Canadian Tax Highlights

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Dutch Double Under Pressure

Dutch companies are used frequently in international finance structures because of the Netherlands' favourable tax rules and extensive treaty network. For example, back-to-back financing transactions through the Netherlands reduce foreign withholding on interest, leaving a small spread there. On March 30, 2001, the Dutch undersecretary of finance issued a decree targeting the use of intragroup financing and royalty companies with little or no economic substance in the Netherlands. The new rules, effective from April 1, 2001, respond to criticism that Dutch international tax rules—the advance ruling (ATR) practice in particular—constitute harmful tax competition. Existing rulings are grandfathered until December 31, 2005.

Previously, conduit companies for the payment and receipt of interest and/or royalties could obtain ATRs from Dutch tax authorities; now companies performing intragroup financing or licensing services are entitled to an ATR only if they fulfill substance requirements demonstrating sufficient economic nexus with the Netherlands. Under the decree, at least 50 percent of the board of directors must be Netherlands residents; the directors must have sufficient expertise and responsibility to carry out their duties; the most important board decisions must be made in the Netherlands; the company must be administered in the Netherlands and its primary bank account maintained there; it must comply with filing obligations; its principal address must be in the Netherlands; and it must have sufficient equity to carry out its functions and to assume risks.

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

If a company meets the substance requirements but does not assume genuine risks regarding the intercompany receipt and payment of interest and royalties, an ATR is granted only if the requesting taxpayer agrees to a spontaneous exchange of information with the treaty partner. A Dutch company that does not assume such risks is also denied a credit for foreign withholding tax against Dutch corporate income tax. If such structures are implemented without obtaining an ATR, the Dutch tax authorities will send information to the relevant treaty partner. Risks relating to financial activities include debtor's risk, currency exchange risk, market risk, and operational risk. A financial service company must assume genuine risks and have sufficient equity to which creditors have recourse if a risk materializes; it is deemed to assume genuine risks if its equity exceeds the lower of 1 percent of the amount of outstanding loans and €2,000,000, but it must also demonstrate that its equity is realistically threatened if such risks arise. Companies that satisfy the substance criteria and assume sufficient business risks can obtain an ATR and benefit from all advantages of the Dutch tax system and treaty network. The standard spreads, however, are no longer available as a safe harbour.

The decree is one of a series that includes the creation of separate ruling practices for advance pricing arrangements and ATRs, guidance on applying for both types of rulings, guidance on how the arm's-length principle applies in the Netherlands, and the formalization of the competent authority procedure. These decrees clearly result from pressure by certain EU countries relating to harmful tax competition both at the EU and OECD levels. The Netherlands does not want its rules to be viewed as fostering the creation of legal or corporate structures solely to obtain tax benefits. The undersecretary has promised to contact treaty partners if activities are carried out in the Netherlands by a corporation that has little nexus with the country and/or does not assume business risks. Using the spontaneous exchange of information with treaty partners as the primary tool to counter potentially harmful tax structures differs from some other countries' approach. For example, US domestic legislation addresses conduit structures, and its treaties contain limitation-on-benefits articles. The Netherlands, like some other countries, is walking the fine line of trying to introduce new measures to appease EU and OECD criticism while maintaining its attractiveness as an investment jurisdiction.

Albert Baker
Deloitte & Touche LLP, Montreal

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Civil Penalties IC Too Broad

The CICA Taxation Committee recently relayed to the CCRA its comments on the draft information circular (IC) concerning the administration of third-party civil penalties. The committee believes that changes are necessary to the IC's process provisions: for example, there should be outside representation on the CCRA's penalty review committee. Highlights of the CICA committee's 12-page report follow.

■ **Liability thresholds.** The committee says practitioners are concerned that certain statements in the IC seem to indicate an administrative lessening of the requirement for "knowing" behaviour in the liability thresholds set by Parliament.

> The new provisions [reserve] civil penalties . . . for egregious circumstances—for those individuals deliberately or knowingly counselling others to commit fraud. Senior CCRA and Finance officials have endorsed this reading, indicating they expected no more than a dozen cases of civil penalties in any given year. . . . We expect that [civil penalties] would be restricted to the most aggressive or scandalous activities of tax shelter promoters or those involved in serious fraud.

As a result, the committee believes that certain IC paragraphs should be clarified to prevent wider than intended application of penalties.

■ **Good faith principle diluted.** The committee says that the IC appears to undercut the penalty's good faith reliance principle: the IC discussion thereof is inconsistent with Finance's comment that there can be good faith reliance unless information is clearly false (principle 7, paragraph 13). The IC must clarify that a third party is protected if he or she has no reason to believe that information provided by a taxpayer is false.

Further, paragraph 36 states: "The good faith reliance exception is available when the information used by the adviser or tax return preparer *is not obviously unreasonable to a prudent person and does not raise questions in the mind of the adviser or tax return preparer.*" (Emphasis added.) In our view, this sentence severely restricts the notion of good faith reliance. At the very least, it brings doubts as to the level of questioning and work necessary to rely on information provided by the client. Most disturbing, this paragraph suggests that tax return preparers must maintain a high degree of suspicion when dealing with their clients.

■ **What is due diligence?** The committee points out that principle 7, paragraph 13 clearly states that the legislation is not intended to create additional audit or verification work for tax advisers who conduct their affairs in accordance with their professional standards. Paragraph 64 notes that if a person exercises due diligence, the third-party penalty cannot be applied, but due diligence is not defined.

> There are countless questions as to what constitutes due diligence: how many questions are enough to avoid liability? Many of our members hold the perception that the [IC] presumes that clients lie and that advisers must ask a series of cross-examination questions to get at the truth. Furthermore, the [IC] suggests that simply asking questions isn't enough—you have to ask the right questions, or more than just one or two. How can this standard possibly be met in the realities of a practice?

The committee believes that there is a need to clearly define and give more examples of how a person can exercise due diligence to avoid penalties. However, due diligence must not represent a significant increase in work if it is to be consistent with the CCRA's stated intent.

■ **Other comments.** The CICA report comments on other aspects of the IC such as factors that determine whether penalties will be assessed; the CCRA's process in considering the application of a penalty; materiality (the CCRA should not focus on minor issues in the absence of repeated abusive behaviour); valuation provisions and how FMV will be determined; liability for industry advisers; dual liability for firms and individuals; and terminology (for example, the phrase "obviously unreasonable" is too subjective and should be changed to "obviously wrong").

The summary of the CICA's concerns comprises a helpful record. It will be interesting to see the extent to which the CCRA takes those comments into account in the final version of the IC.

Paul Hickey
KPMG LLP, Toronto

Regulations Not GAARable

In *Rousseau-Houle* and *Fredette*, Judge Archambault of the TCC held that GAAR did not apply to prevent a partner's maximizing interest and CCA deductions by owning property in a partnership and financing it personally. He concluded that such arrangements are not abusive and that GAAR does not apply to the Act's regulations.

Both cases involved rental property partnership financing arrangements, which were among the first targeted by the CCRA for GAAR challenges. Regulation 1100(11) limits CCA deductible in respect of rental property to the rental income it generates. That limitation is circumvented by holding the property in a partnership and (re)financing its acquisition personally: the interest expense outside the partnership does not reduce the partnership rental income. The partners may deduct against their other income the interest expense related

to capital contributions to the partnership. This arrangement also minimizes the application of the limited partnership at-risk rules.

In *Rousseau-Houle*, the taxpayer personally borrowed to finance her participation in a partnership that was to acquire the rental property, but the partnership could not be established in time to complete the purchase: the taxpayer acquired the property "on behalf of" the partnership and transferred title as soon as the partnership was created. In *Fredette*, the taxpayer and his spouse borrowed to purchase a triplex; they lived in one unit and rented the others. They later formed a partnership and transferred the triplex to it for additional partnership "shares." (The transfer was never registered, but after analyzing the case law the court concluded that the unregistered transfer was legally effective for tax purposes.) They transferred their shares in the first partnership to a second partnership with an earlier fiscal year-end, maximizing CCA and interest deductions and also allowing a two-year tax deferral on income.

The TCC allowed the appeal in *Rousseau-Houle*, saying that GAAR did not apply to the regulations: they are not "provisions of the Act" as referred to in GAAR. The TCC cited the 1941 SCC decision in *Singer*, which said that regulations are not acts of Parliament. The TCC also said that if Parliament intended to cover the regulations, it would have said "this Act or the regulations," as in several other provisions of the Act. Alternatively, the creation, existence, and financing of the partnership and rental property was not abusive: the Act and regulations do not require that rental properties be owned only by partnerships or corporations, nor do they place any restrictions on financing.

The TCC allowed the *Fredette* appeal in part. The undue tax advantage from the use of the second partnership—a two-year deferral—was ordered eliminated on reassessment, but otherwise the taxpayer had the right to arrange his affairs to minimize tax payable and could not be forced to structure transactions more favourable to the CCRA. Amounts relating to the unit occupied by the taxpayer and spouse—personal living expenses—were eliminated from the taxpayer's and partnerships' income and expenses, but otherwise the court allowed the partnership to claim the maximum CCA and the taxpayer to deduct the interest expense. Transactions that permitted the first partnership to benefit from more CCA than if it had been the debtor were not avoidance transactions, and financing partnership activities personally was not an abuse of the Act. Furthermore, an abuse of the Act did not include the regulations.

Wayne Tunney and Lori Dunn
KPMG LLP, Toronto

A Work in Progress?

The 2001 provincial budgets confirmed two suspicions emerging from earlier budgets: provincial business taxes are headed down, and the provinces are competing for bragging rights to the lowest rates. The tables show how the rates for profits of small businesses and non-manufacturing and processing (M & P) operations have declined since 1988 and will continue to drop until at least 2006, when current provincial programs are fully implemented.

Income Tax Rates on General Profits by Calendar Year

	1988	1995	2001	2006
Newfoundland	16.0	14.0	14.0	14.0
Prince Edward Island	15.0	15.0	16.0	16.0
Nova Scotia	15.0	16.0	16.0	16.0
New Brunswick	16.0	17.0	16.0	16.0
Quebec	13.9	16.3	9.0	8.9
Ontario	15.5	15.5	14.0	8.0
Manitoba	17.0	17.0	17.0	15.0
Saskatchewan	17.0	17.0	17.0	17.0
Alberta	15.0	15.5	13.9	8.0
British Columbia	14.0	16.5	16.5	16.5
Northwest Territories	10.0	14.0	14.0	14.0
Nunavut	10.0	14.0	14.0	14.0
Yukon	10.0	15.0	15.0	15.0
Federal	32.5	29.1	28.1	22.1

Income Tax Rates on Small Business Profits by Calendar Year

	1988	1995	2001	2006
Newfoundland	10.0	5.0	5.0	5.0
Prince Edward Island	10.0	7.5	7.5	7.5
Nova Scotia	10.0	5.0	5.0	5.0
New Brunswick	5.0	7.0	4.0	4.0
Quebec	3.2	5.8	9.0	8.9
Ontario	10.0	9.5	6.5	4.0
Manitoba	10.0	9.0	6.0	5.0
Saskatchewan	10.0	8.0	7.0	6.0
Alberta	5.0	6.0	5.3	3.0
British Columbia	10.0	10.0	4.5	4.5
Northwest Territories	10.0	5.0	5.0	5.0
Nunavut	10.0	5.0	5.0	5.0
Yukon	5.0	6.0	6.0	6.0
Federal	13.4	13.1	13.1	13.1

The rate reductions offered to small businesses result only from provincial initiatives; the federal rate has changed little since 1988 and is not scheduled to change in the near future. The provincial rate changes are in addition to the increased profits qualifying for the low rate: in some areas, complete tax holidays for new firms are offered.

The impetus for the reduced general rate on non-M & P profits arose in the federal economic statement of October 18, 2000. Ontario and Alberta had previously announced plans to phase in a rate competitive with Quebec's, and in this year's budgets two more provinces made small reductions in their top rate. The rates shown for 2001 are firm, but those for 2006 are based only on announcements to date. Further reductions are almost inevitable as more provinces enter the competition.

David B. Perry
Canadian Tax Foundation, Toronto

On Partnerships

The SCC recently released decisions in *Backman* and *Spire Freezers*, "Texas partnership" deals whereby Canadians accessed losses accrued by US partnerships by acquiring partnership interests shortly before the sale of partnership property at a significant loss. The issue in each case was whether a partnership existed for Canadian tax purposes after the acquisition by the Canadians. Factual differences resulted in a different conclusion in each case.

In *Backman*, Canadian investors purchased 100 percent of the partnership interests of US-resident partners with unrealized losses on an apartment construction project. Almost immediately, in accordance with plans that included the entry of the Canadians into the partnership, the partnership sold the project to another partnership of the former US partners; the Canadians claimed the resulting losses. On the same day the partnership purchased a 1 percent interest in an oil and gas property over which the partnership exercised no management control; after two months production stopped unexpectedly, and the partnership acquired no replacement. The SCC confirmed that the critical issue was whether there was a valid partnership under Canadian law: a business, new or continued, carried on in common with a view to profit. The "view-to-profit" test, the court said, is not merely quantitative, but the quantum of expected profit is a factor to be considered; thus it is not necessary to show an intention to produce a profit sufficient to recoup or better the acquired losses in even a predominantly tax-driven deal. However, there must be both a business and an intention to profit therefrom. The court found that the purported partnership had no intention to carry on business with a view to profit: its first act was to sell its business assets and thus terminate its business, and there was no expectation of earning a profit in the brief period of ownership. Nor did the nominal oil and gas investment salvage the case: the putative partners did not hold themselves out as providers of related goods and services; they had no management duties in respect of the property; and they expended nothing more than nominal time, attention, or labour on the purchase and holding of the investment and incurred no third-party liability in respect of it. The SCC said that "it may be that that arrangement can be viewed as co-ownership of property" and thus was not a business.

In *Spire Freezers*, the US partnership owned two residential construction projects, an apartment and a condominium. During negotiations the Canadians were apprised of the apartment's profit potential; shortly after the Canadians purchased the partnership, they sold the condominium to the former US partners at a substantial loss. The apartment was retained and managed profitably for several years. Unlike the taxpayers in *Backman*, the partners carried on a pre-existing business after entering into the partnership, a business that required substantial expenditure of time and effort. The view-to-profit requirement was satisfied by their intention vis-à-vis the apartment property.

Amendments in 1993 shut down the "Texas partnership" planning. But these decisions offer general guidance about partnerships and entity classification and the SCC's approach to tax planning. These decisions, together with *Continental Bank*, suggest that the use of partnerships in properly implemented tax planning, even if it is aggressive tax planning, is prima facie acceptable. More than mere window dressing is required to constitute a business, but the SCC appears to have established a relatively low threshold for the size and substance of the continuing business.

Adrienne Oliver
Ogilvy Renault, Toronto

No ABIL Please!

An unpleasant surprise emerged during tax preparation season this year: the reductions in the capital gains inclusion rate over 2000—from 75 to 66⅔ to 50 percent—resulted in a tax increase for some taxpayers, not the tax reduction Ottawa promised. The absence of certain consequential amendments produced deficiencies and/or potential inequities that affect the treatment of allowable business investment losses (ABILs) and the use of the capital gain exemption (CGE) for dispositions of qualifying small business corporation (QSBC) shares or qualified farm property (QFP).

Perhaps the most significant and most inequitable consequences of the capital gains inclusion rate change relate to business investment losses (BILs). There is no election allowing a taxpayer to treat a BIL as an ordinary capital loss, even though it is clearly defined as such; instead, it is treated as a non-capital loss without the gross-up and reduction adjustments afforded a net capital loss. This may not have been of great importance when the same inclusion rate applied throughout the three years preceding the BIL and the seven years after it, but if

1997	
Capital gain	$10,000,000
Reserve	(8,000,000)
Capital gain to be reported	$ 2,000,000
Taxable capital gain 75%	$ 1,500,000
Less CGE	(500,000)
Net taxable amount	$ 1,000,000
Tax at 50%	$ 500,000
1998 and 1999	
Net reserve	$ 2,000,000
Taxable capital gain	$ 1,500,000
Tax	$ 750,000
2000	
1999 reserve (period 1)	$ 4,000,000
Less reduction in BIL re CGE treated as ordinary capital loss	(500,000)
Capital gain to be reported	$ 3,500,000
Taxable capital gain (50%)	$ 1,750,000 (A)
BIL initial	$10,000,000
Less reduction in BIL re CGE	(500,000)
Adjusted BIL (period 3)	$ 9,500,000
ABIL (50%)	$ 4,750,000 (B)
Non-capital loss realized for year	$ 3,000,000 (B - A)
Carryback of non-capital loss: 1997–1999	
Non-capital loss used for 1997	$ 1,000,000
Non-capital loss used for 1998	$ 1,500,000
Non-capital loss used for 1999	$ 500,000
Total non-capital losses used, 1997–1999	$ 3,000,000

the inclusion rate is 50 percent, a BIL realized by a taxpayer during period 2 or 3 of calendar year 2000 or 2001 through 2003 may be worth one-third less than a regular capital loss that would otherwise be carried back and set off against capital gains subject to a 75 percent inclusion rate.

Assume a January 1, 1997 sale of QSBC shares with a nominal ACB for a $10,000,000 interest-bearing promissory note payable in 2002. In January 2000 the promissory note is established to have become a bad debt and is deemed disposed of for nil proceeds at December 31, 2000.

Because the ABIL is accounted for at a 50 percent rate and carried back to years governed by different inclusion rates, the taxpayer pays tax on $1,000,000 of taxable capital gains—the 1999 taxable capital gain of $1,500,000 less the $500,000 loss carryback—for proceeds that will never be received.

Another inequity relating to the capital gains inclusion rate concerns the calculation of the CGE for dispositions of QSBC shares or QFP in 2000. Instead of matching the CGE inclusion rate to the period of disposition for the QSBC shares or QFP, the proposed legislation bases an individual's CGE deduction on his or her average capital gain inclusion rate for the taxation year. If a QSBC share disposition falls in period 1 (from January 1 to February 27, 2000) and larger capital gains were realized in period 3 (post-October 17, 2000), the individual's maximum CGE may be closer to $250,000 ($500,000 × 50%) than $375,000 ($500,000 × 75%). On the other hand, if the disposition fell in period 3 and significant capital gains were realized in period 1, the maximum CGE may be closer to $375,000 than $250,000.

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

Forgone Interest

It is common for a purchaser to effect an acquisition of a target corporation's shares by incorporating a new corporation (Acquisitionco) to borrow to acquire Target's shares. To offset the interest expense against the profitable operations acquired, Target and Acquisitionco are merged as Amalco. Administratively, the CCRA allows a deduction of interest in such a leveraged buyout (IT-315). However, if on the facts the acquisition can be viewed as a recapitalization or redemption of shares, the CCRA may instead apply its administrative position in IT-80, which provides that a corporation can deduct interest on money borrowed to redeem shares to the extent that the borrowing does not exceed their PUC and the corporation's accumulated profits. The IT-80 rules may produce less favourable deductibility, a difference that may reflect the value of Target that is not derived from owners' equity, but is embodied in the price paid for its shares.

At the 1998 APFF congress, the CCRA was asked its views on the following transaction.

> Corporation X is held by several persons, including Corporation Y. Corporation X wishes to buy back the shares held by Corporation Y. The facts are such that if Corporation X borrowed money to buy back [such] shares . . . interest would not be deductible since the amount of the borrowing would exceed the paid-up capital of the shares . . . and the accumulated profits of Corporation X. In addition, Corporation B wishes to acquire Corporation X and incorporates Acquisitionco for this purpose. Acquisitionco borrows the purchase price and subscribes to common shares of Corporation X. Corporation X uses the subscription proceeds to buy back shares held by Corporation Y. Corporation X and Acquisitionco are merged through an amalgamation. [Translated from the French.]

The CCRA responded that on the facts its admin practice as set out in IT-315 did not apply because the debt was incurred effectively to buy back Corporation X's shares: the sequence of events was intended to circumvent

the rules set out in IT-80. The admin position in IT-315 applies only if the transactions are at arm's length and if the acquiror simultaneously acquires control and (almost) all of Target's shares (at least 90 percent, according to the CCRA). Furthermore, interest is deductible only if the transactions do not result in avoidance or undue tax advantage, conditions not outlined in IT-315; the CCRA apparently has no plans to modify IT-315 to reflect these "additional" requirements. It is interesting to consider whether the equity contributed by Acquisitionco should count when Target's PUC is measured.

If it is uncertain how the CCRA would view an amalgamation from an interest deductibility perspective, a windup of Target into Acquisitionco may be preferable: Target's assets are clearly acquired by Acquisitionco and thus outside the ambit of *Palmer-McLellan*, which prompted the apparent relief in IT-315. However, a tax-deferred windup requires that a 90 percent ownership test be met. Caution should be exercised if IT-80's requirements are not satisfied and a recapitalization element to a leveraged acquisition makes it economically equivalent to a redemption of Target's shares. Interest deductibility continues to receive a great deal of attention, and the debate over how to deal with the rules continues to be as controversial as some of the proposals in the still draft amendments of December 20, 1991.

Greg Boehmer and John Jakolev
Ernst & Young LLP, Toronto

E-Branch Profit Allocation

The OECD has finalized its positions on permanent establishments (PEs) and income characterization in an e-business context: most e-business income appears to be business income, and a server may be a PE. Now the main area of debate for direct taxes is the quantum of profit to be allocated to an e-branch.

Earlier this year, the OECD issued draft general and e-commerce reports on transfer pricing: *Discussion Draft on the Attribution of Profits to Permanent Establishments* and *Attribution of Profit to a Permanent Establishment Involved in Electronic Commerce Transactions*. (The former was summarized in "Attributing Profits to PEs," *Canadian Tax Highlights*, March 27, 2001, at 18.) Contrary to existing OECD positions, the e-commerce report tentatively suggests that the use of intangibles in a branch setting may be recognized, bringing a branch's income into line with a sub's. The e-commerce report says that comparable uncontrolled price (CUP) and cost-plus methods are preferred transfer-pricing methodologies (not the transaction net margin method [TNMM] that earlier comments suggested would be preferred), but that profit-based methods may be appropriate in certain circumstances. The report considers the sale of music in digital and traditional formats (CDs) via a self-contained automated server located in a treaty jurisdiction with no personnel at the server location. This business-to-consumer example is of limited use to the majority of practitioners whose clients' business-to-business situations may involve significantly different types of operations and intangibles.

Based on a functional analysis, the report concludes that the e-branch is a contract service provider (CSP) or an independent service provider (IsP). If available, a reliable CUP—of Internet service suppliers, application service providers, or managed service providers—or, alternatively, a cost-plus methodology may be used. The cost base for a CSP is direct and indirect costs incurred in the e-branch (rent, insurance, electricity, telecommunication costs, etc.). Capital costs associated with tangible and intangible assets are excluded for a CSP, but included for an IsP. TNMM or other profit-based methods should not be "overlooked."

Three variations of this basic model are considered. The factors and issues to be considered in the case of multiple servers are the same except that multiple jurisdictions are involved. But if the e-branch does not just provide automated services but employs personnel to perform certain tasks (server maintenance, hardware repair, Web site and customer troubleshooting, and after-sales service and support via e-mail or phone), then the PE's personnel are using tangible and intangible assets. The report tentatively concludes that the e-branch is a service provider, not a retail outlet, and an IsP relationship is more likely than a CSP relationship. Interested parties are invited to comment on this issue. A third variation assumes that the server and Web site are developed at the e-branch, which carries out Web site enhancements and improvements. This is an extreme and likely rare situation. All development costs are assumed to have been incurred in the branch, making it the economic owner of the intangibles, and most of the profits are allocated to the e-branch. The report notes that this is consistent with article 7 as it is worded at present.

The OECD's concern over inappropriate results flowing from non-recognition of intangibles is helpful, but the development of a framework to deal with this concern is still in the preliminary stages and may require changes to the model convention and domestic transfer-pricing legislation. Transfer-pricing considerations must continue to be monitored closely.

Pierre J. Bourgeois
PricewaterhouseCoopers LLP, Montreal

Andrew F. McCrodan
PricewaterhouseCoopers LLP, Toronto

Integration Test Revisited

Case law has long recognized that there is no clear line of demarcation between an employee and an independent contractor. An early control test gave way to four separate tests: control, integration, economic reality, and specified results. In 1987 the FCA articulated a 4-in-1 test in *Wiebe Door*—control, ownership of tools, chance of profit, and risk of loss—in search of the total relationship of the parties. The court recognized an alternative test—the integration test—but said that it was prone to being misused, as it had been in the TCC below. *Wiebe Door* is now invariably cited in cases dealing with this issue, but unfortunately it appears that too often the TCC decision's impugned interpretation of the integration test is applied. The FCA in *Mirchandani* most recently revisited the issues and concluded that the court below had done just that: cited and followed the TCC in *Wiebe Door*, misapplying the integration test in a manner specifically overruled by the FCA in that case.

The FCA in *Wiebe Door* reviewed the judicial history of the various tests distinguishing employees from independent contractors. The integration test (the organization test) was an alternative general test to the preferred 4-in-1 test. The taxpayer operated a business of installing doors, work that was actually performed by installers whose activities were in issue. In applying the integration test, the TCC concluded that "[a]ll the work performed by the installers formed an integral part of the [taxpayer's] business. Without the installers the [taxpayer] would be out of business." The FCA found that the TCC erred in its formulation of the integration test, which "can never be a fair test, because in a factual relationship of mutual dependency it must always result in an affirmative answer." The integration test produces an acceptable result when "the question of organization or integration is approached from the perspective of the employee and not from that of the employer, because it is always too easy from the superior perspective of the larger enterprise to assume that every contributing cause is so arranged purely for the convenience of the larger entity." In *Mirchandani*, the FCA concluded that the court below made precisely the same error as the TCC in *Wiebe*: the TCC in *Mirchandani* found that the clinic in question could not offer psychiatric services without the subject psychiatrists and referred "to the objective perception of a patient or the public as a means of determining the legal nature of the relationships between psychiatrists and the board for whom they were performing services."

History seems to have repeated itself. A quick review of recent cases reveals that the error made by the TCC in *Mirchandani* in the application of the integration test is not uncommon. In *O'Brien*, the TCC said that the most important factor was the fact that an "independent observer" would identify the taxpayer with the company. In *Precision Gutters*, the TCC appeared to view the installers' work as "an integral part of the business of [the larger enterprise]," which established an infrastructure and engaged the customers. The FCA in *Wiebe Door* was indeed correct in saying that the integration test is prone to misuse. It is hoped that the courts will heed the FCA's reiteration in *Mirchandani* that the integration test is not to be applied from the perspective of the patient, the customer, or the general public, but rather from that of the worker.

Leigh Anne Dunn
Thorsteinssons, Vancouver

Bankruptcy Proposals

A corporation experiencing financial difficulties may pursue a number of reorganization options. A superior court must approve a debtor's proposal to or arrangement with its creditors under the Bankruptcy and Insolvency Act (BIA) or the Companies' Creditors Arrangement Act. The recent BCCA decision in *Beach* addresses the relationship between the debt-forgiveness tax rules and BIA proposals (2001 BCCA 7).

In *Beach*, a superior court conditionally approved a BIA proposal assented to by the majority of creditors over the CCRA's objections. Inter alia, the proposal purported to cover all debts arising as a result of the acceptance and full performance of the proposal, including the CCRA's claim for tax payable as a result of the debt forgiveness: the debtor was thus effectively exempted from section 80. The judge declined to rule on the efficacy of that part of the proposal, deferring further review until after a possible assessment by the CCRA.

The CCRA appealed, saying that a proposal term cannot be left for later interpretation; the BCCA agreed. Furthermore, the CCRA said that the proposal term purporting to exempt the debtor from section 80 was illegal. The court noted that a proposal in bankruptcy amounts to a contract between the debtor and its creditors, which here included the CCRA, and the CCRA cannot contract out of its duty to assess tax in accordance with the Income Tax Act. Thus a proposal exempting the debtor from section 80 and imposing that exemption on the CCRA cannot be sanctioned.

Lori Mathison
Fraser Milner Casgrain, Vancouver

CANADIAN TAX *Highlights*

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Canadian Tax Foundation
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US Tax on Canco's Guarantees

US shareholders of Canadian companies are subject to US tax on undistributed earnings in a variety of situations. For example, it is well known that all US shareholders who own 10 percent or more of a company's votes must report their pro rata share of certain income of a Canco that is a CFC: more than 50 percent of votes or value is owned by US shareholders. Similarly, a US shareholder may suffer adverse tax consequences on Canco's "investment of earnings in US property"—which includes holding an obligation of a US person—when Canco guarantees the debt of its US parent corporation or the parent pledges Canco stock as security for the debt. A CFC holds an obligation of a US person if it is a pledgor or guarantor of the obligation: for example, if its assets at any time serve directly or indirectly as security of the performance of an obligation of a US person. In addition, a US shareholder's pledge of a CFC's stock is considered an indirect pledge of assets if at least two-thirds of the combined voting power of all classes of stock entitled to vote is pledged and if the pledge is accompanied by one or more negative covenants or similar restrictions on shareholders that effectively limit the CFC's discretion to dispose of assets and incur liabilities.

Whether or not the full amount of a loan outstanding is included in the US shareholder's gross income depends on whether Canco has sufficient current or accumulated earnings and profits not otherwise or previously (treated as) taxed to the US shareholders. A foreign tax credit is allowed a US corporate shareholder that owns a prescribed minimum percentage of the CFC's voting stock. For example, if a US corporation borrows from a third-party lender and Canco (its wholly owned subsidiary) guarantees the loan, the US corporation has deemed dividend income if Canco has sufficient earnings and profits. A US corporate parent may be able to mitigate the impact via certain foreign tax credits, but other categories of shareholders, such as individuals, may suffer adverse consequences.

Alice A. Joseffer
Hodgson Russ LLP, Buffalo

Family Business Breakups

Family-owned businesses comprise a large percentage of the Canadian economy. Because such businesses are operated by a close-knit group of family members, many owners, managers, and shareholders ignore the tax consequences of a business breakup with potentially very costly consequences for both the exiting and the remaining family members and the business itself. The structure of an exit plan should minimize and defer tax for all family members, and the payment for the exiting member's interest must be feasible in light of the cash resources of the acquiror and the business. The structure should reflect the current tax rate of about 25 percent on capital gains and 31 percent on dividends, and the restrictions on using Familyco's assets to fund the share purchase without tax consequences to the remaining shareholders.

■ **Direct sale of shares.** Familyco shares may qualify for the $500,000 enhanced capital gains exemption (ECGE). A capital gains reserve may defer tax related to unpaid purchase price for up to 5 years (10 years if a parent sells shares to his child). A direct buyout must be funded by the purchaser in after-tax dollars.

■ **Transfer of shares to a holdco.** The exiting member may dispose of the Familyco shares to another company not at arm's length with him or her immediately before and after; if that company is connected with Familyco, the gain realized on the disposition is a deemed dividend, and the ECGE is not available.

■ **Redemption or purchase for cancellation.** If an individual's shares are purchased for cancellation or redeemed, the difference between the redemption price and the shares' PUC is a deemed dividend, taxed at about 31 percent; the ECGE is not available. The otherwise tax-free deemed dividend received by a holdco on a redemption may be recharacterized as a capital gain if, for example, the exiting shareholder is not related to all the remaining Familyco shareholders (subsection 55(2)); siblings are deemed not related. An exception exists for a dividend reasonably attributed to safe income.

■ **Butterfly.** If siblings and their families are involved, a butterfly reorganization allows business assets to be distributed pro rata among corporations owned by each family member, permitting him or her to carry on the family business separately through his or her own corporation. Deemed dividends that arise in the course of a butterfly are not deemed capital gains if subsection 55(3) is satisfied.

Jack Bernstein
Aird & Berlis LLP, Toronto

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