CANADIAN TAX Highlights

Editor: Vivien Morgan, LL.B.

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CP: GAAR Defanged?

In *Canadian Pacific*, the TCC held that GAAR did not apply to a complex series of weak-currency borrowing and hedging transactions. The TCC concluded that the Australian dollar borrowing and the series of transactions of which it formed a part could reasonably be considered to have been arranged primarily for a bona fide business purpose: to raise capital and lower CP's overall borrowing costs. It is not yet known whether Revenue plans to appeal to the FCA. Although the 2000 federal budget now precludes a *CP*-type of transaction, Revenue may wish to challenge the TCC's GAAR analysis, which may assist taxpayers in other tax-planning initiatives.

The facts in *CP* were virtually identical to those in the pre-GAAR case of *Shell*, in which the SCC allowed a full deduction for interest expense arising from a sophisticated financing plan involving weak-currency borrowing and held that the gain on a related hedging transaction was a capital gain. (See "Shell Clears Skies," *"Canadian Tax Highlights*, November 23, 1999, at 81.) After GAAR's effective date, CP borrowed Australian dollars in an identical structure. *CP* trailed *Shell* all the way to the SCC, where *CP* was ordered back to the FCA to be dealt with in accordance with the SCC's reasons in *Shell*. The FCA in turn remitted *CP* back down to the TCC for further findings of fact, bearing in mind the GAAR issue.

Judge Bonner made some particularly noteworthy observations regarding various aspects of GAAR. In connection with "business purpose," he said: "There can be no doubt that a transaction undertaken primarily to achieve a non-tax business objective is not within the scope of the GAAR. As I see it, the use of the word 'primarily' is intended to preserve the right of the taxpayer to structure a business-driven transaction in a tax-effective manner." Judge Bonner also noted that an event cannot be recharacterized to determine whether subsection 245(2) applies: "recharacterization is permissible under paragraph 245(5)(c) only [if] . . . subsection 245(2) applies on the basis of transactions [that have not been recharacterized]."

On the meaning of "tax benefit," the court said: "The definition of tax benefit in subsection 245(1), by referring to a 'reduction, avoidance or deferral of tax . . .' assumes the existence of a standard amount of tax against which reduction may be measured. In my view, in the circumstances of this case, the question whether the transaction resulted in a reduction of tax is to be answered by reference to the amount of tax which would have been exigible had [CP] borrowed the relevant amount directly in [Canadian dollars]. The standard against which reduction is to be measured is not a transaction which is theoretically possible but, practically speaking, unlikely under the circumstances."

On the parsing of a "series of transactions" to weigh the purpose of any particular step, the court said: "No transaction forming part of the series can be viewed as having been arranged for a purpose which differs from the overall purpose of the series." It is not clear whether this statement was intended to be limited to the facts in *CP*.

In closing, Mr. Justice Bonner quoted with approval from Mr. Justice Bowman's decision in *Jabs Construction Ltd.*: "Section 245 is an extreme sanction. It should not be used routinely every time the Minister gets upset just because a taxpayer structures a transaction in a tax-effective way, or does not structure it in a manner that maximizes the tax."

Wayne Tunney and Lori Dunn
KPMG LLP, Toronto

In This Issue

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GST Reg Ultra Vires

In *Société des Alcools du Québec* (*SAQ*), the FCTD allowed an application by the SAQ for a refund of federal sales tax (FST) embedded in its inventory at the time the GST came into force, in an amount greater than was allowed by the regulations. The court concluded that the reg, which permitted a much smaller rebate, was ultra vires.

FST was levied, inter alia, at 19 percent on alcoholic beverages. Businesses with tax-paid inventory on January 1, 1991, when the GST came into effect, were eligible for an FST rebate or "remboursement" under subsection 120(5) of the Excise Tax Act. That subsection provided that the amount eligible for refund was to be determined using a method to be prescribed by regulation. The regulation promulgated under that authority provided for recoveries of FST at various percentages, including a rebate for alcoholic beverages equal to 8.1 percent of the inventory's value, clearly less than the 19 percent FST that was paid.

The court held that the regulation was ultra vires because it was not in accordance with the purpose of the provisions of the empowering legislation that authorized the delegation of power to make the regulation. Counsel for the minister agreed that the intent of the provisions was to avoid any double taxation on the consumer. A partial refund such as that envisioned by the regulation would leave FST embedded in the price paid by the consumer, who would then pay GST on that amount. The judgment was delivered in French, and the court examined the official French version of the ETA to verify the purpose of the provision authorizing the payment related to the FST content of a taxpayer's inventory. The French version calls for a "remboursement." Because there was no statutory definition of that term, the court looked to a dictionary definition—"the act of repaying" and "settling or paying back a sum"—and concluded that the term referred to a refund of an amount in its entirety. (Thus the French terminology more closely approximates the English word "reimbursement" than the term "rebate," which appears in the English version of the ETA transitional rule. The court referred to a dictionary definition of "rebate" without further comment.) The court concluded that in the case of alcoholic beverages, the regulation fell far short of the targeted full reimbursement called for by the ETA; the SAQ was entitled to a full reimbursement of the sum claimed. However, in most cases, the court noted, the regulation would result in an equitable reimbursement and thus was not declared inoperative.

The ultra vires argument is most often seen in relation to the constitutional division of powers between the federal and provincial governments. Numerous non-tax cases also raise the argument in the regulatory context. The reported decisions in the taxation context are consistent on the rule: a regulation is ultra vires if it varies, modifies, or affects "the ambit of the legislative pronouncement" in the empowering statute or attempts to place an inconsistent interpretation or construction on the statute. But the rule's application can be problematic: a flurry of CCA cases under the 1952 Income Tax Act sought unsuccessfully to have regulations declared ultra vires. *SAQ* also highlights the importance to the interpretive process of both official-language versions of a statute.

Paul S. Carenza
Thorsteinssons, Toronto

To Err Is Human

The Ontario Court of Appeal recently upheld the decision of the Ontario Superior Court of Justice in *Juliar*. (See "Between Cup and Lip," *Canadian Tax Highlights*, January 25, 2000, at 2.) In return for the transfer of shares in a family business, a holdco issued a promissory note; the lower court ordered a retroactive rectification of the corporate resolutions authorizing the note's issue, substituting a share issue by the holdco. As a consequence, the Juliars were able to defer tax rather than having to recognize a deemed dividend immediately.

In 1993, the Juliars transferred their shares in the family Opco to a new holdco and took back a promissory note. Mr. Juliar believed that tax had been paid on the original transfer of the Opco shares to him and his wife by her parents. He conveyed this understanding to his new accountant, who consequently concluded that the Opco shares had an ACB equal to their FMV at the time of transfer by the parents. In fact, a capital gains exemption had been claimed at that time; thus, when the Juliars transferred their Opco shares to the holdco for shares and a promissory note, a deemed dividend was triggered under section 84.1.

The Ontario Court of Appeal agreed with the trial court's interpretation of the general principles of rectification: "If by mistake a written instrument does not accord with the true agreement between the parties, equity has power to reform, or rectify, that instrument with the true agreement. What is rectified is not a mistake in the transaction itself but a mistake in the way in which the transaction has been expressed in writing. Courts of Equity do not rectify contracts; they may and do rectify instruments purporting to have been made in pursuance of the contract (*Snell's Equity*)."

The Court of Appeal agreed with the trial judge that the Juliars had a common and continuing intention from the outset to transfer Opco's shares without immediate tax. There was evidence that the transaction would not have been entered into if a resulting tax liability would be necessarily triggered. The trial judge noted that the "division of a family business among the children of the founder of the business is not an uncommon occurrence and is invariably intended to be effected with little or no cash and on a basis that does not attract immediate liability for income tax." The concluded arrangement did not embody that intention of the parties because it triggered an immediate and significant tax liability. Revenue argued unsuccessfully that the parties merely intended to transfer the Opco shares to the holdco and had in fact done that, leaving no need for rectification.

Applying the ratio in *Juliar* in future cases will not be a simple matter. The trial court concluded that the Juliars' intention was not just to transfer the Opco shares, but to transfer them without attracting an immediate income tax liability. Minimizing or eliminating tax is usually an underlying intention in any transaction that has a tax component to it. It will not be an easy task to determine which transactions have a sufficiently integral tax minimization or elimination motive. Furthermore, the equitable doctrine of rectification is not intended to allow courts to rewrite contracts. The doctrine is intended to permit the correction of documentation errors, not planning or implementation errors. *Juliar* seems to have broadened significantly the circumstances in which rectification is granted. However, it may be prudent to document clearly that the primary intention of the parties to a tax-planning arrangement is to avoid any immediate tax liability.

Paul Matthews
Fogler Rubinoff LLP, Toronto

Rebalancing Act

Of all the changes proposed for the personal income tax, the reduction in the effective rate of tax on capital gains has the potential to cause the greatest change in taxpayer behaviour. Although such a reduction is often perceived as relief to some high flyers and thus is anathema to other taxpayers, the break means in fact that over 7 million Canadians—only a few of whom can be considered wealthy—should be reviewing their portfolios.

Extrapolating from Revenue's 1997 taxation statistics, the approximately 2 million Canadians who annually file tax returns with taxable capital gains will see their after-tax returns increase in the near future. In 1997, only 8.4 percent of all taxpayers with capital gains had incomes of over $100,000; 14.4 percent had incomes between $60,000 and $100,000; the other 77.2 percent had incomes below $60,000. With capital gains on investments yielding higher after-tax returns, the approximately 2.3 million tax filers with dividend income qualifying for the dividend tax credit need to reexamine their strategy. As shown in the table, 76.1 percent of dividend recipients had incomes below $60,000. Other investment income, often interest on bank deposits and bonds, appeared on 7.1 million tax returns in 1997; only 12.3 percent of those returns reported income above $60,000. The table also indicates that about 17.3 percent of all returns claiming contributions to registered pension plans and 19.6 percent claiming RRSP contributions had total incomes over $60,000.

All 1997 Personal Income Tax Returns
Percentage Distribution of Returns by Income Class

Reporting	Up to $30,000	$30,000 to $60,000	$60,000 to $100,000	Over $100,000
RPP contributions	25.9	56.9	15.1	2.2
RRSP contributions	33.5	46.8	15.2	4.4
Dividends	40.8	35.3	15.7	8.2
Taxable capital gains . .	44.0	33.2	14.4	8.4
Investment income	58.5	29.3	8.7	3.6
Total income	67.4	24.7	6.1	1.8

The key income tax incentives for saving and investment obviously have broad appeal. They were used by a surprisingly large proportion of the 21.1 million people who filed tax returns in 1997. Changes in the capital gains tax are of most benefit to taxpayers such as the 163,900 filers with incomes over $100,000—8.4 percent of the filers who reported gains—who reported 60.5 percent of all gains. But such changes will nevertheless be appreciated by taxpayers such as the approximately 1.5 million people who reported gains but had income of less than $60,000 in 1997.

David B. Perry
Canadian Tax Foundation, Toronto

When Time Began

In *Carlson*, the TCC recently revisited applications for extensions of time to file a notice of objection once the prescribed limitation period has expired. Previously, unsuccessful attempts by taxpayers have proceeded along the lines of disputing the "complete code" nature of tax statutes or inviting the court to exercise its equitable jurisdiction and thus allow the taxpayer to have its day in court. Courts have almost consistently denied that there is any room in tax statutes for equity. But the TCC in *Carlson* held that time did not begin to run until the taxpayer "discovered" the potential liability.

In 1992, Dennis Carlson, apparently as a favour for an unrelated person, Avery, agreed to accept a transfer of Avery's real property as a bare trustee without consideration. No trust documents were drafted. In August 1993, Revenue assessed Carlson "in respect of" the transfers, without any further explanation. Carlson contacted Revenue and discussed the matter with Avery; a Revenue official told Carlson that he would be contacted after the official looked into the matter. Avery assured him that he would take care of it. When Avery had more run-ins with the law two years later, Carlson, considered by the judge to be a simple, uneducated working man, became concerned and transferred the property to Avery's son. It was not until late 1998 or early 1999 when, while Carlson was speaking with Revenue on another matter, the 1993 assessment appeared on Revenue's computer screen and was brought to Carlson's attention. Realizing the severity of the problem and that the assessment had not gone away, as he had previously thought, Carlson retained counsel and quickly filed an application for an extension to file a notice of objection.

The TCC considered at length the case law on the doctrine of "discoverability" that prevents the commencement of a limitation period until the plaintiff becomes aware of the harm (the assessment) and its likely cause. Several SCC non-tax cases were said to apply to a taxpayer who had "endured an intervening lack of ability to understand and appreciate the situation at hand, and his or her rights to take action." The TCC said that *Carlson* was one of those "rarest of cases" in which the discoverability rule could apply and assist a taxpayer. The original assessment was terse and without explanation, and because there was no consideration for the original transfer that triggered the assessment, Carlson could reasonably expect not to have created any related tax liability by accepting the transfer. The fact that Revenue apparently did not get back to him as promised lulled him into thinking that no further action would be taken. To subsequently revive the issue some five years later to collect the unpaid tax, interest, and penalty without giving him an opportunity to be heard "borders on the iniquitous." There was no need for a time extension: once Carlson "discovered" the assessment and its attendant implications, he filed an objection within 90 days.

There was no discussion of the rule in subparagraph 165(1)(a)(ii), which states that time starts running when the assessment is mailed. Since *Carlson* was heard, the FCA in *Schafer* has examined a GST rule that deems an assessment to have been received on the day it was sent by first-class mail. The third party assessed had claimed that she had not received the last of three separate assessments. The FCA's judgment was more consistent with tax case law in the area and did not examine the issues in the light of the doctrine of discoverability; the FCA easily dismissed the application for an extension of time to file a notice of objection. It now seems that the Crown will appeal *Carlson* to the FCA. Unless *Carlson* is reversed, numerous hardship cases will surface to claim the protection of the discoverablility doctrine.

Chia-yi Chua
Bennett Jones LLP, Toronto

Lost in the Shuffle

Whenever the corporate deck is reshuffled, traps await the unwary, particularly if an entity in the corporate group has non-capital or net capital losses. Losses may be inadvertently streamed or even lost if, for example, a parent recently acquired a company that it interposed in the ownership chain between itself and its loss subsidiary and then wound up the loss sub.

Consider the situation of a parent (A Co) with a wholly owned sub (B Co) that has incurred non-capital losses. A Co then acquires a shelf corporation (C Co) from an arm's-length party. In the course of the reorganization, A Co rolls B Co underneath C Co. If B Co remains in place as a sub of C Co, B Co's non-capital losses are unrestricted, because A Co still ultimately controls B Co. However, B Co's non-capital losses for a taxation year ending before the acquisition of control of C Co may be lost or streamed if B Co is wound up into C Co; paragraph 88(1.1)(e) applies. (Paragraph 88(1.2)(c) applies to capital losses.)

Interestingly, those restrictions do not apply to B Co's losses if it is merged into C Co via a vertical amalgamation, because there is no change in the ultimate control of B Co. Another relieving measure may apply on a windup of B Co into C Co if it is a new corporation that came into existence by way of amalgamation or otherwise after the end of a loss year of B Co. Assume that new C Co continues to be wholly owned by A Co. The relieving measure deems C Co to have been in existence throughout the period commencing immediately before the end of B Co's first loss year and ending immediately after C Co's actual incorporation or formation. Furthermore, C Co is deemed throughout that period to have been controlled by A Co and to have had fiscal periods ending on the day of the year when its first fiscal period ended. Accordingly, C Co may carry forward the charitable donations, losses, unused ITCs, and foreign tax credits that were not deducted by B Co before it was wound up.

Greg Boehmer and John Jakolev
Ernst & Young LLP, Toronto

US Tax Forms Due January 1

Under the Internal Revenue Code and regulations, a US bank that pays interest to a Canadian resident need not withhold US tax if it obtains a withholding certificate from the payee. The certificate verifies, under penalty of perjury, that the recipient of the interest is not a US citizen or resident. The withholding rate is 10 percent under the Canada-US treaty—30 percent to a non-treaty country such as Liechtenstein—but a 31 percent backup withholding rate may also apply.

In conjunction with a general overhaul of its withholding system, the IRS created new forms in 1998 to be used as withholding certificates. A non-resident with a deposit in a US bank must complete and file form W-8BEN with the bank. The effective date for requiring such forms to be on file was repeatedly delayed, but finally arrives on January 1, 2001; old withholding certificates on file with US banks (usually form W-8) are then generally invalid. If the bank does not have a valid form W-8BEN on file, technically it must withhold on interest payments and is jointly and severally liable for the US tax required to be withheld. Most US banks have taken the initiative to obtain new withholding certificates from their depositors. But as a matter of caution, Canadian residents with US bank deposits should make sure that the bank has a form W-8BEN on file before year's end.

Another element of the overhaul of the US withholding rules is the concept of "qualified intermediary," a non-US financial institution (or foreign branch of a US financial institution) that signs a qualified intermediary agreement with the IRS. These agreements are intended to streamline the new information-reporting procedures and maintain the anonymity of the qualified intermediary's foreign clients vis-à-vis the IRS. The IRS recently announced that it has begun to sign qualified intermediary agreements in anticipation of the new withholding regime's January 1 effective date. Interested Canadian financial institutions can find information about becoming a qualified intermediary by accessing the IRS's site at www.irs.gov and clicking "Tax Info for Business" and then "Qualified Intermediaries."

Tim Sawers
Hodgson Russ Andrews Woods & Goodyear LLP, Buffalo

Capital Gains Versus Dividends

The federal mini-budget dropped the inclusion rate on capital gains from two-thirds to one-half, making the tax on capital gains significantly lower than the tax on dividends. For example, for Ontario-resident individuals the tax on capital gains will be 24 percent—if Ontario follows suit—compared with approximately 32 percent rate on dividends. Unless this discrepancy between capital gains and dividends is reduced, tax planning will be affected significantly.

For taxpayers selling shares of their opco, standard tax planning involves a safe income strip to reduce the capital gains arising on the sale. Such a safe income strip usually leaves a portion of the proceeds parked in a holdco for later distribution. The change in the tax rates means that a current tax of 24 percent is avoided in favour of a 32 percent rate sometime later, not an ideal result. The rate discrepancy also affects standard tax planning to avoid the potential double tax that arises on the death of a CCPC's shareholder. The use of subsection 164(6) to convert a capital gain arising on death into a dividend may no longer be an optimal solution. Furthermore, the use of corporate-owned insurance to enhance the tax result under subsection 164(6)—the "one-third solution," soon to be the "50 percent solution"—must also be re-engineered to continue its tax effectiveness. In addition, the lower inclusion rate increases the overall tax cost of an individual's earning capital gains dividends from a mutual fund trust through a holdco from 11.5 percent to 16.5 percent of the overall capital gain. (See "Mutual Fund Disintegration," *Canadian Tax Highlights*, April 25, 2000, at 30.)

Louis J. Provenzano
PricewaterhouseCoopers LLP, North York

SHOE *by Jeff MacNelly*

Tax Measures in Limbo

Parliament was dissolved on October 22, 2000 for the federal election on November 27, 2000. All bills that had not received royal assent before dissolution died on the order paper; those bills and other proposed tax measures will not become law unless they are reintroduced by the newly elected government. The resultant uncertainty will affect taxpayers' tax planning and filing over the next few months.

The following income tax measures died with the election call: the October 18, 2000 mini-budget; the June 5, 2000 notice of ways and means motion (NWMM) (Bill C-43), including emigration rules, trusts, resource expenditures, November 30, 1999 technical amendments, and advertising expenses; the August 8, 2000 draft legislation on foreign bank branch tax proposals and other provisions of general application; the June 22, 2000 draft legislation on non-resident trusts and foreign investment entities; and the 2000 federal budget measures, except for measures enacted as Bill C-32: restoration of full indexation, an increase in child tax credit benefit amounts, and an increase in foreign content limits for RRSPs.

Almost all GST amendments squeaked through in Bill C-24, which received royal assent on October 20, 2000. That bill contained amendments to the Excise Tax Act and consequential amendments to a number of other acts, and enacted proposals from the 1997, 1998, and 1999 budgets. But the GST/HST amendments announced in the 2000 federal budget and some newly proposed changes tabled as a NWMM on October 4, 2000 were not enacted.

Paul Hickey
KPMG LLP, Toronto

GST Allocation Methods

Businesses such as financial institutions that make both taxable and exempt supplies for GST purposes must allocate to each type of supply the GST paid on expenses: input tax credits to recover GST are available only for expenses related to taxable activities. The Excise Tax Act provides relatively little guidance on allocation: methods for allocating expenses must be "fair and reasonable" and used consistently throughout the fiscal year, but there are no prescribed methods. Revenue's administrative guidelines set out its policy and indicate a preference for direct allocation. *Ville de Magog* is one of the few cases on the allocation issue.

Ville de Magog involved a Quebec municipality's allocation of overhead expenses to its taxable electricity-distribution operations. The municipality used an allocation percentage of 50.9 percent, the proportion of total direct expenses of the electricity operations to total municipal expenses. In contrast, for example, Revenue used an allocation method based on the percentage of total municipal employees used directly in the power system operation—9.28 percent—to allocate certain overhead expenses incurred in performing personnel management functions.

The municipality's budget documents for the fiscal year in question showed that revenue generated for electricity operations exceeded expenses by over $3 million. Using its GST allocation methodology and allocating 50.9 percent of the overhead expenses to those operations yielded a deficit of $2 million. The TCC found that the municipality's allocation method led to results that did not reflect the actual financial situation of the electricity operation; the allocation of a large amount of expenses arising from the overhead function contradicted the municipality's own accounting analysis. The court stated that it was necessary to establish the allocation percentage using objective criteria. In the court's view, "fair and reasonable" methods can only be those that most accurately reflect the actual financial situation of an activity. The court referred to comments made by the SCC in *Canderel*, which considered the approach to be taken in determining an accurate picture of a taxpayer's income. The TCC concluded that the municipality's allocation method produced distorted results that were inconsistent with its own accounting information; in contrast, Revenue's method was developed with logical, objective criteria and was more compelling from a common-sense perspective.

The decision in *Ville de Magog* provides guidance on how a method to allocate expenses between taxable and exempt activities for GST purposes can be designed to satisfy the "fair and reasonable" requirement. There is a natural tendency to enhance the allocation of expenses to taxable activities and thereby increase GST recovery. That tendency may be reflected in the design of an allocation method, because that process is, in many ways, more of an art than a science and is inherently flexible because there are no specific statutory or regulatory requirements. While the determination of whether a method is fair and reasonable will always be a question of fact driven by the taxpayer's specific circumstances, a method that departs from the accounting treatment used for other purposes will be vulnerable to attack. As the TCC noted in *Royal Canadian Legion (Branch 164)*, an earlier decision dealing with allocation methods, the method used must be demonstrably impartial and logical; an allocation that departs from that standard is unlikely to withstand judicial scrutiny.

James Warnock
McMillan Binch, Toronto

ELECTION ON EMIGRATION TO US

A recently announced proposed change to the Canada-US tax treaty regarding deemed dispositions on departure leaves some questions unanswered. (See "Treaty Emigration Changes," *Canadian Tax Highlights*, October 24, 2000, at 74.)

Under the Canadian draft exit tax legislation, an individual who ceases to be a Canadian resident after October 1, 1996 is deemed to have disposed of most of his or her property, including taxable Canadian property. An appropriate election and the posting of security may defer the payment of tax (without interest) until an actual disposition occurs, when Canada will grant credit for taxes paid to the treaty country where the individual resides. That credit is an interim measure, pending agreement from treaty partners to recognize the Canadian exit tax. Under the proposed treaty change, an individual emigrating to the United States may elect a deemed disposition and reacquisition of the property at FMV for US tax purposes, eliminating the potential for double taxation and the need for a foreign tax credit in Canada. But such an election accelerates the US tax on US real property interests; the Finance release states that the new rule ensures appropriate tax crediting if tax is triggered in the destination country. It is not clear from the release whether an individual who does not elect can still claim the credit under the Canadian draft exit tax legislation. An election by a Canadian-resident US citizen emigrating to the United States also accelerates US tax; it is also uncertain how the new rule applies in that case.

Allan R. Lanthier
Ernst & Young LLP, Montreal

NSULCS FOR CANADIAN TAX

Cross-border investments using a Nova Scotia unlimited liability company (NSULC) are usually undertaken for US tax treasons, because the NSULC is a flowthrough entity for US tax purposes. Thus an NSULC may seem to be just one of several vehicles for US investors—along with an association, partnership, or joint venture with a Canadian resident—but with the added complication of incorporating a separate entity. However, there are often Canadian tax advantages to the NSULC structure that should be considered.

At least two significant Canadian tax advantages of an NSULC may be relevant. Interest that is deductible to a Canco, including an NSULC, and paid by it to an arm's-length US lender that loaned the funds for more than five years, may not be subject to withholding tax. Interest paid in similar circumstances by a Canadian partnership or association probably will be subject to withholding tax. Furthermore, the withholding tax rate on dividends paid by a Canco, including an NSULC, to a US connected corporation is 5 percent, substantially less than the withholding tax on receipts from the activity carried on by the non-resident in Canada.

Willard Strug
Blois Nickerson, Halifax

MULTINATIONAL SERVICE FIRMS

Professional, consulting, and other service providers such as banks have expanded their global practices to better service other multinational businesses. Accounting firms and their related consulting businesses were leaders in spanning the world; other consulting firms, engineering firms, and law firms have also formed global firms. A host of legal and tax considerations are involved in the combination of professional practices.

- Licensing restrictions may require that all partners qualify to practise in the jurisdiction; accounting firms have formed tandem professional and consulting practices with different regulatory requirements. (Perceived conflicts for US auditing firms have triggered spinoffs of consulting practices.) Some jurisdictions permit professionals to incorporate.
- A global name may be ruled out in a jurisdiction that requires, for example, a firm to use only the names of (former) firm members.
- A larger firm may mean more and larger malpractice lawsuits, and perhaps exposure arising in other jurisdictions.
- Differences in billing practices, cost of living, work practices, and firm cultures, as well as foreign currency differentials, create challenges.
- Tax laws governing the treatment of the entity providing the services and its members will affect the dissolution and combination of businesses or the entity and the admission or withdrawal of partners, as well as the annual tax treatment of the entity and its members, such as reporting of income, timing of recognition of income, and the treatment of foreign currency transactions.
- Corporate governance of a multinational professional or consulting firm is complicated and highly political.

Operating internationally may be accomplished by a separate entity's joining an international affiliation for an annual fee and possibly a referral fee for the use of member services. Members may indicate affiliation on firm letterhead. A closer association may be reached by separate entities using the same or a similar name, perhaps under regional partnerships that pay fees to a central organization. Transfer pricing, withholding

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Canadian Tax Foundation
595 Bay Street, Suite 1200
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Telephone: (416) 599-0283
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Internet: http://www.ctf.ca
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tax (on management fees), and whether each partnership or their partners carry on business may be issues. Alternatively, several separate firms may combine in part—for example, by sharing the cost and profits of international offices. The most ambitious approach is to form a new entity of two or more firms from different jurisdictions or absorb them into one of the firms' current structure. The tax issues surrounding arrangements that may involve tiers of joint ventures or partnerships or corporations and subs will be examined separately in next month's issue.

If predecessors form a single entity, the laws of each jurisdiction must be examined to determine whether accelerated tax on a deemed sale of the entities' assets or the partnership interests can be avoided. The choice of a jurisdiction for the common entity will be affected by realities such as the place of management and the tax treatment of the entity and its members where it conducts business. A hybrid entity may be a partnership in one jurisdiction and a corporation in another. The consistency of income recognition between jurisdictions may raise issues: fiscal year-ends and the computation and reporting of income may vary. The flexibility to allow for different subsidiary entities may yield favourable tax treatment locally. Withholding tax may apply on payments to and from the entity: maximizing foreign tax credits may be problematic. Residence, treaty protection, capitalization structures, and corporate and branch tax may also be relevant. The entity must decide whether customers or clients will be billed locally or by an international entity. Profit sharing is important: local members may draw salaries or share local profits with equalization payments to accommodate international profit sharing; alternatively, the international entity may make all distributions. The structuring of leases, property acquisitions, and banking arrangements must also be considered.

Jack Bernstein
Aird & Berlis, Toronto

Foreign Tax News

Treaties

Canada's treaty with the Grand Duchy of **Luxembourg** entered into force on October 17,2000, effective January 1, 2001. During a trade mission to Eastern Europe, International Trade Minister Pierre Pettigrew signed a tax treaty with the Republic of **Slovenia** on September 15, 2000.

Tax Havens

An October OECD release announced that the 23 of the 35 identified jurisdictions that have indicated an interest in discussing their unfair tax practices have been invited to a series of meetings in November. Those meetings will focus discussion on exchange-of-information issues.

In the meantime, the OECD recently listed Monaco as a harmful tax jurisdiction. The OECD's 1998 report establishes four identifying factors: no taxation on income; no effective exchange-of-information rules; no transparency in administrative practices; and no requirement that an entity have substantial versus tax-driven activities. Caricom, a 14-member group of Caribbean countries, plans to seek the help of the World Trade Organization in mediating with the OECD. Affected British Commonwealth countries are meeting to discuss their dissatisfaction with the OECD's position on tax havens and to establish a consensus on related issues.

South Africa

To encourage foreign entities to set up regional headquarters in South Africa, the finance minister proposed income tax incentives establishing an international headquarters company (IHC). An IHC's entire equity share capital must be held by non-residents. Indirect interests by residents or trusts may not exceed 5 percent and 90 percent of an IHC's assets must be equity in or loans to non-resident subs. The proposals eliminate tax on an IHC's foreign dividend income and its share of the net income in controlled foreign entities; an IHC is not liable for the secondary tax on dividends declared by it.

Carol Mohammed
Canadian Tax Foundation, Toronto

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