Canadian Tax Highlights

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Revenue's New DRUPA Position

In a new technical interpretation (TI), Revenue characterizes a partnership formed under the Delaware Revised Uniform Partnership Act (DRUPA) as a partnership for Canadian tax purposes, a shift from its previous conclusion that the vehicle was a corporation.

Revenue now indicates that it has "fully analysed the attributes of the entity governed by the DRUPA and compared them to the attributes of a Canadian partnership and a Canadian corporation." In Revenue's view, "the attributes of an entity formed under the DRUPA more closely resemble those of a Canadian general partnership under [Canadian] common law and, as such, an entity governed by the DRUPA would be treated as a partnership for Canadian income tax purposes. Furthermore, it is [Revenue's] view that the existence of a separate legal entity clause contained in foreign partnership legislation would not, in and by itself, preclude an arrangement from being considered as a partnership for purposes of the Canadian *Income Tax Act*."

Although Revenue does not indicate what attributes in particular it focused on, it is helpful to know that a separate legal entity clause is not determinative. Revenue's new position is welcome news, given that Delaware is the preferred jurisdiction for entity formation in the United States and that the previous TI threatened to create a host of practical problems.

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US Partnership Status

During November 2000, Revenue issued technical interpretations (TIs) confirming that a partnership governed by the Delaware Revised Uniform Partnership Act (DRUPA) is a partnership—not a corporation—for Canadian tax purposes.

Subject to transitional rules, DRUPA governs all Delaware general partnerships formed after 1999. A DRUPA partnership has a number of attributes consistent with the entity theory of partnerships: for example, DRUPA declares that such a partnership is a separate legal entity distinct from its partners unless it opts out of such status by following certain procedures. The TIs' approach—weighing all of a vehicle's attributes under local law against a Canadian partnership's and corporation's attributes—is consistent with Revenue's longstanding administrative positions and practice. The TIs' conclusion is also technically sound. The revised Uniform Partnership Act (RUPA) was introduced as a model statute in the United States in 1994 and has been adopted in modified form by numerous US states, including Delaware. Even before RUPA, several states generally regarded partnerships as separate legal entities. For about a century, US partnership legislation reflected an amalgam of the entity and aggregate theories of partnerships. Although RUPA may be said to favour the entity theory, it also retains important aspects of the aggregate theory, including the personal liability of partners and the dissolution of a firm when a partner disassociates. Another US model statute applicable to limited partnerships also provides for separate legal personality and has been enacted by many states. Thus the conclusion in the TIs that separate legal entity status is not determinative eliminates considerable uncertainty otherwise surrounding the characterization of most US partnerships.

The TIs are also consistent with Revenue's longstanding approach to the meaning of the term "corporation," generally considered to be an entity created by statute and having a separate legal personality. A partnership, including a DRUPA partnership, is not created by statute: it is formed by private contract between the parties and is thus fundamentally different from joint stock companies or business corporations.

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BONUS MAY BE MISNOMER

Revenue's longstanding administrative policy is to not challenge the reasonability of salaries and bonuses paid to a corporation's principal shareholder-managers in one of two cases: where the corporation's general practice is to distribute profits to its shareholder-managers as bonuses or additional salaries, or where the company's policy is to declare bonuses to the shareholders to remunerate them for profits attributable to their special knowhow, connections, or entrepreneurial skills. Revenue's policy forms the foundation of tax planning for successful owner-managed corporations that bonus down to the annual $200,000 small business limit, a practical solution to the lack of integration for the excess active business income and an offset against the bias in favour of unincorporated businesses. Two recent technical interpretations (TIs) introduce significant doubt regarding the future of Revenue's policy.

Differences over reasonability in non-arm's-length fact patterns can lead to long and difficult discussions and uncertain outcomes. Equally alarming, it seems that Revenue is discriminating against certain corporate structures rather than focusing on the value the manager brings to the employer. An April 10, 2000 TI indicates that Revenue's policy does not apply if the Opco shares are owned by Holdcos that are in turn owned by discretionary family trusts for the families of the owner-managers. The TI says that because the managers are not direct shareholders, the normal tests of reasonableness are used to judge the acceptability of salaries and bonuses. It is not clear why direct shareholding should be a precondition because the bonus was paid directly to the entrepreneur, leaving no room for deferral or income splitting. (See "New Reasonableness Test?" *Canadian Tax Highlights*, July 25, 2000, at 51.) The more recent TI of August 28, 2000 indicates that the administrative position generally continues to apply if the Opco shares are held through Holdcos 100 percent owned by the "owner-managers." Apparently the interposition of a holdco does not rule out the application of the admin policy even though the manager is not a direct shareholder in Opco, so long as "the existence of the holding company or companies does not result in a different relationship between the shareholder-managers and Opco." (Doc. nos. 2000-0013085 and 2000-0016035, respectively.)

These two interpretations only raise questions as to the policy's application. The defining difference is unclear: in particular, it is not clear whether the policy's application is affected by whether the trust is discretionary; who the trustees and beneficiaries are; whether the structure arose in an estate freeze by the former owner-manager in favour of the trust; whether the shareholder composition of the holdco includes other (family member) shareholders; and whether the manager owns some Opco shares directly while others are held by the trust or a holdco.

Informally, rulings personnel have said only that it was the involvement of the family trusts in the April TI that caused their concern: the ownership of shares by the holdco alone was a much "cleaner" structure. Revenue can expect further questions attempting to delineate a body of acceptable structures and to discern the reasons behind the distinction between the two TIs. In the interim, practitioners should view these TIs in light of the decision in *Safety Boss*, which indicates that the direct shareholding test may not be critical (TCC 2000; see "Fire and Rain," *Canadian Tax Highlights*, March 28, 2000, at 17).

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TRADITIONS

In any comparison of tax levels across provinces, Alberta always claims the lowest and Quebec the highest. The recent Statistics Canada release of provincial economic accounts shows that this pattern still held in 1998.

The table shows that in 1998, the latest year for which complete information is available, all tax collections in Quebec equalled 41.1 percent of gross domestic provincial product (GDPP). Tax collections in the Northwest Territories (which included Nunavut in 1998) were the lowest at 23.0 percent of GDPP; but out of all the provinces, Alberta showed the lowest ratio at 30.5 percent.

Personal income taxes ranged from a low of 12.2 percent of GDPP in Saskatchewan to a high of 15.2 percent in Quebec, while corporate income taxes were least important in Nova Scotia—1.8 percent of GDPP—and most important in Alberta—3.7 percent. General sales taxes (including special taxes on alcoholic beverages, tobacco, and motor vehicle fuel) in those provinces that levy a provincial sales tax ranged from 5.6 percent of GDPP in Saskatchewan and Ontario to 8.4 percent in Prince Edward Island. Combined provincial and local property taxes equalled a low of 1.2 percent of GDPP in Newfoundland and a high of 4.2 percent in Ontario. Social insurance levies, which include the Canada and Quebec pension plan levies, employment insurance levies, and premiums of provincial workers' compensation programs, ranged from 3.8 percent of GDPP in Alberta to 5.5 percent in Prince Edward Island (5.8 percent in the Yukon and 5.6 percent in the Northwest Territories).

The same information is available by level of government, but interprovincial comparisons are less useful in that context. For example, the federal tax burden in

Taxes as a Percentage of GDPP,1998

Province	Taxes on personal income	Corporate income	General sales	Property	Social insurance levies	Total all taxes
Nfld.	12.9	1.9	7.1	1.2	5.4	34.8
PEI	13.7	2.4	8.4	2.5	5.5	38.9
NS	14.5	1.8	6.6	2.7	5.3	36.1
NB	13.1	2.2	6.2	3.1	5.1	34.3
Que.	15.2	3.4	6.1	3.2	5.4	41.1
Ont.	14.5	3.6	5.6	4.2	4.8	37.8
Man.	14.1	2.0	6.0	3.8	4.9	36.6
Sask.	12.2	2.1	5.6	3.6	4.1	34.1
Alta.	13.3	3.7	2.7	2.8	3.8	30.5
BC	14.3	2.5	6.3	3.2	5.2	36.3
Yukon	10.2	5.7	3.5	2.2	5.8	31.4
NWT and Nunavut . .	9.0	1.0	2.7	1.7	5.6	23.0
Average	14.3	3.2	5.5	3.6	4.9	37.1

Quebec at 16.2 percent of GDPP is lower than in all provinces east of the Ontario-Manitoba border except Newfoundland, mainly because federal personal income tax collections in Quebec are reduced by the special abatement for the opting-out arrangements. Provincial taxes in Quebec amounted to 19.0 percent of GDPP, nearly double the 9.9 percent figure recorded in Alberta. Quebec personal income taxes are higher to absorb the value of the federal tax forgone through the abatement. Similarly, local taxes varied from 1.2 percent of GDPP in Prince Edward Island to 4.4 percent of GDPP in Ontario—as much a reflection of the distribution of tax and spending responsibilities between provincial and local levels as of the intensity of the tax squeeze.

These ratios may be misleading, however. High ratios may mean that the rates (the numerators) are high, or that gross domestic provincial product is below average (the denominators are small). Fortunately, there are other measures of tax capacity and tax effort, which will be the subject of later articles. Furthermore, these tax comparisons do not take into account variations in the level of services or the extent to which public services may be financed out of user fees.

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Accounting for Tax Cuts

The February 2000 federal budget and the October 18, 2000 mini-budget proposed reductions in corporate income tax rates and the capital gains inclusion rate. The calling of a federal election before these proposals became law raises questions about their impact on companies' financial statements under the new CICA *Handbook* section 3465, "Income Taxes."

The new accounting for income tax standards in CICA 3465 replaces the old deferred tax regime and largely brings Canadian standards into conformity with US and international standards. The new standard is mandatory for fiscal years beginning after 1999 and for public companies for their first quarter after 1999. As a result of the election call, most of the February 2000 budget proposals and all of the mini-budget tax proposals died on the order paper and must be reintroduced in the next sitting of Parliament before they become law. Normally, budget proposals are considered "substantively enacted" before they become law if they are expressed in sufficient detail to be understood and applied in practice, are drafted in legislative form, and are tabled in Parliament.

The CICA Emerging Issues Committee (EIC) recently released a notice stating that the mini-budget tax proposals should not be considered substantively enacted, but that taxpayers may continue to treat the February 2000 budget proposals as substantively enacted. The budgets are being treated differently because the February 2000 proposals were already identified as substantively enacted in the EIC-111 guidance. The problem arises because CICA 3465 and EIC-111 do not mention how to deal with uncertainties that arise after proposals are considered to be substantively enacted.

As a result, companies should not adjust future income tax assets or liabilities based on the announcements in the mini-budget. However, in their third quarter companies need not adjust future income tax assets or liabilities to reverse out adjustments that they made in the first quarter of the year to reflect the February 2000 budget. Corporations that have not yet adopted CICA 3465 but will be doing so in the next few months (such as publicly traded companies with September 2000 or October 2000 year-ends) should not reflect the impact of either the 2000 federal budget or the mini-budget in the CICA 3465 transitional amount (that is, the adjustment to retained earnings required to reflect the retroactive impact of CICA 3465). The EIC plans to meet after the federal election to review this matter.

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Offshore Credit Card Data

US citizens and residents who held credit card accounts issued in 1998 or 1999 by banks in the Bahamas, the Cayman Islands, and/or Antigua, and particularly those individuals who did not disclose the existence of those accounts in their US tax returns, should not be surprised if they are investigated by the IRS in the near future. In a widespread effort to uncover what the IRS perceives to be US tax evasion in offshore tax havens, the IRS recently won a court victory giving it the right to access MasterCard and American Express credit card information with respect to accounts issued in those years to US taxpayers by banks in those three countries.

A US district court in Miami agreed with the IRS that it may access such account information on the grounds that US cardholders may have violated US tax laws and their identities are not readily available from other sources. The IRS believes that credit card and debit cards issued by offshore banks have aided individuals who wish to improperly hide their assets from the IRS, because the cards reduce or eliminate the paper trail arising from the individuals' use of offshore accounts. Before the introduction of such cards, some US taxpayers may have been reluctant to hold accounts in offshore banks because accessing the accounts could leave a paper trail of cheques, telephone communications, etc. Credit and debit cards, on the other hand, apparently allow customers to make purchases, pay for travel, and get cash from offshore accounts without leaving a paper trail; such accounts are being advertised and promoted by the offshore banks for that very reason. According to the IRS, the three countries at issue were chosen because they are representative of other Caribbean tax havens and are believed to have substantial traffic with US persons. Presumably the IRS will compare the credit card information with the US tax returns of the cardholders to be sure they have made proper declarations.

There is nothing illegal or improper about US citizens and residents holding bank accounts or other financial accounts in foreign countries. However, the existence of such accounts must generally be disclosed in the individual's US tax returns (at the bottom of schedule B of form 1040) if the account balance exceeds $10,000 at any time during the year. Annual filings are also required with the Department of Treasury (on form TD F 90-22.1) by US taxpayers whose foreign accounts exceed the $10,000 threshold. Furthermore, interest income generated from the offshore accounts must be reported on US citizens' and residents' US tax returns and is generally currently taxable to them, even if the accounts are held through foreign corporations, foreign trusts, or other foreign entities. Thus there is really no US tax advantage to holding funds in offshore bank accounts as opposed to US bank accounts. However, a Canadian-resident non-US citizen who plans to move to the United States and take up residence may be able to avoid US income tax on earnings from offshore accounts by holding them through properly structured foreign trusts. Avoiding tax on income from offshore accounts can be difficult if the pre-immigration trusts are set up within five years of the individual's moving to the United States. But regardless of when the trusts are established relative to immigration, a Canadian immigrant's pre-immigration trusts are more likely to be successful at insulating the accounts from US estate tax than from US income tax.

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Unforgiving Debt Rules

In the course of reorganizations that involve the acquisition of control of a debtor corporation and a restructuring of debt, several traps and opportunities come into play.

A key concern is to prevent a deemed settlement of the debt via the debt-parking rules. The rules were introduced to block the deferral or avoidance of section 80's application by parking certain debt—a specified obligation—that would otherwise be forgiven in a company that either is not at arm's length with the debtor or has a significant interest in it. A significant interest is defined as ownership of 25 percent of the votes and value by a person and related parties. A specified obligation is generally a debt that was previously owned by a person who dealt at arm's length with the debtor or who did not have a significant interest in the debtor, or who acquired the debt from an unrelated person. A debt is also a specified obligation at a particular time if it is deemed reacquired by the holder under subsection 50(1) following a bad debt claim. If a commercial debt obligation becomes a parked obligation and its specified cost to the holder is then less than 80 percent of its principal amount, it is deemed settled for the specified cost; in consequence, the tax balances of the debtor are reduced. The application of the debt-parking rules can be avoided if the holder does not elect to claim a bad debt, or if the debt's holder deals at arm's length with the debtor corporation and does not hold a specified interest in it. Care should be taken not to cause the debt-parking rules to apply, for example, because the debt holders obtain rights to acquire shares of the debtor as part of the restructuring: the debt holders and the debtor are deemed related in such circumstances.

If control is acquired of a debtor corporation that does not have the ability to repay its debt, the decision must be made as to whether to forgive debt before or after the control change. Forgiven amounts are applied first to reduce non-capital and capital losses of previous years. A non-capital loss incurred in a particular year is not reduced by debt forgiven in that same year. Accordingly, to preserve non-capital losses incurred in the current period either from operations or because of the deemed writedown rules on a go-forward basis, it may be advantageous to forgive debt before the acquisition of control if the debtor corporation has prior-year capital losses or property losses that might otherwise expire after the acquisition of control.

In other circumstances, forgiving debt after an acquisition of control may be beneficial. Assume that Target is about to undergo an acquisition of control, has significant non-capital losses, and owns depreciable property that can be written up in value from its tax cost to fair market value through the elective rules of paragraph 111(4)(e). Further assume that capital losses will be triggered in Target immediately before the acquisition of control because Target owns shares of a subsidiary that is under water. If debt forgiveness is deferred until after the change in control, non-capital losses that are otherwise eliminated if the debt is forgiven before the acquisition of control can effectively be preserved and converted to undepreciated capital cost (UCC) going forward. Upon the acquisition of control, the deemed writedown rules trigger a capital loss in Target in respect of the underwater subsidiary shares for the period immediately before the acquisition of control. If the debt forgiveness is delayed until after the acquisition of control, the tax hit to Target on the forgiveness is absorbed by the capital loss that would otherwise expire. This result follows because the forgiven amount is applied first to reduce capital losses that were available for carryforward into the year when the acquisition of control occurred; only after those losses are exhausted is the UCC reduced by any excess. And for this purpose, capital losses—the relevant loss balance—include losses that expire for other purposes, such as for carryforward into years after the acquisition of control. If the debt forgiveness occurs in the same year as the acquisition of control, the capital loss triggered on the deemed writedown of the underwater shares is not included in the relevant loss balance from prior years, and is thus not available to save Target's UCC from being eliminated by the amount of the debt forgiven.

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GO FIGURE

Recent cuts to the capital gains inclusion rate complicate the preparation of many 2000 tax returns. The February 2000 federal budget reduced the income inclusion to two-thirds; the October 18, 2000 mini-budget pledged a reduction to one-half. As a result, a different rate applies to each of three periods in 2000: 75 percent (January 1 to February 27, period 1); 66⅔ percent (the subsequent period to October 17, period 2); and 50 percent (the balance of the year, period 3). Those with gains or losses in more than one period—including gains allocated by mutual funds, but excluding gains triggered by certain donations—must follow a complicated procedure to determine their effective inclusion rate for the 2000 taxation year.

Mutual funds, segregated funds, and other trusts. As Finance earlier promised the industry, the mini-budget announced that mutual fund trusts and seg fund trusts may treat capital gains and losses for the year as being earned pro rata per diem to calculate net capital gains or losses attributable to a particular period in the year. These amounts are then used to determine the fund's effective capital gains inclusion rate for the year, which rate affects the determination of the percentage used in calculating the fund's capital gains refund for the year. Gross gains allocated to the unit holders for the year are allocated to periods in proportions consistent with the basis adopted by the mutual fund to allocate its gains to such periods. The mutual fund must report to the unit holders the portion of gains allocable to the relevant periods in the income tax information slips issued for

SHOE ***by Jeff MacNelly***

the year. Taxpayers then add the allocated amounts to their gains or losses otherwise realized in each period to calculate their effective inclusion rate for the year. Apparently Finance now plans to grant this special optional method to all trusts. However, eligible personal trusts must have a gain in each period, a limitation designed to prevent a personal trust with a large period 1 gain from using the optional method to reduce its inclusion rate.

Charitable donations. The capital gains inclusion rate is cut in half for capital gains from certain charitable donations of publicly traded securities and ecologically sensitive property. Finance says that the rate that is halved is the unblended rate for the period when the gift occurred, not the effective inclusion rate otherwise determined for the year. For example, the inclusion rate for a gain triggered by a donation on November 1, 2000 is 25 percent, one-half of 50 percent. Thus gains from such charitable donations are isolated from the non-donation net gains or losses in each period when determining the taxpayer's effective inclusion rate of other 2000 capital gains and losses.

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Reflections on Balance Sheets

The recent decision of the TCC in *PCL Construction* provides further guidelines to determine amounts included in capital under the large corporations tax (LCT) under part I.3.

A corporation's LCT capital is generally determined using the amounts "reflected in the balance sheet" that is presented to the shareholders of the corporation; if the balance sheet is not prepared or is not prepared in accordance with GAAP, then the relevant amounts are those that would have been reflected in a balance sheet prepared in accordance with GAAP.

In *PCL Construction*, a liability disclosed on the taxpayer's balance sheet was entitled "Unearned revenues and contract advances." The account balance resulted from numerous invoices sent to clients relating to construction project contracts; the total of the invoiced amounts exceeded the aggregate costs incurred and the profit recognized in connection with those projects up to the date of the balance sheet. The court relied heavily on expert accounting testimony based on "authoritative CICA publications" to determine whether the items in the account created an advance within the meaning of part I.3 and was thus included in LCT capital. The court relied on the Ontario Court of Appeal's decision in *Upper Lakes Shipping* to support the notion that, if not GAAP, then at least the "language accountants speak" must govern the characterization of amounts for purposes of part I.3. The expert witness whose analysis was accepted relied heavily on the CICA *Handbook* and the CICA's *Terminology for Accountants*. The court affirmed that legal characterization is supplanted by accounting concepts in a "provision [that] defines and taxes corporate capital," rejecting the Crown's argument that the SCC's decision in *Canderel* led to the opposite conclusion.

Ultimately, the court concluded that an advance must be received. The account in question contained many invoiced but unpaid amounts. In order to include the amounts received as advances, the court looked behind the balance sheet to divide the global account balance into amounts that were advances and those that were not. The court found the authority for this proposition in the provision's requirement that the relevant amounts are those "reflected in the balance sheet," not those "appearing in the balance sheet." The amount of advances did not appear separately on the balance sheet, but the court concluded that the advances were reflected in the balance sheet as an identifiable component of the global figure that appeared on the balance sheet's face.

Note: PCL was heard on July 24, 2000 and is now under appeal; the other cases were reported in 98 DTC 6264 and 98 DTC 6100, respectively.

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Multinational Service Firms, Part 2

The globalization of consulting and professional practices creates a host of legal and tax considerations. Last month's article focused on non-tax matters; this article looks at tax issues of using joint ventures, partnerships, and corporations. (See "Multinational Service Firms," *Canadian Tax Highlights*, November 28, 2000, at 87.)

Joint venture. A joint venture arrangement shares expenses, including referral fees, but not all profits and losses. Assets may be retained by each party: there is no roll-in for a transfer of taxable Canadian property (TCP) or by a Canadian resident, and no rollout. A co-venturer who is an individual or a partnership of individuals has a calendar year-end. Each co-venturer claims depreciation and incurs losses and is liable for its own debts.

Partnership. Partners share income and losses and are jointly and severally liable for partnership debts. A partnership is generally a flowthrough entity: income or loss is allocated to the partners for tax purposes. A partnership with an individual partner has a calendar year-end. A partnership may have individual, corporate, or partnership members. Partnerships in other jurisdictions may not be partnerships for Canadian tax purposes: a US limited liability corporation (LLC) is a corporation for Canadian tax purposes, and Revenue now says that Delaware Revised Uniform Partnership Act (DRUPA) partnerships are partnerships. (See "Revenue's New DRUPA Position," above.)

A non-resident partner is generally taxable only on his share of the Canadian-source income and capital gains from the disposition of TCP. Although a Canadian resident is taxed on an actual or deemed disposition of a partnership interest (for example, the ACB goes negative), a resident of a treaty jurisdiction is not taxable unless the partnership derives most of its value from real estate. A partner is taxable on capital gains related to partnership property; a treaty may exempt a non-resident partner unless the property is Canadian real estate or personalty used in a Canadian business. A foreign corporate partner in a partnership carrying on business in Canada is liable for income and branch taxes.

The 25 percent withholding tax on passive payments applies if a partnership has at least one non-resident member; resident partners may claim a tax credit for their share of the tax. Regulation 805(1) protects a non-resident partner from double Canadian tax, eliminating withholding tax for amounts reasonably attributed to the business carried on through a Canadian PE: the business income is taxable in Canada.

A Canadian-resident partner is taxable on his share of the partnership worldwide income; foreign tax may be creditable on his return. If the partnership owns shares of a foreign corporation (Forco), the Canadian partners may need to accrue its FAPI, generally passive income, if Forco is a contolled foreign affiliate (CFA): control may reside in a related group or an unrelated group of up to five persons. If Forco is a foreign investment entity—not more than 50 percent of the carrying value of its assets is in active business assets—in 2001 its income must be accrued or the annual increase in share value reported on the mark-to-market method. A dividend from active business earnings of a Forco in a treaty jurisdiction is ordinary income to an individual partner.

Unless a treaty specifies, it is not clear whether a non-Canadian partnership can benefit from any reciprocal tax treaties: it must be liable to tax to be a treaty resident. Revenue allows a US LLC to benefit from the Canada-US treaty only if it elects to be taxed as a corporation. As a result of this uncertainty, it is difficult to argue that a foreign partnership may benefit from treaty-reduced Canadian withholding tax or from the treaty relief available for business profits if there is no permanent establishment. Canada looks through a partnership and grants treaty relief to partners resident in treaty countries, but will not reduce withholding on dividends below 15 percent.

Corporation. Some professionals or consultants may incorporate. Others may only incorporate the management of the practice, as in Tridont's attempt several years ago for Canadian medical and dental practices. US Apple Orthodontics, a public company, effectively purchased a 50 percent interest in orthodontic practices around North America.

A Canadian-resident partner or Canadian partnership cannot roll assets to a Forco. However, Forco may own the common shares of a Canco to which the Canadian partners roll their partnership interests or assets for preference shares—mirror or tracking shares—exchangeable for a predetermined amount of Forco's common treasury shares. Tax is deferred until the exchange.

If Canadian-resident partners invest in Forco shares through a Canadian holdco, they may be insulated from foreign estate tax; dividends out of exempt surplus of an FA avoid Canadian tax, but there is no foreign tax credit for related withholding tax. A Canadian taxpayer must accrue a CFA's FAPI; the accrual increases the shares' ACB and subsequent distribution does not trigger tax. An interest in a CFA or a foreign investment exceeding $100,000 must be reported for tax purposes. The proposed foreign investment entity rules do not apply if all of Forco's assets are used in an active business.

If Forco renders services in Canada, it may suffer 15 percent withholding tax on fees paid by Canadians, but it can credit that amount against Canadian corporate income tax and branch tax. If Forco has no Canadian PE and resides in a treaty jurisdiction, it may be treaty-exempt on management fees or other service income, which are generally treated as business profits—unless the treaty allows withholding on management fees. Maintaining an office wherever it carries on business may subject Forco to tax in each such jurisdiction, as well as where it maintains a head office.

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Departure Tax Negotiations

Under Canada's departure tax rules, a Canadian taxpayer relinquishing residence is generally deemed to dispose of his or her assets, including shares of closely held corporations, at their then fair market value (FMV). Any accrued capital gains deemed realized are subject to tax; an election may defer immediate payment. To measure the gains, the FMV of the emigré's shares at the date of departure is determined in the notional market under Canadian valuation rules, but if US residence is then established, the cost basis of the shares for US tax purposes is based on their original cost, not FMV. New income tax rules grant the Canadian a limited foreign tax credit against the departure tax for US taxes paid

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on a gain realized while he or she is a US resident, but Canada-US valuation differences raise issues. It is hoped that the current treaty negotiations will accommodate these differences.

■ Under Canadian tax law—like the pre-1987 US rules when the *General Utilities* doctrine was in effect—the cost of a Canadian holdco's shares may be bumped to FMV with no resulting tax on the built-in gain on the acquiree corporation's non-depreciable property. However, under the US rules, if there are trapped-in, accrued capital gains in the corporation, full taxes thereon are deducted in arriving at the FMV of the company's shares.

■ In determining the FMV of a company's shares, Revenue does not recognize a minority discount if the shares are held by members of a family-controlled corporation; in contrast, the IRS does not generally deny a discount. (*Information Circular* 89-3 and Revenue ruling 93-12.) Therefore, if the Canadian emigrant held minority shares in a family-controlled company, he or she is liable for departure tax on the non-minority-discounted value, the pro rata value. Double tax looms because the US cost base of the shares is set at an FMV that recognizes the minority discount and is thus lower than the deemed Canadian proceeds.

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Foreign Tax News

Treaties

Protocols to Canada's tax treaties with **Austria** and **Japan** were ratified on November 30 and 17, 2000, respectively. The Austria treaty enters into force January 29, 2001, effective March 1, 2001; the Japan treaty enters into force December 14, 2000, effective January 1, 2001.

Azerbaijan

After many years of drafting, the first tax code was passed by Parliament. The code contains administrative provisions and describes a three-level system: state taxes, taxes of an autonomous republic within Azerbaijan, and local taxes. "Resident" and "non-resident" are defined: for example, a non-resident has a PE in Azerbaijan only after carrying on business there for at least 90 days in any 12-month period, and an individual's presence in Azerbaijan for at least 182 days in any 12-month period establishes residence there. The top marginal individual tax rate is 35 percent; the profits tax remains at 27 percent; withholding rates are reduced from 20 percent to 15 percent; and the VAT rate is reduced from 20 percent to 18 percent.

Italy

New 2000 legislation affects many outbound international transactions. New rules attribute to Italian residents any income earned by a CFC located in a preferential tax jurisdiction—to be identified in a blacklist published by Finance—unless the taxpayer can prove that sheltering income was not the result of the arrangement or that the income is derived by a person primarily engaged in industrial or trading activities. The rules apply to a company, business, or other entity. A rule that excludes 95 percent of dividend income received from EU-resident corporations is extended to dividends from corporations resident in "whitelist" countries—countries with a level of taxation comparable to Italy's and an adequate exchange-of-information system. The repeal of the foreign-source earned income exclusion is itself repealed to avoid double taxation: new rules provide that the income from dependent personal services of residents working abroad for at least 183 days in a 12-month period is taxed on the basis of amounts established in an ad hoc ministerial decree and not on the basis of the actual amount of salary. Estate and gift tax rates are reduced, but gifts perfected abroad for Italian beneficiaries are taxable.

OECD

On November 24, the OECD released a memorandum of understanding to provide a framework to address tax policy issues arising with uncooperative listed tax havens. The memo clearly enunciates the steps required by these jurisdictions "in order to demonstrate commitment to transparency, non-discrimination and effective cooperation."

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NEW ON THE WEB

In mid-January 2001, the Canadian Tax Foundation Web site (www.ctf.ca and www.acef.ca) will have a new look. In addition, some sections of the site will be accessible only by member ID and password.

If you do not receive an e-mail on January 15 from the Foundation with your member ID and password, please contact Norma Forrester (nforrester@ctf.ca).