Canadian Tax Highlights

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Accounting Rules Bump LCT

The new accounting standards in *CICA Handbook* section 3465, mandatory for fiscal periods beginning on or after January 1, 2000, may unexpectedly affect a corporation's large corporations tax (LCT) liability. A recent technical interpretation (TI) describes one such example.

Handbook sections 3465.43 and 3465.44 apply when an asset is acquired (except in a business combination) and its tax basis is less than its cost (for example, on a subsection 85(1) rollover within a corporate group). The cost of future income taxes related to that difference at that time is added to the asset's cost, effectively bumping its carrying value for accounting purposes. The accounting entry to record this bump is a debit to the asset and a credit to the future income tax liability (FITL). The FITL balance is included in capital for LCT purposes: an increase in FITL increases the company's LCT liability.

Is the FITL bump a reserve? The TI request notes that this FITL bump differs from other FITL credits, which generally offset charges to income/retained earnings. However, the CCRA views a corporation's FITL under the new section 3465 as a provision for deferred taxes that thus falls in the definition of reserves and is included in the computation of capital (paragraph 181.2(3)(b)). The CCRA says that subsection 181(3) requires that an amount included in the computation of a corporation's capital be the amount reflected in its balance sheet prepared in accordance with GAAP; thus the entire FITL balance shown on the GAAP balance sheet is used to compute its capital. The CCRA says that nothing in the Act permits a reduction of the FITL balance on the GAAP balance sheet for an amount included on an FITL asset bump. The CCRA adds that the carrying value of the asset as reflected in the balance sheet, including any FITL bump, is used to determine the investment allowance (subsection 181.2(4)). But this is not helpful for a depreciable asset that is not eligible for the investment allowance.

Accounting amortization of the bump. The CCRA says that the accounting amortization of the depreciable asset bump is part of an allowance for depreciation and thus is specifically excluded from the definition of reserves in subsection 181(1); thus the amount of an FITL bump that is amortized to income/retained earnings is not added as a reserve under paragraph 181.2(3)(b) in computing LCT capital.

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CTF ACEF
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Export Distribution Centres

Historically, GST has applied to most goods imported into Canada, except for zero-rated goods (foodstuffs, certain drugs) and the few goods enumerated in schedule VII of the Excise Tax Act. (Goods imported for minor processing and then exported were almost always subject to GST that could be recouped via an ITC claim, but the time lag between payment and recovery often created a cash flow squeeze and administrative complexity.) Effective after 2000, the February 2000 budget proposed an export distribution centre program (EDCP) that allows businesses to acquire or import most goods without upfront GST if they export substantially all their outputs or operate export distribution operations for other businesses. Appropriate changes to the ETA are about to be finalized.

The EDCP is aimed at businesses adding limited value to imported goods, but is a step forward in a global economy. An eligible business has export revenue equal to at least 90 percent of its total revenue generated in Canadian activities. Export revenue is derived, for example, from the sale of goods to be exported and from the provision of services related to other persons' such goods. The business may add only limited value to goods: the direct labour component of the goods' value cannot exceed a specified percentage in the case of businesses processing their own goods for export. Separate limits are set for the value of services provided by a business processing another's goods. Special rules apply for activities that can be undertaken in a customs bonded warehouse.

A qualifying business must obtain CCRA pre-approval for entrance into the EDCP and obtain export certificates

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for the GST-free acquisition or importation of inventory (or parts or components to be used in processing) and importation of goods in respect of which GST-free processing, storage, or distribution services will be performed. Business inputs such as rent and other overhead costs are not eligible, but qualifying businesses can expect real benefits. Not only does the program remove cash flow issues for such marginal manufacturing activities, but Canadian service providers may also effectively import goods owned by unregistered non-resident persons and others unable to claim ITCs. Previously, no ITCs were available unless the parties relied on the cumbersome subsection 169(2) rules. Authorizations run for three-year terms and are renewable, but may be revoked midstream for a variety of reasons. Improper use of the program may result in an export distribution centre's suffering GST under various provisions of the ETA.

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Loss Relief Not Superficial

In addition to losses in today's volatile stock markets, an investor may suffer an unpleasant tax surprise if a rapidly depreciating stock is sold within 30 days of purchase. The CCRA recently confirmed and extended an administrative practice that it believes will result in a reasonable application of the stop-loss and superficial loss rules. The position may provide relief for a taxpayer who sold part of an investment that immediately soured in order to minimize exposure to further losses or perhaps to respond to a margin call.

In general, the stop-loss rules, the superficial loss rules, and the definition of superficial loss prevent the recognition of a capital loss on a property's disposition until it is disposed of to a non-affiliated person (subsection 40(3.4), subparagraph 40(2)(g)(i), and section 54). These rules apply if a taxpayer acquires a substituted property—the property disposed of or an identical property—within the period that begins 30 days before and ends 30 days after the disposition, and the taxpayer or an affiliated person owns the substituted property at the end of that period.

Assume that an individual acquired 100 shares of XYZ Ltd. on January 1 and sold 99 of them on January 25 at a loss. The individual acquired a substituted property—the one share not sold—within the defined period and still owned it at the period's end; a strict interpretation of the superficial loss rules deems the entire loss to be nil because the one share retained is a substituted property for each of the 99 sold. A new technical interpretation (TI) confirms that an administrative practice outlined in a 1992 TI applies to superficial loss rules for individuals and extends it to the stop-loss rule for corporations, trusts, and partnerships. An algebraic formula determines the denied portion of the loss.

$$\text{Denied loss} = \text{loss otherwise determined} \times (\text{least of } S, P, \text{ and } B)/S,$$

where S = the number of items disposed of;
P = the number of items bought in the 60 days period; and
B = the number of items left at the end of the period.

The 1992 TI states that this formula disallows a reasonable position of the total loss incurred on the disposition when fewer items were bought than sold or when fewer items are left at the end of the period than were bought during the period. Thus, if the loss incurred on the 99 shares was $1,000, the formula results in a loss denial of $10.10, the loss on one share. In other words, the one share acquired in and held at the end of the 60 days is a substituted property for only one of the shares sold; thus, only the loss on one of the 99 shares sold is denied. But the administrative position does not always bring relief. If the individual disposed of only 50 of the 100 shares at a loss and held the balance at the period's end, the entire loss on all 50 shares sold is denied and added to the remaining 50 shares' cost base: the 50 shares acquired in and still owned at the end of the period are substituted property for the 50 shares sold.

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Latest Word on Tax Burdens

Recent revisions to Statistics Canada's national income and expenditure accounts have been released in enough detail to determine the ratio of total tax collections to gross domestic product (GDP) for 2000. All of the recent ratios are lower than previously calculated when civil service pension contributions were treated as taxes, but the trend has changed very little.

As the table shows, the ratio's high point was not reached in the depths of the recession, but in 1998 when it touched 36.6 percent of GDP. In the subsequent two years the ratio has lowered only by 0.1 percentage point. Under the earlier measurement of taxes, the old system peaked at 37.4 percent in 1998. Federal taxes fluctuated within the range of 16.9 to 17.2 percent in the past four years, after increasing significantly from about 16.0 percent in 1994 and 1995. In 2000, provincial taxes fell to 13.8 percent of GDP, similar to levels in 1994 and 1995. The ratios of local taxes and Canada and Quebec pension plan contributions to GDP showed the most variation over the past decade: the former dropped from a high of 4.1 percent in 1992 to a low of only 3.1 percent in 2000, and the latter rose from 1.7 percent to 2.4 percent over the same period.

The figures are not recent enough to show the effect of federal cuts to personal and corporate income tax rates,

Taxes as a Percentage of GDP

Year	Federal	Provincial	Local	CPP and QPP	Total
1970	14.9	9.1	4.1	1.2	29.3
1980	14.0	10.4	3.4	1.1	28.9
1985	14.9	11.4	3.3	1.2	30.8
1990	16.3	13.8	3.6	1.5	35.2
1991	16.9	13.7	3.9	1.6	36.0
1992	17.2	13.4	4.1	1.7	36.3
1993	16.5	13.5	4.0	1.7	35.7
1994	15.9	13.9	3.8	1.7	35.3
1995	16.0	13.9	3.7	1.8	35.3
1996	16.4	14.1	3.6	1.8	36.0
1997	17.2	14.0	3.6	1.8	36.6
1998	17.1	14.1	3.4	2.0	36.6
1999	16.9	14.1	3.3	2.2	36.5
2000	17.1	13.8	3.1	2.4	36.5

but they do reflect significant cuts in most provincial personal income tax rates. Federal and provincial collections of corporate income taxes have more than doubled in relative importance over the past decade, offsetting declines in the position of employment insurance premiums and workers' compensation levies. The analysis of taxes using the ratios of tax to GDP is an inexact science, but clearly the overall ratios of the 1990s varied little from bust to boom. Total ratios moved from the low 30s in the 1980s to the mid-30s in the 1990s, but that movement masks a significant shift in those who paid the tax and what services were covered.

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Provincial Corporate Shopping

Selecting a jurisdiction to incorporate or continue based on differences between corporate law statutes in the various provinces and territories (provincial corporate shopping) may solve tax and commercial problems. A corporation is taxed where it has employees and carries on business; thus, the judicious choice of place of incorporation, which is not a determinant of tax nexus in Canada, should not affect the tax result negatively. A corporation formed under the Canada Business Corporations Act (CBCA) or a provincial statute (except a statute of Quebec) may be continued under and governed by another corporate statute.

■ **Majority of Canadian directors.** Many international companies expanding into Canada prefer not to have a majority of Canadian directors. The CBCA and the corporate statutes of Ontario, Manitoba, and Newfoundland (subject to a possible exception) require such a majority to transact business. Alberta imposes restrictions on residency, but the minimum number of resident Canadians required to transact business at meetings is 50 percent, and an exemption is provided. British Columbia requires that a majority of directors be resident Canadians, including one BC resident. Nova Scotia, the Northwest Territories, Prince Edward Island, New Brunswick, and Quebec do not require a majority of Canadian directors.

■ **High-low shares: Stock dividends.** It is often desirable from a tax standpoint to increase, reduce, or restrict paid-up capital (PUC) of shares or to issue a stock dividend with a high redemption amount and low PUC. A stock dividend's recipient is deemed to receive a dividend equal to the stock's PUC. The Ontario Business Corporations Act (OBCA) requires that the stock dividend's PUC for corporate law purposes correspond to the dividend amount, precluding a low-PUC, high-redemption-amount stock dividend (section 38(2)). The CBCA and all provincial and territorial corporate statutes except for those of British Columbia and Nova Scotia have similar restrictions. Nova Scotia has no statutory rules on stock dividends, but allows par value shares, which may be used for this purpose. Similarly, in British Columbia shares may be issued with low par value and a high redemption amount. The difference between the redemption price and the PUC (par value) is considered contributed surplus.

■ **Special needs: American investors.** American investors may prefer to use a transparent corporate vehicle for US tax purposes. A Nova Scotia unlimited liability company, a corporation for Canadian tax purposes, is for US purposes ignored if there is a single shareholder and is otherwise treated as a partnership. The US shareholder may treat the Canadian business as a branch for US tax purposes and avoid US controlled foreign corporation, foreign personal holding company, and passive foreign investment company rules.

■ **Subsidiary owning shares in parent.** Butterfly transactions often involve a rollover of assets within a corporate group. Many corporate jurisdictions prohibit a subsidiary from owning shares in a parent, and thus a parent must often form a subsidiary to achieve part of a rollover. British Columbia and Prince Edward Island may permit a subsidiary to own its parent's shares. British Columbia neither specifically prohibits nor specifically allows such ownership, but a subsidiary cannot vote shares it holds in its BC-incorporated parent.

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Brain Drain

The October 1996 departure tax proposals for individuals became law on June 14, 2001. One aspect of these rules is particularly troubling: it may discourage former Canadian residents from returning.

In a nutshell, the legislation ensures that an emigrating taxpayer pays Canadian income tax on gains accrued on assets to the date of departure. The new rules expand the scope of affected assets: in particular, taxable Canadian property (TCP) is now included. The treatment of post-emigration losses is also changed, and special treatment is provided for returning residents who continue to hold assets subject to departure tax. The rules appear intended to allow the unwinding of the departure tax liability of a returning taxpayer; but if any non-TCP's value decreased during non-residence, an unwinding may be prohibited because re-entry triggers the tax (subsection 220(4.5)). This year's carnage in the high-tech sector makes this more than a hypothetical danger.

If non-TCP held by the taxpayer at the departure date subsequently declines in value, the current legislation may impose a departure tax liability far in excess of the asset's now diminished value. On re-entry a taxpayer is deemed to dispose of and reacquire all assets, triggering the gain. The election that "generally," according to Finance's technical notes, allows a continued deferral of Canadian tax that accrued pre-emigration may be of no assistance.

Assume that a taxpayer leaves Canada holding Publico shares with an FMV of $3,000,000 and an adjusted cost basis (ACB) of $500,000. Upon re-entry, the shares' FMV is $250,000. The taxpayer elects to unwind his departure tax liability (subsection 128.1(6)).

Departure from Canada	
Determination of gain on departure:	
FMV/deemed proceeds at departure	$3,000,000
ACB	(500,000)
Deemed capital gain	$2,500,000
Re-entry to Canada	
Redetermination of gain on departure:	
FMV/deemed proceeds at departure	$3,000,000
Adjustment per subsection 128.1(6)	(250,000)
	2,750,000
ACB	(500,000)
Deemed capital gain	$2,250,000
Determination of ACB of assets:	
FMV/ACB on re-entry	250,000
Adjustments per subsection 128.1(6)	(250,000)
ACB	$ 0

Re-entry triggers a departure tax liability on a gain of $2,250,000: the downward adjustment to the deemed proceeds at departure is limited to the asset's FMV on re-entry. The taxpayer may not have the financial means to pay this liability if the shares are then worth only $250,000. Moreover, an immediate sale at FMV results in the recognition of an additional $250,000 gain because the ACB is nil. In total, the taxpayer must pay tax on a capital gain of $2,500,000 after in fact realizing a capital loss of $250,000. Deferring a return to Canada may be only a temporary reprieve: the departure tax liability may become payable if the minister determines that the related security is inadequate. For departures to date and after October 1, 1996, security is due by April 30, 2002. Thus, if the taxpayer is still non-resident and the would-be security is the property itself, the departure tax liability may be triggered. The fact that Canada's relatively high personal income tax rates may encourage Canadians to leave Canada is less troubling than tax policies that may effectively preclude Canadians from returning to Canada. It is hoped that a legislative remedy will be forthcoming.

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Federal Flowthrough Mining Rules

The federal October 18, 2000 mini-budget introduced a 15 percent non-refundable tax credit for individuals (other than trusts) in response to Ontario's May 2000 proposals, which were designed to stimulate flowthrough share activity in that province. On December 6, 2000, Ontario announced that its incentive would harmonize with the federal rules and take the form of a 5 percent tax credit for qualifying Canadian exploration expense incurred in Ontario (OCEE). (See "Ontario Flowthrough Proposals," *Canadian Tax Highlights*, March 27, 2001, at 20.) The federal rules as recently enacted differ somewhat from expectations.

■ A "flow-through mining expenditure" qualifying for the 15 percent credit is an expense described in paragraph (f) of the definition of Canadian exploration expense (CEE), but not an expense in respect of preliminary, non-specified sampling; trenching, if one of its purposes is to carry out preliminary, non-specified sampling; or digging test pits other than for the purposes of specified sampling (subsection 127(9)). Specified sampling, an eligible expense, means the collecting and testing of samples in respect of a mineral resource; however, the definition excludes both the collection and testing of a sample that at the time of collection weighs more than 15 tonnes and situations where the total weight of samples collected in a calendar year in respect of one mineral resource exceeds 1,000 tonnes and each sample weighs 1 tonne or more. CEE is deemed incurred by the taxpayer in the usual manner if expenses are renounced by a corporation in favour of the taxpayer or a partnership of which the taxpayer is a member. The definition clarifies that qualifying CEE must be incurred pursuant to a flowthrough share agreement made after October 17, 2000 and before 2004 without reference to the 60-day extension rules by

a corporation in conducting mining exploration activity from or above the surface of the earth for the purpose of determining the existence, location, extent, or quality of "mineral resource" as defined in paragraph (a) or (d) of the definition.

- The investment tax credit (ITC) is limited to 15 percent of the taxpayer's flowthrough mining expenditures for the year, and only an individual (other than a trust) is eligible.
- The proposals contemplated a one-year drag in reducing the taxpayer's cumulative Canadian exploration expense (CCEE) pool for the 15 percent tax credit. The definition of "government assistance" for ITC purposes carves out an ITC claimed under the federal rules in respect of a flowthrough mining expenditure; however, the definition does not carve out provincial tax credits like those recently introduced in British Columbia or proposed for Ontario flowthrough incentive programs. Paragraph 127(11.1)(c.2) provides that the amount of any government assistance in respect of expenses comprising the taxpayer's flowthrough mining expenditures for the year must reduce such expenditures if, at the time of filing the taxpayer's return of income for the year, the taxpayer has received or is entitled to receive or can reasonably be expected to receive the assistance. Thus the reduction of the flowthrough share expenditure base for computing the federal credit by the provincial credits results in a grind of the amount of the 15 percent federal ITC available. This result was not the stated intention of the programs. A simple solution might be to expand the definition of government assistance to carve out certain prescribed amounts for those particular provincial programs.
- A taxpayer's cumulative CEE pool is reduced under (L) of the CCEE definition on a one-year drag basis for federal ITCs claimed in respect of a flowthrough mining expenditure (subsection 66.1(6)). Although the definition of assistance arguably could also apply to reduce the CCEE pool for the federal tax credit under (J), on general principles the more specific rule in (L) should take precedence. Further, on the basis of CCRA administrative practices developed 15 years ago for petroleum incentive program grants, under (J) the assistance receivable in the form of provincial credit does not arise until the subsequent year when the individual files a claim for it in a tax return. Thus, even if (J) applies, the grind is delayed until the year in which that return is actually filed.

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Back to the Future?

The tax exemption under section 87 of the Indian Act for employment income situated on a reserve has long suffered from a lack of interpretive consistency in its core situs test. The SCC may now have a chance to examine the FCA's application of the latest connecting-factors test.

Before 1972 the Crown said that an Indian must live and work on a reserve to access the exemption for employment income, but later exempted on-reserve services regardless of the employee's residence. In 1978 the FCTD in *National Indian Brotherhood* held that employment income was a debt situated at the debtor-employer's location, a conclusion apparently confirmed by the SCC in *Nowegijick* in 1982. The resultant certainty allowed predictable and liberal access to the exemption, but in 1992 the SCC, concerned that the test's simplicity might harbour abuse and inequity, moved to a flexible and purposive connecting-factors test in *Williams*:

> [T]he various connecting factors which are potentially relevant . . . should . . . be analyzed to determine [their] weight . . . in identifying the location of the property, in light of three considerations: (1) the purposes of the [Indian Act] exemption . . . (2) the type of property in question; and (3) the nature of the taxation of that property. The question . . . is therefore what weight should be given

SHOE by Chris Cassatt and Gary Brookins

> [each connecting] factor in answering the question whether to tax that form of property in that manner would amount to an erosion of the entitlement of the Indian *qua* Indian on a reserve.

In *Mitchell*, the SCC had identified the exemption's purpose: "to insulate the property interests of Indians in their reserve lands . . . so as to ensure that [they] are not dispossessed of their entitlements," but not to "remedy the economically disadvantaged position of Indians by ensuring that [they] may acquire, hold and deal with property in the commercial mainstream on different terms than their fellow citizens."

In the recent *Shilling* case, the plaintiff maintained connections with her reserve but lived and worked in Toronto. The employer, located on another reserve, subcontracted Ms. Shilling's services to a native health centre in Toronto, where she coordinated health and social programs for off-reserve First Nations people. Her wages were paid between the employer's and her on-reserve bank accounts. At trial, Ms. Shilling's residence was not seen as relevant, and the performance of employment duties off-reserve for the benefit of off-reserve Indians weighed against locating the income on-reserve. However, the most important factor was the employer's on-reserve location: the court inferred the work's benefit to the employer and hence to its reserve. The FCTD relied partly on the SCC's comment in *Williams* that "[i]t may be that the residence of the debtor remains an important factor, or even the exclusive one." The trial decision in *Shilling* was widely regarded as a significant victory for Indians working off-reserve.

Shilling was reversed in the FCA: Evans, Malone, and Rothstein JJA said that the income was in the commercial mainstream and not located on a reserve (2001 FCA 178). The FCA said that the significant weight given at trial to the employer's location and the resultant benefit to its reserve was not supported by evidence. In obiter, the court suggested that this factor may be relevant only if the employer and employee are located on the same reserve. While noting that the employee's residence is normally not important, the court gave some weight to her off-reserve location. The most important factor appeared to be the location and nature of the services, which, as the trial judge held, pointed to off-reserve situs. The decision narrowed the Indian Act exemption for employment income, but the full extent of the loss was not clear until *Monias* (2001 FCA 239).

Monias involved Indian employees of Awasis, a federally funded child-care agency incorporated under Manitoba's Child Welfare Act that was responsible for providing services for children and their families on reserves. Awasis serves about 25 reserves and is operated by a board of directors composed of chiefs of the bands it serves; its articles and a provincial order in council mandated that its services be provided on-reserve, but practical difficulties, such as its large geographic jurisdiction and a lack of on-reserve facilities, demanded an off-reserve location in Thompson, Manitoba. Mr. Monias resided off-reserve and spent about 15 percent of his time on-reserve; other employees provided 5 to 75 percent of their services on-reserve. Evans JA (Strayer and Isaac JJA concurring) said that the employment's location—predominantly off-reserve and often at great distance therefrom— indicated off-reserve situs. The on-reserve residence of the employer's directors was apparently offset by its business's being conducted primarily off-reserve and its off-reserve registered office. Contrary to its comment in *Shilling*, the FCA said that the employees' off-reserve residences are an important factor. Moreover, the FCA said that the employment services did not connect the income to a reserve, even though they supported Indian families and children on reserves and were perhaps integral to maintaining the reserves as viable social units. The court adopted the view that a connecting factor must relate to a reserve as a physical location or an economic base: "the protection of reserve lands from erosion by tax lies closer to the core of section 87 than does the protection of items of individually-owned personal property while they are situated on a reserve." Both these conclusions are open to question. And the FCA's statement that "it would be difficult to justify a conclusion that the respondent acquired his employment income on the reserves served by Awasis, when he neither lived, nor worked there" sounds remarkably like the Crown's pre-1972 position. Mr. Monias's counsel has indicated that he will seek leave to appeal to the SCC.

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Dividends Still Preferred (Part 2)

To remain competitive with Alberta and Ontario, the newly elected BC government's July 30, 2001 mini-budget announced a general BC provincial corporate income tax rate reduction from 16.5 percent for 2001 to 13.5 percent on January 1, 2002, prorated for corporations with taxation years straddling that date. A dual-stage elimination of the corporation capital tax on non-financial institutions and a sales tax exemption for production machinery and equipment were also good news for business. However, the flurry of good news somewhat buried changes to the BC dividend tax credit (BCDTC): the rate falls from 6.6 percent to 5.9 percent for 2001, and to 5.1 percent for

Tax on Distribution of $10,000 of ABI
Year Ending December 31, 2001

	Ontario	Quebec	BC
		dollars	
ABI eligible for SBD			
Dividends			
Corporate tax	1,962	2,216	1,762
Individual tax	2,519	2,603	2,725
	4,481	4,819	4,487
Salary			
Individual tax	4,552	4,672	4,570
Provincial health levy	191	409	0
	4,743	5,081	4,570
Tax savings	262	262	83
Tax deferral	2,781	2,865	2,808
ABI: no SBD, no MPD			
Dividends			
Corporate tax	4,212	3,716	4,462
Individual tax	1,814	2,101	1,832
	6,026	5,817	6,294
Salary			
Individual tax	4,552	4,672	4,570
Provincial health levy	191	409	0
	4,743	5,081	4,570
Tax cost of dividend	1,283	736	1,724
Tax deferral	531	1,365	108
ABI: no SBD, full MPD			
Dividends			
Corporate tax	3,412	3,116	3,862
Individual tax	2,065	2,302	2,031
	5,477	5,418	5,893
Salary			
Individual tax	4,552	4,672	4,570
Provincial health levy	191	409	0
	4,743	5,081	4,570
Tax cost of dividend	734	337	1,323
Tax deferral	1,331	1,965	708

Note: The figures assume a top individual marginal income tax rate and, where applicable, a top health levy rate. The impact of CPP, EI, and other payroll taxes has not been considered.

2002. Those reductions increase the combined federal and BC top marginal tax rate applicable to Canadian dividend income by about 0.9 percent for 2001 (from 32.21 percent to 33.08 percent) and by about 1.9 percent for 2002 (from 29.71 percent to 31.58 percent). The table updates data that originally appeared in "Dividends Still Preferred," *Canadian Tax Highlights*, July 24, 2001, at 54, for the changes to the BCDTC.

Also on the provincial taxation-of-dividends front, the Quebec alternative minimum tax (AMT) may apply to taxable dividends received by a Quebec-resident individual: 100 percent of Canadian dividends are taxable for Quebec AMT purposes at a rate of 20.75 percent and 20 percent for 2001 and 2002 respectively, and the top marginal Quebec provincial tax rate applicable to dividend income for regular tax purposes is about 17.1 percent and 16.5 percent in those years. Bearing this in mind, Quebec-resident owner-managers may choose to alter their respective salary-dividend mix to minimize exposure to provincial AMT.

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Votes and Value

Although premiums paid to acquire voting control of a public company are often 20 to 30 percent over the stock price, in the absence of a takeover the price differential between voting and non-voting common shares held by minority shareholders is generally quite small: two examples are Air Canada and Reitmans, traded on the TSE. After all, a minority shareholder with voting shares in a public company is still a minority shareholder.

A minority shareholder's swing vote, however, may command a substantial premium. For example, voting shares held by a 2 percent minority shareholder may be attractive to a controlling shareholder (or group) with 65 percent of the votes if 66⅔ percent of the votes are required under the relevant corporate law to effect a fundamental corporate change. And if a small block of voting shares controls the entire corporation, the per-share price of the voting shares can be substantially higher.

Various US empirical studies on the price differential between voting and non-voting shares of public companies show that the market generally places little or no value on voting rights of small minority shareholdings (generally an average of 1 to 5 percent if no takeover is imminent). One Canadian study took into account a minority's coattail protection; excluding takeover scenarios, 3.5 to 4.5 percent of the corporation's total equity value was attributed to voting control. In the last few years, several US Tax Court cases found a 3.5 to 4.0 percent discount to be reasonable. In light of these conclusions, taxpayers should be ready to support the price differential between voting and non-voting shares of a private company for estate or other tax-planning purposes.

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Should PFIC Rules Change?

Several US corporate anti-deferral regimes may apply to US citizens or residents owning stock in non-US (foreign) corporations, including the notoriously intricate passive foreign investment company (PFIC) regime. PFIC rules

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target portfolio income such as dividends or interest from passive assets, but are written so broadly that they often catch active business operations. On May 22, 2001, the tax section of the New York State Bar Association (NYSBA) submitted to IRS and Treasury officials a report outlining several flaws in the PFIC rules.

The PFIC rules are complex. They are designed to put a US shareholder in the same tax position as if the foreign corporation had annually distributed and not accumulated its earnings: otherwise, funds such as an offshore mutual fund would enjoy a competitive advantage over domestic mutual funds and similar investment vehicles in attracting capital from US investors. However, PFIC characterization may also apply, for example, to a foreign corporation that raises significant capital to expand business operations via a public offering or a venture capital investment; a foreign company in a technology business; or a company involved in an active business generating rents, royalties, or commodity income.

A foreign corporation is a PFIC if 75 percent or more of its gross income is passive income or 50 percent or more of its assets produce passive income, which generally includes interest, dividends, rents, royalties, annuities, gains from property generating such income, and some types of commodity gains. Numerous exceptions apply; lookthrough rules do not always achieve their intended exclusion of companies holding shares in active business operations. A PFIC's US shareholders (including indirect shareholders through trusts and partnerships) face punitive taxation. Excess distributions—including dispositions of PFIC stock, even in otherwise non-recognition transactions—are taxed at the highest US rate (39.1 percent for individuals) with a compound interest charge to reflect the tax result if earnings had been distributed rateably during the shareholder's holding period. A qualified electing fund (QEF) election avoids the PFIC rules, but then US tax is paid on the PFIC's current earnings, whether or not distributed. The requirement to provide significant information on the PFIC to the IRS is often impracticable for a US investor.

The NYSBA report makes several suggestions for change, including liberalizing the standards for making retroactive and current QEF elections. The report is directed at establishing rules responsive to a changing world economy, but preserving the rules' object: to place foreign and domestic investment on the same footing so that US investors abroad cannot defer US tax. The report's influence on legislative or regulatory change remains to be seen, but it reflects a growing concern of US tax advisers that the PFIC regime in particular is now quite unworkable for US offshore investors. The report notes, for example, that an offering of shares in an offshore fund to US citizens or persons generally requires US tax disclosure, but the rules' complexity and uncertainties militate against "clear, complete and informative" disclosure. A foreign company facing possible PFIC characterization and its potentially draconian effect on US investors may simply decide not to make such an offering. Foreign companies with existing or potential US investors need to be aware of the rules and their sometimes undue application and effect.

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Foreign Tax News

United States

Bill HR 1552 extends the moratorium in the Internet Tax Freedom Act for five years; representatives are suggesting a shorter time period and possibly an amendment to deal with sales tax collection issues.

The IRS has launched a Web site to alert taxpayers to tax scams and frauds at http://www.treas.gov/irs/ci or http://www.irs.gov (click on sidebar link "Tax Scams and Tax Fraud Alerts; IRS Criminal Investigation").

OECD

Secretary General Donald Johnston postponed publication of the list of uncooperative tax haven jurisdictions from July 31, 2001, but gave no new deadline.

Joint Working Group members published answers to most of the 17 questions concerning the OECD campaign against harmful tax competition.

Under pressure from the **United States**, the OECD has tentatively agreed to relax criteria under tax haven guidelines and to allow such countries to maintain low-tax systems offering ring-fenced tax breaks to foreign investors that are available to locals. The deadline for jurisdictions to comply with the guidelines has been extended from July 31 to November 30, 2001. The new agreement focuses on information exchange.

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