Canadian Tax Highlights

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Penalties Deductible

In *65302 British Columbia Ltd.*, the SCC held that fines and penalties incurred for the purpose of earning income from a business are deductible and that their deduction is not against public policy. *65302* is the latest in a series of decisions in which the SCC has said that the plain words of the Act cannot be embellished.

The taxpayer carried on a poultry farm business regulated by the BC egg-marketing board, which assigns egg production quotas. For several years, the taxpayer exceeded its quota for fear of losing its major customer. Additional quota could be purchased only outside the taxpayer's area of operation, at almost twice the rate. The taxpayer reported the over-quota profits for tax. An inspector discovered the infraction and imposed an over-quota levy of $269,629, which the taxpayer paid. The minister disallowed a deduction: the levy was either on capital account or not a business expense.

The TCC distinguished between the board's power to fix levies and to impose penalties: the over-quota levy was a fee for services, not punishment for an offence. But even as a penalty it would be deductible because, like the damages resulting from the marine collision in *Imperial Oil*, it was a risky but necessary expense resulting from day-to-day business operations. Public policy did not preclude deduction, and the levy was not on capital account. Then, in *Amway*, the FCA disallowed the deduction of penalties arising from the fraudulent falsification of value on imports because the offence was avoidable. On hearing *65302*, the FCA said that the over-quota levy was avoidable and thus not deductible and that public policy precluded a deduction that was inconsistent with the egg-marketing system.

The SCC disagreed. The majority said that the characterization of the levy as a fine or penalty was an extraneous distinction for tax purposes. The Act imposes tax on net business profits: paragraph 18(1)(a) disallows expenses not incurred for the purpose of earning business income—clearly the purpose behind the over-quota activity—but its wording does not support a more rigorous test for a fine or penalty. In *von Glehn*, the UK CA denied a deduction for a penalty, but the statute disallowed expenses not "wholly, exclusively and necessarily laid out or expended for the purpose of earning the income." Those words, incorporated into the Canadian Income War Tax Act, were broadened in 1948 in the predecessor to paragraph 18(1)(a). The earlier phrasing governed the decision in *Imperial Oil*, but the current rule cannot sustain the *Amway* avoidability test. The Crown argued that the ordinary meaning of paragraph 18(1)(a) should be modified to accommodate Parliament's general legislative intent that the interpretation of one statute should not frustrate the object of another: the deduction of a penalty would dilute its deterrent effect. The SCC disagreed, referring to its decision in *Antosko*: interpretive technique cannot alter clear and unambiguous words. Courts should be reluctant to embrace unexpressed notions of policy or principle in the guise of statutory interpretation and thus introduce intolerable uncertainty into the application of the Act; Parliament may resolve any apparent conflicts between the Act and other enactments. The deduction of fines and penalties incurred to earn income accords with principles of neutrality and equity: a taxpayer's ability to pay depends on net income.

The minority also allowed the deduction, but preferred to determine the issue case by case depending upon whether the levy's nature was primarily compensatory or penal: a truly penal levy is not incurred for the purpose of earning income. The majority highlighted the inherent complexity of such a distinction and reiterated that if the taxpayer cannot show the requisite income-earning purpose, then paragraph 18(1)(a) denies a deduction and the analysis ends. A breach so egregious or repulsive that a fine cannot be justified as incurred for an income-earning purpose would be rare. The court further held that the levy was not on capital

In This Issue

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account, even though a producer's licence and quota could be cancelled for non-payment. Non-payment of an electrical bill may result in discontinued service, but that fact does not make the expenditure one of capital. The governing principle is the portrayal of the most accurate picture of the taxpayer's income for the year.

In my view, the majority was correct: disallowing the deduction of a fine or penalty amounts to double jeopardy, because it effectively taxes an amount that has already been contributed to government coffers. The levy here was designed to offset over-quota production profits on which the taxpayer paid tax. The SCC's decision in *65302* is a clear and well-reasoned judgment based on first principles of tax policy and fairness. Any disallowance should be left to Parliament.

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Between Cup and Lip

A recent decision of the Ontario Superior Court of Justice in *Juliar* illustrates the value of rectification orders after tax planning goes awry.

In November 1993, Mr. and Mrs. Juliar exchanged shares of 867871 Ontario Ltd. for promissory notes from Juliar Holdings Ltd. to allow them to hold their interest in an operating business through their own personal holdco. The taxpayers' accountant erroneously believed that their shares' cost base aggregated $470,000; in fact, their cost base arose on the shares' transfer by Mrs. Juliar's father to the Juliars and was reduced under section 84.1 by the capital gains exemption then claimed. In a 1996 audit, Revenue reassessed the Juliars for a deemed dividend in 1993. The accountant's insurer applied to the court to correct the mistake.

The issue was whether the court could rectify the concluded agreement, cancel and declare void the promissory notes, and substitute share consideration as the subject of the exchange on the share transfer to Juliar Holdings. The court found that the Juliars and Juliar Holdings had a common intention from the outset to transfer the shares without immediate tax effects, and that that intention was a fundamental term of the contract. (The court did not refer to any written documentation on these points.) Thus the issue of the promissory notes was a mistake common to the parties. Only Mrs. Juliar held common shares of the holdco because the parties intended that all growth accrue to her. The court allowed a rectification order of the corporate resolutions to substitute a share issue of an existing class of Juliar Holdings in lieu of the promissory notes, retroactive to 1993, the date of what is now the rollover.

Juliar holds out the promise that if the facts clearly show that the transaction was intended to have no immediate tax consequences, tax planning that fails because of a mistake may be rectified. In *Juliar*, there was no documentary evidence to show that common intention, but there was convincing evidence that the transaction was intended to be tax-deferred. It may be wise to document this intention so as to give credence to the view that the tax result is of paramount importance and that the parties' common intention was to defer the tax liability.

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Winners and Losers

For the first time this decade, Ottawa collected more taxes and other revenue in 1997 than it paid out. In seven provinces and the territories, however, the fed's income, as defined for national accounts, failed to cover spending. The surplus arose in Ontario, Alberta, and British Columbia. If the federal balance is interpreted as the net cost or benefit to provincial citizens of Confederation, then those three provinces alone did not receive a net benefit from our federal system. The figures are drawn from Statistics Canada's 1997 provincial economic accounts, its most recent data.

Federal Surpluses or Deficits as a Percentage of GDPP

	Actual		If revenue changed to equal spending	
	1997	1992	1997	1992
Nfld.	−26.1	−37.2	−27.1	−33.2
PEI	−20.3	−30.5	−21.4	−25.5
NS	−17.6	−22.6	−18.8	−17.5
NB	−14.4	−22.8	−15.4	−18.3
Que.	−2.1	−7.0	−3.0	−3.1
Ont.	5.4	1.3	4.4	5.7
Man.	−8.2	−12.2	−9.1	−8.0
Sask.	−4.6	−14.7	−5.4	−10.7
Alta.	5.6	0	4.8	3.9
BC	3.8	0.4	2.8	4.8
National average	1.0	−4.3	0	0

The limitations of the figures are important. Federal spending on goods and services can be allocated to the province where the goods are used or the services rendered. Interest on the public debt can be allocated according to the addresses on the interest cheques or by examining the provincial distribution of the ultimate owners: pension and pooled RRSP funds headquartered in two or three cities are owned by citizens all across the country. Income tax revenues are easily allocated if the agreed-to formulas are still valid, but some taxes and duties—customs duties, for example—are allocated to the collecting regional office regardless of the goods' ultimate destination. Thus the regional distribution of revenues and expenditures may lack precision and theoretical purity. It is also important to grasp the weaknesses of this approach in measuring gains or losses associated with membership in the federation. A federal institution located in a province, such as a defence installation, may serve a national purpose. Even if Ottawa demands more of a particular province than it puts back, an economic benefit may still be derived from free access to a national market. And more abstractly, the nation's existence arguably benefits all citizens.

Nevertheless, the figures for the federal surplus or deficit in each province provide one of many approximations of the gains or losses associated with membership in the federation. Even this measure is useful only in the context of a balanced budget. During the period 1992 to 1996, the federal government registered deficits in its national accounts budget. If we arbitrarily assume that revenue is adjusted to match spending, the signs of the surpluses or deficits do not change, as shown in the table. The actual deficits in Quebec, for example, declined steadily from 1992 to 1997, just as the overall federal balance did. After that adjustment to eliminate the overall surplus or deficit, the federal balance in Quebec was approximately the same in 1997 as it was in 1992.

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PRE-BUDGET REPORT

Following its annual pre-budget consultations, the House of Commons Standing Committee on Finance tabled its recommendations for the 2000 federal budget.

Budget surplus. The government should not commit beyond its current mandate to any disposition of surplus such as the existing 50-50 formula—half to spending, half to debt reduction and tax cuts. Expenditures should be maintained at close to current real per capita levels, even though the cost of government programs is rising. To ensure continued funding for government social spending, debt should be reduced significantly via repayment and via tax cuts that will spur continued economic growth and accelerate the reversal of the deficit spiral that created the compounding debt. No new spending should be considered until the debt spiral is reversed.

Personal income tax. A five-year package of personal income tax reductions should include the following initiatives:

- Increase basic personal amounts that can be received tax-free by 15 percent to protect against inflation.
- Increase tax bracket thresholds by 15 percent.
- Reduce the middle tax bracket rate to 23 percent from 26 percent.
- Increase the foreign property content limit for RRSPs to 30 percent over five years. RRSP contribution limits should increase $2,000 over five years and be indexed.
- Eliminate the 5 percent surtax.
- Reduce the capital gains inclusion rate to 65 percent to align it more closely with that on dividends, to make Canada's system of capital gains taxation more competitive with the US system, and to remove financing barriers for business startups. If personal and corporate rates decline, neutrality could justify a 50 percent inclusion rate.
- Substantially reduce the benefit reduction rate for the Canada child tax benefit.
- Reduce EI premiums by 40 cents.

The committee reiterates that full inflation indexation will ensure an end to bracket creep. The system should be reformed to ensure horizontal equity: similar treatment for those in similar financial circumstances—for example, married or single parents of dependent children and people with disabilities.

Capital gains on donations. Many petitioners who appeared before the committee proposed tax assistance for charitable donations of appreciated property. The committee recommends a blanket capital gain inclusion rate for donated property equal to one-half of the general rate, as amended: a one-half rate now applies to donated publicly listed securities.

Business tax. Profound reform of the business tax system is recommended to substantially reduce business tax rates, restore neutrality, and adapt to global competition. A technology-neutral tax system will help reduce the transition risk to more business use of e-commerce. A five-year package for corporate tax reduction was recommended:

- Reduce the general corporate income tax rate from 28 to 23 percent.
- Reduce the capital gains inclusion rate to 65 percent.
- Devise a joint federal and provincial plan to reduce capital taxes and harmonize their bases, using a common definition of capital.
- Reduce EI premiums until they reach the breakeven point.

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Delaware Adopts RUPA

Effective after 1999, Delaware has a new general partnership statute—the Delaware Revised Uniform Partnership Act (DRUPA)—which adopts the 1994 model statute (RUPA) of the national conference of commissioners on uniform state laws. DRUPA has some important differences and improvements aimed at enhancing flexibility and allowing Delaware to continue as the leading state for the formation of business entities.

DRUPA entrenches the so-called entity theory of partnerships in preference to the aggregate theory. Such a partnership is more practical primarily because it may convert to or merge with other types of entities, but it may be less useful to non-US persons who desire a more traditional partnership: foreign jurisdictions may treat the entity partnership like a corporation. In Canada, a partnership is generally considered a relation between persons and not a separate entity under partnership and commercial law; this clearly reflects an aggregate theory, even though a partnership is treated as a separate entity for the computation of income for tax purposes. In recognition of the problems associated with these new entity attributes and the potential impact on foreign entity classification, DRUPA generally allows an override of its provisions in the partnership agreement: the rule that grants separate entity status specifically refers to such overriding. Thus, for Canadian tax purposes, if the basic DRUPA partnership is a corporation, the option to create a more traditional partnership may be seen as a de facto check-the-box election.

All general partnerships formed after 1999 are governed by DRUPA. Pre-existing partnerships are covered after 2001 unless they elect early adoption, providing a two-year window to determine the partnership's status for Canadian tax purposes and the need for partnership agreement amendments to ensure partnership classification thereafter. Those who find that amendments are insufficient or too uncertain may look to those states that have not yet adopted RUPA.

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Scant US Tax Changes

Many international tax proposals evaporated in 1999, including those from the Clinton administration's 2000 budget and others that arose in the summer and were felled by presidential veto in September. But an "extenders" bill enacted on December 20, 1999 contains some measures of interest.

The subpart F active financing exception was extended two years to December 31, 2001. Advance pricing agreements (APAs) and related background information were confirmed to be confidential return information: they cannot be released under public inspection requirements, irrespective of when the APA was executed. The R & D credit was extended for five years. The credit is available beginning July 1, 1999, but cannot be taken into account for estimated tax purposes—for expenses incurred after June 1999 and before October 2000—until October 1, 2000; expenses incurred in the following 12 months will not affect estimated tax payments until October 1, 2001. The twist is a US budgetary manoeuvre. The new rule may have an impact on some companies' cash flow, but will not otherwise adversely affect financial statements.

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US Forms and Withholding

New US Treasury regs mean revisions to numerous IRS forms applicable to non-US persons. Although the new regs' effective date was delayed until January 1, 2001, an IRS representative recently indicated at a tax forum in Washington, DC that the replacement forms should be used immediately.

The new regs deny tax treaty benefits to anyone without a US social security number or an individual taxpayer identification number (ITIN). Many non-US persons, including visiting scholars, do not obtain an ITIN; as a result, for example, any college or university in the United States must withhold and remit 30 percent of their pay to the IRS. The tax is later recoverable on filing a US tax return, but such individuals often fail to file. A US educational institution (reg. section 1.501(c)(3)-1(d)(3)(i)) can become an acceptance agent to assist these non-US scholars and students with the new requirements via a written agreement with the IRS. Other eligible entities include a financial institution (section 265(b)(5)), a federal agency (section 6402(f)), and persons who provide professional assistance to taxpayers in tax return preparation. Detailed guidance on becoming an acceptance agent is outlined in Rev. Proc. 96-52, 1996-2 CB 372 (1996).

Under article XX of the Canada-US treaty, a Canadian resident who is a full-time student in the United States is generally exempt from US tax on payments received from abroad and used for maintenance, education, and training. No treaty rules apply specifically to professors or teachers, but special Code rules on US tax-residency status apply to both teachers and students. Generally, a non-resident without a green card qualifies as a resident for a particular year under the Code if he or she meets a days-counting test (the substantial presence test): physical presence in the United States (1) for 183 days or more during that year, or (2) for at least 31 days during that year, provided that the physical presence test was met during a three-year lookback. Canadian teachers and students who are in the United States under certain types of visas can exclude a limited number of US days of presence for the purposes of this test if their visa requirements are substantially complied with: an individual who was exempt as a student or teacher for any part of two of the preceding six years cannot exclude current-year days of presence if all his or her compensation during the current and preceding years was not described in section 872(b)(3).

IRS form 1001 (Ownership, Exemption or Reduced Rate Certificate) is superseded by form W-8BEN (Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding). Canadians use this form to certify to US customers and payers that they have no US permanent establishment and are therefore US-withholding-tax exempt on their US-source business profits. In addition, form 4224 (Exemption for Withholding of Tax on Income Effectively Connected with the Conduct of a Trade or Business in the United States) is replaced by form W-8ECI (Certificate of Foreign Person's Claim for Exemption from Withholding on Income Effectively Connected with the Conduct of a Trade or Business in the United States). Two other new forms include W-8IMY (Certificate of Foreign Intermediary, Foreign Partnership or Certain US Branches for United States Tax Withholding) and W-8EXP (Certificate of Foreign Government or Other Foreign Organization for United States Tax Withholding.) All new forms are available on the IRS Web site at www.irs.ustreas.gov.

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SHOE *by Jeff MacNelly*

US R & D Tax Credits

The US Congress has extended the US R & D tax credit program by five years—one year was past practice—until June 30, 2004, and has made technical changes. The accompanying public announcement contains some interesting comments.

- There were concerns that the IRS was too hard on R & D claims; Congress hopes that program "qualified research" will be interpreted in a manner consistent with policy intent.
- Qualified research is confirmed as undertaken to discover technological information that is new to the taxpayer and not freely available to the general public; this addresses concerns that the IRS "eureka" standard was too extreme.
- Qualified research may employ existing technologies or rely on existing engineering or scientific principles to discover information; claims were denied if the taxpayer used standard practices in performing R & D.
- Some IRS record-keeping requirements may be unnecessary and costly: concern was expressed that credit eligibility not hinge on unreasonable record-keeping requirements.

The US Congress has recognized and is dealing with issues familiar to Canadian practitioners; it is hoped that Revenue will follow suit in its current overhaul of SR & ED administrative practices.

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Auto Benefits and Expenses

Auto expense deduction limits. For post-1999 purchases, the capital cost ceiling for CCA on passenger vehicles increases by $1,000 to $27,000 plus sales taxes. For post-1999 leases, maximum leasing costs increase by $50, to $700 per month plus sales taxes (prorated if vehicle value exceeds the CCA ceiling). The maximum allowable interest deduction for auto purchases remains at $250 per month.

Tax-exempt allowances paid by employers increased 2 cents, to 37 cents per kilometre for the first 5,000 kilometres and 31 cents thereafter (41 cents and 35 cents in the Yukon, Northwest Territories, and Nunavut). The rate to determine the taxable benefit on the personal portion of employer-paid automobile operating expenses increases 1 cent, to 15 cents per kilometre (12 cents for employees principally selling or leasing automobiles).

Simplified method for travel expenses. After 1998, taxpayers may use a simplified method for calculating qualified meal and vehicle expenses for moving and medical expense credits and for northern-resident deductions. The regular detailed method requires that taxpayers keep receipts and submit them on request; the simplified method uses flat rates without receipts. The flat rate for meals is $11 per meal ($33 per day per person). The simplified method for vehicle expenses requires a record of the number of kilometres driven; the flat rate ranges from 34.5 cents per kilometre in Saskatchewan to 42.5 cents per kilometre in the territories. This is a change from *Enns* and *Watt*, in which Revenue conceded medical care travel rates of only 5 cents per kilometre (see "Medical Care Travel," *Canadian Tax Highlights*, June 17, 1997, at 45).

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Ontario CMT Still Burns

Corporations subject to Ontario corporate minimum tax (CMT) that issued convertible debt experienced inequities that the 1999 Ontario budget proposed to correct for interest incurred after May 4, 1999. (See "Ontario CMT Burns Again," *Canadian Tax Highlights*, March 16, 1999, at 23.) Problems still exist if losses are carried back.

Assume that an Ontario corporation has $1 million accounting income and taxable income in year 1. In year 2, a $1 million loss arises for both purposes and is offset against taxable income in year 1. CMT of $40,000 ($1 million × 4%) may arise because there is no loss carryback to year 1 for CMT purposes. The adjusted net loss of $1 million in year 2 is simply carried forward as a CMT-eligible loss for 10 years. Unless the taxable income of a future year is significantly less than that year's accounting income, the benefit of the eligible loss may never be realized.

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Foreign Affiliate Changes

Finance's technical amendments package of November 30, 1999 includes a number of foreign affiliate proposals, both relieving and tightening.

■ Revenue has consistently said that if a partnership owns shares of a non-resident corporation (FA Opco), a partner (Canco) cannot deduct dividends paid to the partnership and cannot elect on any capital gain the partnership realizes on a share disposition. If another foreign affiliate of Canco (FA Holdco) is a partner, FA Opco dividends paid to the partnership are not added to FA Holdco's surplus accounts and may constitute FAPI vis-à-vis Canco. A complex series of proposals addresses these inappropriate results. Partners are deemed to own the partnership's FA Opco shares and to receive related dividends based on their proportionate FMV interest in the partnership, and may elect on their direct or indirect share of gains on the partnership's disposition of the shares.

■ If an FA realizes a capital gain or loss related to a fluctuation in value of foreign currency against the Canadian dollar on the settlement of interaffiliate debt, then the amount is deemed to be nil for both FAPI and surplus account purposes. A similar rule applies to currency gains or losses realized by a particular affiliate on a share redemption or reduction of capital of another affiliate, and on a non-arm's-length share disposition to another affiliate. These deeming rules are now generally extended to apply also to such currency gains or losses on income account or arising on the redemption or reduction of capital of the particular affiliate. On the other hand, new restrictions apply: for example, Canco must have a qualifying interest (at least 10 percent of votes and value) in the relevant affiliates or the parties must be related.

■ The five-year carryforward of unclaimed FAPI losses is extended to a seven-year carryforward and a three-year carryback. However, as a tightening measure, if foreign affiliates determine their tax liabilities on a consolidated or combined basis, a compensatory payment by one FA to another for the use of its loss only qualifies as a foreign accrual tax if the loss is a FAPI loss.

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Silent on GST

Almost a decade after the introduction of the GST, the courts are still exploring a supplier's ability to recover tax that the transaction failed to address. (See, for example, "GST Not Collected," *Canadian Tax Highlights*, August 18, 1998, at 60.) In *Leong v. Princess Investments*, the BCSC reviewed the jurisprudence on the right of recovery: in the absence of unusual facts, it may no longer be worthwhile to resist a supplier's claim for recovery of tax—as opposed to penalty and interest—if requisite notification was given.

In *Princess Investments*, an individual shareholder was prepared to pay a set amount for a company asset on a buyout of his interest; he assigned the right to buy the asset to his son just before the sale. The agreement was silent on GST. After the company was assessed for the GST, penalty, and interest, it sent a demand letter for the amount assessed to the former shareholder, who refused to pay. The company recovered the tax, interest, and penalties in small claims court. On appeal, the son, whom the BCSC said was the only proper defendant, argued that the sales price was tax-included and that disclosure of the GST had not been made in an invoice as required. A review of the jurisprudence indicated two views of the purpose of the GST disclosure obligation: consumer protection and mere identification that the GST is payable, an approach based on the GST's being the supply recipient's liability. Applying a purposive approach to the interpretation of the GST disclosure requirement, the BCSC concluded that disclosure need not be made at the time of the transaction and was not time-limited by the statute. Thus a post-transfer demand letter was adequate notice. Although recovery of the GST was allowed, interest and penalties were the company's liabilities because the recovery rule does not refer to those amounts and they arise due to the supplier's failure to collect and remit, not the purchaser's failure to pay.

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PARTICIPATING LOANS

November 30, 1999 draft legislation amends paragraph 20(1)(e) to deny the deduction of profit participation and similar payments incurred in the course of borrowing money, except for payments under a written agreement made on or before that date. The change captures payments dependent on the use of or production from property, or computed by reference to revenue, profit, cash flow, commodity price, or any other similar criterion or by reference to dividend payments, and mimics the exclusion of five-year participating loans from the withholding-tax exemption. The explanatory notes indicate that the change does not affect amounts treated as interest because they are compensation for the use of money, leaving the *Sherway* decision intact.

A participating loan allows a lender, in exchange for favourable loan terms, to participate in, for example, a percentage of the cash flow, gross income, or net profit or appreciation of a real estate project via a percentage of the proceeds or of a valuation of a particular property at a particular time. A developer may thus enhance its access to funds and the lender may participate in a project's potential profitability. Until the November 30 amendment, a developer-borrower might currently deduct a qualified participation payment as interest expense or otherwise over five years as an expense incurred in the course of borrowing funds. Revenue traditionally said that a participation payment often did not qualify as interest, which must be calculated on a daily accrual basis and on a principal sum or a right thereto and must represent compensation for the use of the principal sum or the right thereto. Although participation payments were held deductible as borrowing costs by the FCA in *Yonge-Eglinton*, Revenue said that the decision was limited in scope to commitment fees.

The more recent *Sherway Gardens* decision allowed the deduction of participation payments as interest expense. The taxpayer-developer raised funds to construct a large shopping centre; it issued bonds at the below-market coupon rate of 9.75 percent per annum plus annual participatory payments equal to 15 percent of the taxpayer's operating surplus in excess of $2.9 million. The TCC allowed a deduction for the participating payments as a borrowing cost but not as interest: the payment did not accrue daily and was not computed as a percentage of, or otherwise related to, the principal amount outstanding. The Crown appealed, and the FCA allowed a deduction both as borrowing costs and as interest, broadly interpreting the term "interest" in accordance with commercial reality: a contrary finding "would be sending a message that the . . . Act discourages entrepreneurship. . . . [I]ndividuals looking to start-up new businesses . . . need to find new and innovative ways of financing their ventures in order to succeed." Although the participation payments were not calculated as a percentage of the principal amount of the bonds, they related to the principal amount because they were "payable only so long as there was principal outstanding." Revenue agrees that the *Sherway* participation payments were not distributions of profit because the sum of the stated interest and the participation payments approximated the then current commercial rate of interest. Thus an open-ended participation payment runs the risk of Revenue's denying an interest deduction; prudence dictates that the payment be calculated to reflect market interest rates. The November 30

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proposals responded to Revenue's querying whether paragraph 20(1)(e) needed clarification after the FCA allowed a deduction for participation payments in *Sherway* as interest and as borrowing costs.

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Foreign Tax News

Treaties

Canada signed a new treaty with **Chile** on January 2, 1998. On December 16, 1998 and October 28, 1999, respectively, Canada and Chile gave notification that all procedures necessary to bring the treaty into force had been complied with; the treaty enters into force on the latter date. A new agreement with **Nigeria** was ratified on November 16, 1999. Both treaties are effective January 1, 2000. Canada will shortly commence negotiations on a new treaty with **Armenia** and a replacement treaty with **Romania**.

Mexico

Tax reform is now law, incorporating changes that simplify the system and help combat tax evasion. These include a six-month extension for the expiring special reduced rate of withholding on interest payments; the creation of limited-purpose financial entities—non-bank banks—entitled to the reduced 15 percent withholding tax rate (4.9 percent for treaty-country residents); and changes to sourcing rules for domestic and foreign income. The definition of "royalty" is expanded to include proceeds for certain goods or rights determined by productivity, use, or disposition proceeds. Taxpayers may seek APAs for the current year, the previous years, or the three succeeding years—five in total, versus the old nine-year rule. (See "Foreign Tax News," *Canadian Tax Highlights*, November 23, 1999, at 88.) New information returns must be filed annually to report all transactions with related foreign parties in the previous year. The 1999 rule regarding the gross-up of dividends to calculation of withholding tax was not clarified; some commentators say that a treaty could override such a rule.

The safe harbour rules for maquiladoras were officially gazetted on December 28, 1999 (ibid.).

OECD

After 18 months of discussions among OECD governments, business communities, and consumer organizations, the OECD released guidelines for protecting consumers engaged in electronic commerce, aimed at encouraging fair business, marketing, and advertising practices. The guidelines are available on the OECD's Web site or from the Foundation's library.

United States

The IRS extended the effective date of final regs on withholding on US source income paid to foreign persons to payments made after 2000 (originally applicable to payments after 1998). (See TDs 8856 and 8734; for summaries and full details, contact the Foundation's library.)

Venezuela

A new constitution, effective December 30, 1999, requires modification to the tax code to eliminate exceptions to the principle of non-retroactivity in the application of tax laws; to impose prison terms for tax evasion; to impose criminal sanctions against tax advisers—lawyers and accountants—for acts of conspiracy to defraud the Treasury; to eliminate the limitation period for serious tax offences; to increase the rate of moratorium interest for tax debts; and to establish the principle of strict interpretation of tax laws.

Netherlands Antilles

To revitalize the country's financial services sector and shed its tax haven image, new tax proposals include a flat tax rate of 34.5 percent. When the law is passed in 2000, the current offshore regime will be abolished, with grandfathering for offshore companies existing before 2000, to the end of 2009 or 2019.

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