Canadian Tax Highlights

Editor: Vivien Morgan, LL.B.

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Dudney Prevails

In a strongly worded judgment, the FCA upheld the TCC in *Dudney*, concluding that a self-employed consultant who performed services at the premises of his Canadian client did not have a "fixed base regularly available to him in Canada" within the meaning of the Canada-US treaty. The decision could have important implications for cross-border service providers.

Mr. Dudney was a US resident who specialized in the development of computer systems and provided services to PanCanadian Petroleum (PanCan) in Calgary. The taxpayer trained PanCan personnel and assisted them in creating computer systems; he spent 300 days in Canada in 1994 and 40 days in 1995. The services were provided at PanCan's Calgary premises, which the minister argued was Mr. Dudney's fixed base in Canada. Referring in part to the OECD model convention and commentary, the FCA said that, for purposes of the treaty's business profits article, an enterprise has a permanent establishment where it has an identifiable location with a certain degree of permanence in which it carries on its business; by analogy, a self-employed consultant has a fixed base—thereafter referred to by the court as a fixed place of business—only at the location where he or she carries on business. The fact that Mr. Dudney had access to and the right to use the PanCan offices did not create a fixed place of business: he could use the offices only to perform services for PanCan under his contract but not otherwise as a base for the operation of his own business. The FCA concluded that there are no doubt providers of independent personal services who, because of the nature of their skills and services, require little in the way of a fixed place of business, but it does not follow that they have a fixed place of business wherever their services are performed. The minister had stressed the duration of Mr. Dudney's contract: the FCA noted that this went to the issue of permanence only and that on the facts Mr. Dudney had no fixed place of business in Canada, permanent or otherwise.

The court referred to two Norwegian treaty cases—*Mats Johansson v. Stavanger Municipality* and *Creole Production Services v. Stavanger Municipality*—in which the taxpayers, who had an identifiable location on an offshore oil platform at their disposal to provide services to the owner, were found to have a fixed place of business. The FCA did not accept that the Canada-US treaty partners contemplated such a result; the court referred to *SFWI v. Belgium*, in which non-exclusive and limited access to space at a Belgian construction site was not a permanent establishment of a firm contracted to study, design, and supervise construction. There has been limited jurisprudence with respect to the meaning of "fixed base" in the context of service providers. It will be interesting to see if the Crown seeks leave to appeal to the SCC.

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In This Issue

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SR & ED Outside Canada

The much-debated eligibility for Canadian investment tax credit (ITC) purposes of SR & ED expenditures for work carried on abroad has received a blow from the FCA's decisions in *LGL* and *Tigney*. In each case the SR & ED project was carried on in Canada, and work done outside Canada was necessary and an essential part of the project.

The FCA first determined that the project was SR & ED and then looked at the location where the SR & ED was carried on. The court said that the language of paragraph 37(1)(a) is clear and that there is no basis for treating an SR & ED project as an indivisible whole. Doing so would lead to uncertainty for SR & ED projects that involve activities both in Canada and abroad. A court would need to determine whether the Canadian portion of a project was sufficiently integral to justify calling the entire project Canadian. Furthermore, current expenditures incurred in Canada might be disallowed if the lion's share of the project was undertaken outside Canada, a result contrary to the incentive nature of the SR & ED rules.

The FCA said that in the face of clear words in the Act, principles of statutory construction cannot be used to strain the plain meaning of the words. Paragraph 37(1)(a) is clear and comprehensible. If an SR & ED project is carried on partly in and partly outside Canada, the only criterion for determining which expenditures come under subsection 37(1) is whether the expenditures were for SR & ED activities carried on in Canada. For the FCA, the words "carried on in Canada" must be read in the context of the rest of the subsection, which clearly contemplates the assessment of individual expenditures in its reference to "the aggregate of all amounts each of which is an expenditure of a current nature made by the taxpayer on SR & ED carried on in Canada."

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Parent Gifts, Student Benefits?

In late 1999, the FCA in *Woolner* denied a donation credit for gifts made by parents to a church that provided funding to a private secondary school for the education of their and other members' children.

The TCC concluded that the parents' contributions were used to fund the tuition fees of all children attending and were linked to the educational benefits received by their own children, although Revenue's auditor was unable to link fund contributions directly with students benefiting from the school programs. The FCA said that there was at least an expectation that parents contributing to a designated fund would benefit by not being required to pay tuition to the school. Presumably the result might have been different if the church had paid the tuition fees out of its general funds.

It appears that in some situations Revenue auditors may be stretching the logic in *Woolner* and questioning the validity of gifts to not only elementary and secondary but also university-level institutions if those gifts were made by parents or other relatives of students; in no case was any bursary given or tuition reduced. Revenue's queries appear to be based on the restrictive interpretation of "gift" in IT-110R3. Arguments were made in *Woolner* and other cases that parents must provide an education for their minor children. If sufficient gifts were received by an institution to obviate the need for tuition, then Revenue may have a point, but such an argument should not hold for university-level students who have attained the age of majority. Furthermore, the sole fact of a relationship—by blood, marriage, or adoption—should not be decisive. In fact, the Canada-US treaty contemplates and gives special treatment to gifts made by relatives to qualified educational institutions attended by themselves or a family member, apparently even if the net effect might be an overall reduced tuition. There is no reason to conclude that a donation credit should flow from such a gift to a foreign university but not from such a gift to a domestic institution.

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Mikey Likes It

More than a decade ago, a former minister of finance was criticized for stating that Canada did not have enough rich people. Well, things are improving. The relative share of taxpayers with incomes over $150,000 doubled from 1988 to 1997. In fact, all but one income class increased in relative importance: individuals with incomes less than $30,000 per year.

Percentage Distribution of Taxpayers, Taxable Income and Tax, 1988 and 1997

	Assessed income level ($000)				
	Under 30	30-60	60-100	100-150	Over 150
1988					
Taxpayers	65.7	29.0	3.9	0.8	0.6
Taxable income . . .	41.2	40.4	9.2	3.0	6.1
Federal tax	26.9	44.1	12.9	4.8	11.2
Provincial tax	24.9	43.7	13.1	5.1	13.2
1997					
Taxpayers	52.5	35.8	8.9	1.6	1.2
Taxable income . . .	31.2	38.7	16.2	4.5	9.3
Federal tax	15.1	39.1	21.7	7.1	17.1
Provincial tax	12.7	36.2	21.9	7.9	21.3

As the table shows, almost two-thirds (65.7 percent) of all taxpayers had assessed income of less than $30,000 in 1988, when the present rate schedule became effective. These taxpayers accounted for 41.2 percent of all taxable income, but only 26.9 percent of federal tax and slightly less of the tax levied by provinces and territories that were party to federal-provincial tax collection agreements. By 1997, however, slightly over one-half (52.5 percent) of all taxpayers had income below $30,000, accounting for one-third (31.2 percent) of taxable income, but only 15.1 percent of federal tax and 12.7 percent of provincial tax.

The decline in the relative importance of those taxed only at the lowest rate was offset by an increase in the concentration at higher income levels. Those with income over $60,000 increased from 5.3 percent of all taxpayers in 1988 to 11.7 percent in 1997, during which period their share of federal tax increased from 28.9 percent to 45.9 percent and their share of provincial tax increased from 31.4 percent to 51.1 percent.

The curious feature that emerges from a brief review of summary statistics for the two years is the trend in average tax rates. Expressed as a percentage of taxable income, federal tax decreased from 9.2 percent to 7.0 percent over the period for the first bracket, and provincial tax from 3.4 percent to 2.5 percent. The trend was less pronounced for those in the middle bracket and was reversed for those with incomes over $100,000. Overall, federal tax increased from an average of 14.0 percent of taxable income to 14.5 percent over the period, and provincial tax rose from 5.7 percent to 6.0 percent.

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Blood and Stone

The Ontario Superior Court of Justice decided in *Stone* that transfers by a terminally ill husband under the guise of estate planning were void against his spouse and set them aside as fraudulent conveyances.

Mr. and Mrs. Stone had both been married to other persons and had children, but their respective spouses had died. Mr. and Mrs. Stone later married each other when they were in their 50s and remained married for almost 25 years until Mr. Stone's death in July 1995. In March 1995, Mr. Stone was told that his death was imminent. Because he had an "unshakable desire" to leave his assets to his children and not to Mrs. Stone or her children via her estate, in early April Mr. Stone transferred business assets with a value of about $1.3 million to his children—in addition to the spouses' condo in Florida and the matrimonial home, without spousal consent.

In Ontario, a spouse is entitled to receive an equalization payment of one-half of the difference in the value of the family assets on divorce or death. If the assets had passed to Mr. Stone's children via his will rather than by way of inter vivos transfers, Mrs. Stone could have elected under the Family Law Act to receive her equalization payment of approximately $950,000. From the evidence it was clear that Mr. Stone intended to defeat his wife's right to equalization by stripping his estate of assets. The court had no trouble in concluding that Mr. Stone's actions had improvidently depleted his assets, but the Family Law Act clearly does not create property rights in a non-owning spouse. The court concluded that the legal obligation to make an equalization payment effectively created a debtor-creditor relationship between spouses that is enforceable only by them. Mr. Stone's children were now the owners of the assets: did Mrs. Stone have any right to their return? In the course of finding that the Fraudulent Conveyances Act could be used to set aside the transfers, the court observed that a marriage arrangement requires the utmost good faith; if separation or divorce or death is certain, a spouse is under a duty not to deplete his or her net family property. Furthermore, that good faith obligation forms a duty to disclose: if there had been disclosure—and presumably Mrs. Stone's consent—then the transactions may have been viewed as fair. On the facts, however, there was no disclosure and Mr. Stone's acts were clearly done with the intention of preventing his spouse and ultimately her children from receiving the assets via equalization.

Mr. Stone's children alleged that Mr. Stone carried out the transfers in pursuance of a legitimate course of estate planning. Clearly, estate planning may transfer both present and current value to other family members. Although the *Stone* case is extreme, it does point out that if assets are improvidently depleted, the court may set aside conveyances that effectively defeat equalization. Estate planners, lawyers, and accountants may wish to ensure that the spouse is consulted in and informed of the estate-planning process to ensure that the disclosure obligation is satisfied and the other spouse's "tax planning" is not upset by claims of improvident depletion.

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Tax Accounts Not Merged

To qualify as a section 87 amalgamation, all shareholders (except a predecessor) of the predecessors must receive amalco shares. In a non-qualifying amalgamation, do the predecessors' tax attributes and accounts flow through to amalco? Neither corporate law theory nor section 87 provides an answer, but Revenue maintains that there is no flowthrough.

The relevant corporate law may provide for a continuation of the predecessors in amalco, as described in *Black and Decker*. In such a situation, Revenue has reiterated that the predecessors' assets are not considered disposed of to amalco—they simply become amalco's assets—but has not addressed the tax attributes issue. Revenue now confirms its view that predecessor tax accounts and other tax attributes are not "acquired" by amalco in a non-qualifying amalgamation: the subsection 87(2) rules would be redundant if amalco inherited tax attributes in a non-qualifying amalgamation.

To ensure that section 87 applies, on most amalgamations shares are issued to all predecessor shareholders. But if continuity of shareholders is not desirable, amalco shares are typically issued to the non-continuing shareholders and then are redeemed by amalco or purchased by other shareholders. Alternatively, it may be possible to remove the targeted shareholders before the amalgamation.

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RULINGS FEES ET AL.

Rulings fees. Effective in April 2000, Revenue's fees for preparing advance income tax rulings will rise from $90 to $100 plus GST per hour ($155 plus GST per hour in excess of 10 hours). Groups representing tax professionals who reviewed the proposed increase queried whether a faster turnaround time for rulings would ensue. Revenue intends to dedicate more rulings officers to the function to reduce average controllable time for processing a rulings request from 120 to 60 days over the next two years. Technical interpretations continue to be free of charge.

Foreign affiliate information returns. Minor administrative changes to forms T-1134A and T-1134B, "Information Return Relating to [Controlled] Foreign Affiliates," clarify them without changing the underlying information to be disclosed. We understand that Revenue will accept "old" forms during a one- to two-month grace period so long as the proper dates are specified in the date file and all pertinent information required is reported.

New 1-800 tax inquiry service. Revenue has launched a new 1-800 phone network for taxpayers with general tax inquiries: 1-800-959-8281 (English) and 1-800-959-7383 (French). Until April 30, agents will be available Monday to Friday between 8:15 a.m. and 10:00 p.m. (except holidays) and on Saturdays and Sundays from 9:00 a.m. until 1:00 p.m. (All times are local.) An automated system will allow callers to access tax information outside these hours.

Filing deadline extension. Revenue announced that the filing deadline for personal tax returns is extended to Monday, May 1, 2000 from Sunday, April 30.

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GREEN-CARD COMMUTERS

A green-card holder has been granted lawful permanent resident status under US immigration laws by the Immigration and Naturalization Service (INS). A green-card holder ordinarily lives in the United States; a commuter green card is a special type of green card held by a Canadian or Mexican resident. (There are other differences under US immigration and naturalization law.) Apparently, an INS handbook—now no longer in use—stated that a commuter green-card holder is a nonresident alien for US tax purposes. Late in 1999, the IRS issued corrective advice concerning the US income tax status of commuter green-card holders (SCA-199950009).

The IRS says that a commuter green-card holder is a US resident for income tax purposes until that status is either revoked or administratively or judicially determined to have been abandoned. The IRS reached this conclusion because under immigration and naturalization laws a commuter or any other green-card holder is considered a lawful permanent US resident and as such is a US resident for income tax purposes (Code section 7701(b)).

Unfortunately, the IRS advice raises more questions than it answers. No mention is made of the fact that a commuter green-card holder may qualify to take a treaty position that he or she is not a US income tax resident even if the Code residency test is met. (A filing with the IRS is generally required if one is to take this position.) US tax regulations, however, provide that green-card status may be jeopardized by one's taking such a treaty position. In the case of a commuter green-card holder, the INS has already acknowledged that the person clearly is resident outside the United States, so it seems unlikely that the INS would say that a treaty filing position of non-residence jeopardizes the green-card holder's status. The IRS also does not address the issue of whether the commuter green-card holder may be a US gift or estate tax resident; for that purpose, residence is based on domicile, the physical presence of an individual in the United States with the intent to remain there permanently or with no present intention to leave. It seems that US domicile is not established for the commuter green-card holder because the person's home is presumably outside the United States, but the legal fictions in play muddy the waters.

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STOCK OPTION DEFERRALS

Share ownership plans and stock options have become increasingly important incentives for recruiting and retaining key employees, especially in the high-tech sector. In recognition of this trend, the 2000 federal budget proposes to defer tax on benefits related to $100,000 per year of qualifying employee stock options, from the options' exercise until the shares are sold. As welcome as this measure is, the proposal raises a number of questions about the deferral's mechanics.

Assume that an employer grants options to employee A for 20,000 shares with an exercise price of $10 per share and FMV of $200,000. All the options vest in year 1, and A exercises them in year 2, when the shares are worth $25 each: a total FMV of $500,000 and a potential income inclusion of $300,000. We understand that only the benefit from stock options with $100,000 FMV at the time of the grant—one-half of the options—is eligible for deferral. The employee must designate the shares or particular securities to which the deferral applies. Accordingly, 10,000 shares with a specified value of $100,000 may be designated, and one-half—$150,000—of the potential income inclusion is deferred. The $100,000 is not reduced by the specified value of a related security, because no other share was acquired by the employee under the terms of an option agreement with the same or a related entity that vested in that year—year 1—and resulted in income deferral. The remaining 10,000 shares are not eligible for deferral; the resulting $150,000 benefit on exercise is included in income less any paragraph 110(1)(d) deduction, raised to 33⅓ percent to parallel the budget's reduced inclusion rate for capital gains.

Changing the vesting period yields dramatic results. Assume that options for 20,000 shares granted to employee B at the same time vest 50-50 in years 1 and 2. If B exercises all the options in year 2 when the share price is $25, the entire $300,000 income inclusion can be deferred. The 10,000 shares vesting in year 1 are eligible for the deferral: the specified value of $100,000 is not reduced because there is no related security that vested in year 1. Similarly, the 10,000 shares vesting in year 2 are also eligible for the deferral, and there is no related security that was subject to the deferral and vested in year 2. More complexity arises if the options are exercised at different times and prices. Assume that A exercises his options at different times in year 2. Depending on whether A designates the first or the second 10,000 shares, his deferral is $150,000 or $200,000.

	Options exercised (no. of shares)	FMV at exercise	FMV at grant	Benefit per share	Benefit
May 1 . . .	10,000	$25	$10	$15	$150,000
Nov. 1 . . .	10,000	$30	$10	$20	$200,000
	20,000				$350,000

Finance is currently attempting to resolve the appropriate level of designation flexibility. Other unresolved issues include reporting requirements, withholding requirements, and ordering rules for the disposition of shares that are identical properties.

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E-PEs

On March 3, 2000, the OECD issued a revised draft of the commentary to article 5 of its model convention, dealing with the permanent establishment (PE) definition in the e-commerce context. The revised draft is more extensive than the late 1999 draft and presents various perspectives of OECD member countries rather than majority views. (See "OECD on E-Business," *Canadian Tax Highlights*, November 23, 1999, at 81.)

The draft reiterates that a server can constitute a PE if it is fixed, without indicating a required time period. Some members seem to believe that a server may be a self-contained automated PE, a view supported by commentary to article 10 concerning the carrying on of a business through automatic equipment (gaming and vending machines) and German jurisprudence related to pipelines in the natural resource sector. Other members say, for example, that a retailer accessed via the Internet does not carry on its business through the

SHOE *by Jeff MacNelly*

server, but through the bricks and mortar facilities where its income-generating activities occur.

The need for human intervention is also broached: is human intervention required before a server can constitute a fixed place of business? If so, must the intervention occur at the server's location, or can it occur, for example, remotely via a modem connection? Is an employer-employee or other relationship critical? What level of intervention is necessary?

The revised draft includes preliminary views on an e-business exception for preparatory and auxiliary activities. Subject to a caveat that case-by-case analysis is required, some activities are generally excepted if they are not the e-business's core functions—supplying information, gathering market data, advertising of goods and services, using mirror services for efficiency and security purposes, and providing a communications link between suppliers and customers.

Comments from interested parties are invited before June 15, 2000; the working party's views will be finalized at its September meeting. Consensus may be elusive, given the draft's divergent views. What constitutes a taxable presence for e-business in a given jurisdiction is likely to continue to be shrouded in uncertainty.

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IRS Valuation Reform

In response to comments from valuation professionals, an IRS review team examined IRS valuation practices and policies. (See "IRS Valuation Deficiencies," *Canadian Tax Highlights*, May 20, 1997, at 40.) Draft recommendations in a soon-to-be-released report suggest that the IRS should assume a leadership role in valuation and, with input from valuation professionals, develop strategy for prefiling activities and provide guidance and education.

The team consulted with IRS personnel and reviewed the law and its administration, IRS publications and practice, industry practices and guidelines, and concerns of both the IRS and the private sector. The team recommends that a national IRS valuation policy council should set the direction for a valuation policy that cuts across functional lines, and that issue and industry specialists within the IRS industry-specialization program should provide support to the council. The council should solicit input from the valuation profession and groups such as the American Bar Association. Various measures are recommended to enhance communication on valuation policy.

■ Guidelines for valuing real property interests and for personal property in the estate and gift tax area should be developed. A proposed revenue procedure for the latter is currently in process.

■ The 40-year-old IRS Rev. ruling 59-60 should be updated. That ruling contains IRS business valuation guidelines, similar to those in Revenue's IC 89-3.

■ Taxpayers should substantiate their valuation opinions in conformity with IRS guidelines.

■ A vehicle should be developed to provide guidance to taxpayers on valuations, incorporating information from IRS regs, rulings, procedures, and publications.

■ An information return similar to that used to report non-cash charitable contributions should be created.

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Mutual Fund Disintegration

Owners of a Canadian private holdco should think twice about its purchasing mutual fund trust (MFT) units. Although the 2000 federal budget proposes a reduced capital gains inclusion rate, the overall cost of an individual's earning capital gains dividends from an MFT through a holdco remains significantly higher than a direct investment. The additional tax cost may exceed 11.50 percent of the overall capital gain. Although some of that additional cost reflects the fact that an individual's top marginal tax rate on capital gains is now slightly below that of dividends in all provinces and the net tax on corporate capital gains is higher than that on individual capital gains, most of the incremental cost arises because the untaxed portion of capital gains dividends from an MFT does not fall into the holdco's capital dividend account (CDA).

Income Tax Payable on $10,000 of Investment Income Through a Corporation and Directly, Year Ending December 31, 2000

	Regular capital gains	*Capital gains dividends*
Corporate tax	$3,419	$3,419
Refundable tax	(1,624)	(1,778)
Individual tax on dividend	1,575	2,702
Combined tax	$3,370	$4,343
Individual tax	$3,191	$3,191
Tax cost with Holdco	$ 179	$1,152
Tax deferral with Holdco	$ (228)	$ (228)

Note: The individual is an Ontario resident taxed at the top marginal tax rate (pre-2000 Ontario budget); the enhanced capital gains deduction is not available; the taxable dividend paid is the net after-tax amount less any capital dividend; the capital gains dividends are distributions from a Canadian MFT; and Holdco is taxable only in Ontario.

The table assumes that the individual is a resident of Ontario and that Holdco is taxable only in Ontario, but a negative deferral exists in most provinces and territories; the ultimate tax cost depends on the province of residence. Furthermore, federal and provincial capital taxes may pose a formidable disincentive for using a holdco: Holdco's MFT investment does not qualify as an eligible investment for an investment allowance. It is hoped that Finance will rectify the federal income and capital tax imbalances associated with corporate-owned MFT units.

Given the size of the potential tax cost, the route for distributing the after-tax corporate proceeds should be carefully considered. To the extent that Holdco has "trapped" refundable dividend tax on hand, a dividend refund reduces but does not eliminate the overall tax cost. In lieu of direct MFT investment by Holdco's shareholders, Holdco could mirror the share purchase and sale patterns and proportionate holdings of the MFT of choice. As an alternative to distributions of after-tax corporate proceeds via the CDA, a corporate-owned life insurance policy may provide future estate-planning opportunities.

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"Arranging for" Services

For GST purposes, the service of arranging for other specified financial services—such as the granting of credit or the transfer of shares or receivables—is treated as a financial service, which is generally exempt. Whether a service is exempt is particularly important if the recipient is a financial institution or other person with limited ability to recover GST paid on expenses. Revenue recently released a draft policy statement on the meaning of "arranging for" in this context.

Previously, there was scant administrative guidance on the meaning and scope of "arranging for" services. Although explanatory notes issued on GST implementation referred to services provided by traditional financial intermediaries such as investment and mortgage brokers and insurance agents, the legislative wording suggests a far broader application. There was also some discussion in a few Revenue policy statements. Criteria in UK cases on their VAT exemption for "making of arrangements" for specific types of financial services appear to form the basis of Revenue's new policy. (See, for example, *Civil Service Motoring Association*, which involved an affinity credit card program.)

Revenue seems to equate an "arranging for" service with the activities of an intermediary or go-between bringing together two or more persons for the supply of a financial service that has a clear nexus with the activities; ultimately, it is a question of fact that depends on the intermediary's degree of involvement. In Revenue's view, the intermediary must work "actively" with both supplier and recipient, who must both look to the intermediary for assistance. The intermediary must also be "fully and directly involved" in the supply of the financial services. Examples are given involving automobile dealerships, credit card applications distributed on behalf of financial institutions, business brokerage, credit card marketing and advertising services, and referral services. A referral or introduction does not qualify, a position perhaps inconsistent with Revenue's view that finders' fees payable to a deposit-taking financial institution for referring a client to a third party supplying a financial service are exempt (*Technical Information Bulletin* B-060).

The draft policy is a useful guide: it indicates the factors that Revenue will consider and suggests how a particular service relationship can be favourably structured. But only plain vanilla financial intermediary situations are considered. The exemption is much broader and covers such ground as the facts in *Skylink*. (See "Financial Services and GST," *Canadian Tax Highlights*, November 23, 1999, at 84.)

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Capital Gains Rate Changes

The 2000 federal budget proposes a capital gains inclusion rate reduced to two-thirds from three-quarters, so that capital gains are taxed at about the same rate as dividends. Consequential changes were made in the budget, and other ramifications follow.

■ Loss carryforwards are adjusted to the two-thirds rate when applied against gains in the new regime. It is not clear whether the new rate for ABILs applies to adjust a pre-budget ABIL offsetting post-budget new-system income. The stock option benefit deduction increases to one-third; options previously granted but unexercised at budget time will benefit. The enhanced capital gains deduction is adjusted. The inclusion rate on gains realized on a gift of listed securities to a registered charity is reduced to one-third, increasing the already enhanced benefit from charitable giving of such properties.

■ Capital gains may still be preferred over dividends in spite of an equivalence in tax rates. For example, the capital gains exemption may be available; if minor children are the recipients, capital gains, unlike dividends, continue to avoid both income attribution and the new kiddie tax. A non-resident prefers capital gains if shares are not taxable Canadian property or if a treaty capital gains exemption applies. A tax haven resident

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prefers dividends if shares are taxable Canadian property: the 25 percent withholding on dividends is less than the 33⅓ percent on a section 116 certificate. The section 116 withholding has now largely lost its pre-budget edge over the domestic effective rate of 37 percent of capital gains. If there is safe income, dividends continue to be preferable between connected companies. A holdco continues to offer tax deferral on dividends received from connected companies in Canada. Stock dividends permit the conversion of a dividend into a capital gain. The recipient receives dividend treatment on the amount of the stock dividend's PUC but claims capital gains treatment on the stock sale; this may continue to be a useful planning tool for minor children.

■ The reduced capital gains rates may mean that existing life insurance coverage exceeds the anticipated taxes on death. In the case of corporate-held insurance subject to a buy-sell, consideration should be given as to whether the estate or the survivor should benefit from any excess insurance, except for a grandfathered policy to be used to purchase the estate's shares for cancellation, because the estate is not taxable in those circumstances.

■ Many tax shelters provide an income deduction and then a capital gain on the partnership windup (for example, grandfathered partnerships with negative ACBs) or after a finite time period, such as flowthrough shares or film production service deals. Tax shelters priced on the basis of the old capital gains rate may provide a windfall for investors when the gains are realized and taxed at a lower than forecasted rate—provided, for example, that share value has not vanished.

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Foreign Tax News

United Kingdom

The 2000 budget included (1) an end to the use of foreign mixer companies to blend income carrying high and low tax rates effective for dividends paid after June 2000; (2) a tighter CFC exempt-activities test generally and specifically to prevent diversion of profits to low-tax jurisdictions via intragroup services; and (3) the extension of group relief to shareholdings in foreign corporations. Domestic changes were minimal.

United States

The IRS issued its first annual report on advance pricing agreements from 1991 to 1999. No guidance is provided on the application of the arm's-length standard.

Tax Havens

US House Ways and Means Committee members introduced legislation to prevent foreign-controlled property and casualty insurers' using tax-free or low-tax jurisdictions to reinsure their US-owned subs' reserves. The **OECD** supports the US 2001 budget's tax haven blacklist proposal. **Korea** will study 200 domestic companies with subs in 42 tax havens, focusing on transfer pricing and on equipment imports by tax haven subs on purchases from other foreign subs. **Iceland**'s new law imposing a preferential 5 percent tax on international trading companies may draw the scrutiny of the OECD forum on harmful tax practices.

Spain-Canary Islands

The European Commission has agreed to the introduction of special tax privileges for a new economic zone (ZEC) in the Canary Islands to encourage economic development. A firm that reaches investment thresholds and employs at least five people receives reduced corporate tax rates ranging from 1 to 5 percent, which may be reduced by one-fifth (to a minimum 1 percent) if the activities were previously underrepresented in the islands. Further tax aid is available on capital transfers and local taxes. There will be taxes on initial and annual registration and on issuance of ZEC documents.

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Civil Penalties: Proposed Section 163.2 of the ITA—Submission to and Response from CCRA
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Final conference programs:

- Estate Planning Course, May 13-16, Montreal
- Prairie Provinces Conference, May 29-30, Saskatoon
- Aboriginal Tax Policy Tax Conference, May 31-June 1, Saskatoon

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