Canadian Tax Highlights

Editor: Vivien Morgan, LL.B.

Volume 9, Number 2, February 27, 2001

New OECD E-PE Commentary

Following a series of discussion drafts in 1999 and 2000, on December 22, 2000 the OECD adopted changes to its model treaty commentary on article 5 dealing with the permanent establishment (PE) definition in the context of e-commerce. (See "OECD on E-Business" and "E-PEs," *Canadian Tax Highlights*, November 23, 1999, at 81 and April 25, 2000, at 29, respectively.)

The commentary contrasts the operation of a server and a Web site by distinguishing the computer equipment from the software and electronic data processed by it. Although a Web site is stored on a server, it is an intangible with no physical presence in the foreign jurisdiction; thus there is no place of business, facility, or machinery giving rise to a PE, a position with which Spain and Portugal do not concur. Internet service providers (ISPs) engaged in hosting services are generally independent agents for the Web site operators they service and thus do not create PEs for their customers, unless they regularly exercise for them a general authority to contract. However, if the Web site operator owns or leases a server in a jurisdiction, the commentary says that the use of that equipment may give rise to a PE, settling the debate on whether a server should be viewed differently from other automated equipment. As in the case of oil-pumping equipment, the fact that no human presence is required to operate the equipment does not preclude a PE's existence: the reference to oil-pumping equipment arguably lowers the PE threshold below that of the previously analogized gaming or vending machines. Thus the degree and scope of economic activity carried on through the server are the determining factors; case-by-case analysis may lead to different interpretations by the various treaty partners. The United Kingdom takes the view that servers never constitute PEs and intends to make that observation in the commentary.

The debate on e-commerce PEs is not yet fully settled: another OECD technical advisory group (TAG) is considering whether in the e-context the PE definition should be modified or the concept abandoned, and is expected to release a draft report on related transfer-pricing issues this year. An article next month will comment on yet another TAG's February 2001 final report dealing with income characterization, which reflects a much broader consensus of members than the previous draft; the TAG has submitted modifications to the model treaty commentary to OECD Working Committee no. 1. (See "OECD Virtual Redraft," *Canadian Tax Highlights*, October 24, 2000, at 76.)

Pierre J. Bourgeois and Pierre Gonthier
PricewaterhouseCoopers LLP, Montreal

In This Issue

CTF ACEF
Canadian Tax Foundation
L'Association canadienne d'études fiscales

Draft IC on Civil Penalties

Revenue recently released the long-awaited information circular on civil penalties for tax advisers. (See "Third-Party Penalties: Consultations," *Canadian Tax Highlights*, July 25, 2000, at 49.) Although the draft guidelines were drawn up after extensive discussions and consultations between tax practitioners, taxpayers, and Revenue, many practitioners remain concerned about whether the penalties will be applied reasonably.

The IC outlines eight guiding principles concerning the legislative intention that Revenue says ensure fair and reasonable application.

■ The legislation is directed mainly at arrangements and plans that contain false statements, often without the client's knowledge—for example, certain tax shelter arrangements that are defective.

■ Advisers, tax return preparers, and promoters are targets if they make or participate in making false statements knowingly or in circumstances amounting to culpable conduct.

■ Tax return preparers and advisers who counsel and assist others in making false statements in their returns are also targets.

■ Regular day-to-day business activities and conventional tax-planning strategies that do not involve making false statements knowingly or evidencing culpable conduct should not be impeded.

■ Honest mistakes, oversights, and errors in judgment are not targeted.

■ The legislation is not intended to apply to differences of interpretation if a reasonable argument—one not obviously wrong—exists as to the law's application. Nor is it intended to apply to differences of opinion on such issues as capital gains versus income or personal expenses versus business expenses.

■ The legislation is not intended to create additional audit or verification work for accountants and lawyers conducting their affairs in accordance with professional standards.

■ Activities that Revenue accepts administratively as the correct application of the law—such as paying a bonus to the principal shareholder-manager or other key employees to reduce small business income to the small business deduction limit—should not attract penalties.

Elsewhere the IC notes that the penalties are not intended to apply to an otherwise technically effective arrangement that is struck down by GAAR (paragraph 75). The draft IC includes 17 examples of the penalty's application in a range of circumstances including good faith reliance, honest error, failure to ask questions, indifference as to whether the tax law is complied with, personal expense recorded as business expense, salaries and wages paid to family members, estate planning, inflated royalties, and transfer pricing. However, the examples and related commentary may be too theoretical to reassure tax practitioners that the penalties will be applied fairly and reasonably in real-life situations.

Revenue has also created procedural checks and balances, including a central penalty and review committee to review the facts of each case before proposing a penalty. Revenue says that the objective of civil penalties is to deter third parties from making false statements or omissions relating to tax matters, while recognizing that tax professionals' responsibility to act in their clients' best interests includes the right to legally minimize their clients' tax liability. Although it is comforting that Revenue acknowledges this responsibility, it may be many years before a clear administrative profile emerges. Ultimately the courts will interpret the matter in the event of a dispute. But in the meantime, tax advisers must decide whether it is prudent to incorporate additional documentation steps and procedures into their day-to-day tax practice routines to better defend against any possible civil penalty assessment. And in this vein it should be noted that the penalty may be assessed at any time with respect to any false statements made after June 29, 2000; no statutory limitation period applies.

Paul Hickey
KPMG LLP, Toronto

Employer-Provided Computers

Revenue recently ruled that an employer may deduct the monthly rental costs of a program to provide computers, printers, and Internet access to employees for use in their homes. Furthermore, Revenue ruled that the plan did not give rise to taxable employee benefits.

Revenue previously held that employer-subsidized computer purchase plans generate taxable benefits, and employees may not deduct CCA on computers or purchase-related interest costs. The summary of facts in the latest ruling says that several multinational corporations launched similar programs last year, and the ruling claims to be consistent with another ruling given for a similar program.

Revenue says that the program described in the ruling meets the guidelines for general employment-related training in the May 1998 *Income Tax Technical News* no. 13, "Employer-Paid Education Costs." The ITTN says that business-related courses—for example, on stress management, employment equity, first aid, and language skills—are generally non-taxable to the employee even if they are not directly related to the employer's business. This ruling adds to that list programs designed to promote computer literacy in the workforce. The ruling says that in the light of the rapid expansion of electronic communication, the program in question was designed to address the urgent need for employees to become fully computer-literate and to develop and maintain the electronic communication skills required to improve productivity, create more mobility in the workforce, and reduce costs.

The employer concluded that of several alternatives, the provision of a home computer and related Internet access would develop its employees' business technology skills on a user-friendly basis, enhance the dissemination of information across its network, and provide opportunities to streamline its business processes. The employer strongly believes that it will reap considerable business and commercial benefits. All employees are eligible. Participants pay a portion of the monthly costs—the percentage was "sanitized" out of the ruling—but no indication is given of this factor's importance. The employee contributions may demonstrate that the program was genuinely business-motivated rather than a disguised gift or additional remuneration.

Wayne Tunney and Lori Dunn
KPMG LLP, Toronto

Watch for the Icebergs

The focus on corporate income tax burdens obscures what the Mintz Committee pointed out nearly three years ago and what every business person knows: that income taxes are the least of the corporate tax department's worries. A recent study by the Conference Board of Canada entitled "Are Corporations in Canada Paying Their Dues?" shows that corporations paid about $125 billion in taxes, the equivalent of 13.2 percent of GDP, in 1999. The comparable figures from the Mintz report for 1995 were taxes of $84 billion, the equivalent of 10.4 percent of GDP. (See "Business Taxes," *Canadian Tax Highlights*, May 19, 1998, at 34.)

The table shows that income and capital taxes in 1999 accounted for only 32.5 percent of all taxes paid by corporations, a level well below the 50 percent share of 50 years ago but above the 28.5 percent share in 1995. The emergence of stronger profits in recent years and the broadening of the income tax base (as discussed last month) have raised the importance of income tax relative to profit-insensitive taxes such as those on payroll, property, and purchases. (See "Simple Patterns," *Canadian Tax Highlights*, January 23, 2001, at 2.)

Percentage Distribution of Business Taxes

	1999			1995
	Federal	Provincial/ local	Total	Total
Taxes on income and capital	47.9	22.9	32.5	28.5
Payroll taxes	38.5	23.8	29.5	26.7
Property taxes		26.6	16.3	17.9
Other taxes	13.6	26.8	21.7	26.9
Subtotal, non-income taxes	52.1	77.1	67.5	71.5
Total all taxes	100.0	100.0	100.0	100.0

Payroll taxes levied by the federal and provincial governments represented 29.5 percent of all taxes paid by corporations in 1999, up from only 6 percent in the 1950s and from 26.7 percent in 1995. Provincial and local property taxes decreased in relative importance from over 40 percent of the total tax bill in the 1950s to 17.9 percent in 1995 and continued to drop in relation to income taxes to 16.3 percent of all taxes in 1999. All other taxes, including sales and excise taxes and withholding taxes, made up 21.7 percent of the total tax bill in 1999, down from 26.9 percent 4 years earlier.

The Conference Board study continues the work of an earlier study, and that of the Mintz Committee, keeping information on the total tax bill of the corporate sector up to date. While the changes of the past 15 years in the corporate income tax system have been significant, the fact remains that the largest part of the total corporate tax burden is insensitive to profitability and irrelevant to the usual international comparisons of income tax rates or burdens.

David B. Perry
Canadian Tax Foundation, Toronto

UK Rejects Substance over Form

UK tax planners breathed a sigh of relief when the UK High Court in *Griffin v. Citibank* declined to give precedence to the substance of the transactions in issue over their form. *Griffin* should be considered in the light of recent Canadian decisions in *Shell* and *CP*.

The United Kingdom does not have a statutory anti-avoidance rule, and its courts have developed various anti-avoidance doctrines. The House of Lords first articulated the step transaction or fiscal nullity doctrine in *Ramsay*, clarifying its application in *Burmah Oil* and *Furniss v. Dawson*, and then in *Craven*, which summarized the relevant preconditions: "(1) that the series of transactions was, at the time when the intermediate transaction was entered into, pre-ordained in order to produce a given result; (2) that that transaction had no other purpose than tax mitigation; (3) that there was at that time no practical likelihood that the pre-planned events would not take place in the order ordained, so that the intermediate transaction was not even contemplated practically as having an independent life; and (4) that the pre-ordained events did in fact take place."

In *Griffin*, Citibank invested £150 million from the sale of a capital property for about 15 months (after which it intended to use the funds to repay a loan) not in an interest-bearing debt instrument, but in two equity-linked option contracts (a so-called "equity box") that produced a guaranteed return. Citibank reported the yield as a capital gain, not as interest income, and offset it against capital losses. The option contracts were "European" option contracts (exercisable only on the last day of their terms) with identical commencement and maturity dates that were linked to a European share index—a call option with a capped exercise price and a put option with a floored exercise price. Appropriate pricing of the options ensured a fixed return. The options were in standard form approved by the International Swap Dealers Association; for accounting purposes, Citibank treated them as options and not as a loan or deposit. Citibank exercised the options at the end of their terms.

Inland Revenue argued that the return was ordinary trading income, not a capital gain—the transaction was a single composite transaction for tax purposes, a loan, under the *Ramsay* doctrine—but admitted that each option in isolation qualified for capital gain treatment under a specific statutory provision. On appeal, the High Court found that *Craven*'s first and fourth requirements were met. But for the second requirement, the impugned transaction must be inserted into a series of transactions and be solely tax-motivated before it could be regarded as a fiscal nullity. The options in question were purchased, and there was no solely tax-motivated intermediary step. Furthermore, regarding the third requirement, the court found that each option had an independent existence because "there was always the [real, not merely theoretical] possibility that one option could be assigned before exercise." The court adopted a strict view of the judicial anti-avoidance doctrine.

> Only if one finds an integrated and interdependent series of transactions with no purpose other than the avoidance of tax can the Court ignore those steps in assessing the legal and fiscal effect of the composite transaction as a whole . . . If I were to accede to [Inland Revenue's] submissions, ignore the terms of each option contract which provide for its independent assignment and exercise, and concentrate on the fact that if exercised together the options are guaranteed to produce a fixed return in favour of the taxpayer, then it seems to me that I would be doing the very thing which [*Ramsay*] . . . emphasized . . . that the Courts cannot do: i.e. to go behind the transactions and search for some underlying substance which as a matter of ordinary legal analysis they do not possess.

The *Griffin* approach contrasts starkly with that in another recent UK case, *NMB Holdings*, in which benefits in kind—excluded from National Insurance contribution requirements—were treated as cash payments to directors although there were no tax-motivated intermediate steps to disregard. (*Griffin* [2000] SPC 1010; *NMB* [2000] EWJ No. 40.)

Sandra E. Jack and Donald K. Biberdorf
Felesky Flynn LLP, Calgary and Edmonton

ACCOUNTING FOR PUC INCREASES

Paid-up capital (PUC) can be an important element in tax planning, but its calculation is not always clear.

Before the recent lowering of the capital gains inclusion rate, structuring a sale of shares often involved a PUC increase to convert a capital gain to a taxable dividend. The corporation increases the shares' PUC, resulting in a taxable dividend to the shareholder and a bump in the shares' cost base. Even after rate changes, a PUC increase can still capitalize safe income before a sub's shares are sold. Dividend treatment may also be attractive for distributions between related companies and to a non-resident shareholder (withholding may be less than the section 116 tax). Other transactions such as stock dividends or share exchanges may achieve the same result, but a PUC increase offers a fairly simple and cost-effective mechanism.

PUC is a tax concept, an amount that the corporation can generally distribute tax-free to its shareholders. Determining PUC for a class of shares starts with its stated capital—or its par value in some jurisdictions—for corporate law purposes. Certain adjustments are required, mainly following reorganizations under section 51, 85, 85.1, 86, or 87. These sections generally limit the PUC on the class of any new share to the PUC of the old share or to the rolled property's ACB.

Section 24 of the Ontario Business Corporations Act (OBCA) requires that Ontario-incorporated corporations maintain a separate stated capital account for each class of shares. The directors must add to a class's stated capital account the full amount of the consideration received by the corporation on a share issue, or less on an issue to related parties. The directors may increase or reduce a class's capital, but the upper limit on increases is not clear. Section 24(5) limits stated capital increases to the amount previously credited to retained earnings or other surplus accounts, but the breadth of the rule's application is uncertain. Some commentators think that the rule applies only to corporations that existed when the OBCA came into effect or that subsequently continued thereunder: corporations incorporated thereunder are not so limited in their ability to increase PUC. Other commentators say that the provision governs adjustments to stated capital for pre-existing and continuing corporations to reflect OBCA rules; thereafter, like corporations incorporated under the OBCA, such corporations may only capitalize retained earnings and surplus accounts. This latter reading is not clear and is not supported by the general scheme of the OBCA. For example, if a stock dividend is paid, its full amount may be added to the stated capital without reference to the amount in retained earnings or other surplus accounts. Similarly, dividends paid in cash or property are not so limited, but must meet a solvency test that sets a ceiling of the realizable value of the corporation's assets in excess of liabilities and stated capital, including unrealized gains and, arguably, goodwill. It would be anomalous to interpret the legislation as restricting stated capital additions on issued shares to amounts less than the net realizable value of assets limit for stock and other dividends.

A limit on PUC increases for corporations incorporated under the OBCA to the amount in retained earnings and surplus accounts may not be problematic if a holdco capitalizes a sub's safe income before its sale, and if retained earnings in the financials mirror safe income for tax purposes. However, the interpretive uncertainty becomes an issue if the tax plan requires an increase in stated capital to the shares' FMV, comprising not only retained earnings and surplus accounts but also other unrealized gains and goodwill. In practice, surplus may be created through a reorganization. For example, if the shareholders transfer their shares to a holdco or effect an internal tax-deferred share exchange under section 85, contributed surplus may be created equal to the difference between the shares' FMV and their ACB, allowing an increase in stated capital and PUC. Alternatively, in some cases shares may be redeemed or purchased for cancellation, creating a deemed dividend in excess of retained earnings.

Jack Bernstein
Aird & Berlis, Toronto

ECP Election for Capital Gain

The October 2000 mini-budget and the February 2000 budget included income inclusion rate adjustments for dispositions of eligible capital property (ECP) consequential on the capital gains inclusion rate reductions to two-thirds and then one-half, respectively. Draft legislation released December 21, 2000 contains new measures concerning ECP.

Section 14 governs the treatment of expenditures and receipts in respect of ECP. The cumulative eligible capital account operates on a pooling basis. Three-quarters of eligible capital expenditures (ECE) fall into the cumulative eligible capital expenditure (CEC) account. ECE includes outlays or expenses made or incurred by taxpayers on account of capital (other than specified expenditures) for the purpose of gaining or producing income from a business, such as customer lists, goodwill, incorporation costs, farm quotas, and licences of indeterminate duration. A taxpayer may claim up to 7 percent of its CEC pool in a taxation year; a new measure introduces a short-taxation-year rule for taxation years ending after December 21, 2000.

For taxation years ending after February 27, 2000, a taxpayer may elect in its tax return for the year to effectively remove a particular eligible asset from the CEC pool and treat the related gain in the year from its disposition as a capital gain from ordinary non-depreciable property. The new measure recognizes that from time to time there may be circumstances in which a taxpayer may prefer to recognize either one-half or two-thirds of the capital gain on ECP: crediting the CEC pool for the requisite amount did not always provide an equitable result, particularly if the pool was large relative to the sale proceeds. For example, the taxpayer may choose to elect if it has available capital losses and wishes to conserve the CEC balance. This election is only available to recognize gains, not losses, and cannot be used for goodwill or other types of property for which an original cost cannot be determined or to recognize a capital gains that can be sheltered by the taxpayer's "exempt gain balance," an election regarding gains accrued to February 22, 1994. The provision applies to a particular ECP only if its proceeds exceed the cost of the ECP and the taxpayer's exempt gain balance is nil. Finance officials indicate that the goodwill carve-out applies even if the goodwill has a cost. Due to its amorphous nature, goodwill may fluctuate in value between the time of purchase and sale because the goodwill sold at a later date may be entirely different from the goodwill purchased. For example, there may have been a loss of customers since the original purchase took place and a shift in a business niche, a complexion that does not lend itself readily to an identification process. Accordingly, Finance is of the view that measuring the portion of the proceeds that should qualify for election treatment on a sale of goodwill is problematic. There are no plans at the moment for a prescribed form; the calculation is expected to be outlined in specific detail in the return.

John Jakolev
Ernst & Young LLP, Toronto

GST on Lease Inducements

Insurers may only claim limited GST input tax credits (ITCs) because they provide largely exempt services. The FCA in *London Life* allowed an insurer to claim ITCs for GST paid on leasehold improvement costs for which it had received tenant inducements. The court highlighted

JEFF MACNELLY'S SHOE by Chris Cassatt and Gary Brookins

the discrepancy between the Crown's position on appeal and Revenue's published position.

London Life received leasehold improvement allowances from its landlords, collected and remitted GST thereon, and then paid GST on the related construction inputs. But Revenue denied the claimed ITCs, saying that the improvements were acquired for use in an exempt insurance business. The TCC agreed: London Life did not undertake the leasehold improvements to make a supply to the landlord, but rather for use in its exempt insurance business. (See "Chinks in the Armour?" *Canadian Tax Highlights*, October 20, 1998, at 77.) Revenue's then published position said that the tenant was making a taxable supply of the improvements to the lessor in exchange for the payment (*Technical Information Bulletin* B-054). In August 1999, before London Life's appeal to the FCA was heard, Revenue refined its published policy to say that a tenant makes a taxable supply of the construction inputs such as the services of contractors and building materials to a landlord in consideration for an inducement payment (section 19.4.1 of the GST/HST memoranda series). The original bulletin said that ITCs could be claimed "to the extent the improvements were for use in a commercial activity," a phrase omitted from the 1999 revised policy.

At the FCA, London Life argued that the supply of leasehold improvements to its landlords was an activity separate and independent from its insurance operations, giving rise to ITCs. London Life was obliged under the leases to use the allowances to make the improvements, which became the landlords' property on completion. The rule governing ITCs for capital property improvements was held not to apply because their cost was not included in the leasehold interests' ACB. After reviewing the GST apportionment rules, the court held that the general ITC rule—which allows credits to the extent that property or services are acquired for use in commercial activities—applied because London Life was making a supply of taxable real property in the form of leasehold improvements and incurred the construction expenses to make that supply. Thus the apportionment rules deemed London Life to have incurred the expenses in the course of a commercial activity, and it was entitled to claim ITCs. The court contrasted Revenue's latest administrative policy, which appears to apply even if the tenant conducts an exempt business from the leased premises, with the earlier bulletin, which arguably denied ITCs in such circumstances. The court noted that Revenue failed to provide a satisfactory explanation for refusing to apply its new interpretation, a failure that called into question the validity of the Crown's argument on appeal. The FCA also said that allowing the ITCs was consistent with the basic principle underlying the Excise Tax Act that double taxation should be avoided.

The FCA carefully analyzed the ITC rules and concluded that the leasing transactions were to be viewed separately from London Life's exempt insurance business. Because London Life was regarded as making a taxable supply of improvements on which it must collect and remit GST from the landlords, the recovery of GST paid on expenses incurred in making the supply was appropriate; this analysis could have been made by the TCC even though Revenue's then stated policy appeared narrower. The FCA's approach also accords with Revenue's preference for financial institutions to apportion GST on expenses between taxable and exempt activities using the direct allocation method: GST paid on improvements was attributed directly to the supply to the landlords. The FCA's comments on Revenue's inconsistent policy and appeal positions will no doubt also prove useful.

James H. Warnock
McCarthy Tétrault, Toronto

Clothes Make the Man

Late in 2000, the FCA once again faced tax issues of work-related clothing, this time focusing on GST input tax credits (ITCs). Casual dress days for GST registrants may now take on new meaning.

In *Midland*, a Hutterite commune operated a farming business; members worked in return for shelter, education, food, and clothing from the colony. Members were allotted one type of fabric for church clothes and one other type for work clothes, a heavier material comprising 75 percent of the total. Members had no other clothes; church clothes were never used for farming and work clothes were never worn to church. The colony claimed a 50 percent ITC on GST related to the work fabric's purchase. Revenue's denial of the claim was upheld by the TCC.

Before the FCA the minister argued the SCC decision in *Symes*, saying that personal use of the clothing disqualified the work fabric for ITCs. The majority in the FCA observed that under the Income Tax Act personal use is an issue for deductibility or in determining whether an employee benefit exists: "Neither of these questions is relevant to this case." The GST rules contain a formula for apportioning ITCs when goods or services are "acquired . . . for use . . . in the course of commercial activities," but not for such use exclusively. The FCA said that that wording was unambiguous and that the only issue was the extent of the apportionment. In the absence of any finding at the TCC level, the fact that the claim was for only a 50 percent ITC was enough for the majority to conclude that the claim excluded any personal-use component.

The dissent concluded that the phrase "in the course of" was ambiguous and needed contextual interpretation.

The expenditure had "too tangential a connection with the production of taxable supplies" to be creditable: the fabric "was acquired for a use that satisfied the personal need of the members for warmth and decency." The dissent said that the majority's reasoning would allow ITC claims to GST registrants for ordinary business clothes because "clients are likely to have more confidence in them if they wear business suits, and the profitability of their practice or business is thereby enhanced." (*Midland* [2000] GSTR 2114.)

Rob Kreklewetz
Millar Wyslobicky Kreklewetz LLP, Toronto

Permanent Minimum Tax?

The validity of estate and succession planning has generally gone unchallenged by both Finance and Revenue. But a permanent alternative minimum tax (AMT) may result if a minor, who otherwise suffers only the split tax, uses his or her enhanced capital gains exemption (ECGE) against capital gains realized on qualified small business corporation shares or qualified farm property.

A minor's AMT credit can be carried forward for up to seven years to offset income tax otherwise payable and in excess of the then AMT liability. But AMT credits cannot offset split tax, which applies to certain income earned by minors. Therefore, if a minor's only source of income is dividends from private corporations, received directly or through an inter vivos family trust or partnership, any AMT paid on a crystallization of the minor's ECGE may become a permanent tax cost. (See "Minors' AMT Credits Languish," *Canadian Tax Highlights*, April 20, 1999, at 29.)

To avoid AMT, a taxpayer must crystallize less than the maximum ECGE. Before February 28, 2000, when the capital gains inclusion rate was 75 percent, a taxpayer with no other sources of income and only the basic personal tax credit available could crystallize up to about $189,000 of capital gains free of AMT; the non-taxable portion of the capital gains equalled the sum of his or her $40,000 AMT exemption and the AMT basic personal credit ($7,231 for 2000). The cutoff point dropped to about $141,700 of capital gains in the subsequent period through October 17, 2000, when a two-thirds inclusion rate applied. The new capital gain inclusion rate of 50 percent for post-October 17, 2000 capital gains further reduced the cutoff, but the backgrounder to the December 21, 2000 draft legislation announced that the AMT inclusion rate for capital gains is 80 percent, not 100 percent. Accordingly, for post-October 17, 2000 dispositions, up to about $158,000 of capital gains may escape AMT.

Louis J. Provenzano and Donald E. Carson
PricewaterhouseCoopers LLP, Toronto

Deemed Class Not a Class

A technical reading of subsection 84(3) and regulation 6201(2)(c) may lead to an anomalous result on the redemption of shares listed on a prescribed Canadian stock exchange and held by a specified financial institution (SFI). A recent technical interpretation corrects this situation.

If an SFI and non-arm's-length corporations own 10 percent or less of a class of shares of a corporation listed on a prescribed Canadian stock exchange, the shares are generally prescribed shares per regulation 6201(2). An ordinary dividend on such shares is generally deductible in computing the SFI's taxable income, but if it is deemed paid on a share redemption, subsection 84(3) deems a dividend to have been paid and received on "a separate class of shares comprising the shares so redeemed." If the term "class" in the regulation refers to the deemed class of shares, then the deemed dividend is not deductible: if only the SFI's shares were redeemed, it would receive the dividend in respect of 100 percent of the deemed class, more than the 10 percent of the "class" allowed by the prescribed share definition. This clearly anomalous and unintended result is eschewed in Revenue's TI, which says that "class" in the regulation refers to the actual class of shares listed on the exchange.

Mitchell Thaw
Fasken Martineau DuMoulin LLP, Toronto

Remuneration and Value

For private companies, shareholder-manager remuneration is largely tax-driven. Frequently the goal is to reduce the taxable income to the $200,000 level to maximize the small business deduction. Although taxpayers may sometimes find themselves at odds with Revenue when they argue that all the corporation's net income before bonuses is attributable to their efforts, they may be surprised to discover the effect on a valuation of the corporation.

If a business is being valued, it is the worth of the services rather than the amount booked that is relevant. Any difference could have a substantial effect on the valuation figure once a valuation multiple is applied to the adjusted true earnings of the business. For example, an additional bonus to the shareholder-manager of $500,000—say, $300,000 after corporate tax—can reduce FMV by over $2 million if a seven-times multiple is applied for valuation purposes. The level of remuneration that an uncompelled, arm's-length buyer would pay to maintain a proper management team following acquisition is an issue frequently debated by the taxpayers' and Revenue's valuators.

Recently the US 9th Circuit Court of Appeals in *LabelGraphics* affirmed a US Tax Court decision on the

Readers are invited to submit ideas or written material to *Canadian Tax Highlights*.
Please write to Vivien Morgan in care of the Canadian Tax Foundation.
Published monthly
Price: $13.33 per copy
Subscription rate: $160 per year

Canadian Tax Foundation
595 Bay Street, Suite 1200
Toronto, Canada M5G 2N5
Telephone: 416-599-0283
Facsimile: 416-599-9283
Internet: http://www.ctf.ca
ISSN 1192-2672 (Print)
ISSN 1496-4422 (Online)

deductibility of reasonable compensation for a taxpayer's president and sole shareholder. The same criteria apply for valuation purposes. The appeal court relied on five factors, none of which is decisive, from the 1983 *Elliotts* decision concerning reasonableness "from the perspective of a hypothetical independent investor": the employee's role in the company; a comparison of the employee's salary with salaries paid by similar companies for similar services; the character and condition of the company; potential conflicts of interest; and evidence of inconsistency in a company's treatment of payments to employees. In addition to the "Elliotts factors," the court compared the shareholder's compensation with that paid in the six preceding years and the subsequent year, and concluded that it was "truly off the charts." The court said that reasonable and true compensation is what would ordinarily be paid for like services by like enterprises under like circumstances—as per the relevant regulatory wording. Furthermore, a court should "do more than enumerate the factors and leap to a figure" between those proposed by the litigants; it should "benchmark" an independent investor's expectations.

Richard Wise
Wise Blackman, Montreal

FOREIGN TAX NEWS

Treaties

Treaties have been ratified with Jordan and Algeria (effective January 1, 2001) and Kyrgysztan (effective February 1, 2001).

Mexico

Mexico and the United States have signed an addendum to their maquiladora taxation agreement. (See "Foreign Tax News," *Canadian Tax Highlights*, November 23, 1999, at 88.) Existing exemptions are said to be extended indefinitely, but the agreement may be modified with advance notice to taxpayers, in 2003 or later. There are apparently still deficiencies in regulations with respect to leased assets, the asset base on which to compute the safe harbour threshold, and the circumstances in which exemption may be lost.

China

Fifteen new "export-oriented processing trade zones" with tax incentives and simplified customs rules are designed to encourage domestic and foreign entities to establish export operations with a view to stimulating manufacturing and exporting. The incentives reduce or eliminate customs duties, VAT, and consumption taxes, but not local taxes.

Michigan

Amended legislation provides relief for Canadian truckers under the single business tax of 1999, exempting foreign persons or firms if the business activity has no Michigan permanent establishment and is limited to transportation and loading or unloading of goods by truck.

Russia

The upper house finally approved the tax reform bill aimed at reducing the tax burden, eliminating inconsistencies, and increasing compliance. The bill, which will be signed into law shortly and is effective in 2001, eliminates progressive income tax rates of 12 to 30 percent in favour of a 13 percent flat rate; consolidates payroll deductions for pensions and medical insurance into a single, lower social security tax; and reduces the business turnover tax from 4 to 1 percent.

Liechtenstein

Justice Minister Heinz Frommelt defended Liechtenstein's tax policies and secrecy laws in Washington on December 13: existing tax rates are reasonable and more than cover the country's expenditures, and underlying the secrecy laws is a respect for individual privacy. Liechtenstein, identified on the OECD's list of uncooperative tax havens, relies on the financial services industry for 28 percent of its GDP.

Lithuania

New regulations revise and define criteria for determining when a permanent establishment exists, retroactive to January 1, 2001. Conditions that will constitute a PE in Lithuania are permanent engagement in commercial activity; commercial activity through a dependent agent; operation of a construction, assembly, or installation site; or the operation of heavy equipment for exploration or exploitation of natural resources. Broad definitions do not include the term "fixed place of business," and do not provide exemptions such as those in article 5(4) of the OECD model treaty; tax authorities seem to have broad discretion in interpreting the scope of the PE definition.

Carol Mohammed
Canadian Tax Foundation, Toronto