Tax Topics

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COVID-19 Update



# COVID-19 UPDATE

## Federal

### CEBA Update (June 26, 2020)

After a one-week delay, small businesses can now access the Canada Emergency Business Account ("CEBA") under the new expanded criteria through their financial institutions as of June 26, 2020.

### OAS Recovery Return for Non-Residents (June 19, 2020)

Non-resident seniors who receive Canadian old age security ("OAS") payments may have to pay recovery tax on those payments. A non-resident senior who receives OAS payments must submit an Old Age Security Return of Income ("OASRI") so that the CRA can determine if they have to pay recovery tax and also to ensure that OAS payments are not suspended.

In response to the COVID-19 pandemic, OAS payments to non-resident seniors have been temporarily extended if their 2019 OASRI has not been assessed. To avoid an interruption in benefits, non-resident OAS recipients are encouraged to submit their 2019 OASRI as soon as possible and no later than October 1, 2020.

### No Change to SR&ED Filing Deadline (June 25, 2020)

The CRA website was updated with a confirmation that reporting deadlines for the scientific research and experimental development ("SR&ED") tax incentive program have not changed. Corporations still have 18 months after their tax year-end to file their SR&ED claim. However, businesses are strongly encouraged to file their SR&ED claim with their income tax return.

### Canada Student Service Grant Launches (June 25, 2020)

The new Canada Student Service Grant ("CSSG") aims to encourage young people to take part in service activities that will help them support their communities' COVID-19 response and gain invaluable experience. Administered by WE Charity, the CSSG is a one-time payment available at five levels, ranging from $1,000 to $5,000. The amount will vary based on the number of hours each volunteer completes, with $1,000 provided for each 100 hours completed, up to a maximum of $5,000 for 500 hours.

In order to be eligible for the grant, participants must be 30 years of age or younger and a Canadian citizen, permanent resident, or a student with refugee status, and either:

- enrolled in and attending post-secondary education during the spring, summer, or fall 2020 semesters;
- a recent post-secondary graduate (no earlier than December 2019); or
- studying abroad and currently residing in Canada.

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Post-secondary students and recent graduates must register no later than August 21, 2020 to be eligible to receive the grant. Completed applications for the CSSG must be submitted no later than November 6, 2020, and participants will only be able to count hours accumulated from June 25 to October 31, 2020.

Not-for-profit organizations will be able to submit volunteer opportunities to the I Want to Help platform. Eligible and high-quality placements will be posted on the platform, where students can search and apply for opportunities in their communities.

In order to be eligible, a placement must:

- be with a not-for-profit organization, which includes registered charities;
- take place in Canada and support Canada's response to COVID-19;
- be a minimum of two hours per week for four weeks;
- follow all applicable public health requirements.

# Provincial

## Alberta

### COVID-19 Response Bill Introduced (June 18, 2020)

The government has introduced Bill 24, the *COVID-19 Pandemic Response Statutes Amendment Act*. The bill proposes numerous amendments relating to the province's COVID-19 response efforts.

## British Columbia

### New Legislation Proposes Tax Amendments (June 24, 2020)

The provincial government has introduced the *Economic Stabilization Act*, which proposes to enact the many tax measures that have been introduced in response to COVID-19.

### Temporary Rental Supplement Extended (June 19, 2020)

The provincial government is extending the temporary rental supplement ("TRS") until the end of August 2020 to continue to support renters and landlords. It will also maintain the moratorium on rent increases and evictions for non-payment of rent, while enabling other notices to end tenancy to resume.

## Manitoba

### Manitoba Job Restart Program (June 23, 2020)

The provincial government is introducing the Manitoba Job Restart Program, which will provide direct payments to a maximum of $2,000 to help qualified Manitobans return to work. The program will provide one initial payment of $500 plus three additional bi-weekly payments of $500 each, for a total of $2,000 over six weeks. Program participants must voluntarily stop collecting CERB or CESB support from the federal government. The province will fully finance the program, which does not require any contributions from employers for workers to qualify.

To remain in the program, approved applicants must:

- actively return to work in Manitoba to a job with at least 30 hours per week in order to be eligible for the first $500 payment;
- complete a simple declaration for each of the following two weeks certifying that they are still working at least 30 hours per week in order to receive the next three $500 payments;
- no longer receive CERB, CESB, or similar COVID-19-related support from the federal government;
- follow Manitoba's COVID-19 health guidelines in the workplace; and
- continue residing permanently in Manitoba and be legally entitled to work in Canada.

The Manitoba Job Restart program will accept applications until July 31. This is a voluntary-participation program, and there is no obligation for Manitobans to stop receiving CERB or CESB benefits if they choose not to participate. The amounts received will be a taxable benefit.

### Extension for RST Remittances (June 24, 2020)

Retail sales tax ("RST") returns for small and medium-sized businesses with monthly RST remittances of no more than $10,000 per month that would normally be due on April 20, May 20, June 22, July 20, August 20, and September 21 will now be due on October 20, 2020.

Businesses that file on a quarterly basis that have a due date of April 20 and July 20 will now have the due date extended to October 20, 2020.

Businesses that qualify for the above filing extension that were not able to file and remit their February sales tax return by the March 20 due date will not be assessed a late filing penalty, and interest will not be applied until after October 20, 2020.

Interest will continue to apply on all outstanding tax debts established prior to the March remittance deadlines. Businesses will still receive paper returns in the mail or web notice reminders by email for return periods March, April, May, June, July, and August.

### Extension for HE Levy Remittances (June 24, 2020)

Health and Post Secondary Education Tax Levy (also known as "HE Levy") returns for small and medium-sized businesses with monthly HE Levy remittances of no more than $10,000 per month that would normally be due on April 15, May 15, June 15, July 15, August 17, and September 15 will now be due on October 15, 2020.

Businesses that qualify for the above filing extension that were not able to file and remit their February HE Levy tax return by the March 16th due date will not be assessed a late filing penalty, and interest will not be applied until after October 15, 2020.

Interest will continue to apply on all outstanding tax debts established prior to the March remittance deadlines.

Businesses will still receive paper returns in the mail or web notice reminders by email for return periods March, April, May, June, July, and August.

## Ontario

### Support for Indigenous-Owned Businesses (June 19, 2020)

The government of Ontario is providing up to $10 million to Indigenous-owned small and medium-sized businesses to help them with much needed capital as the province begins to safely and gradually reopen the economy.

Loans of up to $50,000 will be available to businesses that are either ineligible for, or unable to access, existing federal and provincial COVID-19 response initiatives for small businesses. The funding is being delivered through the Support for People and Jobs Fund.

Loans will be available through Aboriginal Financial Institutions. Up to 50% of each loan will be in the form of a non-repayable grant, with no interest due on the loan portion until December 31, 2022. Businesses may use these funds to cover general expenses such as payroll, rent, utilities, and taxes. They may also be used towards increasing production capacity, developing new products, moving to online marketing, or to make improvements to accommodate social distancing requirements.

# International

## US Bill Would Provide COVID-19 Tax Relief for Remote and Mobile Workers

Bipartisan legislation was introduced in the United States Senate on June 18, 2020 that would ensure that individuals working across state lines, as well as those working remotely as a result of the restrictions on movement introduced to tackle COVID-19, do not face adverse tax consequences.

The Remote and Mobile Worker Relief Act 2020 builds on the Mobile Workforce State Income Tax Simplification Act, introduced in the Senate last year, by establishing a special 90-day standard for workers who traveled to another state

during the pandemic, said Senator John Thune (R-SD), one of the bill's sponsors. In particular, the bill is aimed at medical professionals who traveled to other parts of the country to help tackle the virus.

Under current law, non-resident employees who visit a state for as little as 24 hours to do work can be subject to certain state income tax laws. Businesses must also comply with states' varying withholding requirements with regards to employees who travel out of state for work purposes.

Under the Remote and Mobile Worker Relief Act 2020, no part of the wages or other remuneration earned by an employee who performs employment duties in more than one taxing jurisdiction shall be subject to income tax in any taxing jurisdiction other than:

- the taxing jurisdiction of the employee's residence; and
- the taxing jurisdiction within which the employee is present and performing employment duties for more than 30 days during the calendar year in which the wages or other remuneration is earned.

In the case of employees performing duties in a tax jurisdiction other than their own due to the COVID-19 pandemic, the 30-day period is increased to 90 days with respect to calendar year 2020.

The bill would also ensure that employees working remotely in a tax jurisdiction different from their physical place of work would be taxed according to the tax rules of the location of their normal workplace.

## SUBPART F SALES INCOME

*— Lowell D. Yoder, Partner in the Chicago office of McDermott Will & Emery LLP*

Following the Tax Cuts and Jobs Act ("TCJA"),[1] most of the income derived by a controlled foreign corporation ("CFC") is included in the gross income of its US shareholders. A CFC's income is subject to US taxation either as Subpart F income[2] or as global intangible low-taxed income ("GILTI").[3]

For a US shareholder that is a corporation, Subpart F income is taxed at a 21% rate and GILTI is taxed at an effective tax rate of 10.5%.[4] Thus, whether a CFC's income is Subpart F income remains important after the TCJA.[5] Furthermore, for open years prior to the effective date of the TCJA, the character of a CFC's income as Subpart F income is even more significant in the event of an IRS audit[6] (i.e., a potential 35% tax on the amount of a proposed adjustment less any deemed paid foreign tax credits).[7]

This article provides an overview of the Subpart F income rules that apply to income derived from the sale of inventory, i.e., foreign base company sales income ("FBCSI"). The general definition of FBCSI has not changed since Subpart F was enacted in 1962. The Treasury and IRS, however, in 2008 issued regulations that substantially modified the application of a manufacturing exception and the manufacturing branch rule. In addition, recent litigation highlights areas of dispute surrounding the application of the FBCSI rules to certain supply chain structures.[8]

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[1] Tax Cuts and Jobs Act (TCJA), P.L. 115-97.

[2] Code Sec. 951(a)(1).

[3] Code Sec. 951A(a)(1). The amount of income derived by a CFC that is taken into account in calculating GILTI, i.e., tested income, is reduced by 10% of the average of the corporation's aggregate adjusted bases in depreciable tangible property giving rise to the tested income, which amount would not be subject to US taxation. Code Sec. 951A(d).

[4] Code Secs. 11 and 250(a)(1). A US shareholder is allowed a deduction for 50% of the amount of the GILTI inclusion. The GILTI deduction, however, is limited by the taxable income of the domestic corporation. Code Sec. 250(a)(2).

[5] In addition to being subject to a lower US tax rate, GILTI tested income of a US shareholder is reduced by a routine return on tangible property used to generate the income, and tested losses of one CFC can reduce tested income of other CFCs of the US shareholder.

[6] On September 10, 2018 — after the enactment of the TCJA — the IRS announced that one of its International Compliance Campaigns was to identify and select for examination returns of US shareholders of CFCs that may have underreported subpart F income based on certain interpretations of the manufacturing branch rules. See www.irs.gov/businesses/irs-announces-the-identification-and-selection-of-five-large-business-and-international-compliance-campaigns-0.

[7] The ultimate cost of a Subpart F income adjustment for a pre-TCJA year would be less to the extent the earnings would no longer be subject to taxation under Code Sec. 965.

[8] See *Whirlpool Fin. Corp. & Consol. Subs.*, 154 TC No. 9 (2020) (the Tax Court held for the IRS in a dispute concerning the application of the manufacturing branch rule). The Tax Court issued its decision in the *Whirlpool* case as this article was going to print and therefore the

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## General Definition of FBCSI

As a general rule, income derived by a CFC from selling products is not Subpart F income. Such income is Subpart F income only if it falls within the definition of FBCSI.

FBCSI consists of income derived by a CFC in connection with:

(1) the purchase of personal property from a related person and its sale to any person;

(2) the sale of personal property to any person on behalf of a related person;

(3) the purchase of personal property from any person and its sale to a related person; or

(4) the purchase of personal property from any person on behalf of a related person.

Income derived from such transactions, however, is not FBCSI unless the property is both manufactured outside the CFC's country of organization and sold for use outside such country.[9]

Therefore, if a CFC does not purchase property from, or sell property to, a related person, its sales income generally is not FBCSI. This is the case even if the CFC uses the services of other related or unrelated persons to assist with the generation of the sales income, such as assistance with purchasing the products from suppliers or selling the products to customers. In addition, income from selling products manufactured by anyone in the CFC's country of organization, or from selling products to customers in the CFC's country of organization, is not FBCSI even if derived in a related person transaction.

## Manufacturing Exception

The regulations provide that income derived by a CFC from the sale of products that it manufactures generally is excluded from the definition of FBCSI.[10] For many years the regulations defined manufacturing as the transformation, conversion, or major assembly of purchased property ("physical manufacturing"). The Tax Court has broadly interpreted this definition in favour of taxpayers (e.g., assembly of sunglasses qualified as manufacturing).[11]

Subpart F regulations finalized in 2008 provide a second definition of manufacturing. Specifically, a CFC principal that hires a contract manufacturer (whether related or unrelated) to manufacture products on its behalf will be considered as manufacturing the property if the CFC makes a "substantial contribution" to the physical manufacture of such property ("substantial-contribution manufacturing").[12]

The regulations provide that activities for satisfying the substantial-contribution manufacturing definition include: oversight and direction of the physical manufacturing activities; material selection, vendor selection, or control of raw materials, work-in-process, or finished goods; management of manufacturing costs or capacities; control of manufacturing-related logistics; quality control; and developing, or directing the use or development of, intellectual property for the purpose of manufacturing property. Other activities related to manufacturing also may be considered (e.g., selecting the contract manufacturer).[13]

Whether a CFC engages in sufficient activities to satisfy the substantial-contribution manufacturing definition is determined based on the facts and circumstances. The weight given to any particular activity will depend on the economic significance of those functions to the manufacture of the particular product. It is not necessary that the CFC engage in any particular activity or number of activities, and a CFC can be considered as manufacturing property when the manufacturing is largely automated where the employees conduct "industry-sufficient" substantial-contribution activities.[14]

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holding is not analyzed herein. For a discussion of the facts and arguments raised in the case, see Yoder, *Subpart F Sales Income: The "Whirlpool" Case*, 49 Tax Mgmt. Int'l J. 48 (Jan. 10, 2020).

[9] Code Sec. 954(d); Reg. § 1.954-3(a)(1)(i).

[10] Reg. § 1.954-3(a)(4).

[11] *Bausch & Lomb, Inc.*, 71 TCM 2031, Dec. 51,160(M), TC Memo. 1996-57. See Yoder, *Subpart F: LMSB Provides Guidance Concerning the Definition of Manufacturing*, 35 Tax Mgmt. Int'l J. 360 (July 14, 2006).

[12] Reg. § 1.954-3(a)(4)(iv).

[13] *Id.* See Yoder, *Subpart F: "Indicia of Manufacturing"*, 38 Tax Mgm't Int'l J. 642 (Oct. 9, 2009). Also taken into account are any physical manufacturing activities that fall short of satisfying one of the physical manufacturing tests.

[14] The manufacturing definition technically must be satisfied on a product-by-product basis. A taxpayer should be allowed to apply the test to a product line when a CFC performs similar functions for all products in the product line.

To qualify for the manufacturing exception, the regulations provide that a CFC must manufacture the property sold through functions performed by its own employees. Therefore, the activities of a CFC's own employees (including employees of its branches and disregarded entities) must physically manufacture products, or engage in important substantial-contribution manufacturing activities (e.g., direction, oversight and/or quality control) with respect to products manufactured by a contract manufacturer. For this purpose, an employee seconded to a CFC is counted.[15]

The substantial-contribution manufacturing exception is available for both consignment (toll) and buy-sell contract manufacturing arrangements. In addition, the IRS has privately ruled that the manufacturing exception can apply to commissions and fees received by a CFC for performing substantial-contribution manufacturing, procurement, and sales activities where the income is analyzed as sales income for Subpart F purposes.[16]

## Branch Rules

Income derived by a CFC from the sale of inventory that is not FBCSI under the general rule may nevertheless be FBCSI under a branch rule. The branch rule can apply when the CFC carries on purchasing, selling, or manufacturing activities in one or more foreign branches and a tax rate disparity ("TRD") test is met.[17] The regulations provide separate rules that apply to sales branches and to manufacturing branches.

### Foreign Branch

The branch rule applies only if a CFC engages in manufacturing, purchasing, or selling activities by or through a foreign branch.[18] The Tax Court has held that the definition of a branch for this purpose means a "[d]ivision, office, or other unit of business located at a different location from the main office or headquarters."[19] The activities of another corporation do not create a branch of a CFC for this purpose.[20]

### Sales Branch Rule

A portion of a CFC's sales income derived from transactions that do not involve related persons can nevertheless be FBCSI if the products are purchased or sold through a foreign branch. The sales branch rule can also apply where a CFC manufactures products in its country of organization and sells the products through a foreign branch.

The sales branch rule applies only if the CFC engages in purchasing or selling "activities" in a foreign branch.[21] Under the sales branch rule, the purchasing or selling income of the branch (but not the income of the home office) can be FBCSI if a TRD test is met.[22]

The TRD test is met where the branch's income derived from purchasing or selling activities is taxed at an effective tax rate that is both less than 90% of, and at least five percentage points less than, the effective tax rate that would apply

[15] Reg. §1.954-3(a)(4)(i). The general definition of employee for Federal income tax purpose applies, and such term may include seconded workers and employees of related entities. Reg. §31.3121(d)-1(c); Rev. Rul. 87-41, 1987-1 CB 296. The preamble to the Subpart F regulations states: "This definition of the term 'employee' may encompass certain seconded workers, part-time workers, workers on the payroll of a related employment company whose activities are directed and controlled by CFC's employees, and contractors, so long as those individuals are deemed to be employees of the CFC under §31.3121(d)-1(c). Consistent with commentators' request, this definition of the term employee may result in an individual being treated as an employee of two or more entities simultaneously." T.D. 9438, 73 FR 79,334, 79,338 (2/2/09). See also Rev. Rul. 69-316, 1969-1 CB 263; Rev. Rul. 66-162, 1966-1 CB 234.

[16] LTR 201325005 (May 28, 2013) (sales commission); LTR 201340010 (Apr. 15, 2013). See Yoder, *Subpart F Manufacturing Exception Applies to Sales Commissions*, 42 Tax Mgmt. Int'l J. 633 (Oct. 11, 2013); Yoder, *Subpart F Manufacturing Exception Applies to Procurement Commissions*, 42 Tax Mgmt. Int'l J. 716 (Dec. 16, 2013).

[17] Code Sec. 954(d)(2); Reg. §1.954-3(b).

[18] Reg. §1.954-3(b)(1)(i)(a) and (b).

[19] *Ashland Oil*, 95 TC 348, 357, Dec. 46,899 (1990). See also *Vetco, Inc.*, 95 TC 579, Dec. 47,001 (1990).

[20] *Id*.

[21] See Reg. §1.954-3(b)(1)(i)(a) (only income from "purchasing or selling activities" in a branch is taken into account for purposes of applying the regulatory purchasing or selling branch rule).

[22] See Reg. §1.954-3(b)(1)(i), (2)(i)(b)(2) and (ii)(b)(2) (under the "purchasing or selling branch" rule only purchasing and selling income derived in a branch is subject to the branch rule; any purchasing or selling income derived by the CFC's home office is not subject to the purchasing or selling branch rule, even if such income is taxed at a much lower rate than if the home office income were earned in the purchasing or selling branch).

to such income in the CFC's country of organization.[23] For purposes of determining the effective rate of tax which would apply to such income under the laws of the CFC's country of organization, the entire income of the CFC is hypothetically considered as derived by the CFC from sources within such country from doing business through a permanent establishment therein, received in such country, and allocable to such permanent establishment.[24]

If the TRD test is met, the home office and the branch are treated as separate CFCs, and the branch CFC generally is treated as purchasing or selling products on behalf of the home office CFC. For example, the sales branch rule would apply where a CFC organized in Germany with income subject to a 30% tax rate sells products through a foreign branch in Ireland subject to a 12.5% tax rate. The Irish branch would be treated as a separate CFC that sells the products on behalf of the home office CFC, and the branch's income generally would be FBCSI. On the other hand, the sales branch rule would not apply to income earned by an Irish CFC from selling products through a branch in Germany, because the TRD test would not be met.

Exceptions are provided where the products are manufactured or sold for use in the branch's country.[25] For example, in the first illustration above, the Irish branch's income would not be FBCSI to the extent the products were manufactured in Ireland or sold for use in Ireland.

The regulations provide that purchasing or selling activities performed through a branch will not be treated as performed "on behalf of" the home office where the home office does not engage in any purchasing, manufacturing, or selling activities.[26] Under these circumstances, the branch rule would not operate to create a related person transaction (even if the income of the branch is subject to a low tax rate). For example, the sales branch rule should not result in FBCSI where the branch purchases products from unrelated persons and sells the products to unrelated persons, and all purchasing and selling activities are performed in the branch.[27] This should be the result even if the branch pays a royalty to the home office for the use of intellectual property.[28]

## Manufacturing Branch Rule

The regulatory manufacturing branch rule applies where a CFC manufactures products in a foreign branch and carries on purchasing or selling activities in its home office or in another foreign branch.[29] When the branch rule applies to a CFC that manufactures products, the branch and home office (or purchasing or selling branch) are treated as separate CFCs for purposes of applying the FBCSI rules, and the income derived at the purchasing or selling location is treated as earned from purchasing or selling products on behalf of a related person.

The manufacturing branch rule applies only if a TRD test is met. This test is satisfied if the purchasing or selling income earned in the home office, or alternatively in a purchasing or selling branch, is subject to a tax rate that is both less than 90% of, and five percentage points less than, the effective tax rate that would apply to such income if earned at the manufacturing location.[30] As with the sales branch rule, the TRD test is determined by treating the income as attributed to a permanent establishment and subject to taxation in the country where the manufacturing takes place.

[23] The determination of tax rates is based on local law. Reg. § 1.954-3(b)(2)(i)(e). See Reg. § 1.954-3(b)(1)(ii)(b) (the above determinations take into account actual tax treatment "by statute, treaty obligation or otherwise . . . ."); LTR 201002024 (Jan. 15, 2010); LTR 200945036 (Nov. 6, 2009); and LTR 200942034 (Oct. 16, 2009). See also Yoder, *Local Law Governs Manufacturing Branch Determinations*, 36 Int'l Tax J. 3 (July–August 2010). The IRS in the LTRs determined the effective tax rate by reference to the taxable income computed under the tax laws of the country where the purchasing or selling branch is located. As discussed below, the IRS subsequently expressed the view that the actual effective tax rate and the hypothetical effective tax rate should be determined by reference to the taxable income computed under the tax laws of the CFC's country of organization (or country of manufacture). AM 2015-002 (Feb. 9, 2015).

[24] If a CFC operates through multiple sales branches, the sales branch rule is applied separately to each branch, treating each branch as a separate CFC. Reg. § 1.954-3(b)(1)(i)(c).

[25] Reg. § 1.954-3(b)(2)(ii)(e).

[26] Regs. § 1.954-3(b)(2)(i)(b) and (ii)(b). See *Preamble to Proposed Regulations*, 73 FR 10,721 (Feb. 28, 2008) ("Section 1.954-3(b)(2)(i)(b) and (ii)(b) are intended to apply only to purchasing or selling by a branch with respect to personal property manufactured, purchased, or sold by 'the remainder of' the CFC . . .").

[27] Regs. § 1.954-3(b)(2)(i)(b) and (ii)(b); (b)(4), Ex. 3; REG-124590-07, 73 FR 10,721 (Feb. 28, 2008). See Yoder, *Limits on the Application of the Subpart F Branch Rules*, 38 Tax Mgmt. Int'l J. 366 (June 12, 2009).

[28] See LTR 200945036 (Nov. 6, 2009) and LTR 200942034 (Oct. 16, 2009).

[29] Reg. § 1.954-3(b)(1)(i)(*b*). The manufacturing branch rule can apply even if the taxpayer does not rely on the manufacturing exception, i.e., because the CFC does not purchase property from, or sell property to, a related person.

[30] Reg. § 1.954-3(b)(1)(i)(*b*), (ii)(*b*).

For this purpose, the IRS has expressed the view that the rules for calculating taxable income in the country of manufacture should be used for purposes of determining whether the TRD test is met.[31] Under this approach, a lower tax rate provided by a ruling and any special incentives should be taken into account if they would apply to the purchasing or selling income had the income been earned in the country of manufacture.[32]

The regulations provide that substantial-contribution manufacturing activities can cause the manufacturing branch rule to apply. A CFC will be treated as manufacturing in the country where its employee activities independently satisfy the definition of manufacturing. If there is more than one such country, for purposes of applying the TRD test, the location of manufacture is the country with the lowest tax rate. Where neither the home office nor any branch location independently satisfies the definition of manufacturing, but the CFC as a whole satisfies the substantial-contribution definition, the CFC will be treated as manufacturing in the lowest-rate country where substantial-contribution activities are carried out but there is a TRD with the sales location. However, the branch rule will not apply where a greater amount of manufacturing activity occurs in the sales location, taking into account manufacturing activities occurring in other branches where there is no TRD when compared with the sales country.[33]

If the TRD test is met, the manufacturing branch is treated as a separate CFC, and the home office (or purchasing or selling branch treated as a separate CFC) is treated as purchasing or selling products on behalf of a related person. Therefore, the purchasing or selling income generally is FBCSI. The purchasing or selling income of the home office or purchasing or selling branch would not be Subpart F income to the extent the products are either manufactured in such country or sold for use in such country.[34] Income derived by the manufacturing branch would not be Subpart F income.[35]

The manufacturing branch rule should not apply if the CFC has a manufacturing branch but the home office and other branches do not engage in any purchasing or selling activities. For example, the branch rule should not apply if the home office receives a royalty from licensing intangible property to a disregarded entity of the CFC that manufactures products in another country.[36]

## Conclusion

Whether a CFC has Subpart F income continues to be relevant because such income is subject to a higher tax rate than GILTI, and the amount of a CFC's income taxable as GILTI is reduced by a routine return on tangible assets and losses of related CFCs.[37] The characterization of a CFC's income as Subpart F income also continues to be an issue for pre-TCJA years, as illustrated by the International Compliance Campaign and the *Whirlpool* case. Therefore, a taxpayer must continue to monitor its supply chains to confirm the Subpart F positions and document that the income is not FBCSI.

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[31] AM 2015-002 (Feb. 9, 2015). On the other hand, the IRS in footnote 19 indicated that, once it has been concluded that the TRD test is met, US tax principles apply to determine the amount of net income treated as earned by the purchasing or selling location for purposes of calculating a CFC's FBCSI under the branch rule.

[32] The regulations affirm that "uniformly applicable incentive tax rates" should be taken into account for purposes of the hypothetical rate test, but the government declined to modify the hypothetical assumptions as beyond the scope of the regulations. See Yoder, *IRS Provides Guidance for Calculating the Subpart F Branch Rule's Tax Rate Disparity Test*, 44 Tax Mgmt. Int'l J. 436 (July 10, 2015). Unlike AM 2015-002, the IRS in three private letter rulings determined the effective tax rate at the purchasing or selling location by reference to the taxable income computed under the tax laws of the country where the purchasing or selling branch was located. LTR 201002024 (Jan. 15, 2010); LTR 200945036 (Nov. 6, 2009); and LTR 200942034 (Oct. 16, 2009). See also *Whirlpool*, *supra*, note 8 (where a Luxembourg CFC derived income from the sale of products manufactured in its Mexican branch, the Tax Court attributed to the home office the amount of income that was not subject to tax in Mexico).

[33] Reg. § 1.954-3(b)(1)(ii)(*c*)(*3*)(*iii*). The sales branch rule does not apply if the CFC manufactures products in a branch. Reg. § 1.954-3(b)(1)(ii)(*c*)(1).

[34] Reg. § 1.954-3(b)(2)(ii)(e).

[35] See Reg. § 1.954-3(b)(4), Exs. (2) and (3)(ii) (last sentence).

[36] See LTR 200945036 (Nov. 6, 2009); LTR 200942034 (Oct. 16, 2009).

[37] There can be situations where characterizing income as Subpart F income provides a more favourable result.

# CURRENT ITEMS OF INTEREST

## Prescribed Interest Rates for Q3 (June 22, 2020)

The CRA announced the prescribed annual interest rates that will apply to any amounts owed to the CRA and to any amounts owed by the CRA to individuals and corporations. These rates will be in effect from July 1, 2020 to September 30, 2020. Many of the rates have decreased since the previous calendar quarter.

The income tax rates are as follows:

- The interest rate charged on overdue taxes, Canada Pension Plan contributions, and employment insurance premiums will be 5% (down from 6%).
- The interest rate to be paid on corporate taxpayer overpayments will be 1% (down from 2%).
- The interest rate to be paid on non-corporate taxpayer overpayments will be 3% (down from 4%).
- The interest rate used to calculate taxable benefits for employees and shareholders from interest-free and low-interest loans will be 1% (down from 2%).
- The interest rate for corporate taxpayers' pertinent loans or indebtedness will be 4.27% (down from 5.65%).

## Canada and Madagascar Tax Treaty Enters Into Force (June 24, 2020)

The *Convention between Canada and the Republic of Madagascar for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income* entered into force on June 3, 2020. The Convention was signed on November 24, 2016.

In accordance with Article 28 of the Convention, its provisions generally have effect in Canada:

- in respect of tax withheld at source;
- on amounts paid or credited to non-residents on or after the first day of January 2021; and
- in respect of other Canadian taxes, for taxation years beginning on or after the first day of January 2021.

# RECENT CASES

## Corporate taxpayer not under audit, but still required to furnish Minister with identity of its customers and details of its transactions with those customers

Roofmart was a large supplier of roofing and building materials. The Minister obtained from the Federal Court an unnamed persons requirement order (the "UPR") under subsection 231.2(3) of the *Income Tax Act* (the "ITA") and its equivalent subsection 289(3) of the *Excise Tax Act* (the "ETA"). This order required Roofmart to supply to the Minister particulars concerning, among other things, the identity of its customers and the details of its transactions with those customers. Roofmart itself was not under tax audit at the time. On its appeal to the Federal Court of Appeal, Roofmart argued that: (a) the Minister's application for the UPR was *ultra vires* because it was not brought by a person authorized by statute to do so; (b) the Federal Court judge erred in applying the relevant statutory criteria, and in particular in finding that the unnamed persons mentioned in the UPR were "ascertainable" within the meaning of subsections 231.2(3) of the ITA and 289(3) of the ETA; and (c) the Federal Court judge applied the incorrect burden of proof to his assessment of the Minister's application.

Roofmart's appeal was dismissed. There was no merit in Roofmart's arguments. The application in this case was brought by the Minister, and not by the CRA official who swore the affidavit in support of the UPR application, as the taxpayer had contended. Also, there was ample evidence to justify the Federal Court's conclusion that the unnamed persons mentioned in the Court's order were ascertainable, and, finally, the Minister did meet the high standard of proof

required in this case. The jurisprudence on which the taxpayer had applied was from a different era when UPR applications were made *ex parte*, which is no longer the case. Accordingly, the taxpayer's contention that the *ex parte* standard of disclosure should still apply in this case because UPR orders are intrusive was untenable. Finally, when a court of appeal is faced with the exercise of discretion by a lower court judge it must be cautious in intervening, only doing so where it is established that the discretion was exercised in an abusive, unreasonable, or non-judicial manner (see *Minister of National Revenue v. Rona Inc.*, 2017 DTC 5069 (FCA)). In the present proceedings, the Federal Court judge made no error in the exercise of his discretion.

¶50,491, *Roofmart Ontario Inc. v. Canada (MNR)*, 2020 DTC 5046

## Accused convicted by jury of tax related offences; trial judge interpreted the facts as found by the jury prior to pronouncing sentence

The accused taxpayer was found guilty by a jury of the Supreme Court of British Columbia of income tax evasion (Count 1); evasion of GST/HST (Count 2); and claiming false losses in his income tax returns (Count 3). The Crown submitted that the trial judge should interpret each of the jury's verdicts for purposes of sentencing.

The Crown's submission was granted. The trial judge determined that, for the purpose of determining a fit and appropriate sentence, he should make his own finding as to the facts that were found by the jury to have been essential to its verdicts in this case. The trial judge noted, in part, that: (a) where a fact is not express or implied in the jury's verdict, the judge must, to the extent possible, make his or her own finding for the purposes of sentencing (*R. v. James*, 2018 BCSC 1586); (b) facts that are implicit in the jury's verdict of guilty are not determinations of the sentencing judge, but are simply his or her elucidation of the facts that the jury logically and necessarily must have relied on to convict the accused (see *R. v. Punko*, 2012 SCC 39); and (c) the taxpayer was entitled, in this case, to the benefit of the doubt created by the manner in which the Crown chose to frame the indictment and to prosecute its case at trial. After summarizing the evidence and reviewing the parties' submissions, the trial judge concluded that the taxpayer should be sentenced based upon the following findings of fact that were implicit in the jury's verdicts: (a) Count 1: he defrauded the governments of income tax payable on $609,745 in unreported income for 2004 and 2005; (b) Count 2: he failed to remit GST/HST of $121,179; and (c) Count 3: he attempted to defraud the governments of money in excess of $5,000.

¶50,492, *R. v. Reynolds*, 2020 DTC 5048

# INTERNATIONAL NEWS

## OECD Paper Advises on the Design of Effective Carbon Taxes

The OECD has released a new Taxation Working Paper on how countries can implement effective carbon tax regimes.

The paper considers how the design of carbon pricing instruments affects a regime's effectiveness, efficiency, and feasibility.

The authors, Florens Flues and Kurt van Dender, write that design choices matter both for taxes and Emissions Trading Systems ("ETSs").

The paper shows how volatile carbon prices can cause risk-averse investors to forego clean investment that they would have undertaken with more stable prices. The paper then evaluates the effectiveness and efficiency of policy instruments to stabilize carbon prices in ETSs, which tend to produce more volatile carbon prices than taxes.

The paper analyzes the auction reserve price in California, the carbon price support in the UK, and the market stability reserve in the EU ETS.

Considering feasibility, the paper discusses the tax (or emissions) base, how revenue use can affect support from households and firms, and administrative choices.

## Top US Lawmakers Urge Pause on OECD Digital Tax Work

The leading members of the United States Senate Committee on Finance have called on the OECD and member countries to abandon plans to introduce digital services taxes and defer discussions on multilateral digital tax measures until the COVID-19 health crisis has passed.

Shortly after the OECD issued a statement confirming that it will continue its work to build an international consensus on new rules to tax digital multinationals, Finance Committee Chairman Chuck Grassley (R-IA), and Ranking Member Ron Wyden (D-OR) made the following response:

> We strongly encourage OECD member countries to abandon plans for digital services taxes on US businesses and to continue working toward an agreement on a more realistic timeline given the COVID-19 crisis. We support Treasury continuing to negotiate on these important issues and urge the Inclusive Framework to find areas of consensus that do not unfairly target and discriminate against US companies.
>
> We agree these negotiations cannot be rushed, particularly at a time when the world should be focused on addressing the current economic and health crises. The proposals under discussion would have a dramatic effect on the global tax landscape, and on US businesses in particular, and they deserve appropriate attention and continued deliberation.
>
> The OECD is the best venue for resolving these issues, but an agreement should not be reached unless it is fair to the United States and the US business community.

However, in his June 18 statement, OECD Secretary-General Angel Gurria urged all members of the Inclusive Framework to remain engaged in the negotiation towards the goal of reaching a global solution by year-end.

"Absent a multilateral solution, more countries will take unilateral measures and those that have them already may no longer continue to hold them back. This, in turn, would trigger tax disputes and, inevitably, heightened trade tensions," Gurria warned.

However, on June 17, US Trade Representative ("USTR") Robert Lighthizer informed Congress that the US Government has withdrawn from these multilateral discussions. The Office of the USTR is also examining the legitimacy of certain national digital tax measures and proposals under Section 301 of the 1974 Trade Act, which gives the USTR broad authority to investigate and respond to a foreign country's action that may be unfair or discriminatory and negatively affect US commerce.

## US Supreme Court Refuses *Altera* Ruling Appeal

The Supreme Court of the United States has declined to review an appeals court ruling in favour of the Internal Revenue Service ("IRS") in a key transfer pricing case involving the methodology of sharing the cost of stock-based compensation schemes among cost-sharing groups.

The Supreme Court's denial of certiorari was noted in an order list issued on June 22, 2020. This means that the June 2019 decision published by a three-judge panel of the Court of Appeals for the Ninth Circuit in *Altera*, which reversed the decision of the Tax Court, stands.

Among other things, that ruling agreed with the IRS Commissioner that the Treasury Department had acted lawfully under the Administrative Procedure Act when issuing regulations that provided for a "purely internal" method of allocating costs among related parties (and specifically among cost-sharing groups) for transfer pricing purposes.

In particular, the Ninth Circuit Court decided that the Treasury Department had the authority to issue regulations to compel cost-sharing groups to share the cost of employee stock-based compensation in proportion to the income enjoyed by each controlled taxpayer, even though unrelated parties do not do the same.

The court said that the Treasury Department was empowered to do so, as in amending Section 482 of the IRC in 1986, Congress had indicated its intention to reject primacy of the arm's-length standard and, where necessary to prevent base erosion and profit shifting, enforce a commensurate-with-income standard.

**TAX TOPICS**

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