelines, they also have little grounding in section 247 of the ITA or Canadian transfer pricing case law. In addition to the "value creation" argument discussed above, the Crown in *Cameco* can be seen as having presented a version (albeit an extreme one) of "accurate delineation", which was also rejected by the TCC. Invoking the doctrine of sham or window dressing, the Crown in *Cameco* argued that the various contracts between the taxpayer and related parties created the illusion of transactions that were different than those that were actually entered into. The Crown further argued, that it was these other 'actual transactions' to which the transfer pricing analysis should apply. While the Court agreed that in identifying the relevant transaction it can be appropriate to look beyond the contract and consider the broader circumstances,[44] it did not accept the Crown's invitation to disregard the contractual relationships that were validly established:[45]

> I find as a fact that the Appellant, Cameco US and CESA/CEL entered into numerous contracts to create the very legal relationships described by those contracts. The arrangements created by the contracts were not a facade but were the legal foundation of the implementation of the Appellant's tax plan.

Further, the 2017 Transfer Pricing Guidelines' "accurate delineation" concept could cause recharacterization in a domestic Canadian transfer pricing dispute under paragraphs 247(2)(a) and (c) of the ITA in circumstances where not even the explicit mandate in the ITA's transfer pricing recharacterization rule (the "**TPRR**") would do so. Pursuant to paragraphs 247(2)(b) and (d) of the ITA, the TPRR only permits recharacterization of controlled transactions if arm's length parties would not have entered into such transactions and a tax avoidance motive test is satisfied. In determining whether arm's length parties would enter into a particular transaction, the standard set out in *Cameco* is high: that is, whether the transaction is "commercially irrational". For instance, in *Cameco*, Justice Owen noted that a parent company passing up a favourable business opportunity and instead allowing its foreign subsidiary to avail itself of the opportunity would not be acting in a commercially irrational manner, so long as the parent is fairly compensated. Since the same commercially driven renunciation could occur between arm's length parties, where there is such fair compensation the threshold for recharacterization in the ITA's TPRR would not be met.[46]

The Court's interpretation of Canadian transfer pricing rules in *Cameco* appears consistent with earlier OECD transfer pricing guidelines that suggested recharacterization should be limited to narrow circumstances, such as where there is commercial irrationality – and not routinely applied, as the OECD now purports should be the case using "accurate delineation". The OECD's proposed approach in the 2017 Transfer Pricing Guidelines would effectively allow tax authorities to routinely recharacterize transactions according to their perceived view of what the taxpayer should have done – rather than analyzing what the taxpayer actually did. This is particularly evident in the OECD's recent Discussion Draft, in which the OECD suggests that it would be permissible for revenue authorities to recharacterize such fundamental decisions as the relative mix between debt and equity funding for a corporation under the guise of "accurate delineation".

There is a particularly interesting tension between accurate delineation of debt versus equity in a corporation's capital structure as conceived by the OECD and Canadian case law on characterizing an instrument as debt or equity. The OECD acknowledges in the Discussion Draft that the domestic legislation of certain member states may already provide guidance on the debt versus equity distinction. In particular, the Discussion Draft notes that under domestic legislation, approaches other than accurate delineation may

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be (and in fact are) taken to address the debt to equity ratio of the capital structure of a given entity within a multinational group. For instance, the United States has number of regulations in place, enacted under Section 385 of the *Internal Revenue Code*, that set out the principles to be used in addressing whether certain instruments that exist between related parties within a multinational group should be treated as debt or equity. Canada has its own specific set of rules, known as the "thin capitalization" rules that effectively ensure that a non-resident can only capitalize a Canadian subsidiary using a maximum of 60% debt and also treat any disallowed interest deductions as dividends, that are in turn subject to withholding tax.

Given that countries other than the United States and Canada have similarly implemented targeted legislation that sets a domestic standard for the debt-to-equity ratio of the capital structure of an entity within a multinational group, and that some such rules may result in either classifying or reclassifying instruments as debt or equity, the OECD has stated that the guidance in respect of the application of accurate delineation is not intended to prevent countries from implementing such legislation. In doing so, the OECD explicitly notes that it does not seek to mandate accurate delineation as the only approach that should be taken when determining whether an instrument that is purported to be debt, should in fact be treated as debt. As a result, it appears that the concept of accurate delineation, as it is set out in the Discussion Draft, may be applied either to the exclusion of, or alongside, any specific domestic legislation that addresses capitalization and interest deductibility. However, this makes the role of accurate delineation unclear: is it a necessary step in actually determining the true nature of a transaction in a transfer pricing analysis, or is it a tool for recharacterizing transactions to achieve certain tax allocation outcomes between jurisdictions where no other re-classificatory regime is available?

CONCLUSION

To the extent the 2017 Transfer Pricing Guidelines represent a significant departure from previous guidance provided by the OECD in respect of transfer pricing, the Canadian courts have indicated that such changes should only be applied prospectively to tax treaties that are entered into after the date the revised guidelines are introduced. As a result, the CRA's recent interpretation of the 2017 Transfer Pricing Guidelines is likely inconsistent with Canadian law.[47]

Moreover, it is important to keep note of the fact that although the OECD's guidelines may be relevant for interpretative purposes, they do not override domestic Canadian law. They are merely guidelines.[48] In particular, even when applicable, the 2017 Transfer Pricing Guidelines do not allow the CRA to reassess taxpayers in a manner that is inconsistent with section 247 of the ITA and Canadian law.

If the CRA proceeds to treat the 2017 Transfer Pricing Guidelines as being applicable on a retroactive basis, despite the significant changes therein, as well as the various inconsistencies with Canadian law, then we anticipate that the volume of transfer pricing disputes in Canadian courts will continue to increase.

Footnotes

[1] Where, for example, the excluded property is assets used in the carrying on of an active business.
[2] CRA Document No. 2015-0592551I7, dated March 27, 2018.
[3] *Income Tax Act*, R.S.C. 1985,c. 1 (5th supp.) . All references to statutory provisions are references to the provisions to the Act, unless otherwise noted.
[4] Except where the "excluded property" is shares of a foreign affiliate and the gain arises in connection with certain corporate reorganizations.
[5] As defined in subsection 95(1) of the Act.
[6] For example, an inter-affiliate receivable the interest on which is deemed to be active business income by subparagraph 95(2)(*a*)(ii).
[7] See CRA Document No. 2006-0187681R3, issued in 2007.
[8] See CRA Document No. 2014-0536331E5, dated July 17, 2014.
[9] See paragraph 95(2)(*f*).
[10] Formerly, Reg. 5907(12).
[11] See paragraph 261(2)(*b*).
[12] Despite the fact that the disposition of the underlying excluded property can give rise to surpluses.

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[13] Bill C-48, enacted June 26, 2013.
[14] Including France, Ireland, Italy and Luxembourg, among others.
[15] Other commonly used terms include “segregated cell company”, “segregated portfolio company”, or “protected cell company”.
[16] Notwithstanding the existence of “series LLC” legislation, as noted above.
[17] Related issues arose in the fairly recent US case of *Glenn E. Alphonse, Jr. v. Arch Bay Holdings, L.L.C.* (No. 13-30154, 5th Cir. 2013) a decision of the US 5th Circuit Court of Appeal. The Court did not ultimately resolve the relevant questions, and instead remanded the case back to a lower court for further “factual development” (and the lower court ultimately concluded it did not have jurisdiction to hear the case). However, the appeal Court did note that “the separate juridical status of a Series LLC with respect to third party plaintiffs remains an open question”. The Court also engaged in a lengthy (but ultimately inconclusive) discussion of the question of which jurisdiction’s laws applied in deciding these questions.
[18] There need not be any connection between the four Canadian residents and the taxpayer, nor do they need to be acting in concert.
[19] See the definition of “investment business” in subsection 95(1).
[20] Or, essentially, of each country in which the business is carried on, and of the country under whose laws the affiliate is governed. Additional details have been omitted.
[21] Additional details of the six employee test have been omitted.
[22] More accurately, “foreign accrual property loss”, or “**FAPL**”.
[23] In particular, if the tracking class was non-voting, it appeared that the shares of the separate corporation would also be non-voting. In such cases, it seemed that the separate corporation would never be deemed to be a CFA, even if the taxpayer was deemed to own 100% of the shares of the separate corporation.
[24] Of particular concern was the fact that the election was required to be made on or before the filing due date for the relevant year.
[25] Specifically, the rule in paragraph (b) of the definition of CFA in subsection 95(1) whereby a foreign affiliate of a taxpayer will be a CFA if, essentially, the taxpayer, *together with any four other Canadian residents (not necessarily related to or acting in concert with the taxpayer)*, and persons not dealing at arm’s length with them or the taxpayer, control the corporation.
[26] As defined in the existing subsection 91(1.3).
[27] In addition, the shares of the separate corporation would be deemed to have full voting rights under all circumstances, unlike in the July 27 proposals.
[28] Organization for Economic Cooperation and Development [OECD], *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017* (July 10, 2017).
[29] OECD, *Discussion Draft on Financial Transactions* (July 3, 2018.)
[30] The CRA Roundtable took place on November 27, 2018 in Vancouver. Official CRA responses to the questions posed are expected to be released to the public in early December of this year.
[31] [2009] 3 C.T.C. 160 at paragraphs 10-11 (***Prévost Car***).
[32] OECD, *Model Tax Convention on Income and on Capital: Condensed Version 2017* (December 18, 2017).
[33] [2013] 3 C.T.C. 2021.
[34] [2014] 3 C.T.C. 2001.
[35] OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 – 2015 Final Reports* (October 5, 2015).
[36] *Ibid*. at 3.
[37] *Ibid*.
[38] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 1995* (1995); OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017* (August 18, 2010).
[39] 2018 D.T.C. 1138 (***Cameco***).
[40] Submissions to the OECD, Osler, Hoskin & Harcourt LLP, *Discussion Draft on Financial Transactions released July 3, 2018* at ¶ 31.
[41] Discussion Draft, at para. 16.
[42] [1992] 3 SCR 558.

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[43] 2018 TCC 200 (***Barejo***).
[44] *Ibid*. at ¶ 708, footnote 802.
[45] *Ibid*. at ¶ 604.
[46] *Ibid*. at ¶ 717 to 719.
[47] Other than with respect to the more routine/interpretative aspects of those guidelines.
[48] *Canada v. GlaxoSmithKline*, [2012] 3 S.C.R. 3. Therefore, it is difficult to understand how the concepts of "value creation" and "accurate delineation" can be considered to be incorporated into Canadian law. As a result, taxpayers may be faced with a different set of principles at the assessment stage and on appeal to the TCC.

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