CANADIAN TAX Highlights

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Volume 9, Number 8, August 28, 2001

55(2): Contemplation of Sale

In *Granite Bay*, the TCC recently applied the anti-avoidance rule in subsection 55(2) to deem the proceeds of redemption of shares to be a capital gain, not a tax-free intercorporate dividend.

Granite Bay and its shareholders, Mr. and Mrs. Cox, owned shares in Greenstone, which the Coxes decided to sell in the summer of 1993. In late 1993 they rejected one offer and accepted another, from one Dougan. While the Dougan offer was still alive in December 1993, the Coxes authorized a reorganization of Greenstone that included the redemption of its shares held by Granite Bay. That redemption triggered a deemed dividend that Granite Bay reported as a tax-free intercorporate dividend. The Dougan deal fell through in late January 1994, when it became apparent that the financing to fund the acquisition was inadequate. Within three or four days the Coxes were visited by new prospects, and a third offer, the Olsen offer, was tendered and a sale finalized in February 1994, less than a month after the final step in the Greenstone reorganization was executed.

According to Granite Bay, paragraph 55(3)(a) saved the dividend from recharacterization as a capital gain because the Greenstone share redemption, which gave rise to the deemed dividend, was not part of the series of transactions that resulted in the sale of the Greenstone shares: in December 1993, when the reorganization was set in motion, the sale of the Greenstone shares to the Olsen group could not possibly have been contemplated by the Coxes. At the time of the reorganization they did not know of the purchaser's existence, the purchase price, or anything concrete to do with a potential sale. The TCC concluded that earlier authorities on the meaning of "series of transactions or events" establish that transactions or events comprise a series if there is some nexus between them. The determination must be driven largely by the facts of each case, but it is relevant to consider proximity in time as well as purpose and result. In *Meager Creek*, the TCC had rejected the proposition that any possible future sale can bring subsection 55(2) into play. But in *Granite Bay*, the TCC explained that the earlier TCC case clearly intended only to ensure that subsection 55(2) was not interpreted so broadly as to embrace future sales not yet in contemplation. The TCC viewed *Granite Bay*'s facts as being at the other end of the spectrum: a conclusion that no nexus existed between the Greenstone share redemption in December and the sale in February would ignore the obvious tax-avoidance purpose of subsection 55(2) and the words of subsection 248(10). The TCC said that there was no question that the Greenstone share sale was contemplated by the Coxes at the time of the redemption, and the dividend in kind paid on the redemption prepared Greenstone for sale by removing its non-logging assets. If the Dougan sale had closed, there was no doubt that that sale would have been part of a series caught by subsection 55(2). The TCC held that the change in identity of the purchaser, where the intention to sell remained intact throughout and the hiatus was so brief, cannot divorce the share redemption from a subsequent sale of the shares. Referring to UK step-transaction cases holding that a series did not include transactions that occurred when the identity of the final purchaser was unknown, the TCC said that such decisions were made in the context of a judicially developed anti-avoidance rule and should not be used to unduly limit the efficacy of specific anti-avoidance legislation.

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In This Issue

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Delaware: Unclaimed Property

All 50 US states have unclaimed property laws that generally require any holder of unclaimed funds to report and remit them to the appropriate state after a specified time. Delaware has initiated a compliance program to determine whether Delaware-incorporated businesses are properly filing unclaimed property reports: if such a company has never filed, has filed a negative report,

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or appears to have underreported, the company is likely to receive a warning letter. The company has 60 days to respond and must file reports for property back to 1990 in order to avoid penalties and interest for failure to file.

Typical sorts of unclaimed property include all intangible personal property such as dormant cheques, securities, dividends, insurance proceeds, oil and gas proceeds, gift certificates, bank accounts, traveller's cheques and money orders, and payroll. The lack of nexus for tax purposes does not avoid the reach of Delaware's unclaimed property laws: incorporation in Delaware is sufficient. The sourcing rules for unclaimed property differ from reporting responsibilities triggered by nexus. Unclaimed property is primarily reportable to the state of the apparent owner's last known address. But if no last known address is available, or if it is known but the state of last known address exempts the property from its own unclaimed property laws, the property must be reported to the state of incorporation. Because there is often no last known address for an owner, these rules benefit states like Delaware, the place of incorporation for many US corporations.

The letter now being sent to Delaware-incorporated companies presents both an incentive to file and a warning of an unclaimed property audit if no response is made. The letter indicates that a review of state records either does not show that a report was filed or shows that the report appears to be incorrect. The company is given 60 days from the date of the letter to respond and benefit from a waiver of interest and penalties. To encourage compliance Delaware only requires a five-year reporting period—only unclaimed property dated 1990-1996 is currently reportable, as opposed to the technically longer lookback period. If the company does not respond as requested, it may be targeted for audit, in which case "the audit look back period will be twenty years, which will result in 15 report years. Any amount of unreported property found during the audit will be subject to interest and penalties as provided by Delaware Law."

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US Regs on Foreign Trusts

Effective after the July 19, 2001 issue date, final regs under Code section 679 apply to transfers of property by US persons to foreign trusts with US beneficiaries, with only minor modifications from proposed regs of August 2000. Final regs under section 684 on transfers of appreciated property by US persons to foreign trusts were also issued.

Under section 679, a US transferor of property to a foreign trust is treated as the owner of the trust attributable to such property during each year that the trust has a US beneficiary; the rule prevents foreign trusts from enjoying the advantage of tax-free accumulation of income. A US beneficiary exists unless during the taxable year of the US transferor, under the trust's terms, no trust income or corpus may be paid or accumulated for the direct or indirect benefit of a US person, whether or not the trust terminates in the year. Under the final regs, income or corpus is considered so paid or accumulated without regard to actual distribution and any contingency attached to a US person's interest, except for contingencies so remote as to be negligible. Moreover, the existence of a US beneficiary may be established, inter alia, by written and oral agreements and understandings outside the trust document or if the trust terms are actually or reasonably expected to be disregarded by the parties. In response to concerns of some practitioners that new and unclear rules for determining a trust's existence have been thus created, the IRS said that rules in reg. section 301-7701-4 continue to apply to that determination, and section 679 regs are not intended to add new factors.

Rules in the proposed regs dealing with a foreign trust that is subsequently treated as having a US beneficiary within five years of the trust's creation were adopted without changes: in its taxable year that includes the later time, the US transferor is imputed additional income equal to the trust's undistributed net income under section 665(a) at the end of the transferor's preceding taxable year, plus an interest charge thereon (section 668). For example, assume that a US citizen/Canadian resident settles a Canadian trust for the benefit of his spouse and children who are not US citizens; if one of the beneficiaries later takes up US residence within five years, the settlor may then be exposed to US tax on all the trust income accumulated to date plus interest. Some practitioners believe that the regs exceed the authority of section 679 because the US transferor does not usually receive trust income; the IRS believes that the result is supported by legislative history. The final regs also preserve proposed exceptions for transfers at death and to employee benefit trusts and charitable trusts.

If a foreign person transfers property to a foreign trust with US beneficiaries and within five years becomes a US person, he or she is generally subject to the regs for US income tax—but not estate tax—purposes. Thus a trust may be structured that is a non-grantor trust for US estate tax purposes and that insulates trust assets from estate tax at the Canadian transferor's death.

The new regs under section 684 generally require recognition of gain when a US person transfers appreciated property to a foreign trust. The proposed regs excepted transfers on death if the property fell into the transferor's gross estate for US estate tax purposes and the trust's basis of the property was determined under step-up rules in section 1014. The final regs contain only the second requirement, a change that affects primarily individuals who are US residents for income tax purposes but non-domiciliaries for estate tax. The final regs carry forward the exception for US transferors treated as trust owners under the grantor trust rules. However, despite requests from practitioners, the final regs do not add an exception for transfers of life insurance contracts to foreign trusts.

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PARTIAL BALANCE

As the Canadian population ages and more of our aging taxpayers retire to live off pensions and annuities, the federal and provincial governments begin to reap the benefits of their earlier generosity. But only a portion of the annual tax relief conferred by government on registered retirement savings vehicles is recovered. Retired individuals, however, are returning most of the tax saved during their working years.

The table shows that in the 1998 taxation year, Canadians reported pension income of $64 billion, excluding Old Age Security pensions. Those still working claimed $33 billion in deductions for registered pension plan (RPP) and RRSP contributions and credits for a further $9 billion in contributions to the Canada and Quebec pension plans that cost the tax collector less than the RPP and RRSP deductions. Both the income and principal portions of RPP and RRSP payouts are taxable, unlike receipts derived from non-sheltered retirement funds, of which only the income is taxable. Nevertheless, taxation of the principal substantially offsets the current deduction of principal for those now working. Two vital pieces of information are missing from taxation statistics, making it difficult to determine the tax cost of retirement savings: the deductions from taxable income claimed by employers who contributed all or part of the funding for RPPs and the tax forgone on income earned within the sheltered funds.

Traditionally, the benefit of saving for retirement within a sheltered vehicle was the possibility of making withdrawals during retirement, when lower marginal tax rates apply. However, the flattening and broadening of the rate schedule reduces the differential between pre- and post-retirement tax regimes. Taxation statistics show that average assessed income for all tax returns varied little. In 1998, taxpayers aged 20 to 60 years reported average incomes of $30,450; those over 65 showed average incomes of $29,563; and the average for all tax filers was $29,087. Thus, for retired taxpayers, much of the income taken out of the tax net for retirement savings is returned to taxable status at comparable rates of tax during retirement.

Age	Percentage distribution of all returns	Credits and deductions for retirement savings	Retirement income from shelters	Average assessed income
	%	$ billion	$ billion	$
Under 20	4.6	0.1	0.0	6,266
20 to 59	64.4	38.6	13.2	30,450
60 to 64	5.3	2.2	10.5	30,027
Over 65	25.7	1.1	40.3	29,563
All returns . . .	100.0	41.9	64.0	29,087

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HOLDCO: FUTURE RESURRECTION?

With the nation's overall competitiveness sinking along with the Canadian dollar, a wide range of groups are calling on Ottawa to use its burgeoning surpluses for a variety of initiatives, including a recommitment to increased health funding and further reductions to both personal and corporate tax rates. As discussed in "Dividends Still Preferred" (*Canadian Tax Highlights,* July 24, 2001, at 54), in 2001 individuals and small businesses continue to benefit from lower provincial income tax (PIT) rates. The elimination of the 5 percent federal "deficit" surtax after 2000 benefited all top marginal rate individuals; however, taxpayers in British Columbia, Alberta, Saskatchewan, and Newfoundland also benefited from aggressive reductions in their respective top provincial marginal tax rates. The combined effect is a diminution of the appeal of earning investment income through a holdco rather than personally.

The February 2000 federal budget proposals, accelerated in the October 2000 mini-budget, reduced the general federal corporate income tax (CIT) rate on active business income and also reduced the capital gains inclusion rate from three-quarters to, ultimately, one-half. However, no adjustments were made to the general federal CIT rate on investment income, the additional 6⅔ percent refundable tax on CCPC investment income, the dividend refund structure, or the 4 percent federal surtax.

On the provincial front, the battle for bragging rights to the lowest provincial small business income tax rate continued in 2001 with rate cuts in a majority of jurisdictions. Announced reductions to the general CIT rates are greatest in Ontario and Alberta, which will stage in a reduced rate of 8.00 percent from 14.00 and 13.50 percent, respectively, by January 1, 2005 and April 1, 2004 (subject to affordability), respectively; on implementation, the earning of investment income through a CCPC taxable only in those provinces may be tax-advantageous.

Tax deferrals for interest income and capital gains no longer exist in any jurisdiction. In addition, the top personal marginal tax rate on dividend income for all jurisdictions (except Manitoba and Quebec) is lower than the

Income Tax Payable on $10,000 of Investment Income Earned Through a Corporation and Directly, Year Ending December 31, 2001

	Ontario	Quebec	BC
		dollars	
Portfolio dividends			
Corporate tax	3,333	3,333	3,333
Refundable tax	(3,333)	(3,333)	(3,333)
Individual tax on dividend	3,134	3,344	3,308
Combined tax	3,134	3,344	3,308
Individual tax	3,134	3,344	3,308
Tax cost with Holdco	—	—	—
Tax deferral with Holdco	(199)	11	(25)
Capital gains			
Corporate tax	2,489	2,615	2,614
Refundable tax	(1,256)	(1,193)	(1,193)
Individual tax on dividend	1,181	1,196	1,184
Combined tax	2,414	2,618	2,605
Individual tax	2,320	2,436	2,285
Tax cost with Holdco	94	182	320
Tax deferral with Holdco	(169)	(179)	(329)
Interest			
Corporate tax	4,979	5,230	5,229
Refundable tax	(2,511)	(2,385)	(2,386)
Individual tax on dividend	2,361	2,393	2,368
Combined tax	4,829	5,238	5,211
Individual tax	4,641	4,872	4,570
Tax cost with Holdco	188	366	641
Tax deferral with Holdco	(338)	(358)	(659)

Note: The figures assume that (1) the individual is taxed at the top marginal tax rate, (2) the capital gains are realized after October 17, 2000 and qualify for the 50% inclusion rate, (3) the capital gains deductions for qualifying small business corporation shares or qualified farm property are not available, and (4) the taxable dividend paid is the net after-tax amount less any capital dividend. Further, the Quebec combined tax amounts include, where applicable, the 1.60% Quebec Youth Fund corporate surtax and assume that the Quebec resident individual has sufficient other income to avoid having a net AMT liability arising from the payment of taxable dividends by Holdco to the individual.

federal part IV tax rate, creating a negative tax deferral. Accordingly, to avoid trapped RDTOH in the corporation and to achieve the lowest overall combined tax on capital gains in most jurisdictions, it may be prudent to maximize the dividend refund by paying a sufficient taxable dividend instead of the maximum capital dividend. The timing of the taxable dividend distribution from Holdco should be planned in view of additional reductions proposed to provincial PIT rates in 2002 et seq.

The table shows that earning investment income in a corporation in 2001 creates a tax cost ranging from about 1.9 percent (for Ontario-resident individuals and holdcos) to about 6.4 percent (for BC-resident individuals and holdcos after the July 30, 2001 BC mini-budget) for interest income, and one-half those amounts for capital gains. This tax cost increased substantially as general PIT rates were reduced aggressively in the past few years. Recent federal proposals appear to correct an inequitable and significantly larger tax cost for CCPCs earning capital gains dividends from a mutual fund trust rather than a mutual fund corporation. (See "Mutual Fund Reintegration?" *Canadian Tax Highlights,* April 24, 2001, at 29.)

As in earlier years, strictly on rates, an individual will prefer to earn investment income personally, not through a corporation; however, numerous other factors must be considered. An investment holdco allows the individual shareholder to control income flow from investments to minimize various federal and provincial clawbacks, and allows significant estate, probate fee, and income-splitting opportunities. (However, the split tax has reduced most of the income-splitting opportunity for minors who are holdco shareholders, either directly or through a discretionary family trust.) A holdco is also a valuable tool in various financing and corporate restructurings and dispositions, including the deferral of tax on safe income and creditor-proofing dividends. Costs associated with incorporating an investment holdco include accounting and legal fees, provincial capital tax, federal large corporations tax, the inability to offset corporate capital gains against losses at the personal level (or vice versa in certain circumstances), Ontario corporate minimum tax, and, for residents of Quebec, the applicability of Quebec AMT to taxable dividends received from Holdco.

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Challenging Audit Assumptions

Tax auditors sometimes rely on CCRA-accepted industry norms or benchmarks; a business outside the norm may red-flag an assessment. In *Huyen*, the TCC rejected an extrapolation over a long period of an audit sample covering a brief period. (See "Minimum Audit Standard," *Canadian Tax Highlights*, July 22, 1997, at 50.) The TCC recently looked at the use of industry norms in *Gestion Cheers*.

The taxpayer corporation, which operated a bar near the Montreal Forum, was assessed for the period from June 1991 to January 1995 and denied a 30 percent deduction from sales revenue for spillage, events, and promotion. The auditor relied on a rule of thumb that the average such deduction in similar establishments was 10 percent of total sales. The taxpayer's owner testified that the 30 percent deduction reflected an all-out promotional effort to increase sales during the audited period, which included a recession. The corporation used a special anti-theft system to account for all liquor used, whether or not money was collected. The sales figures in the corporation's financials recorded each drink poured but not the value of drinks given away for promotional purposes or sold at discounted prices; a deduction for those amounts was required to arrive at actual sales figures. The CCRA auditor testified that there was no substantial discrepancy between the cash register receipts and the corporation's bank records; he denied the deduction solely because reported spillage and promotional amounts were excessive relative to an industry norm and concluded that the excess claim represented underreported sales on which GST was not remitted.

The TCC characterized the issue as one of fact and concluded that the corporation established evidence sufficient to refute the CCRA's assumption of fact. The owner's testimony was supported by the books and records, which were generally accepted as accurate, and was not rebutted by the auditor's evidence. The auditor only had his suspicions and had not spoken to any of the corporation's employees or taken any other steps to substantiate the allegation of unreported sales.

Gestion Cheers illustrates that assessments based on unsupported (and in this case unwarranted) audit assumptions can be successfully challenged. From a cost perspective, attempts to rebut any assumptions proposed by the auditor to buttress an assessment should be made during the audit phase, but it may prove difficult to divert him or her from a CCRA industry norm or audit guideline. In any event, the analysis will assist in preparing evidentiary groundwork for an administrative or judicial appeal.

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Exchangeable-Share Pitfall

In an exchangeable-share transaction there may be a concern as to whether a deemed dividend arises under section 84.1 to a Canadian-resident individual shareholder when a Canco's shares are exchanged for shares of the foreign company that is closely held.

SHOE by Chris Cassatt and Gary Brookins

Assume that Forco wishes to purchase the shares of Target, a widely held Canadian-resident corporation owned by Canadian-resident individuals, none of whom holds a substantial interest. Target undergoes a capital reorganization: Target's vending shareholders roll their common shares under subsection 85(1) for Target exchangeable shares plus ancillary rights, and it has only a single voting common share owned by a Canadian corporation of Forco (Callco). In recent structures, Callco is usually a Nova Scotia ULC with an overriding call right allowing it to effect the switch of Target exchangeable shares for Forco shares when an exchangeable-share right is exercised. Callco acquires Forco shares by having it subscribe either for Callco shares in exchange for its own shares or for cash that is then used by Callco to purchase Forco shares.

Effecting the exchange by a corporation other than Target can achieve favourable results: the possible application of part VI.1 tax is mitigated (a concern if Target is not taxable and cannot benefit from the nine-fourths deduction to offset tax paid); the cross-border PUC of the Callco shares owned by Forco is increased to the FMV of the Forco shares delivered; and withholding tax for non-resident vending shareholders is mitigated. Because the tax hit to a Canadian-resident individual at the top marginal rate is greater on a deemed dividend than on a capital gain, a sale to Callco is generally preferred.

Section 84.1 applies if a non-corporate taxpayer disposes of shares (the subject shares) of a Canadian-resident corporation to another corporation (the purchaser corporation), the vendor and the purchaser corporation are not at arm's length, and immediately thereafter the subject corporation is connected (under subsection 186(4)) with the purchaser corporation. Section 84.1 is an anti-avoidance provision intended to prevent the conversion of taxable corporate surplus into share proceeds in non-arm's-length transactions that result in an exempt capital gain. Upon the exchange, a Canadian individual shareholder of Target may be deemed to receive a dividend to the extent that the value of non-Callco-share consideration received exceeds the greater of the Target shares' modified ACB and the PUC of the Target shares sold (or any increase in ACB under section 84.1). An extended definition of "arm's length" with a purchaser corporation (Callco) captures situations in which immediately before the disposition the exchangeable-share holder was one of a group (not necessarily related) of fewer than six persons who controlled Target (the first group) and immediately after the disposition was one of a group of fewer than six persons who controlled the purchaser corporation (Callco) and each member of that group was a member of the first group. This extended definition could apply in the assumed situation if Forco's control is closely held by a group of fewer than five at the time of the transfer.

Diluting control of the existing Forco shareholders through a share offering may be a solution—the application of section 84.1 is determined at the time of the exchange—but relinquishing control may be an issue for the Forco owners. Moreover, because section 84.1 does not apply if the vendor is a corporation, another solution may be for the vending shareholders to transfer their Target shares to a holdco before the exchange. Or Forco may acquire the Target exchangeable shares from the individuals directly: that tactic eliminates concerns about section 84.1, but the absence of PUC step-up for Forco may be problematic. Anti-avoidance provisions similar to those in section 84.1 are also extended to non-resident vending shareholders in section 212.1.

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Foreign Spinoff Deadline Looms

Under 2001 federal budget proposals, a taxpayer who received shares after 1997 in a foreign spinoff may be eligible for tax-deferred treatment. To be eligible, the foreign distributing corporation and the Canadian shareholder-taxpayer must fulfill certain requirements by the September 12, 2001 deadline set by the enabling legislation's receiving royal assent on June 14, 2001 (Bill C-22).

To defer tax on the distribution, a Canadian taxpayer must elect by submitting a letter before September 13, 2001 and provide information to the CCRA: the number, cost amount, and FMV of the original shares pre-distribution; the number and FMV of the original and the spinoff shares immediately after spinoff-share distribution; the manner in which the distribution was reported by the taxpayer; and details of any subsequent disposition of original and spinoff shares. The CCRA also requires Canadian taxpayers to confirm with the distributing corporation that it has submitted information as follows. By September 12, 2001, the distributing corporation must provide the CCRA with satisfactory information establishing (1) that at the time of distribution, the distributing corporation common shares (the original shares) were widely held and actively traded on a prescribed stock exchange; (2) the date of the distribution and the type and FMV of each property distributed to Canadian residents; (3) the name and address of each Canadian resident to which property was distributed; (4) that neither the distributing corporation nor the spunoff corporation were ever Canadian residents; and (5) that the distribution was not taxable to shareholders resident in the country of the distributing corporation.

Original corporation	Spinoff corporation	Year
Ford Motor Co.	Associates First Capital Co.	1998
General Motors Corp.	Delphi Automotive Systems Corp.	1999
Ford Motor Co.	Visteon Corporation	2000
Ralston Purina Company	Energizer Holdings Inc.	2000
Hewlett Packard	Agilent Inc.	2000
AMR Corp.	Sabre Holdings Corp.	2000

A series of questions and answers on foreign spinoffs on the CCRA's Web site includes a list of foreign distribution corporations for which, as of July 16, 2001, the CCRA had approved submissions for tax-deferred treatment of their distributions. The list should grow with additional approvals; its status can be checked at http://www.ccra-adrc.gc.ca/tax/business/taxtopics/foreign-e.html/.

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Roadblock Lifted from Large Gifts

Finance will recommend the elimination of an obstacle currently preventing a person or non-arm's-length group from making large charitable donations in certain circumstances. Finance says that the amendment should apply to determine a charitable organization's status after 1999 and should appear in a future technical bill.

Currently, one person or a related group can contribute no more than 50 percent of a charitable organization's contributed capital. To ensure that the rules do not effectively prohibit or limit charitable giving and in light of other income tax restrictions such as disbursement requirements, Finance issued a comfort letter confirming that it intends to recommend the replacement of the "contribution amount" test in the definition of "charitable organization" with a post-donation arm's-length test. The new test will require that at all times after the donation, any person or non-arm's-length group contributing more than 50 percent of a charitable organization's capital must deal at arm's length with more than half of its directors, trustees, and officers. Furthermore, such a person or group must not have any direct or indirect influence over the organization such that, if exercised, it would be reasonable to conclude that the person or group controls the organization or one or more of its activities.

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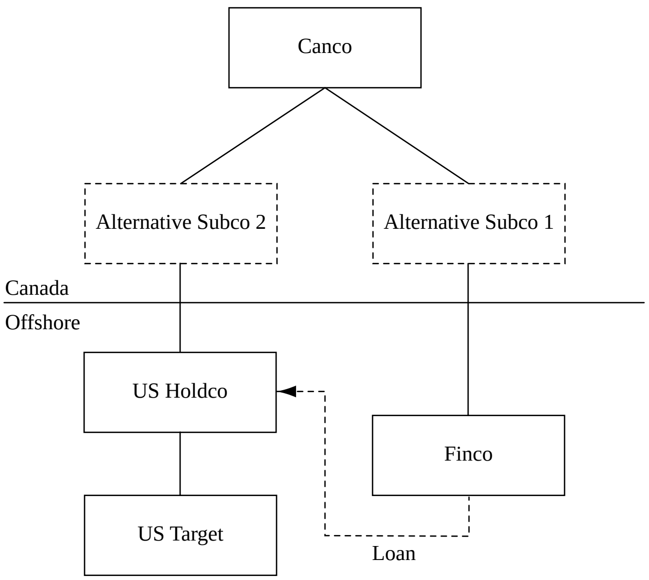
Financing Affiliate Purchases

A trap exists in clause 95(2)(a)(ii)(D) if interaffiliate loans are used to acquire the shares of target companies.

Assume that a Canadian taxpayer intends that interest income earned by Finco will be recharacterized as ABI rather than as property income (clause 95(2)(a)(ii)(D)). Inter alia, the Canadian taxpayer must have a qualifying interest (QI) in Finco, US Holdco, and US Target. Subco 1 has a QI in Finco, but not in US Holdco or US Target because it does not hold their shares directly. In fact, US Holdco is not an FA of Subco 1. Thus if Subco 1 is used, it has FAPI from Finco's interest earned on the loan used by US Holdco to acquire US Target's shares. In contrast, if Subco 2 is used, Canco must include Finco's FAPI in its income, but Canco has a QI in each of the US companies and in Finco. Thus Finco's potential FAPI is recharacterized as ABI. Finance is aware of this issue and is considering whether a legislative amendment is appropriate; a concept similar to that in subsection 17(3) is one possible approach.



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Expansion in the US

Geographic proximity, NAFTA, and the lure of the US dollar prompt many Canadian companies to expand into the United States for the purpose of selling goods or services, opening an office and hiring employees, or purchasing US competitors. Each stage may trigger different cross-border tax considerations.

A Canco may be taxable on US business profits if it carries on a trade or business—regularly and continuously transacting a substantial portion of its ordinary business in the United States, including frequent attendance at US trade shows where sales are made to US customers. Whether the additional requirement of effectively connected income (ECI) exists depends on where contracts are negotiated and signed and whether title passes inside the United States. ECI from the sale of goods may not exist if Canco negotiates its sales from Canada and title passes inside Canada, even if an independent sales agent with no authority to contract is used. Moreover, the Canada-US treaty protects Canco from US tax if it has no US permanent establishment (PE). A treaty PE is a fixed place of business, including an office, a place of management, a construction site lasting at least 12 months, US employees, or a US agent who has and habitually exercises authority to contract. The definition excludes a warehouse or the use of facilities for storage, display, or delivery; maintenance of goods for processing by another person; the purchase of goods or collection of information; advertising; and independent sales representatives without authority to contract or acting in the ordinary course of their business. A treaty-protected Canco carrying on a US trade or business with ECI should file a US income tax return and a section 6114 treaty-based return (form 8833); failure to file may result in disentitlement to US deductions if Canco is found to have a US PE.

No US trade or business or ECI. Canco makes occasional sales to US customers, but has no US office, warehouse, employees, or agents. Canadian sales staff take orders over the phone or Internet; inventory is in Canada and is shipped to the United States.

US trade or business. With an increase in US sales, Canadian salesmen travel regularly to the United States, attending trade shows and meeting US customers directly. Sales contracts may be signed in the United States, but goods are still shipped from Canada. Canco may be carrying on a US trade or business and may have ECI but has no US PE if salesmen do not habitually contract in Canco's name in the United States. It is prudent to file US forms 1120F and 8833. Tax may be exigible by the states, which are not party to tax treaties; regular sales in a state may establish sufficient tax nexus.

The level of US sales may justify the retention of US independent contractors as commission salesmen and the

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Published monthly

Price: $13.33 per copy
Subscription rate: $160 per year

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ISSN 1192-2672 (Print)
ISSN 1496-4422 (Online)

leasing of a US warehouse. All sales are approved in Canada. Arguably there is no US trade or business and no US PE. A protective US return should be filed.

US PE. The success of the US business warrants opening a US office, hiring US employees, and possibly opening a US manufacturing facility: a US trade or business, ECI, and a US PE will exist. If Canco should decide to incorporate its former branch in a new US company, substantial savings may or may not follow: double tax may even apply. The average US combined federal and state tax rate is 40 percent, and 5 percent withholding applies on dividends paid to a Canadian holdco. Even dividends paid out of active business earnings—not taxable to the Canadian holdco—attract tax of, say, 31 percent on eventual distribution to individual shareholders, resulting in aggregate tax of 60.67 percent. A branch of Canco continues to attract Canadian federal tax as well as US federal and state taxes and US branch tax of 5 percent on profits exceeding Cdn$500,000. A Canadian foreign tax credit or deduction is available for US tax paid.

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Foreign Tax News

Four newly signed treaties are effective for withholding taxes as of January 1 in the calendar year following entry into force (for other taxes, beginning on or after that day). The **Ecuador** treaty limits withholding to 5 percent on dividends paid to a company controlling at least 25 percent of the payer's votes (15 percent otherwise) and on interest, and to 10 percent on royalties for the use of, or the right to use, industrial, commercial, or scientific equipment (15 percent otherwise). The **Venezuela** treaty limits withholding to 10 percent on dividends paid to a company controlling at least 25 percent of the payer's votes of the paying company (15 percent otherwise); to 10 percent on interest; and to 5 percent on copyright royalties, royalties on certain software patents, and knowhow (10 percent otherwise). The **Peru** treaty limits withholding to 10 percent on dividends paid to a company controlling at least 10 percent of the payer's votes (15 percent otherwise) and to 15 percent on interest and royalties. The **Senegal** treaty limits withholding to 15 percent by Canada and 16 percent by Senegal on dividends; to 15 percent on interest by Canada and to 16 percent by Senegal except for 20 percent withholding on Senegal's investment certificates (bons de caisse); and to 15 percent on royalties.

Canada's Tax Treaties

In force (71)

Algeria
Argentina
Australia
Austria
Bangladesh
Barbados
Belgium
Brazil
Cameroon
Chile
China, PR[1]
Croatia
Cyprus
Czechoslovakia[2]
Denmark
Dominican Rep.
Egypt
Estonia
Finland
France
Germany
Guyana
Hungary
Iceland
India
Indonesia
Ireland
Israel
Italy
Ivory Coast
Jamaica
Japan
Jordan
Kazakhstan
Kenya
Korea, Republic of
Kyrgyzstan
Latvia
Lithuania
Luxembourg
Malaysia
Malta
Mexico[3]
Morocco
Netherlands
New Zealand
Nigeria
Norway
Pakistan
Papua New Guinea
Philippines
Poland
Romania
Russia
Singapore
South Africa
Spain
Sri Lanka
Sweden
Switzerland
Tanzania
Thailand
Trinidad & Tobago
Tunisia
Ukraine
United Kingdom
United States
Uzbekistan
Vietnam
Zambia
Zimbabwe

Signed but not yet in force (11)

Bulgaria[4]
Czech Republic
Ecuador[5]
Germany
Lebanon[4]
Peru[5]
Portugal[4]
Senegal[5]
Slovak Republic
Slovenia
Venezuela[5]

Under negotiation/ renegotiation (22)

Armenia
Australia
Barbados
Belgium
Colombia
Egypt[6]
Gabon
Greece
Ireland[6]
Italy
Kuwait
Mauritius
Mexico
Moldova
Mongolia
Norway
Romania
St. Lucia
Turkey
United Arab Em.
United Kingdom
United States[7]

[1] This convention does not apply to Hong Kong. [2] Continues to apply to both the Czech and Slovak republics. [3] A convention for the exchange of information is also in force. [4] Part of Bill S-3, which received royal assent on June 29, 2000. [5] Recently signed; see above. [6] Will eventually replace the existing treaty. [7] Protocol.

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