Canadian Tax Highlights

Editor: Vivien Morgan, LL.B.

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Declaratory Amendment?

The *CNG Producing* case involved retroactive changes to Alberta income tax law. CNG argued unsuccessfully that the changes did not apply to it because, inter alia, it was engaged in litigation with the province at the time.

Alberta granted CNG and other coventurers the right to produce oil from two oil sands leases commencing in 1983. Production royalties on oil sands leases were set at a lower rate than royalties on conventional oil leases; as a consequence, Alberta had taken the position since at least 1985 that oil sands lease royalties did not meet the definition of Alberta Crown royalty, a prerequisite for Alberta royalty tax credit (ARTC) entitlement. The ARTC is designed to compensate a taxpayer for the disallowance for federal income tax purposes of certain royalties paid to Alberta and thus encourages oil and gas operators to produce there. Alberta Treasury policy regarding oil sands royalties was applied inconsistently; CNG was allowed to claim ARTCs after two separate audits for the taxation years 1985-90, but was denied ARTCs for its share of the approximately $1.3 million in royalties paid in 1991-94.

In 1996, CNG filed a notice of objection claiming that the royalties were eligible for ARTCs. In early 1997, Alberta took steps to amend the relevant legislation to clarify that, for taxation years beginning after 1980, oil sands royalties did not qualify: the changes received royal assent one day after CNG filed its notice of appeal in the Alberta Court of Queen's Bench. CNG argued that the new legislation was generally retroactive, but not in CNG's case, because there was not sufficient indication of an intention to retroactively interfere with CNG's vested right to the ARTC claimed and because the amendment did not specifically refer to pending legislation. Further, CNG said that the new rules were ambiguous: did the changes open up statute-barred years back to 1980, or did normal reassessment periods apply?

Under the common law, retroactive legislation is presumed not to apply to interfere with vested rights, but the court failed to find the legislative ambiguity necessary to trigger the presumption. And even if there was an ambiguity, the court said that the legislation clearly expressed an intention that it should apply to all taxation years back to 1980. The court also gave short shrift to the argument that there was any ambiguity concerning the limitation-period rules.

The final argument was a variation of the vested rights argument: a statute is not retroactive vis-à-vis parties in pending litigation without express intention or unless it is declaratory of the law. Published information circulars made it clear that since 1985 Alberta Treasury had considered the subject royalties not eligible for ARTCs—there was no evidence regarding earlier years—and that the field auditors' assessing practice was at least sometimes inconsistent with the stated policy. The court did not find enough clarity in the use of the term "taxation year" in the coming-into-force provision to specifically address pending litigation. However, the court concluded that the amendments were made to clarify the law: the previous wording was ambiguous, and the inconsistency between Treasury's policy and practice indicated that the law was sufficiently unclear as to require clarification. Thus the change was declaratory in nature and applied retroactively to CNG even though the issues were then in litigation.

There was precedent for similar changes of a declaratory nature in the oil patch. In the mid-1980s Revenue "clarified" that it had meant capital cost and not cost for the purposes of calculating depletion on qualifying depreciable property. The net investment tax credit change cost oil and gas producers significant amounts of depletion.

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In This Issue

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Charitable Waters Muddied

On January 28, 1999, the SCC delivered a split decision in *Vancouver Society of Immigrant and Visible Minority Women*, the first case in 25 years in which the court dealt with charitable purposes. There are some troubling aspects to the decision that have not yet captured the attention of commentators.

The majority of the SCC denied registration to the society as a charitable organization for two primary reasons: the target group, immigrant women, included those who did not require assistance, and the ancillary object clause allowed activities that were "incidental or conducive" to achieving charitable objects. The majority said that the word "conducive" was too broad and might encompass activities that could take on a life of their own. One of the society's activities was the provision of a job skills directory, which was made available to all beneficiaries, not just those in need. The same example was cited by the court as an activity conducive to achieving the society's objectives under corporate law, but not as an activity in pursuit of a charitable purpose—for example, the advancement of education. The job skills directory did not exclusively provide a public benefit because personal benefits could be derived by those who were not in need. For a charity to maintain its status for income tax purposes, its non-political, non-charitable activities must be incidental to the charitable purposes—"merely a means to the fulfilment of those purposes."

The significance of this reasoning becomes apparent when one considers that most post-secondary educational institutions in Canada engage in similar activities, and the legislation under which most charities are incorporated includes powers that are "incidental or conducive" to achieving those objects, or even broader powers in some cases. Thus, if individuals who are not the objects of charity may benefit, it appears that all such institutions must cease to engage in job placement and other activities not directly related to the advancement of education, the relief of poverty, or the advancement of religion. Compliance with such restrictions may prove difficult for Canadian colleges and universities.

The "or conducive" issue may set a standard so rigorous that few corporate charities will be able to meet it. Revenue had taken umbrage at the phrase for some time before *Vancouver Society* was litigated. If Revenue must now apply the SCC decision equitably and consistently to all charities, most educational institutions and many incorporated charities will have their charitable registration revoked. These concerns must be addressed quickly. Affected institutions may separate their various activities. Education or other services funded by fees, such as tuition or government grants, may be carried on under the existing corporate structure. Charitable activities funded by charitable gifts, such as pure research activities or the granting of scholarships and bursaries, may be carried on in a trust established by the existing corporation with itself as the trustee. Noncharitable activities can be carried on in a separate not-for-profit corporation whose directors are appointed by the existing corporation. This approach has been tentatively developed in the *Charities Handbook: 2000 Edition*, published by the Canadian Council of Christian Charities, 1-21 Howard Avenue, Elmira, ON N3B 2C9.

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Foreign Non-Affiliates Safe?

Reversing the TCC's decision in *Lamont*, a majority in the FCA concluded that safe income encompasses a foreign non-affiliate's earnings. The strong dissent may spur the Crown to seek leave to appeal to the SCC.

From February 1986 Canpac, a Canadian corporation, held an indirect equity investment in a foreign non-affiliate, Westcorp. In December 1992, a Canadian-resident individual transferred his Canpac shares to a Canadian holdco, Lamont. The next day, Canpac purchased the shares for cancellation, resulting in a deemed dividend of $7 million to Lamont. There was no dispute that the result of the transactions was a significant reduction in a capital gain that Lamont would have realized on an FMV disposition of the Canpac shares, $1.7 million of which related to Westcorp's earnings since 1986. Nor did it appear that the one-day holding period by Lamont was considered relevant. The only dispute was whether safe income includes earnings of a foreign non-affiliate.

The core provision in section 55 refers to income earned or realized (safe income) by "any corporation," but the interpretive rules only prescribe the means of determining amounts of safe income of Canadian corporations and foreign affiliates. The TCC said that the word "any" is all-embracing and in its natural meaning excludes limitations, but concluded that the provision must be interpreted in its entirety: because no rule prescribes the determination of safe income for a foreign non-affiliate, such a corporation is not "any corporation." The FCA came to the opposite conclusion: the absence of a specific rule for foreign non-affiliates does not mean that their safe income cannot be determined, even though such a calculation may be more permissive than that for Canadian corporations and foreign affiliates. The FCA did not agree with the TCC that this result was absurd, and declined to seek "an implied but unexpressed legislative intent in the face of ambiguity."

The dissent said that the provision was ambiguous and looked to its underlying object and purpose. It concluded that the statutory scheme of the provision confirms that safe income is income that has been taxed in Canada or can be repatriated to Canada on a tax-free basis from a foreign affiliate. Accordingly, a foreign non-affiliate's income is not safe income.

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NOT NECESSARILY SO EVIL

There are no new jokes. Similarly, there are no new taxes, but old ones may suddenly acquire importance. The Foundation recently published *Gambling and Governments in Canada, 1969-1998: How Much? Who Plays? What Payoff?* by François Vaillancourt and Alexandre Roy (affiliated with the University of Montreal and the Centre de recherche et développement en économique), which shows governments' gaining substantially from the operation of legalized gambling.

Apart from the moral and ethical issues—off-limits for economists—the authors conclude that the benefits of gambling activities to society and governments far outweigh the costs, as summarized briefly in the table. Detailed statistics and an appendix show how government gambling income has risen from nothing to about 2 percent of all government revenues in about 30 years. The $4.5 billion collected in 1997, although less than other "sin taxes" on alcoholic beverages and tobacco, represents an effective rate of tax of 60 percent on net spending on gambling, after payouts to winners. The total expenses of running the three main forms of legalized gambling—lotteries, casinos, and video lottery terminals—equate to about 45 percent of associated government revenue. A cost-benefit study developed by Vaillancourt and Roy using their own analysis of Statistics Canada data and international studies shows that the costs—including increased crime and policing, additional health care costs, job-related losses, and the costs associated with family breakup—were more than offset by the associated government revenue.

Costs and Benefits of Gambling in Canada

	Society		Government	
	1990	1995	1990	1995
	millions of dollars			
Benefits (low estimate)	2,238	5,486	1,450	3,557
Costs (high estimate)	1,712	2,442	776	1,227
Net benefits	526	3,044	674	2,330

Source: François Vaillancourt and Alexandre Roy, *Gambling and Governments in Canada, 1969 -1998* (Toronto: Canadian Tax Foundation, 2000), table 4.12.

The study did not examine how governments account for and spend gambling revenue. The fiscal crisis of the early 1990s moved some provinces to take such revenue into their general accounts, but others still dedicate the proceeds to special funds, which are used only for charitable or recreational purposes. The idea apparently remains that governments should not rely on gambling revenues, just as the gamblers should not consider it a steady source of income.

The study's statistics paint a dismal picture of governments filling their coffers at the expense of poor old men. The study points out that if government-run gambling—which can be traced back at least 21 centuries—were to end, illegal gambling might fill much of the void. Many of the societal and governmental costs would continue, but none of the profits would flow in to help government meet those costs. Although the present "voluntary taxes" are regressive and expensive to collect, it may be best to keep the money in Canada's public sector.

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DON'T WAVER IN WAIVER

Conventional wisdom says that the best opportunity to negotiate with the Canada Customs and Revenue Agency exists before a reassessment is finalized. If the limitation period is about to expire, a taxpayer may be well advised to sign a waiver to forestall the issue of a reassessment, but should also ensure that the waiver is carefully drafted.

Without a waiver and with the end of a limitation period looming, in an excess of caution the agency may issue a premature reassessment that includes many items not yet fully examined. The weight of the taxpayer's burden of proving the reassessment wrong is thus increased, and the agency acquires more issues to trade off during any further negotiations. The taxpayer must then direct attention and resources to drafting a notice of objection: the related time and costs of preparation and filing can be considerable. There is no doubt that the objection's assertions of fact and law are pivotal, especially for large corporations, should the matter proceed to court. But if during their review Appeals Directorate and Justice officials notice inconsistencies in the facts as stated, or if there are changes in a legal position, the damage to the taxpayer's credibility may threaten the settlement process and the taxpayer's future dealings with tax administrators.

It is not unusual for an auditor to request a waiver in the course of a complex audit. A taxpayer will find it extremely difficult to argue that a waiver was not given voluntarily: the extraction of a waiver under the spectre of a reassessment within 15 days is not considered bias. Although refusal guarantees an unfavourable reassessment, a waiver that is not carefully drawn can broaden the ambit of the agency's inquiry and indefinitely extend the auditor's stay, thus creating an opportunity for the auditor to muse about the return or make demands for information. A reassessment made pursuant to a waiver is not fettered with the requirement that it be made with all dispatch as in the case of a notice of objection. A waiver remains active until it is revoked.

The courts take a broad interpretive brush to waivers, which are considered made for the parties' mutual benefit. Technical errors—such as a reference to part III instead of part I—are resolved by ascertaining the parties' intention. Although the court in *Solberg* said that any ambiguity must be interpreted against the Crown as the drafter of the document, the Crown was able to establish the parties' intention without any direct evidence. In *CAL Investments*, a waiver was not invalidated by the failure to affix to it the corporate seal as required in the waiver itself. In *Placements TS*, the court said that by definition matters in issue are not fully defined at the waiver stage and therefore a waiver's ambit is not limited by their less than perfect description. In general, the courts have been generous in delineating the periphery of a waiver; the view has been expressed that a waiver's purpose is to allow the agency to continue and complete a review of the transaction, not to bind it on an issue.

It is important that the waiver be clear and deal expressly with the purpose of its grant and with the degree of latitude in reassessing that it is intended to provide. Because the facts and circumstances surrounding the grant of the waiver may be critical in determining the parties' intention and the waiver's ambit, the transmittal letter should clearly outline the waiver's basis and the limitations therein contemplated by the taxpayer and agreed to by the agency. Correspondence with the agency should also reflect the waiver's purpose and intended scope. If there are multiple issues, a separate waiver should be filed for each and revoked as each issue is addressed.

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Dividends Currently Preferred

Now that federal coffers are overflowing with excess revenue and most provinces are in the black, governments of all political stripes can afford to lower both individual and corporate tax rates meaningfully and invest more in priority services. A number of provinces have cut personal and/or small business tax rates aggressively over the last few years. The 2000 federal budget offers small but welcome relief for all taxpayers, although corporate reductions are not effective until January 1, 2001 and a new layer of complexity will largely offset the benefit to small business. The general federal corporate rate applicable to active business income (ABI) will drop from 28 percent to 21 percent over five years, but no adjustments are proposed to the 4 percent federal surtax or the federal small business deduction (SBD) rate or business limit.

Tax on Distribution of $10,000 of ABI
Year Ending December 31, 2000

	Ontario	Quebec	BC
		dollars	
ABI eligible for SBD			
Dividends			
Corporate tax	2,045	2,213	1,824
Individual tax	2,571	2,729	2,830
	4,616	4,942	4,654
Salary			
Individual tax	4,694	4,859	5,126
Provincial health levy	191	409	0
	4,885	5,268	5,126
Tax savings	269	326	472
Tax deferral	2,840	3,055	3,302
ABI: no SBD, no MPD			
Dividends			
Corporate tax	4,395	3,813	4,562
Individual tax	1,812	2,168	1,882
	6,207	5,981	6,444
Salary			
Individual tax	4,694	4,859	5,126
Provincial health levy	191	409	0
	4,885	5,268	5,126
Tax cost of dividend	1,322	713	1,318
Tax deferral	490	1,455	564
ABI: no SBD, full MPD			
Dividends			
Corporate tax	3,495	3,113	3,862
Individual tax	2,120	2,413	2,124
	5,597	5,526	5,986
Salary			
Individual tax	4,694	4,859	5,126
Provincial health levy	191	409	0
	4,885	5,268	5,126
Tax cost of dividend	712	258	860
Tax deferral	1,390	2,155	1,264

Note: The figures assume a top individual marginal income tax rate and, where applicable, a top health levy rate. The impact of CPP, EI, and other payroll taxes has not been considered.

After 2000, the full federal rate reduction applies to small businesses with taxable income between $200,000 and $300,000: the 22.12 percent rate already applies to taxable income in excess of the $200,000 business limit of businesses qualifying for the full manufacturing and processing deduction (MPD). This change, combined with the Ontario budget's proposed gradual doubling of its small business limit to $400,000 and its clawback thresholds for an associated group with taxable income over the small business limit, will increase the complexity of determining the appropriate corporate taxable income level after providing bonuses to owner-managers.

The trend of the past few years toward reduced provincial small business income tax rates continues. Ontario's existing reduction commitment was enhanced and accelerated to reach 4 percent by 2005. British Columbia, New Brunswick, and Manitoba are also aggressively lowering small business rates to 4.75 percent, 4.50 percent, and 5.00 percent respectively on various timetables. The 2000 Ontario budget also dropped its general corporate rate significantly—from 15.50 percent to 8.00 percent over five years.

As in earlier years, strictly on rates, owner-managers benefit from a significant tax deferral and some tax savings on the receipt of dividends in lieu of salary in 2000 if the underlying corporate income is ABI that is eligible for the SBD. If the ABI is eligible for neither the SBD nor the MPD, a deferral is available in all provinces except Alberta. A prolonged deferral may outweigh the generally significant tax cost that accompanies distribution and varies with the province or territory. Numerous other factors must also be considered. (See "Dividends Still in Favour," *Canadian Tax Highlights*, July 20, 1999, at 51.)

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New York Non-Resident Taxation

The use of worldwide income as the starting point for calculating the NY taxable income of a Netherlands Antilles corporation was recently upheld by the New York Division of Tax Appeals in *Schlumberger*. The court also upheld penalties assessed on the ground that the corporation's position lacked substantial authority, reasonable cause, and good faith.

Because the US states are not bound by the Canada-US treaty, a state can tax a Canadian corporation in situations in which the US federal government cannot; for example, a state can tax a Canco that maintains inventory within the state, an activity that alone does not constitute a permanent establishment (PE) for federal tax purposes. Moreover, most state methods of calculating a Canco's taxable income differ from the federal government's: the IRS can tax only income that is attributable to Canco's PE (determined on a branch accounting basis), but most states apply an apportionment formula to Canco's worldwide income to arrive at taxable income for state tax purposes. The formula is based on the percentage of Canco's total sales, property, and payroll situated within the state; some states double-weight the sales factor.

A Canco with state nexus may avoid reporting worldwide income by forming a US sub to conduct its state operations, thus isolating state tax reporting to the sub's income. However, if the US sub acts as a selling agent for the Canco, additional structuring may be needed to avoid Canco's being deemed to have state tax nexus because the US sub's activities may be imputed to it. A US limited liability company does not exempt Canco from reporting worldwide income to a state if the LLC is treated as a partnership or branch rather than as a corporation for US federal tax purposes.

New York taxes individuals somewhat differently from corporations. If an individual is resident for NY tax purposes but is also a Canadian resident for US federal tax purposes, New York does not exercise its right to tax worldwide income; instead, it taxes only the US federal taxable income of such individuals. This result arises because New York calculates the taxable income of its resident individuals by making certain additions to and subtractions from US federal taxable income, and foreign-source income that is not subject to US federal tax is not added back. Because of this piggyback rule, an individual who is a Canadian resident for federal tax purposes but, for example, maintains a home or apartment in New York and spends sufficient time there to be considered a NY

SHOE ***by Jeff MacNelly***

resident for NY tax purposes can pay NY tax only on his or her income that is subject to US federal tax.

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Stock Option Update

Federal reporting. The 2000 federal budget allows the deferral of income from the exercise of employee stock options for publicly listed shares until the shares' disposition, subject to a $100,000 annual vesting limit. (See "Stock Option Deferrals," *Canadian Tax Highlights*, April 25, 2000, at 28.) Finance's May 9, 2000 press release says that related reporting will not require employers to track dispositions of shares acquired under a stock option plan, but will concentrate on the benefit at the time of exercise and on compliance with the $100,000 annual limit.

Ontario research employee stock option deduction. Ontario's May 2, 2000 budget provides details on the 1999 budget's proposed research employee stock option deduction of up to $100,000 annually of the taxable amount of stock option benefits and capital gains from the sale of shares acquired thereunder. An eligible employee works for an eligible research corporation and spends at least 30 percent of his or her time directly undertaking, supervising, or supporting SR & ED in the corporate tax year when the stock option agreement is entered into. In general, an eligible corporation incurs at least $25 million or 10 percent of revenue on SR & ED and undertakes SR & ED through a permanent establishment in Ontario. Only stock options granted after royal assent of the not-yet-tabled legislation are eligible: replacements or exchanges of pre-existing options are excluded.

Ontario EHT. The 2000 Ontario budget proposed a benefit for high-tech companies that compensate employees with stock options: the 1.95 percent employer health tax (EHT) is eliminated on employee stock option benefits from the exercise or disposition of stock options granted by eligible SR & ED-intensive companies, for options exercised post-budget. The definitions of eligible stock options and eligible SR & ED expenditures mirror the definitions for the employee deduction, above; so does the definition of an eligible corporation, but it also requires that the corporation conduct significant SR & ED in Ontario.

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Treaty Exemption Filing

For tax years beginning after 1998, non-Canadian corporations claiming exemption from Canadian tax under a tax treaty must now file a corporate tax return within six months of the corporate fiscal year-end. The return must include new schedule 91, "Information Concerning Claims for Treaty-Based Exemptions," designed to disclose details of the reliance on a treaty-based exemption.

Non-resident corporations are subject to federal income tax if they dispose of taxable Canadian property such as private Canadian company shares or if they carry on business in Canada—for example, by soliciting orders or providing services in Canada. A treaty exemption may arise in the latter situation if the corporation has no Canadian permanent establishment. Failure to file a tax return that includes schedule 91 triggers a minimum penalty of $100 based on the number of days the return is outstanding (to a $2,500 maximum). But if tax is payable, an additional penalty based on taxes owing may apply.

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A Different Tax Lottery

Taiwan operates a tax lottery to encourage consumers to ask for an invoice, which serves as a lottery ticket. This ensures compliance with commodity tax rules and assists tax auditors.

The Ministry of Finance prescribes the invoice and its uses: uniform invoices are printed and sold by the government, or a business may print its own. All invoices are numbered—the numbers are controlled by the ministry—and each company must report bimonthly the numbers of uniform invoices issued in the latest period. A draw of issued numbers is held shortly after each filing due date. Winning numbers are published in the newspaper. Seven prizes are currently offered, ranging in size from about US$6 to US$66,666. In fiscal 1999, about US$162 million in prizes was awarded.

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Tax Avoidance Matters

The Canada Customs and Revenue Agency's tax-avoidance program exists to deter unacceptable tax avoidance. The program involves identification and correction measures, and seeks to reinforce compliance and maintain responsible levels of enforcement with increased audit coverage of key sectors at risk. Some practitioners have raised concerns that the agency is applying GAAR too often and not as the last resort intended.

The Tax Avoidance and Special Audits Division started out as a consultation service to auditors back in 1968, evolved through a period of headquarters control of all tax-avoidance audits, and in 1991 became the current decentralized audit program present in most taxation services offices (TSOs). To ensure consistency nationally, GAAR's administration was not decentralized and approval for its application still rests with a headquarters GAAR committee composed of representatives from Rulings, Justice, Finance, and Audit. The tax-avoidance audit program is one of the smallest within the Verification, Enforcement and Compliance Research Branch: there are about 260 audit staff in 39 TSOs out of a total of about 9,300 auditors. About 30 auditors at headquarters provide program direction, technical support, and case assistance on the application of the GAAR and other specialty audits such as flowthrough share and tax shelter arrangements and BC mining exploration tax credit claims. The division is also responsible for the development of a compliance strategy for businesses conducting commerce electronically and, most recently, for coordinating consultation with the tax community on the proposed third-party civil penalty.

The auditor general's 1996 report noted that the resources and opportunities available to large corporations, particularly those with extensive domestic and foreign operations, pose a high risk of tax-avoidance arrangements that was not reflected in audit referrals to the Tax Avoidance Division: in 1994-95, large-file auditors referred 27 such cases. In response to the AG's observations and as part of an initiative to enhance service by channelling client contact through large-file case managers, tax-avoidance and other specialty auditors always participate initially in the planning and screening of all large field audits and may withdraw or re-enter the audit on a needs basis.

From its introduction in 1988 to March 31, 2000, GAAR has been a reassessing position in only 281 cases, an average of 24 per year. To put this in perspective, 276,000 returns were audited in the 1998-99 fiscal year. The agency relies on its auditors and their supervisors to identify transactions that should be referred to Tax Avoidance. To ensure that only appropriate tax-avoidance issues are raised on audit and that GAAR remains a measure of last resort, training courses are provided to all tax-avoidance auditors and made available on request to other (including provincial) auditors and Justice officers. Headquarters staff visit TSOs to provide technical information sessions to update auditors on the GAAR and related current cases and issues, and also issue periodically summaries of all referrals to the GAAR committee, describing both the issue and the decision. Most TSO Tax Avoidance sections meet regularly with their auditors to inform them of local tax-avoidance issues and headquarters' position. Both auditors and practitioners have access to the GAAR *Information Circular* 88-2. And the agency continues to welcome practitioners' suggestions as to how it may improve the conduct of its business.

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Kiddie Tax: Sourcing

After 1999, minor beneficiaries of inter vivos trusts earning dividends from private companies and business income from or in support of related businesses are subject to kiddie tax, generally at the top marginal rate—32 percent and 47 percent, respectively—on distributions, without the benefit of personal exemptions. New source-tracing issues may arise if the trust also earns other business income, interest income, capital gains, royalty income, or rental income.

Assume that an inter vivos trust has two beneficiaries, aged 18 and 15. The trust is discretionary and may make distributions to the exclusion of one beneficiary. The trust earns $7,000 of interest and $7,000 of income from a partnership that provides services to a related business. Can the trustee allocate the interest to the minor and the business income to the adult, allowing each to claim the personal exemption and, in the absence of other income, not pay tax? On a 50-50 split of each type of income, the minor pays tax at 47 percent on $3,500 of the business income. The trust may accumulate the income and make it payable to the beneficiaries by creating a legal and enforceable right to payment, or the income may actually be paid to a particular beneficiary as it is received by the trust. There is no longer any legislative mechanism that specifically allows the designation and flowthrough of interest income to a beneficiary, nor is there a mechanism for designating business income. A rule permits the allocation of taxable dividends from taxable Canadian corporations that may reasonably be considered as part of a particular beneficiary's income inclusion from the trust. Otherwise, a beneficiary's income is income from a trust and not any other source. (This rule is being amended so as not to affect the application of the kiddie tax.)

Revenue may dispute favourable allocations. The fact that the trust is discretionary is probably not enough to justify an arbitrary source-of-income designation. Newly established trusts may grant trustees more power to track income and channel it to specific beneficiaries, and existing indentures may be varied accordingly. Alternatively, a new trust may be formed for the minor's benefit and funded by a nominal gift from a preferably non-resident settlor; the old trust may monetize its interest-bearing investments and, if its investment powers permit, lend the capital interest free to the new trust for interest-bearing

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investment. No imputed interest arises on the loan, per *Cooper*. It is not clear that the income may be attributed to a personal trust. And the income attribution rule in subsection 56(4.1) arguably does not apply because the business income earned by the original trust is not a transfer of property, unless it was settled by a Canadian resident not at arm's length with the new trust's beneficiary. The safer alternative may be to segregate different types of income into separate trusts for minors and adults.

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Income Reconstruction

Under its market segment specialization program, the IRS has issued more than 50 audit technique guides to specific industries for IRS examiners conducting audits and for the information of taxpayers and practitioners. Some of the industries are prone to non-reporting of income and/or padding of expenses.

The guides highlight business practices. For example, the pizza restaurant guide includes a chapter entitled "The Pizza Industry—Skimming, Cash Payroll, Cash Purchases," an "Initial Pizza Restaurant Information Document Request," and suggested questions for the IRS auditor's initial interview with the owner. Another chapter explains the steps necessary to reconstruct income from the sale of pizzas and submarine sandwiches. These audit guides are of interest to business valuators who are attempting to establish maintainable earnings—capitalized to determine FMV—by reconstructing the financial statements to reflect the true business income of entities with inaccurate and/or incomplete books of account. The guides are available from the IRS Web site at http://www.irs.ustreas.gov. In Canada, Revenue's underground economy initiative has targeted four business sectors: construction, jewellery, hospitality, and automotive.

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Foreign Tax News

Bahamas

Earlier this year, the international press quoted the Bahamian minister of finance as having said in the course of a lengthy interview that there was "no question" that the Bahamas would institute an income tax as part of its response to OECD initiatives against harmful tax competition. In May, the *Nassau Guardian* reported that in his speech from the throne, the governor general said, "Any form of income taxation or the usual forms of capital taxation are not conducive to the continuing economic and social development of The Bahamas." The *Guardian* stated that this comment should comfort persons troubled by the earlier report. The governor general added that "the Bahamian tax system will be studied in an attempt to modernize, simplify, and improve it." (See "Foreign Tax News," *Canadian Tax Highlights*, February 29, 2000, at 16.)

United States

On May 15, the IRS released a 240-page document containing revisions and additions to 1997 tax withholding and reporting regulations affecting, inter alia, payments to non-qualified intermediaries and non-withholding foreign partnerships; withholding on sales and redemptions of debt obligations, including those carrying original issue discounts; estates and trusts; the presumption rules for payments to undocumented recipients and partnerships; permission to transmit form W-8 electronically; and the use of documentary evidence. These changes are designed so that the benefits of reduced withholding tax rates under US income tax treaties and the portfolio interest exemption enure only to non-US beneficial owners resident in a treaty country and non-US persons, respectively.

European Union

The European Commission approved a single-rate VAT on digital sales from non-EU suppliers. The single-state option may encourage the establishment of foreign firms in low-VAT jurisdictions such as Luxembourg and Germany.

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ON THE CTF WEB SITE

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