COVID-19
AND CANADIAN TAX
Tax for the Owner-Manager · Canadian Tax Focus
CTF FCF
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July 2020

The Canada Emergency Wage Subsidy: Affiliated Group Issues

The Canada Emergency Wage Subsidy (CEWS) became law on April 11, 2020. It applies to "eligible entities" other than a corporation exempt from tax under part I of the Act or a public corporation.

The CRA stated in document no. 2020-084779 (May 8, 2020) that "exempt from tax under Part I" is meant to refer to corporations exempt from tax under subsection 149(1), other than those entities specifically referred to in paragraph (d) of the definition of "eligible entity." The entities specifically referred to in paragraph (d) are as follows:

- agricultural organizations;
- chambers of commerce;
- boards of trade;
- non-profit corporations for the purpose of carrying on SR & ED;
- labour organizations or societies;
- benevolent or fraternal benefit societies; and
- clubs, societies, or organizations operated exclusively for any purpose other than profit.

The CRA stated that whether a corporation is "exempt from tax" is determined by the *type* of corporation and does not depend on whether certain amounts earned by a corporation are included in the computation of income for the calculation of part I tax.

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To qualify for the CEWS, an eligible entity must have a decrease in qualifying revenue over certain comparative periods. "Qualifying revenue" is defined in subsection 125.7(1) to mean the inflow of cash or any other consideration arising in the course of ordinary activities, generally from the sale of goods or rendering of services. (Certain specific exceptions to the qualifying revenue definition will not be discussed here.)

Subsection 125.7(4) expands the definition of qualifying revenue in a number of ways. One of these applies if the eligible entity is part of an affiliated group of persons. We refer to this as the "affiliated entity rule."

Paragraph 125.7(4)(b) may be summarized as follows:

- An eligible entity along with each member of an affiliated group of eligible entities may calculate their revenue on a consolidated basis in accordance with relevant accounting principles.
- Each member of the affiliated group of eligible entities can then use the consolidated revenue as a proxy for stand-alone qualifying revenue when calculating its eligibility for the CEWS.
- Each member of the affiliated group must jointly elect to use this method.

This rule can be useful in organizational structures where the payroll function is handled by an entity separate from the operating business, since it would allow that entity to access the subsidy based on an entity-wide determination of revenue if it would not meet the qualifying revenue test on a stand-alone basis.

There are a number of interpretive issues, including the following.

What Is an Affiliated Group?

Paragraph 125.7(4)(b) refers to an affiliated group of eligible entities. However, the phrase "affiliated group" is not defined in the Act. There is a definition of "affiliated group of persons" in subsection 251.1(3), but this definition applies only for the purposes of section 251.1. Notwithstanding this, the CRA has indicated that it will apply that definition for the purposes of the affiliated entity rule. See question 10-1 in Frequently Asked Questions—Canada Emergency Wage Subsidy (CEWS).

What Is the Meaning of a Consolidated Basis of Revenue?

The affiliated group of eligible entities must calculate its revenue on a consolidated basis. "Consolidated basis" is not a defined term. Consolidation is an accounting concept whereby the financial information of a parent and one or more wholly owned subsidiaries is merged into one notional entity. Does this imply that in order to use this approach, eligible entities must be in a parent-subsidiary relationship? Or is the intent that any entities that normally prepare their financial information on a combined basis are allowed to use this method? On the basis of a CRA comment, it appears that the phrase will not be limited to a strict application of the accounting concept of consolidation, and that a "combination" of qualifying revenue of each entity will be acceptable. See example 7 in question 9.

What Is the Meaning of Relevant Accounting Principles?

Revenue must be calculated in accordance with "relevant accounting principles." The phrase is not defined. Presumably, as long as an eligible entity is using accepted accounting practices to calculate its revenue, and is not changing them for the purposes of the CEWS calculation, its particular method would be accepted. The CRA has not provided any specific guidance on this point. However, the legislation includes a broadly worded anti-avoidance provision that would likely catch a deliberate manipulation of revenue (subsection 125.7(6)).

Which Eligible Entities Constitute Members of the Affiliated Group?

Each member of the affiliated group of eligible entities must jointly elect to use this method. In this context the CRA says "affiliated group" is intended to be interpreted in the broadest sense possible. See question 10.

Eligible entities that are affiliated cannot opt out of the election once it is made, nor can a subset of entities form a smaller affiliated group. This may present practical difficulties in some cases.

Example: Affiliated Group with International Structure

Consider a company with subsidiary corporations in multiple international jurisdictions, none of which have a connection to Canada. Consider also a Canadian subsidiary of a foreign entity. The Canadian entity has sister companies in multiple international jurisdictions. All of the corporations in this structure would meet the definition of an affiliated group of persons. Does this mean that each company in the entire international structure is part of the affiliated group for the purposes of this rule, even if some of them have no connection with the Canadian entities, and the Canadian entity is insignificant compared with the entire international structure?

As discussed earlier, an eligible entity is defined to include, among other things, a corporation, other than a corporation that is exempt from part I tax by virtue of subsection 149(1). Also, as discussed earlier, the CRA says that this comment is meant to refer to only to the *type* of corporation and *not to the computation of taxable income*.

A non-resident corporation that has no Canadian-source income is generally outside the purview of Canada's income tax regime. However, if a non-resident corporation earns certain types of Canadian-source income, it will be taxable in Canada under subsection 2(3) and section 115. Therefore, all non-resident corporations other than those referred to earlier as being exempt under subsection 149(1) are caught, on the basis of a literal interpretation of the affiliated entity rule. Therefore, all companies everywhere in the world would have to participate in the joint election. The CEWS claimant would need to take account of the qualifying revenue of all of the corporations worldwide in order to determine whether the decrease-in-revenue threshold is met. As well, it would need signatures on the joint election from authorized representatives of all of the corporations. This could prove to be problematic if information is not generally shared between the different international entities. As of the date of writing, the CRA has not provided any guidance on this type of international organization.

Example: Affiliated Group That Is Different from Prior Year

Consider another example where four entities meet the definition of an affiliated group in March 2020, but one of the entities was newly incorporated in 2020 and only three of the entities existed during the comparative period. Can the affiliated entity rule still be used in this case? If so, would the affiliated group be composed of the four entities, which would then calculate revenue on a consolidated basis and compare it to the consolidated revenue of the three entities that existed during the comparative period? Or would the newly incorporated entity be excluded from this calculation? The CRA has not provided guidance in this area, other than to say that the determination of revenue should be done on a consistent basis, with an "apples-to-apples" comparison, and without any manipulation.

How Is the Election Made?

Each member of the affiliated group of eligible entities must jointly elect in order to use this method (paragraph 125.7(4)(b)). The CRA offers no guidance on what actually constitutes an election, other than to say that it must be made and retained on file, and that it must be produced if the CRA requests it. Presumably, an election would take the form of a letter to the CRA, listing the members of the affiliated group and stating their intention to elect jointly under paragraph 125.7(4)(b) for the relevant period, and would be signed by an authorized representative of each entity.

It should be noted that an election is valid only for one claim period. For example, the election can be made for the initial claim period that begins on March 15, 2020 and ends on April 11, 2020. If an affiliated group of eligible entities wishes to use the affiliated entity rule for a subsequent claim period, it may do so, but it must make another election. On each claim, the individual who has principal responsibility for the entity's financial activities must attest that the election has been made, by checking the appropriate box on the RC661 attestation form. A completed attestation is required for an entity to qualify for the CEWS: see the definition of a qualifying entity in subsection 125.7(1). However, completing the attestation does not of itself constitute making the election.

Who Files the Claim?

Each qualifying entity makes its own individual claim for the CEWS, regardless of whether the affiliated entity rule is being used to determine revenue. The affiliated entity rule exists only for the purposes of determining qualifying revenue and has no bearing on the CEWS claim itself.

Conclusion

There is some uncertainty regarding the application of the affiliated entity rule. The CRA has indicated that there will be strict penalties for non-compliance with the CEWS rules, but hopefully common sense will prevail and the CRA will take a reasonable approach when dealing with uncertainties such as the ones discussed above.

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Affiliation Election for CEWS: Private Corporation Applications

Businesses that do not initially meet the revenue decline test for the Canada Emergency Wage Subsidy (CEWS) may be surprised that the affiliation election may be applicable in a variety of scenarios, including a simple corporate structure where there is only one operating company. This affiliation election may assist businesses in applying for the CEWS when they initially appear to be ineligible.

The term "affiliated group of eligible entities" is not defined in the Act; however, an "affiliated group of persons" is defined in subsection 251.1(3) to mean a group of persons each of which is affiliated with every other member. Presumably, an affiliated group of eligible entities would mean a group of eligible entities each of which is affiliated with every other eligible entity. An eligible entity is broadly defined in subsection 125.7(1) to include corporations, individuals, and partnerships. Affiliation is clarified in subsection 251.1(1) and includes numerous different possibilities for determining whether one person is affiliated with another.

A common approach to the affiliation election has been to apply it in circumstances where there are multiple corporations in a corporate structure. However, for small business owners, there is generally one operating company and the affiliation election may not appear to be initially useful; however, an in-depth understanding of "affiliated" and "eligible entity" may prove otherwise.

Consider a simple corporate structure with one operating company ("Opco") wholly owned by Mr. X. Opco currently has employees, but the revenue of Opco as of May 2020 is identical to May 2019 and would initially not meet the revenue decline test to be eligible for the CEWS. However, Mr. X has his own separate self-employed business whose revenue has declined from May 2019 to May 2020. Note that even if Mr. X earned only passive income, such income should count as revenue, since the definition of qualifying revenue includes cash and receivables derived from "the use by others of resources of the eligible entity" (that is, interest as payment for the use of capital).

Applicants should be aware that eligible entities do not have to be corporations to be able to file the affiliation election. An Opco and an individual shareholder may form an affiliated group of eligible entities for the purposes of the CEWS. See the examples below.

Example 1

Since Mr. X wholly controls Opco, Mr. X is affiliated with Opco pursuant to subparagraph 251.1(1)(b)(i). Therefore, Mr. X and Opco are an affiliated group of eligible entities and they can jointly elect under paragraph 125.7(4)(b) to permit Opco to use the consolidated revenues of the group to determine its own revenue decline test. Under this approach, Opco will now be eligible for the CEWS (see table 1).

Table 1

	Opco revenue	Mr. X business revenue	Consolidated revenue
May 2019	$100	$100	$200
May 2020	$100	$40	$140
% decline year over year	0%	60%	30%

Mr. X does not need a payroll number since an election is permitted among affiliated eligible entities rather than affiliated qualifying entities. Mr. X would need a payroll number only if he were personally applying for the CEWS.

Example 2

As demonstrated above, the affiliation election is a blessing in some cases. However, if the affiliation election is not properly analyzed, disastrous consequences may arise, because the affiliation election must take into consideration *all* affiliated eligible entities; an applicant cannot pick and choose which affiliated parties to consolidate with. Consider the same fact pattern as example 1, but Mr. X fails to identify that Mrs. X, his spouse, is also an affiliated eligible entity. Suppose she has interest income, perhaps from a bank, which leads to the result shown in table 2.

Table 2

	Opco revenue	Mr. X business revenue	Mrs. X interest revenue	Consolidated revenue
May 2019	$100	$100	$200	$400
May 2020	$100	$40	$200	$340
% decline year over year	0%	60%	0%	15%

If Mr. X is not careful with his analysis, Opco may erroneously apply for the CEWS and be subject to repayment and penalties.

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How Does the Canada Emergency Wage Subsidy Apply to Non-Resident Employers?

The much-welcomed Canada Emergency Wage Subsidy (CEWS), enacted on April 11, 2020 (Bill C-14), may apply in unexpected ways to non-resident entities that send their non-resident employees to Canada. In general, to qualify for the CEWS, an employer must:

1) be an *eligible entity*;
2) experience a decline in qualifying revenue;
3) employ an *eligible employee*;
4) pay that person *eligible remuneration* in a qualifying period; and
5) have a payroll account on March 15, 2020.

Consider the case of a US-resident corporation, NR Co, that provides services in Canada. It does not have a permanent establishment in Canada under the provisions of article V of the Canada-US tax treaty, in particular the so-called deemed services provision of article V(9). It does have a payroll account in Canada, which it maintains in respect of its US-resident employees who work in Canada on an intermittent basis. These employees are allowed to travel to Canada during the COVID-19 pandemic under the essential services exception to the border restrictions. Assume that NR Co had the requisite decline in qualifying revenue for the relevant periods from March 15 to August 29, 2020.

Assume that A is an employee of NR Co, is a tax resident of the United States, and works in Canada for three days during the period March 15-April 11, 2020 and in the United States for the remainder of the period. A is paid a salary by NR Co for the entire period. Is NR Co entitled to a CEWS benefit in respect of all of the wages paid to A?

NR Co is an eligible entity because it is a corporation and is not exempt from tax. In CRA document no. 2020-084779 (May 8, 2020), the CRA says that the words "exempt from tax" in paragraph (a) of the definition of an "eligible entity" in subsection 125.7(1) are meant to exclude, generally, corporations described under subsection 149(1). Therefore, a non-resident corporation that is not subject to Canadian income tax under the relevant tax treaty can qualify as an eligible entity.

To qualify for the CEWS, NR Co must pay "eligible remuneration" as defined in subsection 125.7(1). The salary paid to A in respect of the services performed in Canada will qualify only if NR Co has not applied for a non-resident employer certification pursuant to paragraph 153(7)(a). Eligible remuneration is defined as amounts described in paragraph 153(1)(a) or (g). These paragraphs generally include salary, wages, or other remuneration paid to an employee. However, amounts paid at any time by an employer to an employee at a time that the employer is a "qualifying non-resident employer" and the employee is a "qualifying non-resident employee" are excluded. These amounts are not subject to the employer withholding requirements of section 153 and regulation 102. If NR Co chooses not to file an application pursuant to paragraph 153(7)(a) to be classified as a qualifying non-resident employer, or is not eligible to be considered a qualifying non-resident employer for some other reason (for example, failing to comply with the requirements of the certified non-resident employer program), it would be liable to withhold, but it would be eligible for the CEWS.

Also, pursuant to the definition of eligible remuneration in subsection 125.7(1) and the references to paragraphs 153(1)(a) and (g) in the definition, eligible remuneration is not specifically limited to the salaries and wages paid for the services performed *in Canada*. However, note that under the salary withholding requirements applicable to non-resident employers that do not qualify under the certified non-resident employer program, regulation 104 generally limits the withholding to "remuneration reasonably attributable to the duties of any office or employment performed or to be performed in Canada by [a] non-resident person."

It is not clear at this time if a proper interpretation of the CEWS legislation would require the CRA to apply a similar approach to the calculation of eligible remuneration for the purposes of the CEWS. If it does not, a non-resident employer may claim the subsidy for all of the wages paid to a non-resident employee during the qualifying period regardless of the number of days actually spent working in Canada.

Our example illustrates this anomaly. A performed services in Canada from March 15-17, 2020 and was paid for the entire period from March 15 to April 11, 2020. Read literally, the definition of "eligible employee" requires only that an employee be employed in Canada by an eligible entity in the qualifying period and receive remuneration in respect of 15 or more days from the eligible entity during the qualifying period. In the given fact pattern, could NR Co claim a subsidy for the full amount of A's salary during the qualifying period (March 15-April 11, 2020) even though the eligible employee worked in Canada for only three days?

It is unclear whether the legislation should be applied in this way, but such a conclusion seems possible on a literal reading of the provisions. It does seem anomalous to us that Parliament would want to provide a subsidy to a non-resident employer in respect of wages paid for services rendered outside Canada. To date we are unaware of how the CRA might administer the provisions in circumstances such as those outlined here.

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Sharing COVID-19 Assistance with Foreign Entities Through Transfer Pricing

Transfer Pricing Memorandum (TPM)-17 (March 2, 2016) states that when a Canadian taxpayer receives government assistance and participates in a cross-border controlled transaction, it should not share all or part of that assistance with non-arm's-length non-resident persons. This policy is meant to prevent Canadian government assistance from being used to benefit a party outside Canada that would not have been able to directly apply for the assistance, such as a foreign parent. But, since this guidance is not the law and COVID-19 government assistance can be quite material, it can be tempting for multinational groups to share the assistance among the related group. If that is done, pushback from government should be expected and planned for.

Consider a Canco that performs research and development (R & D) in Canada for its foreign parent. Canco incurs costs of $100. Canco's policy is to charge the parent the total cost of this work plus a markup of 10 percent on these costs. The issue is how to treat COVID-19 government assistance of $20 received in 2020 in determining the chargeback price to the foreign parent. The $20 could be received in various forms: administrative concessions, payment deferrals, loans, subsidies, or grants.

One method is to follow TPM-17 and ignore this assistance in determining the allocable costs (that is, the costs charged by the Canadian taxpayer to the non-arm's-length non-resident person for the provision of services or sale of goods). In that case, Canco's taxable income would be $30 ($100 × 1.1 + $20 − $100). Another approach would be to reduce Canco's allocable costs or markup by the amount of this assistance. Assuming that Canco reduces its allocable cost, its taxable income would be $8 ([$100 − $20] × 1.1 + $20 − $100). Alternatively, Canco could reduce the markup to, for example, 5 percent of the costs it incurred. In that case, its taxable income would be $25 ($100 × 1.05 + $20 − $100).

The CRA has not specifically indicated that TPM-17 will apply to COVID-19 government assistance, but it is clear that the general policy is that such assistance should not be directly or indirectly shared abroad. The CRA has noted that taxpayers engaging in tax evasion or avoidance schemes that attempt to exploit the crisis can expect the CRA to pursue all compliance tools at its disposal to protect the integrity of Canada's tax system.

Where a Canadian taxpayer plans to directly or indirectly share all or part of the COVID-19 government assistance with a non-arm's-length non-resident person by way of reducing its allocable cost or markup, it should perform an in-depth economic analysis to develop support for this approach. In other words, it should have documentation that shows that the prices charged reflect arm's-length prices and are not merely a mechanical application of a cost-plus formula. These analyses have been challenging historically, and given the current economic crisis, their importance cannot be overstated. Failure to perform a proper economic analysis could result in penalties under the relevant COVID-19 government assistance program and possibly also increase income tax obligations and penalties under section 247.

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Freezes and Refreezes: Opportunities and Risks in the Era of Self-Isolation

The economic havoc wreaked by COVID-19 is self-evident. With the chaos, however, comes opportunity. Those looking to minimize future income tax may consider "freezing" the value of their investments now, at depressed values. Similarly, those who previously undertook an estate freeze may consider "refreezing" their equity interests. This article explores the mechanics, principal benefits, and risks of each such strategy.

In general, a freeze transaction aims to fix—or "freeze"—the freezor's value in a subject asset. All growth in value of the frozen asset thereafter accrues to other persons, typically the freezor's family members (or a personal trust created for their benefit). A freeze may also indirectly result in other benefits—for example, multiplication of the capital gains deduction for qualifying shares of certain active business corporations.

Freeze transactions typically involve a tax-deferred reorganization through an underlying corporation (Freezeco). Myriad methods of implementing a freeze exist. If the freezor already owns growth shares in Freezeco, an "internal freeze" can be undertaken, whereby the freezor exchanges such shares for fixed-value preferred shares with specific share rights and restrictions. Interests in personally owned assets—such as real estate held as capital property—may also be frozen by transferring such assets to Freezeco in return for preferred shares (with an election under section 85 typically being filed). The freezor may take back non-share consideration (for example, a promissory note) equal to the cost amount of the subject asset without necessarily impairing the tax-deferred nature of the transaction.

In either case, the freezor's family members, or a trust settled for their benefit, then subscribe for the Freezeco common shares. The freezor may wish (or be advised for post mortem "bump" planning reasons) to retain voting control over Freezeco. Preferred shares received are then frequently transferred to a life-interest trust—for example, an alter ego, spousal, or joint partner trust—for other estate-planning reasons.

Significantly, estate freezes are driven in large part by administrative concession. The CRA's view that fixed-value preferred shares can have an FMV equal to that of the frozen asset is critical to the effectiveness of an estate freeze. Therefore, any preferred shares issued should have rights and restrictions that comply with longstanding CRA policy—namely, that such preferred shares (1) are redeemable at the holder's option (that is, retractable); (2) carry voting rights in respect of matters pertaining to the relevant class of shares; (3) have first preference on any distribution arising from the underlying corporation's liquidation, winding up, or dissolution; (4) have no restriction on transferability (other than as mandated by governing corporate law); and (5) are issued by a corporation that is restricted from paying dividends on any other class of shares if doing so would impair the corporation's ability to pay the full redemption amount of the preferred shares.

Valuation is also always a critical consideration. Undervaluing the preferred shares received on a freeze transaction risks benefit conferral, attribution, and double taxation. Prudence thus dictates that a price adjustment clause (PAC) always be used where possible and, to ensure that the CRA will respect such a PAC, bona fide steps should be taken to determine the FMV of the frozen asset when setting the redemption value of the preferred shares.

Here is where COVID-19 presents the clearest opportunities. Public securities trading at historically low values (as determined by true market forces) are ripe for an estate freeze before markets recover. Commercial real estate, especially in the urban centres most directly affected by the pandemic, is similarly well positioned. Private company shares may also be ideal candidates for an estate freeze given widespread cash flow and revenue losses (though if such losses are temporary only, caution suggests that declines in value may not be as acute as instinctively perceived).

Similar considerations apply for taxpayers who have already undertaken a freeze transaction. If COVID-19 has resulted in the value of the underlying corporation decreasing since the time of an earlier freeze, a "refreeze" transaction may be an equally attractive planning opportunity.

Refreeze transactions generally involve a taxpayer exchanging preferred shares received on an earlier freeze for newly issued preferred shares with a redemption amount equal to the current (lower) equity value of the underlying corporation. The preferred share redemption amount is thus "reset" at present values. Naturally, a refreeze is only prudent where the aggregate redemption amount of the existing preferred shares exceeds the current net equity value of the corporation (such that the common shares effectively have nil value).

The CRA has commented favourably on the viability of refreezes (see, among others, CRA document no. 9607635, May 28, 1997). In particular, the CRA has confirmed that no benefit is conferred on a corporation's common shareholders where the post-freeze decline in value was not caused by intentionally stripping the corporation's assets (see, for example, CRA document no. 2010-0362321C6, June 8, 2010).

Refreezes are subject to the same considerations that apply to freeze transactions. In particular, CRA administrative positions—including those regarding the necessary share rights and restrictions—should be complied with, and a PAC should be used when possible. Particular scrutiny should be given to the value of the underlying corporation and whether the existing common shareholders have indirectly received a benefit from the refreeze. Practitioners should be mindful of the basis for the post-freeze decline in value, especially if it is significant, and whether the CRA could challenge the decline as having been "manufactured" to justify the refreeze. External valuations and third-party appraisals may be particularly advisable when considering a refreeze transaction.

The corporate attribution rule is particularly relevant in the context of a refreeze. As background, that rule may apply if an individual transfers property to a corporation and one of the main purposes of the transfer is to reduce the individual's income and benefit a "designated person" (as defined in subsection 74.5(5)) in respect of the individual. If the rule is applicable, the individual may be subject to an annual deemed interest benefit. There are various exceptions and caveats to that rule, a full discussion of which is beyond the scope of this article. However, in the context of refreezes, the corporate attribution rule may result in unforeseen, and seemingly unintended, consequences.

In particular, an individual freezor subject to the corporate attribution rule—knowingly or otherwise—who undertakes a refreeze transaction may continue to be subject to a deemed interest benefit calculated by reference to the value of the assets transferred to the corporation on the initial freeze. The preferred shares received on the refreeze do not appear to reduce the "outstanding amount" of the transferred property (as determined under subsection 74.4(3)). Thus, it appears that the amount on which the deemed interest benefit is computed will not be reduced, notwithstanding that the underlying transferred property has presumably declined in value. Further, if the refrozen preferred shares are redeemed, the "outstanding amount" will apparently be reduced only to the extent of the value of the refrozen shares. Thus, the freezor may technically be deemed to continue receiving "phantom" interest income, even after all outstanding preferred shares are redeemed.

In conclusion, alongside the extreme difficulties brought by COVID-19 come planning opportunities. Freeze or refreeze transactions may be particularly advantageous given the present circumstances. However, the benefits, considerations, and risks outlined above should be kept directly in mind.

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Distress Preferred Shares: Tips and Traps

As a result of the current economic downturn, many corporations may find themselves in financial difficulty and need to refinance their existing debt obligations with creditors (lenders). Distress preferred shares (DPS), as defined in subsection 80(1), are an option in that regard for a corporation resident in Canada. This method of refinancing can be attractive to lenders because they can receive equal or better after-tax returns on their investments—essentially by converting taxable interest to non-taxable intercorporate dividends—without jeopardizing their security and priority. Part of this increase in after-tax returns to the lender normally coincides with a dividend rate that is lower than the prior interest rate, providing the borrower with extra cash to assist in the financing of its business. Tips and traps associated with this financial instrument are provided below. For an introductory overview, see our earlier article.

Three Tips

1) In issuing DPS, the borrower and the lender will ordinarily negotiate a fixed cumulative dividend entitlement that is lower than the interest that would otherwise be paid. Although the borrower is unable to deduct the dividend in calculating its income, and was likely deducting the interest, the borrower is typically in a loss position by the time DPS are issued and may not benefit from such interest deduction in any event. Also, expenses incurred in the course of issuing the DPS are generally deductible to the extent that they are reasonable in the circumstances.
2) The CRA's administrative position in respect of the time period when a corporation "could reasonably be expected to default" is not more than three or four months away (IT-527, "Distress Preferred Shares," June 12, 1995). This specific period has no basis in law. Whether a corporation could reasonably be expected to default should be determined on a case-by-case basis and any analysis should be largely fact-driven. As a result, there are circumstances where a corporation could reasonably be expected to default within a time frame that is longer than the one stated by the CRA.
3) Structuring a DPS issuance to include a new taxable Canadian corporation that is a subsidiary of the borrower can help to quell any lender concerns regarding subordination of their debt interest to equity at the borrower level.

Three Traps

1) Dividends may be paid only when the solvency tests outlined in the relevant corporate statute are satisfied. For example, section 42 of the Canada Business Corporations Act states that a "corporation shall not declare or pay a dividend if there are reasonable grounds for believing that (a) the corporation is, or would after the payment be, unable to pay its liabilities as they become due; or (b) the realizable value of the corporation's assets would thereby be less than the aggregate of its liabilities and stated capital of all classes." If the distressed borrower does not meet these legal tests, the lender will not receive payment. In contrast, the payment of interest has no such corporate restrictions.
2) DPS refinancing may not be attractive to non-resident lenders. Certain non-resident lenders may prefer to receive interest income rather than dividend income, particularly in circumstances where there is no withholding tax attached to the receipt of interest income. For example, article XI of the Canada-US tax convention effectively eliminates the withholding tax imposed in the country where the interest arises.

ISBN 978-0-88808-308-1 (Online)

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3) A share may qualify as a DPS for a period of five years, after which period it will become an ordinary preferred share. To avoid falling into the disadvantageous categories of "taxable preferred share," "short-term preferred share," or "term preferred share," the terms of a DPS should include a mandatory redemption requirement at the end of the five-year period.

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COVID-19 and Communicating with the CRA

CRA offices have been temporarily closed during the COVID-19 pandemic and officials are working from home. Standard CRA communications channels are under strain. E-mail is an obvious answer: at the time of writing (June 16), procedures have been created for international waivers and compliance certificates, and a general commitment has been made for e-mail's use in audits. But e-mail could be more widely used right now, and other forms of electronic communication should be investigated for the post-pandemic future.

Generally, the CRA's methods of communication are more limited than those used in the private sector. The CRA is subject to strict rules of confidentiality, both under legislation and under its own internal policies. The CRA also handles an immense amount of sensitive information, so its communication lines must understandably remain tight. Thus, the typical means of communicating with Appeals or Audit officials have been sending a letter to the central mailroom at their office, faxing to their line, or calling them at the landline that is hardwired to the official's desk. E-mail has not been an option, presumably owing mostly to security risks.

But now, with offices closed, there is no one in the mailrooms and no one sitting at the desks to receive calls. Certain general CRA call lines are open, but it is not clear what is happening with CRA mail. On a recent call with the CRA Charities Directorate, a CRA employee recommended submitting charity applications through the CRA's web portals, because that employee's understanding was that the reviewers had no access to mail—meaning that mailed applications would remain unread until the CRA resumed office access. Further, we understand that CRA employees who are permitted in exceptional cases to enter their offices are not allowed to access anything that is or is part of a space that includes "high-touch points." This likely means that no one is retrieving messages from the fax machine that is shared across floors of the office. Thus, it has become harder for taxpayers and tax practitioners to contact the CRA, which makes it harder for all parties involved to effectively manage their files and resolve tax audits and disputes.

Given this state of affairs, we would like to make the case for the CRA to allow more taxpayer communication by e-mail both during and after the pandemic. First, it is quick and cheap. Second, it is accessible: allowing e-mail communication prevents taxpayers from potentially exposing themselves to COVID-19 by venturing to the post office or accessing a fax machine. Finally, the practices of the Rulings Directorate from long before the pandemic started show that the CRA can successfully communicate in this manner. Appendix F of *Information Circular* IC70-6R9 ("Advance Income Tax Rulings and Technical Interpretations," April 23, 2019) contains the standard authorization form to allow communication with taxpayers by e-mail.

One implementation issue is limited remote access for CRA employees. To our knowledge, many CRA employees have already been given a remote device, and for those who have not, plans to issue one are in the works. The bigger implementation issue is, of course, the security risks. In the long term, the CRA could look to security systems already available and in use in the private sector and other government and sensitive sectors, both in Canada and in other countries, to protect taxpayer information—end-to-end encryption is the goal. In the short term, the use of e-mail could (1) be restricted to taxpayers who have signed a consent similar to the form used by Rulings to accept e-mail risk, and (2) where such a form has not been signed, limit the topics of e-mail communication to non-sensitive matters such as exchanging status updates and setting up phone calls.

A related issue, but one of which we have limited knowledge, is how CRA officials communicate with each other in the current situation of remote work. The OECD's Forum on Tax Administration, of which Canada is a member, suggests "[a]s an emergency measure, allowing employees to use private emails or private phones to communicate, with guidance on when such communications might be appropriate and how to take account of security and data protection."

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