CANADIAN TAX Highlights

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Place of Effective Management

The OECD technical advisory group (TAG) that monitors the application of treaty norms for the taxation of e-commerce business profits has issued a draft report, "The Impact of the Communications Revolution on the Application of 'Place of Effective Management' as a Tie Breaker Rule." The draft reviews the concept of place of effective management, its application in various countries, and the impact thereon of modern communications technology (such as videoconferencing and electronic discussion via the Internet). The draft suggests that the location of corporate residence may not be as easily determined in an electronic era and that the application of existing principles to a given fact situation may not be appropriate. Furthermore, the increasing mobility of MNCs consequent on new technologies and increased globalization leads to greater risk that they may be viewed as dual residents. The OECD has requested comments by the end of June. New technologies deployed as a result of the growth of e-business affect the tax position of all businesses, but place particular pressures on the cornerstone concept of corporate residence in the international tax area.

The current "place of effective management" test considers the substantive locations where key management and commercial decisions are made; where the most senior person or group of persons makes its decisions; and where the actions to be taken by the enterprise as a whole are determined. The draft considers refining or replacing the test or establishing a hierarchy of tests similar to the individuals' tiebreaker rule. A refinement of the test would involve its augmentation with factors such as the location of and functions performed at headquarters; location of the company's central management and control based on articles of incorporation or association; place of incorporation or registration; relative importance of functions performed in each state; and residence of the majority of directors. Alternatively, the draft considers three replacements for the test: (1) incorporation; (2) place of residence of directors or shareholders; and (3) the principal place of economic nexus via the use of land, labour, and factors of production. If the approach in the tiebreaker rule for individuals was followed, the draft suggests one possible hierarchy of tests: place of effective management, place of incorporation, economic nexus, and mutual agreement.

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ESBC Versus QSBC

The 2000 federal budget introduced a measure to permit individuals the opportunity to defer up to $500,000 ($2 million per the October 2000 economic statement) of capital gains on common shares of eligible small business corporations (ESBCs). Numerous conditions apply, including the timely reinvestment in another ESBC's shares of an individual's proceeds from the sale of ESBC shares. The proposed ESBC rollover, which differs significantly from the capital gains exemption (CGE) for qualified small business corporation (QSBC) shares, is modelled on the US qualified small business stock capital gain rollover (IRC section 1045).

It is not uncommon for an opco's shareholders to transfer their shares to a holdco to facilitate estate planning and creditor proofing. In order for the holdco shares to qualify as QSBC shares, the holdco must generally own opco shares representing more than 10 percent of its votes and value; capital gains on any QSBC shares are eligible for the CGE. To qualify as an ESBC, the holdco must be related to the opco, which generally requires the holdco's owning more than 50 percent of the opco's outstanding shares; only capital gains from the sale of ESBC common shares qualify for the ESBC rollover. In addition, the individual must own the ESBC common shares throughout the 185 days immediately preceding their disposition, whereas qualifying QSBC shares must not have been owned by an unrelated person throughout the immediately preceding

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24 months. A number of specific relieving provisions apply with respect to the ESBC holding period test to purify otherwise qualifying shares that have passed through various non-arm's-length share exchanges or transfers: for example, reorganizations may qualify for relief if they are undertaken using sections 85, 85.1, and 87, but not section 86 or section 86 overridden by a section 85 election. The relieving proposals are not as flexible as those under the QSBC rules, and thus care must be taken so as not to disqualify ESBC shares when implementing a share reorganization. We understand that the CCRA may deal case by case with taxpayers who were adversely affected by reorganizing their share ownership to accommodate a sale of otherwise qualifying ESBC shares before the draft legislation's release on December 21, 2000. A specific anti-avoidance proposal disallows an ESBC rollover if a (series of) transaction(s) is implemented in order to increase the eligible capital gain.

The ESBC rollover proposals are another example of how minority shareholders face unequal tax treatment. For example, assume that Ms. A owns 100 percent of Holdco A, which owns 55 percent of Opco. Ms. B owns 100 percent of Holdco B, which owns 45 percent of Opco. Ms. A and Ms. B also own Lossco 55 and 45 percent, respectively. Ms. A and Ms. B are contemplating an offer for their respective Holdco shares that may result in significant capital gains. Ms. A can take advantage of both her remaining CGE and the ESBC rollover, and shelter any remaining capital gain with losses in Lossco. Ms. B can take advantage of her remaining CGE but is ineligible for the ESBC rollover: Holdco B is not an ESBC because it is not related to Opco. Furthermore, Ms. B cannot shelter the remaining capital gain with her share of Lossco losses: she is not related to and thus not affiliated with Lossco. In fact, Ms. A may be able to access 100 percent of Lossco's losses even though she owns only 55 percent of its shares.

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Form over Substance?

At the Canadian Tax Foundation's 2000 annual conference, CCRA officials stated that *Interpretation Bulletin* IT-233R would be withdrawn by year-end, allowing practitioners time for comments. They said that the CCRA's position was that whether a transaction was a lease or a sale depended on the legal relationships as determined from the terms of the agreement, not on the transaction's economic substance. The officials have now completed their review and indicate that the bulletin will be withdrawn later this month. No replacement bulletin will be issued.

The CCRA says that this change creates certainty for commercial transactions and makes the treatment of this issue consistent with the form-over-substance rule applicable for all purposes of federal taxation. The *Shell* decision (99 DTC 5669) suggests that there is no substance-over-form doctrine, and is no doubt a key factor in the decision to withdraw IT-233R: many aspects of the bulletin conflict directly with *Shell*. In particular, paragraph 3 of the bulletin outlined four examples of supposed lease transactions that would be considered sales, of which the latter two suggest a substance-over-form doctrine:

- the lessee automatically acquires title after payment of a specified amount in the form of rentals;
- the lessee is required to buy the property before or at lease-end or at the termination of the lease, or is required to guarantee that the lessor will receive the full option price from the lessee or third party (except where such guarantee is given only in respect of excess wear and tear inflicted by the lessee);
- the lessee has the right during or at lease-end to buy the property at an option price that at the inception of the lease is substantially less than the probable FMV at the option date; or
- the lessee has the right during or at lease-end to buy the property at an option price or under terms and conditions that at the lease's inception are such that no reasonable person would fail to exercise such option.

Operating lease treatment was only possible if the option price estimated at the inception of the lease was at FMV. Lessors had to ensure that the value used was supportable, so as to withstand CCRA scrutiny into the substance of the transaction. At the annual conference, CCRA officials stated that the legal relationship between the parties to the contract creates the lease or sale, not simply the document's self-referencing as a lease or a sale. Automatic ownership of property after some rent is paid is viewed as a conditional or instalment sale and not as a lease. The CCRA states that its GAAR policy remains unchanged: it will continue to apply GAAR in circumstances viewed as abusive.

Reaction from industry groups so far has been mixed. Many critics who suggested that the bulletin had no support in case law will welcome the withdrawal. Proponents of the change say that income tax classification will be more certain and less arbitrary, reducing pricing risk. Opponents suggest that the IT's withdrawal will create more uncertainty: there will be a lengthy hiatus before a body of case law develops, and even then the emergence of practically useful guidelines may be far from guaranteed. Costs for technical advice can mushroom, and a misstep could easily rupture the economics of a transaction, especially in a long-term deal. Furthermore, the lack of guidelines will increase the risk of inconsistencies in the audit handling of similar files across the country.

Transitional administrative costs to lessors may be significant in situations where the lease agreements are regularly customized and many different types of leases

with different combinations of variables are written. Concern has also been expressed that the CCRA's position should be uniform across Canada vis-à-vis common law and civil law. The CCRA has said that there will generally be no grandfathering of IT-233R.

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Provincial Caution

All of the provinces and territories have presented at least one budget in 2001. British Columbia's new government may present its own budget late this year. The thrust of the budgets to date has been similar: smaller surpluses or bigger deficits forecast for the 2001-2 fiscal year than the preliminary results indicate for 2000-1; some tax cuts, but not on the scale of recent years; and no major tax increases.

Adjusted Surplus or Deficit

	2000-1 (preliminary)	2001-2 (forecast)
	$ million	
Newfoundland	−148.7	−146.5
Prince Edward Island	−6.7	1.6
Nova Scotia	−198.9	−90.7
New Brunswick	33.1	34.8
Quebec	500.0	0.0
Ontario	3,192.0	140.0
Manitoba	26.0	−50.0
Saskatchewan	839.5	−260.9
Alberta	5,549.0	817.0
British Columbia	1,317.0	1,090.0
Northwest Territories	23.3	1.7
Nunavut	−69.5	−34.8
Yukon	−33.8	−24.1
Total	11,022.3	1,478.0

The table shows that four provinces and two territories expected to end the present fiscal year in a better position than last year, but four provinces and one territory expect smaller surpluses in 2001-2. Manitoba and Saskatchewan will move from surplus to deficit this year. The figures have been adjusted to convert accounting systems to a more uniform basis, but full comparability is possible only when the Statistics Canada analysis of provincial budgets becomes available later this year. The provincial budgets are still tinged with caution, and the final results may be better than forecast. Alberta's is the best example: embarrassed in past years with overly optimistic forecasts of natural resource revenue, the provincial finance minister must now deliberately cut back from reasonable forecasts of revenue. Although Alberta's surplus may not be as big as last year's, only a major drop in oil and gas revenue will produce the modest surplus forecasted.

Although only Manitoba increased a tax rate (on cigarettes) in the 2001 budget round, all provinces east of the Ontario-Manitoba border (except Newfoundland) will see higher tobacco taxes as a result of the federal changes announced on April 5. On the other hand, New Brunswick, Quebec, Ontario, Manitoba, and the Yukon reduced personal income tax rates, and Saskatchewan and British Columbia enriched their credit systems. New Brunswick and Manitoba will lower their corporate income tax rates for small businesses, matching, or nearly matching, the previous announcements of rate cuts in Ontario, Alberta, and British Columbia. There were no major changes in the provincial sales tax and motor fuel tax systems.

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Planning for Double Tax on Death

Winding up a holdco or redemption of its shares held by an estate freezor at death has been standard practice to avoid double taxation on the gain. But the reduction in capital gain inclusion rates suggests a different tactic.

A standard estate freeze involves a rollover of opco shares to a holdco in exchange for preference shares with redemption value set at the opco shares' FMV. The pregnant gain is now potentially taxable in both the hands of the individual and the holdco. On the individual's death, the holdco shares are deemed disposed of at their FMV. That gain and the double tax issue may be eliminated by a redemption of the deceased's shares and a loss carryback to the terminal return. (Stop-loss rules, which deny the loss if the estate controls the holdco de facto or de jure, are assumed not to apply.) Assume that John's Opco shares—cost and PUC of $100 and FMV of $1 million—are rolled to Holdco at $100. Both John and Holdco have an inherent gain of $999,900 in the Holdco and Opco shares, respectively. John dies a widower when the Opco shares are worth $2 million; his son owns non-voting Holdco common shares—tax cost and PUC of $100 and FMV of $1 million. Winding up is not particularly favourable because it crystallizes Holdco's (and the son's) gain and tax liability, frustrating the purpose of the estate freeze. A redemption of the deceased's shares avoids these issues, but the ultimate redemption proceeds are taxed as a dividend. Holdco may fund the redemption by issuing a note to the estate.

The reduced capital gains inclusion rates suggest that the preference shares may be more advantageously transferred to Newco in exchange for debt equal to their ACB. (Section

Terminal return (redemption)

Deemed proceeds at death	$1,000,000
Adjusted cost base	(100)
Capital gain	$ 999,900
Taxable capital gain at death	499,950
Subsection 164(6) loss carryback	(499,950)
Taxable capital gain	$ 0
Estate	
Redemption proceeds	$ 100
Adjusted cost base	(1,000,000)
Capital loss	$ (999,900)
Allowable capital loss (carried back)	$ (499,950)
Deemed taxable dividend	$ 999,900
Tax @ 31.3%	$ 312,969

84.1 will not trigger a dividend if John did not claim an enhanced capital gain exemption in respect of the Holdco or Opco shares.) The son could exchange his Holdco common shares for Newco shares to allow a bump to $1 million in the Opco shares' ACB on an amalgamation of Newco and Holdco (subsections 87(11) and 88(1)). (The bump may be restricted if the estate did not acquire control of Holdco from the deceased.) This approach leaves the deceased's deemed disposition on death intact, and the overall tax is meted out at the reduced capital gain rate.

Terminal return

Deemed proceeds at death	$1,000,000
Adjusted cost base	(100)
Capital gain	$ 999,900
Taxable capital gain	$ 499,950
Tax @ 46.4%	$ 231,977

The estate is owed $1 million debt from Amalco, which owns Opco shares with a $1 million ACB. The estate pays about $81,000 less tax than on a redemption, and the stop-loss issues are also avoided. However, a redemption may be preferred if Holdco has a significant level of RDTOH, because it may be difficult to generate a complete refund.

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Treaty Management Exception

In an attempt to prevent non-resident corporations from being characterized as Canadian residents under common law principles or as carrying on business in Canada, tax practitioners generally advise their clients to exercise caution and avoid any management functions in Canada. Advisers generally recommend that mind, management, and control be exercised only in the jurisdiction of incorporation or where the corporation is otherwise intended to be taxed. This advice, while prudent, may be overly restrictive for Canada-US cross-border operations, at least concerning profit allocations to a Canadian permanent establishment (PE).

The exercise in Canada of mind, management, and control in respect of a USco usually results in its being a Canadian resident under common law principles, but USco is not subject to Canadian tax on worldwide income: subsection 250(5) and the residence tiebreaker rule in the treaty (article V(3)). For exempt surplus purposes, USco must be a US resident under both the common law and the treaty. Residence based on the treaty tiebreaker and subsection 250(5) alone may create surplus repatriation problems.

The exercise of management functions in Canada in respect of USco generally constitutes carrying on business in Canada through a PE (TI9801607). A PE is treaty-defined to include a place of management, and normally profits attributable to a PE are taxed in Canada as business profits (article VII). However, article VII(4) states that profits from the mere provision of "executive, managerial or administrative facilities or services" are not allocable to a Canadian PE through which USco carries on business and are therefore not subject to Canadian tax. This management exception appears to override the logical consequence of including a place of management in the definition of PE and also appears to be unique: there is no comparable provision in Canada's or the United States' other bilateral tax treaties or in the US model treaty.

The scope of the management exception has not been directly considered. Labour relations case law reveals an extremely broad ambit for management functions, including organizing, arranging, and directing all the corporation's resources to achieve the objectives set by the board of directors. In the context of part XIII, the CCRA considers the term "management or administration" to be very broad, including "functions of planning, direction, control, co-ordination, systems or other functions at a managerial level. These functions may involve services for [a business's] various departments . . . such as accounting, financial, legal, electronic data processing, employee relations, management consultation, labour negotiations, taxation, etc. relating to the management or administration." The treaty's technical explanation refers to the management exception in terms of "stewardship or other managerial services." The OECD commentary on transfer-pricing issues states that stewardship costs include costs of managerial and control activities related to the management and protection of a corporation's investments, but not costs that improve operations.

In summary, executive, managerial, and administrative services appear to include planning, direction, control, coordination, systems, and other functions at a managerial

level, but not management of day-to-day operational functions or revenue-generating activities. Thus a US treaty-resident corporation should be able to perform such functions in the exercise of mind, management, and control in Canada without triggering Canadian federal income tax on profits so derived, although surplus account issues may arise. Moreover, if exercising management functions in Canada constitutes a "treaty protected business," USco must file schedule 91 to disclose information concerning claims for treaty-based exemptions.

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CGE IPO Trap

A taxpayer taking a qualified small business corporation (SBC) public should be aware that a recent CCRA technical interpretation could severely limit access to the capital gains exemption (CGE). Given the CCRA's view, it may be impossible to make a section 48.1 election if the corporation raises funds through an initial public offering (IPO) and, as is usually the case, the shares are not listed when the IPO closes.

Section 48.1 is intended to allow a qualified SBC shareholder access to the $500,000 CGE for those shares when the corporation goes public. Often such shares represent the individual's only asset that qualifies for the exemption. The election applies if an individual owns shares of an SBC that "immediately after that time" ceases to be an SBC by virtue of its shares being listed on a prescribed stock exchange. On certain exchanges, there may be a delay of up to two weeks after the IPO closing before the shares are listed and called for trading ("the waiting period"). During this hiatus, certain documents are supplied to the exchange and reviewed and approved by it. That delay may result in the corporation's ceasing to be an SBC before—and not because of—the shares' being listed, and thus the prerequisites for the section 48.1 election will not be met. For example, the corporation may fail to meet the SBC active business asset tests during the waiting period because the cash raised on the IPO is used in ineligible investments; thus the SBC loses that status because of its use of the excess cash rather than the share listing.

The interpretation request argued that the phrase "immediately after" should be interpreted liberally to include "the sequence of events that a corporation must complete in order to have its shares listed." However, the CCRA concluded that the wording of section 48.1 clearly suggests that the corporation must be an SBC at the instant in time immediately before the shares are listed. No response was made to the further submission that, given the relieving nature and purposes of section 48.1, it appears illogical to disqualify a taxpayer from the election because the IPO and the share listing are not simultaneous and the IPO funds or other factors taint the corporation's SBC status during the waiting period.

In this case, the corporation was listing its shares on the VSE (now part of the Canadian Venture Exchange), where the listing process is slower than it is at the TSE. The problem may be less acute on the TSE, where the waiting period may be as little as one day. Apparently the TSE also has a procedure for advance qualification for listing that allows listing after the closing of the market on the day preceding the IPO's closing if all other necessary documents are filed three days before the closing.

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Administration Round-Up

Takeover fees

A recently obtained CCRA policy document comments on takeover fees and related expenditures. These policies are effective for assessments and audits completed on or after

JEFF MACNELLY'S SHOE by Chris Cassatt and Gary Brookins

October 15, 1998, but do not apply retroactively to earlier reassessments even if the year is not statute-barred.

■ **Circulars for shareholders.** Expenses incurred to meet obligations under a securities act or business corporations act to produce circulars for shareholders concerning takeover bids are tax-deductible, including legal and accounting fees, costs of obtaining fairness opinions (valuation reports), and printing and mailing costs (subsection 9(1)).

■ **Resisting a hostile takeover.** Over and above those statutorily mandated costs, costs incurred to resist a hostile takeover bid and maintain the status quo—such as the costs of initiating poison pills—are generally not deductible (paragraph 18(1)(a)) and are not considered eligible capital expenditures (ECE). However, if the actions taken include the issuance of shares or debt, subparagraph 20(1)(e)(i) may allow a deduction.

■ **Successful takeover bid.** The bidder's costs in a successful takeover bid are capital expenditures that are added to the ACB of the shares acquired. Costs of an abortive takeover are generally non-deductible, but if the target was in a business similar to the bidder's and the intention was to integrate the two businesses, the costs may be ECE.

2001 Ontario Budget Bill Tabled

The budget bill simplifies corporate tax filing.

■ Effective retroactively from July 1, 2000, one late-filing penalty for a business's retail sales tax returns is waived if it has not late-filed any returns in the past four years.

■ Currently, corporations must pay monthly corporate tax instalments if their annual tax payable in the current or preceding year is at least $2,000 but less than $10,000. The bill would permit these corporations to pay quarterly instalments, effective for taxation years commencing in 2002.

■ Corporations filing their Ontario corporate tax returns will no longer have to file a copy of their federal T2 and related schedules that have already been filed with the CCRA, effective for taxation years ending after 2000.

The May 9, 2001 bill also includes capital tax changes and cuts in the general corporate tax rate and the tax rate on M & P income scheduled to take effect between 2001 and 2005. Not included are some proposed administrative changes and legislative amendments to the tax treatment of the Ontario R & D superallowance; we understand that relevant legislation will be tabled in the fall 2001 session of the Ontario legislature.

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US Estate Tax Update

Tax cut enacted. At the end of May, the US Congress enacted the most sweeping tax cut in a generation, including complete repeal of the estate tax. But relief is not immediate and may never arrive for Canadians who own US real property, stock in US corporations, and contractual obligations of US persons: the estate tax is not completely repealed until 2010, and the entire tax-cut package self-repeals in 2011 unless re-enacted. Complete repeal would obviate the need for foreign owners of US assets to structure their holdings to minimize estate tax exposure, but the repeal's delayed effectiveness and uncertainty means that US tax advice is required to determine potential tax exposure and evaluate the available strategies for its mitigation.

The new law does not change the basic credit that, since 1988, exempts US$60,000 of US assets owned at death by a non-resident non-citizen. The exemption equivalent for US residents and citizens increases from US$675,000 to $1 million in 2002 and in stages to $3.5 million in 2009. The increase to US$1 million in 2002 provides some relief to Canadians with a sufficiently high proportion of US assets via the prorated credit under the Canada-US treaty. For example, a Canadian who dies in 2002 owning a US$400,000 Florida condominium and non-US assets of US$1.6 million has an effective US exemption of US$200,000, up from US$135,000 in 2001. With proper planning, a married couple owning such assets may avoid the tax altogether.

ADRs in IRAs. Many Canadians accumulate funds in IRAs while employed in the United States. In spite of the recent stock market turmoil, the value of many IRAs may trigger substantial US estate tax. Simply cashing out of an IRA during life avoids future estate tax, but the lost income tax deferral often makes such a strategy unattractive. The effectiveness of one alternative—the IRA's investing largely in American depository receipts (ADRs)—is far from certain.

Corporations located outside the United States often use ADRs to encourage US investors to buy their stock. A corporation deposits its shares with a foreign bank acting for a US bank, which issues ADRs to evidence ownership of these shares. Because ADRs are traded on US exchanges, they can be held in IRAs and arguably should be treated as the underlying shares, which are not subject to estate tax. The IRS accepts this argument for other purposes, but no case or ruling sanctions it for US estate tax purposes.

Furthermore, it is not clear whether an IRA should be treated as a revocable trust or as an obligation of the US financial institution where it is held. As a trust, an IRA would most likely be ignored and the owner treated as holding the assets directly; if none of the assets is subject

to US estate tax, the IRA also escapes the tax. However, the IRA is subject to estate tax if it is treated as a claim against and thus the debt obligation of a US obligor (the financial institution). The scope of the term "debt obligation" is not clear; annuities and pensions that take the form of promises to pay are covered, and several cases and rulings have included equitable interests in trusts and estates—for example, accrued income at the death of an income beneficiary. It is uncertain whether the IRS would accept that IRAs are distinguishable from such obligations.

The risk of such an IRA being characterized as a debt obligation may be minimized if the financial institution is a commercial bank. Unless effectively connected with a US trade or business, funds deposited by a non-resident alien in a US bank are deemed to be non-US assets for estate tax purposes. Funds held in brokerage or other non-bank accounts cannot qualify as such a deposit account, which may buttress an argument that an IRA held at a bank is not deemed to be a US asset. Holding ADRs may provide a reporting position that the IRA is not subject to tax.

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GST Audit Tack Backfires II

An earlier TCC decision allowed a Quebec car dealer's appeal from a GST assessment for tax on sales to status Indian purchasers. (See "GST Audit Tack Backfires," *Canadian Tax Highlights*, April 24, 2001, at 30.) Although the recovery and not the collectibility of GST was involved, in *Ventes d'autos Giordano* the TCC noted similarities with that earlier case; input tax credits (ITCs) were allowed for GST payable on the purchase for export of 19 new vehicles that were originally acquired by status Indians.

A company was established to acquire vehicles in Canada for export to Europe and the Middle East. Car manufacturers took steps to prevent dealers from selling vehicles manufactured for the Canadian market to exporters, and the export company turned to secondary sources such as car brokers and wholesalers. The 19 vehicles were acquired from two particular suppliers, and at least a significant part of the purchase price was paid to car dealers and other third parties; the CCRA did not challenge purchases where the exporter paid the broker or wholesaler directly. The CCRA initially denied the ITCs claimed by the exporter because it failed to pay GST when it acquired the vehicles. But at the hearing, the CCRA argued that the status Indians were the exporter's agents on the original purchase; the exporter was not entitled to ITCs because the status Indians had not paid GST. The CCRA argued GAAR in the alternative.

The auditor testified that the exporter maintained proper records for purchases and sales and generally complied with its GST obligations; the exporter's principal provided all information requested, and no irregularities were found on sales. The CCRA saw the direct payment to the car dealers or another corporation as problematic; in some cases the bank draft payable to a car dealer was for the same amount that the status Indian paid. Vehicle registration records revealed that each vehicle was transferred from a car dealer to a status Indian, to a third party, and on to the exporter, all in the same day or two. On four occasions the sale to the exporter occurred before the sale to the status Indian. In addition, the vehicle purchase price paid by the exporter to the wholesaler was always lower than the original and, in three cases, lower than the car dealer's cost.

As in the earlier appeal, the TCC held that because the CCRA's position at the hearing was based on facts different from those relied on for the assessment, the onus shifted to the CCRA; in either case, the facts assumed did not support the assessment. Because GST was "payable" by the exporter on its purchases, an ITC was available, even though GST was not in fact paid. The invoices produced were sufficient documentation to support the ITC claims. Furthermore, GAAR was a provision of last resort: if the CCRA believed that the vehicles had been purchased by status Indians as agents, it should have assessed the exporter for GST payable. In closing, the TCC noted that the exporter should have challenged the CCRA's pleadings as disclosing no reasonable grounds justifying the assessment and avoided five days of hearings.

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IRS Valuation Standards

The IRS has just circulated draft valuation standards to the major American appraisal societies for comment. The draft standards are intended to provide guidelines to IRS valuators relating to the "development, resolution and reporting of issues involving business valuations and similar valuation issues," and "[v]aluators must be able to reasonably justify any departure from these guidelines."

The standards incorporate certain portions of the practice standards that have long been in use by the major valuation bodies in the United States, including the Appraisal Standards Board of the Appraisal Foundation in Washington (a body authorized by the US Congress), and professional organizations such as the American Society of Appraisers, the Institute of Business Appraisers, and the National Association of Certified Valuation Analysts. They include guidelines concerning planning and supervision of IRS valuators, organization of the report, analysis, working papers, review, reporting, and even resolution with taxpayers. The standards to be adopted by the IRS will, of course, be those most relevant to US income, estate, and gift tax issues, and will eventually form part of the IRS's

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internal training manual, "IRS Valuation Training for Appeals Officers," available at http://onlinestore.cch.com/.

These standards are in addition to the IRS's numerous comprehensive, valuation-related revenue rulings, revenue procedures, general counsel memoranda, technical advice memoranda (TAMs), and private letter rulings as well as the Valuation Guide for Income, Estate and Gift Tax. The CCRA has stated on various occasions that it has no intention of issuing valuation guidance, let alone promulgating standards, other than what is contained in *Information Circular* 89-3 (except perhaps for some small revisions in process) and in a few commentaries by staff members at tax and other conferences.

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No ABIL Please!

In "No ABIL Please!" (*Canadian Tax Highlights*, May 29, 2001, at 36) the taxpayer pays tax on $1,125,000, not $1 million, of taxable capital gains for proceeds that will never be received (the 1999 taxable capital gain of $1,500,000 less the $375,000 loss carryback). This result flows from the following changes to the example used in the table: CGE 1997: $375,000; 1997 net taxable amount and tax: $1,125,000 and $562,500, respectively; non-capital loss used for 1997 and 1999: $1,125,000 and $375,000, respectively.

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Foreign Tax News

Tax Treaties

Germany and Canada signed a treaty to replace the existing 1982 treaty. A 5 percent withholding tax applies to dividends paid to a company controlling at least 10 percent of the votes in the payer company; otherwise a 15 percent rate applies. Withholding on interest and royalties applies at 10 percent. The treaty provides for mutual assistance in the collection of each country's taxes. The effective date for withholding tax is January 1, 2001; all other taxes are effective for taxation years beginning after 2001.

Jordan

A new special economic zone (SEZ) with a low 5 percent income tax rate encourages foreign investment opportunities; a 1995 law allows up to 100 percent foreign ownership in projects. The SEZ operates under a separate financially independent authority in the district of Aqaba (located on the Red Sea, south of Amman). Inter alia, customs and import fees and taxes, sales taxes, many property taxes, and social security taxes do not apply in the SEZ. Eligible companies must be registered in the zone and may import and export any products regardless of origin.

Portugal

Regulations governing the free zone of Madeira, established in 1987, incorporate changes required by the EU. Companies established before 2001 continue tax-free. Companies established during 2001 and 2002 have a fixed rate of 1 percent (2003-4, 2 percent; 2005-6, 3 percent). Financial services companies licensed before 2001 remain zero-rated (2001-2, taxed at 7.5 percent; 2003-4, taxed at 10 percent; and 2005-6, taxed at 12.5 percent). All rates continue until 2012. VAT remains unchanged. New reporting requirements are aimed at reducing tax evasion and fraud.

United Kingdom

The new finance bill for 2001 budget proposals also contains measures on double taxation relief and CFCs. Onshore pooling rules are relaxed; a pre-budget report extended the cap to 45 percent. Companies may claim relief for less than the full foreign tax related to a dividend. Tax attributable to dividends from UK subs distributed through a foreign intermediary holdco are deemed equivalent to applicable UK corporate tax. New regulations deal with the mixing of dividends between companies resident in the same country and the surrender of eligible unrelieved foreign tax in a group. New CFC rules are aimed at tax avoidance, including an issue and sale back of shares and the elimination of an acceptable distribution policy (ADP) exemption for dividends under a tax-avoidance scheme. The ADP is extended to CFC dividends paid to a UK company through a chain of foreign holding companies.

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