CANADIAN TAX Highlights

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Virtual Business Profits

The OECD's technical advisory group (TAG) dealing with e-commerce income characterization has issued its final report, which indicates a much broader consensus of its members than did its last draft. (See "OECD Virtual Redraft," *Canadian Tax Highlights*, October 24, 2000, at 76.) The recommended changes to the model commentary have been submitted to the OECD's working committee no. 1 and may be further modified before approval.

Consensus emerged when minority TAG members accepted that the act of copying a digital product onto a hard drive or other computer medium is merely incidental to its storage or copying. Thus most of the 28 types of income considered are viewed as business profits for treaty characterization purposes. (See the accompanying charts.) When consideration is bundled, the model commentary states that the characterization of the dominant part of the consideration "might be applied" to the whole; the TAG suggests that the wording be changed to a statement that it "should generally apply" to the whole. This TAG had no Canadian government representatives, and Canada must consider several issues before it arrives at its position on the revisions. Canada may accept without reservation the proposed wording and revisit its software reservation, or reserve on the proposals and maintain its software reservation. In applying the detailed rationale of the TAG report positions to Canadian withholding, the CCRA may need to review its positions on the application of non-resident withholding to various transactions, particularly if a payment's beneficiary is a non-treaty-country resident or if Canada chooses to register a reservation to the revised commentary regarding e-commerce payments to treaty-country residents. Similar concerns must be considered in the context of certain foreign affiliate deeming rules, especially the definitions of "licensing of property" and "lease obligation," which refer to "the use of or the production or reproduction of property including information or any other thing."

Group 1: Business profit characterization

Sale of tangible goods via the Internet	Delivery of exclusive or other high-value data
Sale of digital products including updates and add-ons	Advertising
Limited-duration software and other digital information licences	Electronic consultancy
Single-use software or other digital product	Information delivery
Application hosting—separate licence	Access to interactive Web site
Application hosting—bundled contract	Online shopping portals
Application service provider including licence fees	Online auctions
Web site hosting	Sales referral fees
Data warehousing	Acquisition of content with full copyright
Electronic customer support activities	Streamed (real-time) Web-based broadcasting
Data retrieval	Carriage fees
	Subscription to a Web site allowing for download of digital products

Group 2: Royalty or mixed consideration profit characterization

Commercial exploitation of copyrighted digital products	Content acquisition—right to display copyrighted digital products
Software maintenance	Technical information

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Getting the Boot

To achieve a rollover under subsection 85(1), the non-share consideration (boot) received by the transferor cannot exceed the elected amount (paragraph 85(1)(b)). Until recently, if the transferee assumed debt that exceeded the tax cost of the property transferred and the debt could not be allocated to other assets transferred, the CCRA would have accepted several techniques to mitigate the adverse consequences to the transferor: this longstanding practice is now reversed for transfers after 2000.

The CCRA's new position applies if a property (the first property) is transferred under section 85 and if (1) the purchaser assumes an obligation (for example, a note) of the vendor as consideration for the acquisition from it of a second property, which the purchaser subsequently disposes of to the vendor; (2) the purchaser assumes an obligation of the vendor as consideration for the redemption or acquisition by the purchaser of its shares held by the vendor; or (3) the purchaser subscribes for shares of the vendor. The CCRA regards the obligation so assumed or the property so contributed as consideration for the first property. The elected amount is increased to the extent that it is exceeded by the total boot given by the purchaser for the first property. The CCRA's former stance regarding the allocation of boot, including the allocation of liabilities among several properties transferred, continues to apply if the properties are retained by the purchaser and the amount allocated to each asset does not exceed its elected amount.

For example, assume that a capital property has a cost of $200 and an FMV of $1,000 and is encumbered by a $700 mortgage. Vendco transfers the property to Purchaseco for $1,000. Using the old technique to achieve a rollover, Vendco issues a promissory note to Purchaseco for $500 (the $700 mortgage less the $200 cost). The consideration paid by Purchaseco consists of the assumption of the $200 mortgage, redeemable preferred shares with a $500 FMV, and common shares with a $300 FMV. As consideration for the $500 promissory note issued by Vendco, Purchaseco agrees to assume $500 of the mortgage liability. On a subsequent cross-redemption, Purchaseco redeems its preferred shares by surrendering the promissory note to Vendco. Under the new policy, the boot received by Vendco is $700, the minimum elected amount; a rollover is not possible because a $500 taxable gain arises.

This policy shift is bound to be particularly frustrating in a divisive butterfly-type reorganization where the objective is to remove certain assets and their related liabilities to a transferee corporation. Companies that have operated for a long time typically have depreciated their assets significantly and have borrowed against their value so that the tax value of the assets to be transferred is often considerably lower than the associated debt. The change also appears to be somewhat inconsistent with the changes to the public company butterfly rules: the "types of property" distribution test has been relaxed for "specified corporations"—basically, a public company spinoff transaction—so that the transferee need no longer receive its pro rata share of each type of property.

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SPC: Ontario Capital Tax

Ontario-resident owners of a sole- or single-purpose corporation (SPC) holding Florida residential property worth more than $2 million (Canadian) should be aware that an Ontario SPC may suffer Ontario capital tax.

SPC is an undefined term used by the CCRA to describe a corporation whose shareholder may not need to include in his or her income a shareholder benefit from using the corporation's assets: among other conditions, the corporation's sole objective must be to hold residential US real estate for the shareholder's personal use or enjoyment. SPC owners may believe that they do not have to pay Ontario capital tax because the SPC's taxable capital is allocable to a Florida permanent establishment (PE). But according to Ontario Finance, an investment in personal-use real property in a foreign jurisdiction does not constitute a fixed place of business or qualify as a PE there. Even if the SPC has an office or an agent in Florida, Finance may not accept that it has a fixed place of business—for example, if the office is merely a document storage facility or if the agent does not have general authority to contract for the SPC.

The Ontario Corporations Tax Act provides that a corporation with no PE in Canada is deemed to have a PE where its head office or registered office is located. Thus if an SPC is incorporated and has its registered office in Ontario, Finance considers it to have an Ontario PE; the allocation rules require the allocation of its taxable capital entirely to Ontario, and it attracts Ontario capital tax if its taxable capital exceeds the $2 million exemption threshold.

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No Downward Trend

The OECD's 2000 edition of the annual survey of tax statistics in member countries contains revised data for a number of earlier years. Although economies gathered steam in the late 1990s and governments began to see improved bottom lines, a decline in the ratio of total taxes collected to gross domestic product (GDP) never materialized. The table shows that tax burdens have never been higher in the industrialized world.

According to the OECD data, Canada's tax-to-GDP ratio rose from 36.9 percent in 1997 to 37.4 percent in 1998. (Statistics Canada data show comparable numbers and a 0.1 percentage point drop in 1999.) The 1998 OECD figures show that Canada has the 15th highest tax ratio of the 29 member countries surveyed: lower than the Scandinavian countries, France, and Italy, for example, but higher than in the United Kingdom, Germany, and the United States.

Our relative position has varied little over the past decade, and slightly different fiscal policies will only move us up or down one or two positions. The OECD analysis shows a consistent, almost universal, upward trend in tax levels in the member countries. If continued strong revenue growth persists alongside spending restraint, the resulting surpluses will force a decision between further tax cuts and enhanced spending programs. In either

Total Tax Revenues as a Percentage of GDP

Selected years	Average for Canada	US	All OECD	European OECD
1965	25.9	25.0	25.8	26.4
1975	33.1	26.9	31.1	32.9
1985	33.1	26.1	33.8	36.6
1995	35.7	27.6	36.1	38.7
1996	36.1	27.9	36.8	39.6
1997	36.9	28.3	36.8	39.5
1998	37.4	28.9	37.0	39.8

event, Canada will be forced to give up competitive ground regained or continue to reduce the relative size of public sector spending.

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Intra-Entity GST

The primary focus of the GST/HST (GST) is the supply of goods and services between separate legal entities. But certain internal cross-border transfers or allocations are deemed to be supplies and may attract tax.

Two rules are of particular interest to Canadian-resident entities. GST may apply to exports from an entity's Canadian branch or division (a branch) that constitutes a permanent establishment (PE) to its offshore branch that is also a PE. Although all of part IX of the Excise Tax Act (ETA) may apply, the rule's practical effect is often not significant. Under division IV of part IX, GST may also apply to imported taxable supplies: certain services and intangible property imported from a foreign branch of the same legal entity are taxable if they will not be consumed, used, or supplied exclusively in the course of the Canadian resident's commercial activities. Thus financial sector participants—banks, insurance companies, etc.—may be affected.

The export rule. Assume that Canco carries on business through domestic and foreign PEs and transfers goods and services to the foreign PE. Any supply of personalty or services rendered to the foreign PE is deemed to be a supply thereof, and the two PEs are deemed to be separate arm's-length persons vis-à-vis those supplies. Most such supplies (outputs) do not require GST remittance: either they are zero-rated exports or they fall outside the ETA's scope because they are in respect of goods delivered outside Canada or otherwise deemed made outside Canada. But not all interbranch supplies qualify as made outside Canada or as zero-rated exports. One common problem area is the supply of intangible personal property (IPP): such supply is not regarded as made outside Canada if the IPP is capable of being used in Canada or if it relates to real or tangible personalty in Canada. Some supplies of IPP made in Canada to a non-resident are zero-rated, but the recipient must not be registered and the IPP must be a patent, trade secret, trademark, trade name, copyright, or similar intellectual property, which does not cover a supply of goodwill or similar IPP. Furthermore, the CCRA appears to treat all of a Canco's PEs as one GST registrant; thus, this zero-rating rule (section 10)—and others such as sections 18-22.1 (specific services) of part V of schedule VI—may not apply because the recipient of the supply is a GST registrant. Some zero-rating provisions contain requirements that may be difficult to fulfill ex post facto, such as the requirement for documentary evidence of exportation.

The import rule. Assume that Canco imports services or intangible property from its foreign PE to its Canadian PE in a transaction that would constitute an imported taxable supply between separate persons. Any transfer of personalty or rendering of a service between the PEs is deemed to be a supply thereof, and the PEs are deemed to be separate arm's-length persons for division IV of part IX. The supply's FMV at the time is the deemed value of the related consideration, which is deemed to have become due and to have been paid to the other PE by the recipient PE at the end of its taxation year in which the supply occurred. This deemed import rule does not apply if the supplies will be consumed, used, or supplied exclusively in the course of the recipient's commercial activities. If the recipient is not engaged exclusively in commercial activities, some GST surprises may arise. For example, if a foreign branch of a Canco in the financial services sector allocates certain expenses to a Canadian branch to reflect consideration for services provided on its behalf, the consideration for the supply is its FMV irrespective of the amount allocated. Similarly, the year-end allocation of management fees is often evidenced only by way of a journal entry booked some months after the event and without the advice or direction of internal or external tax advisers; the time lag may render it difficult to ascertain the nature of the underlying supply and the attendant GST consequences.

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New US Hybrid Regs

On February 26, the IRS issued proposed regs designed to curb perceived tax avoidance through the use of domestic reverse hybrid entities (DRHEs) to obtain treaty benefits. DRHEs are fiscally not transparent in the United States and fiscally transparent in the treaty jurisdiction. The IRS believes that it is inappropriate for related parties to use DRHEs to convert higher-taxed US-source items of income to lower-taxed or untaxed items of income. In particular, the IRS is concerned that foreign acquiring entities may be able to exploit differences between US and foreign law and obtain tax-advantaged financing, such as cross-border payments that are deductible (for example, interest) for US tax purposes but non-taxable in the foreign jurisdiction.

The proposed regs add to last year's guidance issued on DRHEs. The regs' primary effect is to recharacterize certain deductible interest payments as non-deductible dividends for US tax purposes if two conditions are met. First, a domestic entity must make a payment to a related DRHE that is considered a dividend either under US law or under the law of the jurisdiction of a related foreign person that holds an interest in the DRHE, which foreign law also treats that person as deriving its proportionate share of the payment. An 80 percent ownership test establishes related-party status. Second, the DRHE must make a payment—for example, interest—to the related foreign interest holder that is deductible for US tax purposes and that qualifies for a reduced US withholding tax rate under a tax treaty. If both conditions are met, the payment by the DRHE is recharacterized as a dividend up to the amount of the interest holder's share of the payment to the DRHE that is treated as a dividend by the United States or the foreign jurisdiction. The recharacterization as a dividend determines the applicable treaty rate of withholding and results in disallowance of a deduction for an otherwise deductible payment (such as interest) on the payer's US tax return.

The new regs also contain two general anti-abuse rules. The IRS may recharacterize one or more steps of a transaction to render the new regs applicable if it believes that the effect of the steps is to avoid the reg's underlying principles. The regs also apply if the involvement of an unrelated (accommodation) party results in the avoidance of those principles. Furthermore, the regs apply if more than one DRHE or other fiscally transparent entity is used to create certain tiered structures. For example, the new regs may apply if a Canco holds a 99 percent limited partnership interest in a US limited partnership that has elected to be treated as a corporation for US tax purposes—a DRHE—and the DRHE owns all the shares of a US opco. Under current law, if the amount of a dividend from the US opco to the DRHE is paid in turn to Canco as interest, the result is a US tax deduction to the DRHE and US opco (which would likely file a US consolidated return) and only a 10 percent US withholding tax on the interest paid by the DRHE to Canco. In certain situations, the dividend from the US opco to the DRHE is not taxed in Canada, and the interest paid by the DRHE to Canco is a wash for Canadian tax purposes if Canco is allocated 99 percent of the interest deduction in the DRHE from the interest payment. Under the proposed regs, the interest paid by the DRHE to Canco may be recharacterized as a dividend for US purposes, up to Canco's share of the payment by US opco to the DRHE that is a dividend under Canadian law. In the event of recharacterzation, the interest paid by the DRHE to Canco is not deductible for US tax purposes and attracts the 5 percent US withholding tax applicable to dividends.

A public hearing will be held to discuss the proposed regs on June 26, 2001. The regs are not scheduled to become effective until they are issued in final form, which should be no earlier than that date.

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Joint Venture Employees

In *Lerric Investments*, the FCA held that a taxpayer cannot count employees who did not work for it directly to meet the "more than five full-time employees" test for active business eligible for the small business deduction. *Lerric* is of particular interest to real estate corporations owning properties through co-ownerships or joint ventures. A similar definition of "investment business" in the FAPI rules means that *Lerric* may also affect the characterization of income of a controlled foreign affiliate.

Lerric's business was the earning of rental income as a co-owner or joint venturer (not a partner) from eight apartment projects. Lerric had two full-time employees; it met the "more than five full-time employees" test if the 15 employees working jointly for the co-owners in all their projects were allocated according to the co-owners' percentage interest in each property. The CCRA denied the taxpayer's claim, contrary to its own published administrative position in IT-73R5.

The FCA evaluated two approaches under which Lerric could be considered to employ more than five full-time employees. The first approach is based on the fact that a co-ownership or joint venture is not a legal entity separate and distinct from its participants: each employee is said to be employed by each co-owner or joint venturer. But the FCA said that the operative legislative wording—"the corporation employs"—connotes a direct relationship between the corporation as employer and the specified employees. This approach allows double, triple, or even multiple counting of the same employee and ignores the legislative context, which measures business activity by ensuring that it is sufficient to require the employment of more than five full-time employees. The other approach allocates the employee's employment to each co-owner or joint venturer according to an allocation formula—for example, based on the co-owner's or joint venturer's interest in the property. The FCA, however, said that allocation was not envisioned by the words "the corporation employs": allocating fractions of full-time employees to joint venturers involves reading words into the provision. The FCA accepted the CCRA's argument that the co-owners or joint venturers employ the employees together, but not independently; they are responsible for a percentage of each employee's wages in accordance with the co-ownership or joint venture agreement. This, however, does not give rise to an allocation of fractional employees and an aggregation of those fractions to meet the "more than five full-time employees" test.

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Mutual Fund Reintegration?

Capital gains inclusion rates fell dramatically over the past 14 months, causing an increase in the already significant tax cost faced by taxpayers earning capital gains dividends (CGDs) from a mutual fund trust (MFT) through a Canadian private holdco rather than directly. Using the two-thirds inclusion rate applicable February 28 to October 17, 2000 inclusive, the additional tax cost could exceed 11.5 percent of the overall capital gain, depending on both the individuals' and the holdco's province of residence. For subsequent capital gains, subject to a 50 percent inclusion rate, as of January 1, 2001 the additional tax cost exceeded 16 percent of the overall capital gain.

The bulk of the incremental cost arose because the untaxed portion of CGDs from an MFT did not fall into a holdco's capital dividend account (CDA). (See "Mutual Fund Disintegration," *Canadian Tax Highlights*, April 25, 2000, at 30-31.) This treatment unfairly penalized corporate beneficiaries of an MFT (or other trusts): the untaxed portion of a holdco's CGDs from a mutual fund corporation (MFC) is included in its CDA even if the MFC disposed of the investment, not the holdco.

The December 21, 2000 draft legislation relating to the February 28, 2000 federal budget and the October 18, 2000 economic statement appear to provide a brief window of opportunity for a holdco that is a beneficiary of a Canadian-resident trust (including MFTs); it may include in its CDA the non-taxable portion of net taxable capital gains designated by the trust under subsection 104(21). If a trust makes such a designation for a taxation year that includes either February 28 or October 17, 2000, the beneficiary is deemed to have received capital gains—not taxable capital gains—from the disposition of capital property in its taxation year in which the trust's taxation year ends, computed in accordance with the draft legislation (proposed subsection 104(21.4)). But this change did not address the years of tax inequity for holdcos earning CGDs from an MFT. Now the March 16, 2001 notice of ways and means motion (NWMM) contains a long overdue and welcome addition to the definition of CDA (in new paragraphs 89(1)(f) and (g)) that permits additions for distributions to a holdco from a trust in respect of its capital gains or capital dividends. These proposals not only provide holdcos with current and future relief, but also apply to CDA elections for capital dividends payable after 1997. It is not yet clear whether taxpayers should amend post-1997 CDA elections or adjust CDA balances prospectively.

The NWMM addresses the income tax inequity of a holdco earning CGDs from an MFT, but a holdco's MFT investment is still completely ineligible federally and provincially for an investment allowance. It is hoped that Finance and its provincial counterparts will rectify the problem with corporate-owned MFT units.

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More Questions Than Answers

Duncan is another case of Canadian taxpayers' purchasing interests in a foreign partnership in order to import an accrued loss in partnership property, a transaction now

JEFF MACNELLY'S SHOE by Chris Cassatt and Gary Brookins defeated by subsection 96(8). The TCC's GAAR analysis profiles some of the problems inherent with the GAAR.

In 1982, Klink, a US partnership of five US-resident partners, purchased a mainframe computer for $4.5 million that was fully depreciated for US tax and accounting and worth about $7,000 in 1991. On December 13, 1991, 98 percent of Klink was purchased by two Canadians, who one week later sold most of their interest to other Canadians for $320,000. Minutes later, Klink contributed the computer at $50,000 to a new BC partnership (ILP) so as to become its sole limited partner, triggering a terminal loss of nearly $4.5 million. Although the partners claimed that it was their intention to lease the computer in eastern Europe (it was obsolete in North America), they purchased their interest in Klink without any business plan or contacts in Europe and no due diligence of the party purported to be their front line on business opportunities. Klink assigned to ILP the tail end of a lease that produced US$14,000 revenue in December 1991 and US$100 for the next three months.

The CCRA denied the loss claimed by the partners, saying that no partnership existed after 1991; that the computer was not depreciable property; and that, alternatively, the GAAR applied. The TCC's finding that the partnership ceased to exist must be looked at in light of the recent SCC decisions in *Spire* and *Backman*. The TCC also concluded that although the CCA rules permitted the loss, the deduction of a terminal loss was "inconsistent with the object and spirit of the Act's provisions. . . . It was not Parliament's intention to provide an opportunity to permit the manufacture of non-capital losses by the acquisition of an interest in a foreign partnership having capital assets that have been fully depreciated." On whether there was a misuse or abuse for the purposes of the GAAR, the TCC said that the scheme of the CCA rules is to allow a deduction reflecting the diminution in the value of capital assets over time; the terminal loss and recapture rules ensure final adjustments when the CCA rules do not track the assets' value accurately. In contrast, the transactions in issue were "totally inconsistent" with that purpose and the overall scheme of the Act because the loss claimed bore no relation to the computer's value at the time of the investment or to the taxpayers' investment in Klink. The argument that the loss arose by virtue of the CCA rules "has no merit": the GAAR could never be invoked otherwise.

The transaction offered an almost perfect opportunity for the TCC to provide an analytical framework for identifying what constitutes a misuse or an abuse: when does an unintended consequence of applying mechanical rules become an abuse, and how can we know which of the results encompassed by clear and unambiguous rules are unintended? This fundamental problem arises because the misuse or abuse test must be satisfied by reference to the same words in the statute that give rise to the impugned result, without the benefit of any external standard. The courts are forced into an inevitably subjective assessment: acceptable tax planning to one may be an egregious abuse to another. As a consequence, the GAAR becomes a default taxing provision, an ex post facto substantive rule. It is a fundamental tenet of Canada's legal system that the existence and limits of a law must be known. Even though the uncertainty of novel judicial interpretation is a reality in every dispute, the level of uncertainty that is unavoidable in the application of the GAAR may cross the line.

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GST Audit Tack Backfires

Recently, transactions involving status Indian purchasers have attracted significant GST audit focus, especially sales of vehicles for which the vendor did not collect GST in reliance on the exemption under section 87 of the Indian Act. For example, about 80 Quebec car dealers were assessed on sales to native purchasers; *9000-6560 Quebec Inc.* dealt with 95 such sales by one dealer over 12 months.

The CCRA detected a vehicle-smuggling ring in Quebec between 1995 and 1997, apparently involving GST collected but not remitted on sales of luxury vehicles and input tax credits claimed without underlying tax paid. Each vehicle was delivered on a reserve to obtain the Indian Act exemption. The native purchaser then sold the vehicle to a numbered company without collecting either GST or Quebec sales tax (QST). The numbered company in turn sold the vehicle to an exporter, collecting but not remitting QST and GST for which the exporter claimed an input tax credit. The TCC said that in all likelihood the CCRA had not assessed those companies because they had disappeared. The car dealers, however, were still carrying on business and were easy targets for assessment.

The Crown's reply to the notice of appeal set out no assumptions of fact to support the assessment, but made general allegations that, based on circumstantial evidence, the car dealer "knew very well" that the native purchasers were nominees or agents for third parties. For example, some payments to the dealer were made by third parties and some subsequent sales to third parties occurred before the date of sale to the native purchaser. The dealer provided evidence that it took steps to ensure that the Indian Act tax exemption applied, obtaining a copy of each certificate of Indian status and delivering the vehicles on-reserve, in accordance with requirements set out in the CCRA's *Technical Information Bulletin* B-039R.

The court held that the onus was on the Crown to prove the facts supporting the assessment. Although the onus in a tax appeal generally lies with the taxpayer, in this case the reply asserted no assumptions of fact for the car dealer to challenge. Once the minister adduced facts to support the assessment, however, the car dealer had to adduce rebuttal evidence. But the TCC found that the circumstantial evidence raised by the Crown did not necessarily show that the car dealer devised the scheme or knew of any fraud; for example, the advancing of funds by third parties for some native purchasers was not unusual, because vehicle purchasers often borrow funds from lenders to finance the purchase of vehicles. Even if the dealer had noted that particular native purchasers bought several vehicles, the Indian Act exemption applies even if a native purchaser buys for resale. (*Union of New Brunswick Indians*, [1998] 1 SCR 1161.) The failure of any native person over the GST small-supplier threshold to collect and remit GST on taxable sales to non-natives was not the car dealer's responsibility.

Nor did the Crown meet its onus to establish facts essential to the application of GAAR. If the sales were not to native purchasers, the car dealer should have been assessed for failing to collect GST. Furthermore, only the native purchasers received a tax benefit, which flowed from the Indian Act exemption. Sales to native purchasers were made primarily for bona fide commercial purposes in the normal course of the car dealer's business, and there was no misuse or abuse of the legislation.

The TCC allowed the appeal with costs and closed by noting that the Crown had gone after the wrong party. The decision illustrates the difficulties the CCRA faces when assessments are based on supposition and conjecture. The car dealer established that it had taken the steps necessary to ensure that sales to native purchasers were tax-exempt; its knowledge of the scheme could only be inferred from circumstantial evidence, which the court rejected. A clear message was sent to the CCRA that it should direct audit and other enforcement efforts at the parties that design and enjoy the benefits of this type of scheme.

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AGGREGATE OR ENTITY

A partnership is a legal relationship between two or more persons formed for the purpose of carrying on business in common with a view to profit. Under the aggregate theory, a partnership is not a person; each partner owns an undivided interest in the partnership property. Under the entity theory, a partnership is a separate entity. For income tax purposes, a partnership's taxable income is computed "as if" the partnership was a separate person; it is not deemed to be a separate person for that or other purposes. But for tax purposes the aggregate and entity theories are not applied consistently.

For example, in computing income or loss, CCA and various reserves are claimed by the partnership, which deducts employee salaries and is responsible for source deductions. However, investment tax credits, resource expenditures, charitable donations, and political contributions are allocated to and deducted by the partners. A partnership does not file a tax return, but if it has more than five members it must file an annual information return and will receive a tax identification number. A partnership must also file supplementary information slips that the partners file with their tax returns. A partner's partnership interest is treated as a separate property, suggesting the separate entity theory at work, for which a partner must compute an adjusted cost base (ACB)—increasing it for its cost, capital contributions, and undrawn profits and reducing it for income and capital distributions and losses—and may realize a capital gain or loss on its actual or deemed disposition. Separate entity status is also implicit in the tax-deferred rollovers on certain transfers to a Canadian partnership. Withdrawal of a partner does not dissolve the partnership, even in the absence of a continuation clause.

The on-and-off treatment of a partnership as a separate entity has created tax problems and opportunities. The foreign affiliate (FA) rules tax Canadian taxpayers currently on certain undistributed passive income and defer tax on an FA's active business earnings. The CCRA previously said that the rules did not apply to an interest in a foreign partnership unless it is a corporation for Canadian tax purposes. A foreign corporation under a partnership was said not to be an FA of the corporate partner: it was owned by the partnership, and ownership of property is determined as if the partnership was a separate person. A 1999 proposal enables such a partner to benefit from a dividend out of exempt surplus (ES): the shares are deemed owned by the partners based on the FMV of partnership interests. It is unclear how the rules apply to an FA partner of a foreign partnership that has no Canadian-source income. Amendments are also proposed to rules that allow share proceeds to be treated as FA dividends.

The 2000 federal budget extends the thin cap rules to loans by a non-resident shareholder to a corporate partnership. The CCRA had said that thin cap did not apply to a loan to a partnership; but in *Metro-Can Construction* the FCA said that former debt-forgiveness rules applied to a partnership, surprising the many tax practitioners who were of the opinion that the rules applied only to a taxpayer, not to a partnership (2000 DTC 66 495). In contrast, IT-361R2 says that the withholding tax exemption for five-year debt to a Canadian corporation applies to a loan by a corporate partnership. But if a foreign partnership of US corporations receives a dividend from a Canadian corporation, the CCRA says that the dividend retains its character but can never enjoy the 5 percent reduced withholding rate under the Canada-US treaty: that rate benefit requires direct share ownership. On the other hand, the CCRA says that a non-

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resident partner is subject to Canadian corporate and branch tax on its pro rata share of income from a limited partnership carrying on business through a Canadian PE, a stance consistent with the partnership's being a conduit or transparent entity. The proposed foreign investment entity rules (effective in 2002) apply to an investment in a foreign entity regarded as a corporation or a trust, but not to a foreign partnership, which is looked through.

Canada's treaties vary in their treatment of partnerships. For example, a partnership is included in the definition of "person" in treaties with Barbados, Belgium, Spain, and Switzerland. In some treaties, such as those with China, Italy, and South Africa, the definition applies only for Canada. In the German treaty, a partnership is treated as a corporation. Some other treaties, such as the US treaty, define a person to include a body of persons, which may include a partnership, but a partnership cannot satisfy the definition of "resident" because it is not itself liable to tax. Canada usually looks through a partnership and enables each partner to claim treaty relief.

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Partnership-Issued Debt

Depending on applicable law, debt issued by a partnership may be considered debt issued by the partners. IT-361R3 says that debt issued by a partnership of Canadian corporations (and certain non-resident corporations) qualifies for the five-year debt part XIII exemption (subparagraph 212(1)(b)(vii)). The CCRA recently confirmed that partners are considered to be the debtors in determining whether a debt issued by a partnership is a qualified investment in regulation 4900(1)(i) or a foreign property in paragraph (g) of subsection 206(1). However, the CCRA notes that if any partner is a non-resident, the entire note issued by the partnership is foreign property. The CCRA also says that the entire debt issued in the name of the partnership is a non-qualified investment if it would have been such had it been issued by any one partner directly to investors.

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Foreign Tax News

Treaties

Finance opened treaty negotiations with Peru and is soliciting input from Canadians so that any difficulties encountered with Peru's tax system may be taken into account.

Australia

New draft legislation amends thin capitalization debt-equity distinctions to more accurately reflect economic substance. Implementation is deferred for one year to July 1, 2002 for some measures, including consolidated tax reporting and general value-shifting and demerger provisions. The schedule is not yet determined for amendments relating to leasing, partnerships, and joint activities, transfer pricing, capital gains tax on the disposal of non-resident interposed entities, foreign trusts, and conversion to the tax value method of tax accounting.

Tax Havens

Following an inconclusive meeting in Paris on harmful tax practices, some US legislators are recommending that the United States distance itself from the OECD initiatives, suggesting that high-tax countries concerned with losing their tax base should respond by reducing their own tax burdens. (See "Foreign Tax News," *Canadian Tax Highlights*, March 27, 2001, at 24.)

United States

The Senate's permanent subcommittee on investigations commenced hearings on international tax evasion and money laundering in cross-border banking practices and offshore financial centres (OFCs). Initial submissions suggested that tax evasion underlies the use of OFCs and shell banks. After three days of hearings, Justice said that official recommendations will be available within 30 days.

Publication 515, the 2001 rules for withholding tax on non-resident aliens and foreign corporations, incorporates important regulatory changes. Copies are available from the Foundation's library.

Singapore

The 2001 budget cuts resident and non-resident corporate tax rates by 1 percentage point to 24.5 percent. (The new corporate rate is less than the 25 percent cutoff for Japan's CFC rules: Singaporean subs have requested that Japan not put Singapore on its tax haven list.) Individuals benefit, inter alia, from tax reductions of 2 to 5 percentage points and a lower top marginal rate. To lower business costs and encourage the use of new technology, payments for software downloads and site licences are withholding-tax-exempt.

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