CANADIAN TAX Highlights

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BACK TO THE DRAWING BOARD?

In *Ludco*, the taxpayers borrowed to acquire shares in an offshore investment designed to minimize income disbursed and to enjoy capital gain treatment on the repatriation of accumulated income via redemption. The FCA denied the interest expense of $6 million: the true purpose of the borrowing was said to be the production not of the $600,000 dividend income but rather of the $9.2 million capital gain. To the relief of many, the SCC has reversed that decision and concluded that an ancillary purpose of making gross income is enough to satisfy the test for interest deductibility. But some practitioners say that this may be a Pyrrhic victory for taxpayers if Finance is prodded, for example, to reintroduce the 1991 draft legislation on interest deductibility.

Commentators critical of the FCA decision noted that its universal application would result in non-deductible interest on most share investments. (See "Not in Our Best Interest," *Canadian Tax Highlights*, June 22, 1999, at 42.) The SCC decision is at the other extreme and may force Finance to deal with the thorny problem of share investments, which always have a dual investment purpose and rarely yield dividends that match market interest rates. The SCC held that the FCA's bona fide purpose test was based on unwarranted reliance on obiter of the SCC in *Bronfman Trust* that was merely made in passing and did not flow from a textual analysis of paragraph 20(1)(c). Nor does the text of the provision "indicate that the requisite purpose must be the exclusive, primary or dominant purpose, or that multiple purposes are to be somehow ranked in importance to determine the taxpayer's 'real' purpose. Absent a sham or window dressing or other vitiating circumstances, a taxpayer's ancillary purposes" may satisfy the purpose test, which was recast as "a reasonable expectation of income." Apparently the SCC was of the view that dividends of $600,000 on $7.5 million of shares was not window dressing, even in light of the interest charges of 10 times that amount and capital gains of 15 times that amount. The court analogized the creation of a partnership in *Continental Bank* and *Backman*—the intention to obtain a tax benefit was primary, but that did not negate the intention to carry on business in common that was necessary to establish a partnership.

Furthermore, the SCC confirmed that for purposes of interest deductibility, the term "income" refers to income that is subject to tax—not tax-exempt income—and not net income. The SCC decision in *Moldowan* was not concerned with the meaning of "income" per se but with identifying its source and in particular with differentiating between business and hobby activities. "It is clear that *Moldowan* does not stand for the absolute proposition that 'income' necessarily means 'profit.'" The court concluded that nothing in the language of the provisions suggests a quantitative test, nor is there any support therein for such an interpretation: "such an approach would be too subjective and certainty is to be preferred in the area of tax law." The SCC echoed that the modern rule of statutory interpretation is the preferred interpretive approach. The courts' role is distinct from Parliament's: "in the absence of clear statutory language, judicial innovation is undesirable." Because of the many specific anti-avoidance rules, "the court should not be quick to embellish in response to concerns about tax avoidance when it is open to Parliament to be precise and specific with respect to any mischief. To do otherwise would fail to give appropriate weight to the well-established principle that, absent a provision to the contrary, taxpayers are entitled to arrange their affairs for the sole purpose of achieving a favourable position regarding taxation."

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In This Issue

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PHANTOM INCOME SAFE

In *Kruco*, the TCC held that reducing safe income for investment tax credits (ITCs) is not justified by the wording of subsection 55(2) and paragraph 55(5)(c), contrary to the so-called Robertson's rules and more recent and specific CCRA pronouncements. Safe income was reduced for the equivalent of a non-deductible expense: $2 million over the face amount paid for a debt resulting in an SR&ED tax credit.

The repurchase of some of the shares Kruco held in Kruger triggered a deemed dividend. Kruco reported some of the repurchase proceeds as a capital gain (subsection 55(2)) and claimed some safe income. The CCRA made three downward adjustments to the safe income of Kruger. Two adjustments reflected ITCs that reduced the capital cost or undepreciated capital cost of property or were included in income (paragraph 12(1)(t)). A third adjustment reflected excess cost of a $2 million debt that generated an SR & ED tax credit. The ITC reduction of safe income essentially complied with the so-called Robertson's rule no. XX: "There should be a deduction for any amount included in taxable income that does not represent actual income earned by the corporation . . . for example, phantom income" (1981 CR 81, at 91). The CCRA said that subsection 55(2) requires an assessment of disposable income, and that the reduced capital cost allowance claims and the direct income inclusion attributable to the ITCs created phantom income for tax purposes without a corresponding actual increase in cash inflow. The TCC agreed that a number of decisions—particularly by the FCA in *Placer Dome*, *Nassau Walnut*, and *Brelco Drilling*—led to the conclusion that "safe income" means "safe income on hand" or disposable income; the calculation begins with the definition in paragraph 55(5)(c) but does not end there. According to those cases, safe income on hand is the portion of income that can be reasonably considered to contribute to the capital gain on the particular shares ([1992] 2 CTC 99; [1998] 1 CTC 33; and [1999] 3 CTC 95, respectively). Other adjustments to safe income have court approval, such as taxes paid (*Gestion Jean-Paul Champagne* and *Deuce Holdings*); dividends paid and non-deductible expenses (*Champagne*); and losses of foreign affiliates (*Brelco Drilling*) ([1996] 2 CTC 2537 (TCC) and [1998] 1 CTC 2550 (TCC), respectively).

However, the TCC concluded that a reduction for ITC phantom income went too far. In *454538 Ontario*, the TCC held that "income earned and realized" for this purpose, deemed by paragraph 55(5)(c) to be "income for the period otherwise determined" (with specific exceptions), is income determined under division B of part I ([1993] 1 CTC 2746). Safe income is a "creature of the Act" and not disposable income in an accounting sense; the TCC in *Kruco* said that the adjustments sought "go directly against the wording of paragraph 55(5)(c)." The Crown's position "is based on a certain logic," but the ITC adjustments would effectively double-tax amounts that were "taxed once as regular income in [Kruger's] hands . . . [by] allowing a corresponding amount to be taxed again . . . in [its] hands . . . as a capital gain, which clearly contravenes the spirit of the provisions."

Much of the judgment deals with the impact of a change in administrative position on the deduction required for ITC phantom income. Although it had already concluded that no deduction was justified, the TCC said that "the many problems raised by the application of subsection 55(2) . . . and the general reliance on administrative rules call for several comments." The TCC quoted its decision in *Brelco*, which was critical of granting administrative practice greater authority than warranted, a position supported in various SCC decisions: a court must arrive at a reasonable interpretation of legislation in light of its purpose, and neither rewrite legislation nor accept administrative fiat. The Crown's argument that equity would be furthered by confirming the administrative practice applied to other taxpayers was "astonishing. The business community should not feel obliged, because it is expedient, to observe administrative edicts when the law is simply lacking in clarity." The TCC said that an administrative policy may assist to interpret an ambiguous provision unless it contradicts or is not supported by the Act's wording, as in *Kruco*.

> Accepting the application of that policy here would be tantamount to attributing a legislative character to departmental directives and to fettering the Minister's power to apply the Act, which would be contrary to the principle stated by the [SCC] in *Maple Lodge Farm*. . . . To accept such a conclusion would also have the effect of recognising that the Minister has the power to apply an administrative policy as though it were an independent source of law, when . . . it is the Act that the Minister must apply. . . . [T]he adoption of an administrative policy for the purpose of interpreting an ambiguous provision cannot be a substitute for a clarifying legislative amendment. If Parliament wishes to give subsection 55(2) the scope suggested by the [Crown] in the instant case, it is open to it to do so.

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Film Production Services

Since 1998 limited partnerships have been formed to provide Canadian taxpayers an opportunity to participate in revenues generated from the commercial exploitation of feature films and television productions and usually to obtain the benefit of tax deductions. Advance income tax rulings confirmed that the matchable-expenditure rules in section 18.1 did not apply. The tax-assisted financing of these partnerships enabled Canada to attract US studios to film movies and television shows in Canada: such partnerships paid part of the expenses incurred by a studio in exchange for a right to receive income from production. Changes to the matchable-expenditure rules released in a notice of ways and means motion (NWMM) on September 18, 2001 are intended to eliminate the tax benefit inherent in the structures of many film production services limited partnerships.

The matchable-expenditure rules require that for income tax purposes there must be a matching of expenditures related to and income from an investment. Their objective is to eliminate the tax deferral otherwise available if expenses are currently deductible but income is only received in the future. An exception applies if, in the expenditure year, the taxpayer's total revenue from the right to receive production exceeds 80 percent of the expenditure, an exception employed by film production services partnerships that in the expenditure year receive income of 80.08 percent of the non-Canadian labour expense incurred.

Newspaper articles and other media coverage drew attention to these investments, and Finance decided to shut down this deferral opportunity for expenditures after 2001. The detailed NWMM provides that if a tax shelter meets the 80 percent threshold, expenditures are deductible only to the extent of revenues received under the right to receive production, effectively eliminating the almost 20 percent tax-deferral benefit. Grandfathering rules, which are detailed and subject to several conditions, apply to public offerings in place before September 18, 2001 and generally preclude the sale of new units after 2001, but allow the completion of existing deals. Modification of the proposed grandfathering is expected before enactment to enable the current deals to be completed.

Finance's release cautions that grandfathering does not constitute government approval of these tax shelters. "All tax shelters utilizing the exception to the matchable expenditure rules are being closely monitored by the [CCRA]." Furthermore, the Backgrounder document accompanying the NWMM refers the reader to more information on CCRA activity regarding tax shelters via the August 14, 2001 CCRA "Tax Tip" entitled, "Tax shelters: Advance income tax rulings do not guarantee deductions," available on the CCRA Web site at http://www.ccra-adrc.gc.ca. The CCRA notes there that it does not rule on the very issues on which assessments are usually based and enumerates warning signals for investors—for example, if the anticipated net return in the first few years comes mainly from projected income tax refunds.

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One in Eleven

The CCRA recently released the detailed final figures for personal income tax statistics for the 1998 taxation year, available only on its Web site. This release contains a number of specialized tables, including one showing details for tax returns reporting capital gains. Of the 21.4 million returns filed for that year, 1.9 million—8.8 percent—contained taxable capital gains totalling $12.6 billion, as shown in the table. Of those returns containing taxable capital gains, 64,100 claimed the capital gains deduction for farm or small business properties, saving tax on $3.5 million of gains.

All Personal Income Tax Returns

			As a percentage of all returns	
Tax year	Number reporting capital gain	Gain reported ($million)	Number reporting capital gain	Gain reported
1998	1,888,604	12,601	8.83	2.08
1997	1,961,920	13,103	9.29	2.27
1996	1,504,360	9,834	7.23	1.79
1995	1,003,660	7,471	4.89	1.41
1994	1,151,810	13,684	5.72	2.50
1993	1,115,340	14,266	5.62	2.83

Capital gains represented slightly less than 3 percent of all income reported in the taxation year 1993: that percentage quickly fell to a low of 1.4 percent in 1995 when the capital gains deduction was limited to qualifying farm and small business properties. The percentage of income represented by capital gains has levelled off at around 2 percent for the last three years for which information is available.

Average reported gains stabilized at about $6,600 over the last three years for which information is available. And 92 percent of all returns showing capital gains in 1998 reported incomes of less than $100,000, but accounted for only 66 percent of all reported gains. An overwhelming 86 percent of all returns with capital gains showed gains from information slips averaging $2,000; 26 percent of all returns reporting capital gains from the sale of shares reported capital gains averaging $15,200.

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OBCA Professional Corp a Plus?

Amendments to the Ontario Business Corporations Act (OBCA) that allow certain professionals to incorporate their practices have been enacted but not yet proclaimed in force. Affected Ontario professionals have been waiting for enactment with anticipation. For many professionals, tax deferral is a key advantage of a professional corporation: provided that the professional does not need all the practice's income for personal purposes, incorporation of the practice in theory allows him or her to leave up to $200,000 in the company to be taxed at the small business corporate tax rate and reinvested until the funds are needed. Unfortunately, it appears that a provision in the Ontario legislation may limit the tax-deferral benefits one might expect from the ability to incorporate.

The OBCA amendments set out several conditions with which professional corporations must comply. The provision in issue reads as follows.

5. The articles of incorporation shall provide that the corporation may not carry on a business other than the practice of the profession but this paragraph shall not be construed to prevent the corporation from carrying on activities related to or ancillary to the practice of the profession, including the *temporary* investment of surplus funds earned by the corporation. [Emphasis added.]

There is concern that the reference to "temporary investment of surplus funds" will by implication effectively prevent professional corporations from reinvesting after-tax income. The absolute tax savings associated with claiming the small business deduction and then distributing the after-tax income by way of dividends is only a fraction of the tax-deferral benefit achieved by retaining the after-tax income in the corporation for reinvestment at that level. However, if making investments is not considered to be a business, such investments may not offend the OBCA prohibition against carrying on a business other than the practice of a profession: the professional corporation that invests after-tax income is still carrying on only one business, that of the professional. In contrast, the Alberta professional corporation legislation restricts the business carried on by professional corporations to that carried on by an individual member of a professional body, but does not refer to the use of funds retained by the corporation. Further clarification from Ontario Finance is required before Ontario professionals can determine whether there is any significant advantage to incorporating their practices.

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Non-Resident Trusts, Revised

On August 2, 2001, Finance released revised draft legislation regarding non-resident trusts, proposed to apply to trust taxation years beginning after 2001. Finance says the new draft, which replaces a June 22, 2000 draft, reflects consultations with the private sector and is "designed to make the income tax system fairer and prevent tax avoidance." The revised draft legislation appears to target a "fairer" result by placing wealthy individuals who can afford to transfer their assets to offshore trusts in the same position as the average Canadian. In many cases, the proposals go beyond the stated goals and may lead to unfair and anomalous results. It is hoped that the potential inequities, some of which are set out below, will be resolved before enactment.

New section 94 proposes to deem far more non-resident trusts to be Canadian-resident: the former two-pronged test for Canadian residence—Canadian contributor and Canadian beneficiary—is replaced by a test that requires only the existence of a Canadian contributor. The types of property transfers and the class of entities that trigger section 94 are also broadened. The draft legislation also enhances the CCRA's ability to collect tax on the income and gains of non-resident trusts: both a resident contributor and resident beneficiary as defined are, within certain limits, jointly and severally liable for Canadian income tax and reporting obligations of offshore trusts (paragraph 94(3)(d)). One of the main concerns about the draft rules is the general lack of transitional relief for previously established non-resident trusts, a matter of increased concern in light of the exposure of resident contributors and beneficiaries to personal liability for Canadian tax. Individuals not currently affected by existing section 94, who were not aware of the draft's potential personal liability before contributing to a trust and who currently do not exercise any control or influence over the trust property, may be unpleasantly surprised by the new rules.

Assume that a lifelong Canadian resident established an offshore trust for the benefit of non-resident family members in 1982, but is not himself a trust beneficiary. The beneficiaries were not and never will be Canadian residents, the trustee is an offshore trust company, and the trust property consists of funds invested in an offshore account. Existing section 94 does not apply—an appropriate result because the trust's only tie to Canada is the settlor, whose involvement with the trust ended after the settlement. However, the settlor is a Canadian resident, and thus the new draft rules deem the trust to be a Canadian resident and expose the settlor to personal liability for the trust's entire Canadian income tax liability prospectively—a rather extreme result considering the settlor's presumed limited and distant involvement with the offshore trust.

The absence of transitional relief will also create harsh results because a share issue from treasury is now deemed to be a transfer of property, a new rule that will result in tax on many pre-existing offshore trust estate freeze arrangements. Grandfathering in the June 2000 draft has been eliminated without an explanation in either the explanatory notes or the press release.

Proposed subsection 94(5.1) deems a disposition of certain trust property if the trust has no resident contributor, which would be the case on that person's death. If the presumed purpose of section 94 is to level the playing field by putting non-resident and Canadian trusts on equal footing, the role of this deemed disposition is not clear: the Act does not deem a disposition of trust assets on the death of a Canadian-resident trust's settlor. Furthermore, this deemed disposition applies not only if the trust has a resident beneficiary at year-end and the extended personal liability in proposed subsection 94(3) continues to apply, but also if there is neither a resident contributor nor a resident beneficiary at year-end, in which case proposed subsection 94(5) deems another disposition of the trust's property before the trust completely severs its Canadian ties. The purpose of proposed subsection 94(5.1) appears to stem from the Canadian government's desire to collect its fair share of income tax from the trust before it ceases to have any connection with Canada. Apparently, given the presumed need for and appropriateness of extended personal liability, it was considered prudent to deem a disposition before a Canadian-resident contributor could escape potential liability.

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Quebec Transfer-Pricing Penalty

If a company has income that is partly earned in or allocated to Quebec, new Quebec transfer-pricing legislation may impose a higher than expected penalty if a transfer-pricing adjustment is made. However, Revenue Quebec has recently confirmed that the penalty will only be applied in proportion to the taxable income allocated to Quebec.

Under federal transfer-pricing provisions, a 10 percent penalty may apply on transfer-pricing adjustments if the adjustments exceed specified thresholds and if reasonable efforts are not made to contemporaneously document the use of arm's-length standards in setting transfer prices. Quebec's provincial transfer-pricing legislation, enacted on May 23, 2001, mirrors the federal legislation. Companies that conduct business in Quebec with non-arm's-length entities outside Canada should be aware that the Quebec legislation is so similar to the federal legislation that it effectively doubles the amount of the federal transfer-pricing penalty. The penalty provision under the newly enacted Quebec rules does not provide for any adjustment to the penalty to take into account the portion of business conducted in the other Canadian provinces and not in Quebec (section 1082.5 of the Quebec Taxation Act). This omission doubles the penalty on transfer-pricing adjustments for any taxpayer that is taxable in Quebec, whether 1 percent or 100 percent of the taxpayer's income is taxable in Quebec.

Revenue Quebec recently stated that the anomalous penalty arose from a drafting oversight. A forthcoming amendment will provide that the penalty is to be applied only in proportion to the taxable income allocated to Quebec. For now, corporations conducting business in Quebec should be aware of the increased penalty risk in the legislation as it currently reads if contemporaneous documentation in determining transfer prices is not maintained. The penalty provision applies retroactively for taxation years commencing after December 31, 1998, the same as the federal law.

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Only in Quebec

As discussed in an earlier article, Quebec-resident individuals may be subject to Quebec alternative minimum tax (QAMT) on taxable dividends received from Canadian-resident corporations. (See "Dividends Still Preferred [Part 2]," *Canadian Tax Highlights*, September 25, 2001, at 70.) Because 100 percent of Canadian dividends are taxable for QAMT purposes, the QAMT tax cost can exceed 3.6 percent of the actual dividends received for 2001 and 3.5 percent for 2002 and subsequent years. Unfortunately, the reach of the QAMT also extends to capital gains and qualifying stock option benefits realized by Quebec-resident individuals.

It is still common for taxpayers to incur federal and provincial AMT liabilities if the $500,000 capital gains exemption (CGE) is claimed to shelter from tax the gain

SHOE by Chris Cassatt and Gary Brookins arising from a crystallization or sale of qualified small business corporation (QSBC) shares or qualified farm property (QFP). However, the realization of capital gains ineligible for the CGE and stock option benefits (subject to a paragraph 110(1)(d) or (d.1) deduction) ordinarily does not trigger a federal AMT liability: the tax rate applicable to such amounts for regular income tax purposes exceeds the applicable AMT rate. As discussed in another article, the changes to the capital gain inclusion rate and paragraph 110(1)(d) and (d.1) deductions resulting from the February 28, 2000 federal budget and October 17, 2000 mini-budget necessitated consequential changes (retroactive to January 1, 2000) to the federal AMT inclusion rate for capital gains and paragraph 110(1)(d) and (d.1) deduction amounts to prevent federal AMT from automatically applying to such amounts. (See "Unfinished Business," *Canadian Tax Highlights*, January 23, 2001, at 2.) As a consequence, a taxpayer who realizes capital gains not sheltered by the CGE and/or stock option benefits is not subject to federal AMT thereon, because the effective federal AMT rate of 12.8 percent in 2001 and future years for capital gains and qualifying stock option benefits is lower than the effective 14.5 percent federal regular tax rate. This AMT protection is also afforded for provincial (other than Quebec) and territorial purposes, because all those provinces and territories base their respective AMT liabilities on the calculated federal amount.

The 2001 Quebec budget retroactively reduced the QAMT capital gain inclusion rate to 70 percent for 2000 and subsequent years. However, the effective QAMT rates of approximately 14.5 percent (70 percent of 20.75 percent) for 2001 and 14 percent (70 percent of 20 percent) for 2002 and following years for capital gains and qualifying stock option benefits are higher than the top marginal Quebec regular tax rate applicable to such income: 12.25 percent (one-half of 24.5 percent) for 2001 and 12 percent (one-half of 24 percent) for 2002 and following years. Accordingly, unless a Quebec-resident individual taxpayer has sufficient other income taxed at ordinary rates, a QAMT liability may arise when a capital gain is realized. Unfortunately, such QAMT liability may become a permanent provincial tax if the Quebec-resident individual either does not have sufficient income within the subsequent QAMT credit seven-year carryforward period or if the individual relocates to a tax-friendlier jurisdiction.

One method that is currently available to a Quebec-resident individual wishing to avoid QAMT is to file his or her Quebec provincial tax return using the so-called simplified tax system. However, because the available deductions and/or tax credits are markedly restricted compared with the regular tax system—no CGEs, Quebec dividend tax credits, or Quebec equivalents of paragraph 110(1)(d) or 110(1)(d.1) deductions are available—the impact of using the simplified tax system should be carefully considered before any decision is made.

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Directors' Liability

As the number of cases dealing with directors' liability for GST/HST continues to grow unabated, so do the factors to be taken into account in determining the elements of a successful due diligence defence.

In the leading case of *Soper* in 1997, the FCA drew the distinction between what was required of an inside director (one who is involved in the day-to-day management of the company and who influences the conduct of its affairs) and what was required of an outside director with limited involvement. It is permissible for outside directors to rely on the day-to-day corporate managers to be responsible for the payment of the company's debt obligations. However, when such a director obtains information or becomes aware of facts that lead to a conclusion that there may be problems with remittances, then an outside director has a positive duty to act (97 DTC 5407).

Many subsequent cases deal with the action that should be taken or what a reasonably prudent person would do in comparable circumstances to establish due diligence. Several recent cases have discussed the circumstances that should have made apparent to a director or a reasonably prudent person in a comparable position that action was required. In *Smith*, the FCA determined that Smith acted reasonably as an outside director in proposing an action and then relying on inside directors to follow the proposal. Corporate reports subsequently led him to believe that remittances were being made. Later, when Smith became an inside director with a greater involvement in company affairs, greater effort was required on his part. Nevertheless, even as an inside director he was not required to ensure that a failure to remit was prevented; it was only necessary that a reasonable attempt be made to avoid it. From information provided to Smith, he believed that source deduction and GST remittance obligations had been fulfilled (2001 DTC 5226).

Most recently in *Matthews*, a company had not collected and remitted GST for more than 2½ years. Matthews had not been involved in the day-to-day management of the company and was not aware of the failure to file and remit. Counsel for the Crown and Matthews settled the claim against him on the basis that the company's failure should have been apparent to Matthews when he was advised by the managing director about one year after the failure to remit began that a cash infusion was required to pay debts.

Consequently, his liability was limited to the amount unpaid in the last 1½ years of the period, when he should have been aware of the failure (2001-1114 (GST) I).

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State Sales Tax Compliance

Canadian companies doing business in a variety of US states are often surprised by the complexity of state taxes, especially state sales tax. Almost every state imposes a sales tax on the sale of tangible personal property and sometimes on certain services, but each state's rules are different and often confusing. For example, a marshmallow might be defined as a candy in one state, but as a food (and therefore not taxable) in the next. Perhaps more troubling, sales tax rates vary from state to state, from county to county, and often from city to city. It takes the most sophisticated and expensive software to decipher the different tax rates in the more than 7,500 state and local authorities that impose a sales tax. In some respects, there is only one certainty when it comes to state taxes: the rules are different in every single jurisdiction. The advent of Internet commerce and its facilitation of multistate sales only serves to highlight these problems. Recognizing the significance of these issues, federal and state governments have taken action both to clarify the rules and to simplify them for companies doing business in a variety of states.

Federal initiatives. Ever since the Internet became ensconced, the state tax ramifications of Internet activities and transactions have represented perhaps the most unstable area of state sales tax law, with the most pressing issue being whether pure Internet retailers must collect a sales tax when making a sale. Generally, state sales taxes are imposed on the purchaser of the product or service, but all states require the seller to collect sales taxes from its customers if it has "nexus" with the taxing state, a test generally met by its physical presence in the taxing states (see *Quill v. North Dakota*, 504 US 298 (1992)). Cases indicate that the necessary physical presence may be as slight as the temporary presence of a company's property or personnel in a state. Of course, the Internet made it much easier for multistate businesses to sell their products or services to customers in a state without ever having to set foot there. By avoiding physical presence with the states, Internet retailers obviate the need to collect any sales taxes, creating a real problem for state and local governments that rely heavily on sales and use tax revenues.

Fearing the loss of revenue from Internet transactions, some states reportedly tried to force pure Internet retailers to collect taxes on their Internet sales. Before any conclusive action could be taken, however, the federal government stepped in and used its authority to attempt to define the sales tax rules for Internet sellers. In October 1998, Congress enacted the Internet Tax Freedom Act (ITFA), which among other things imposed a three-year moratorium on the states' ability to enact taxes on e-commerce that were discriminatory: that is, if "the sole ability to access a site on a remote seller's out-of-state computer server is considered a factor in determining a remote seller's tax collection obligation." Congress thus prohibited a state from asserting nexus over a pure Internet retailer that otherwise had no physical presence there. Since ITFA's enactment, Congress has studied the matter but taken no conclusive legislative action. Congress is expected to extend the moratorium (set to expire in October 2001) while it continues to pursue a solution on the nexus issues. Canadians who sell products and services to US customers on the Internet should stay tuned for further developments.

Streamlined sales tax project (SSTP). At the state level, a multistate coalition has been formed to simplify multistate sales tax compliance. The SSTP was created, as its name suggests, to simplify sales and use tax collection and administration. The system's key features include uniform definitions and tax bases, simplified exemptions and rates, uniform sourcing rules, and uniform audit procedures. Participating states would also provide free software to retailers to help them calculate, collect, and remit sales taxes. Obviously the system will make compliance easier for multistate businesses; but the states benefit too. The states hope that if multistate sales tax compliance is simplified, many companies currently able to avoid collecting sales taxes by not establishing a physical presence or nexus with the taxing state will be persuaded to collect their sales taxes and bring themselves into compliance.

A model law has already been proposed, but the success of this system depends on the voluntary participation of both states and taxpayers. So far, 19 states have adopted enabling legislation and most others have taken steps to participate. Whether taxpayers will voluntarily participate is another matter altogether. Companies who can legally sell their products without collecting tax because they lack a physical presence or nexus may be inclined to continue selling these products sales-tax-free: the practice arguably gives them a competitive advantage over companies forced to charge sales taxes.

Readers interested in learning more about the project can go to http://www.streamlinedsalestax.org.

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CANADIAN TAX Highlights

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US Valuation Penalties

A recent US Tax Court case levied a staggering US$30 million penalty for a gross valuation misstatement related to estate and gift tax.

Section 6662 of the US Code imposes accuracy-related penalties on the portion of underpaid tax attributable to negligence; substantial understatement of income tax or estate or gift tax; or a substantial overstatement of valuation or pension liabilities. The valuation-related penalties do not apply if the reported value was arrived at in good faith and there was reasonable cause for tax underpayment. Undervaluation penalties for estate and gift taxes are levied at 20 percent if the value claimed on the tax return is 25 to 49 percent of actual value and at 40 percent on gross valuation misstatements: that is, the reported value on the return is less than 25 percent of actual value.

Estate of True involved both estate and gift taxes (TC Memo 2001-167 [July 6, 2001]). The US Tax Court levied penalties aggregating US$30 million on a tax deficiency of US$76 million, over half of which related to estate tax and the balance to gift tax. The deficiencies and penalties arose from declared valuations of ownership interests in various corporations and partnerships, which were subject to buy-sell agreements and transferred individually. The Tax Court said that the most important factor in establishing the good faith and reasonable cause exceptions was the extent to which the taxpayer exercised "ordinary business care and prudence in attempting to assess his or her proper tax liability," but on the facts those exceptions did not apply. Gift taxes and related penalties were levied separately in respect of various inter vivos transfers that had been made by both the deceased and his wife. A valuator was engaged by the taxpayers to value the deceased's interests at the date of death, but his opinion was not relied on. The Tax Court said that if the valuator's opinion had been used, the valuations would not have been grossly understated.

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Foreign Tax News

Treaties

Bill S-31 to implement tax conventions between Canada and Slovenia, Ecuador, Peru, Senegal, the Czech Republic, the Slovak Republic, Venezuela, and Germany received first reading in the Senate on September 19, 2001. The treaty with Germany is a replacement. The 1990 treaty between Canada and the Czech and Slovak Federal Republics currently applies.

OECD

On October 2, 2001, draft changes to the model income tax treaty were issued. Some changes have already been approved. After final decisions by the Working Committee in February 2002, the changes will be sent to the Fiscal Affairs Committee for final approval, and an updated model will be published a few months later. Changes deal with permanent establishment (fixed place of business, building sites, preparatory activities, and agency); e-commerce (servers and software payments); treaty shopping (specifically conduit situations); and a new article regarding comprehensive assistance in tax collection.

IFA

The 55th World Congress opened in San Francisco on September 30, 2001. The events of September 11, 2001 dominated opening-day discussions; up to 30 percent of the attendees were unable to attend. On a positive note, new IFA members from China were welcomed. E-commerce and the use of low-tax regimes were the conference's two policy themes.

Mexico

New transfer-pricing methodologies resulting from a meeting of the minister of finance and the US IRS in July 2001 are in place for the electronics sector maquiladoras requesting advance pricing agreements (APAs) for 2000 to 2002. The methodology involves two steps—a comparable return-on-asset calculation and an adjusted operating profit calculation. Negotiations for the automotive sector export maquiladoras' methodology are expected to be completed soon. Automotive and electronics sectors account for over 60 percent of the active APAs.

China

A new transfer-pricing circular dealing with a refund for foreign investors who reinvest profits in existing or new foreign investment enterprises disallows the refund if the profit increase results from a transfer-pricing adjustment.

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