CANADIAN TAX Highlights

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Final IC on Civil Penalties

On September 18, 2001, the CCRA released a final version of *Information Circular* 01-1, "Third Party Civil Penalties." The IC reflects an apparent effort to provide more useful and practical guidance in response to the over 50 submissions on the January 2001 draft; the CCRA said that it carefully considered the comments it received. The final IC contains 92 paragraphs (8 more than the draft) and one more example (18 in total).

Eight administrative principles gone. The eight administrative principles that the CCRA felt would ensure the penalties' fair and reasonable application (see "Draft IC on Civil Penalties," *Canadian Tax Highlights*, February 27, 2001, at 9) are not explicitly included in the final IC but have been amalgamated to some extent in the "Application of Legislation" section, which now includes these revised statements.

- The penalties should not be assessed after the legislated six-year record retention period, except for cases of fraud (paragraph 13).
- The penalties should not apply to tax-planning arrangements that comply with the law, to honest mistakes or oversights, to differences of interpretation or opinion where bona fide uncertainty exists, or to administratively acceptable activities (paragraph 16).
- In cases where a false statement was made knowingly or in circumstances amounting to culpable conduct, the factors that may be considered in the assessment of the penalties have been revised considerably, and include whether the position taken is obviously wrong, unreasonable, or contrary to well-established case law; the extent of knowledge based on the adviser's experience with the subject matter and the client; whether the culpable conduct represents the most aggressive and blatantly abusive behaviour; whether there is repeated abuse; and whether there is a significant reduction in taxes (paragraph 17).
- Except in cases of repeated abuse, the CCRA does not intend to focus on situations involving small amounts (paragraph 18).

Clarification of terms. A section entitled "Interpretation and Discussion" defines and clarifies some legislative terms.

- The term "person" is discussed in the context of the Income Tax Act and the Excise Tax Act penalties, which apply to partnerships (paragraphs 20-21).
- A "statement" is now defined with specific reference to electronic representations: one example is a professional opinion (paragraph 23).
- A person who reports to one particular partner is not a "subordinate" of any other partner to whom he or she does not report (paragraph 31).
- According to a welcome clarification, the "good faith reliance" exception more specifically applies to the use by an adviser of information that is not "on its face, clearly false. [A] person may rely on information in good faith in the absence of a reason that a reasonable and prudent person may believe that the information could be incorrect." Questions may need to be asked to ascertain the information's credibility. The answers should be documented for future reference (paragraph 35).

Guidance to practitioners. Suggested best practices may minimize the risk of penalties. These include documenting concerns about accuracy or inconsistency, questions asked about those concerns, client response, and assumptions made. On the "rare" occasions when a practitioner is asked to use clearly false or highly suspicious statements and the client rejects the advice being given, the practitioner should consider withdrawal from the engagement to eliminate possible exposure to the penalty (paragraphs 65-66).

CCRA process. The CCRA audit process section, which has been substantially changed, details specific steps to be taken before a determination is made that the penalties apply in a particularly egregious situation.

Examples revised for clarity. The draft's examples were said to raise more questions than answers. Many examples now include more specific facts, more detailed information, and more reasonable assumptions, making it easier to assess whether penalties should apply in a given

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situation. The penalty "could" apply in 11 examples, but "generally not" in the other 7. Two examples have been added ("Discussions regarding voluntary disclosure" (no. 7) and "Deliberately overstated SR & ED tax credits" (no. 14)) and one dropped (valuation issues in an estate freeze (no. 12)). Draft example 4, now revised, raised myriad questions. In the draft an accountant prepared and filed a return based on a $25,000 T4 for a neighbour who recently purchased a $1 million house. The accountant asked whether this was all the neighbour's income and was told that it was: a penalty was said to be assessable because the only question asked did not sufficiently address the concern. The accountant in the revised example also asks: "Have you received money from other sources?" The reply that the neighbour received an inheritance is enough to satisfy the accountant's concerns and eliminate exposure to the penalty.

The examples in which the penalty is said generally not to apply all seem to rely on the adviser's asking the right questions and receiving the right answers. Documentation of these questions and answers therefore seems necessary to support a position. The examples in which the penalty could apply are egregious, which it is hoped reinforces the CCRA's position that only such situations will attract penalties. However, only time will tell how fairly and consistently the rules will be administered by the CCRA, and how easily practitioners will adapt to the requirements of these new civil penalty rules.

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CCRA: Singleton and Ludco

CCRA rulings officials are reviewing the September 28, 2001 SCC decisions in *Singleton* and *Ludco* and will examine all CCRA interpretive and administrative positions regarding interest deductibility in consultation with Justice and Finance. The nature and scope of the review militates against the setting of a fixed completion date, but the CCRA does not intend to modify existing practices on interest deductibility in the interim. Taxpayers and their advisers are invited to submit issues and related comments for consideration during the CCRA review to the attention of the authors, Financial Industries Division, Income Tax Rulings Directorate, 16th Floor, 320 Queen Street, Ottawa, ON K1A 0L5, or by fax at (613) 957-2088.

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EU Corporate Tax Investigation

On July 11, 2001, the European Commission (EC) decided to launch state-aid investigations of 11 corporate tax schemes in eight EU member states, based on doubts that those arrangements are compatible with the EC treaty. Four other member states have been asked to terminate fiscal advantages that are no longer justified in the single market. In 1997, the EU's Ecofin Council adopted a code of conduct for direct business taxation aimed at terminating harmful tax competition and committed to strict application of state-aid rules. A 1998 EC notice publicized the application of state-aid rules to direct business taxation; the newly announced investigations initiate a long-term plan to ensure that EU tax measures are not incompatible with the EU single market. The primary focus is preferential tax arrangements granted to multinational companies or to companies active in the insurance and financial sector.

The tax regimes under investigation are Finland's Åland Island captive insurance regime; France's headquarters and logistics centres and treasury pooling regime (régime des centrales de trésorerie); Germany's control and coordination centres of foreign companies; Ireland's foreign income exemption; Luxembourg's coordination centres and finance companies regime; the Netherlands' international financing activities regime; Spain's Bizkaia coordination centres; and the United Kingdom's Gibraltar qualifying offshore companies and Gibraltar exempt offshore companies. The investigations may result in the EC's requiring a member state to retroactively reverse tax advantages of the last 10 years.

The four member states requested to terminate advantages are Belgium (coordination centres); Greece (offices of foreign companies regime); Italy (Trieste financial services and insurance centre incentives); and Sweden (foreign insurance companies regime). Informally, the EC has said that it has proposed the abolition of these regimes before 2002, with a phaseout until the end of 2005 for existing participants. A member state may reject the proposal and offer reasons therefor, and the EC may then consider whether to launch a formal investigation procedure. However, the EC cannot impose recovery of state aid granted under such schemes before the later of an EC finding that the regime's aid is incompatible with the common market and any later date mentioned in that decision or an interim decision.

Other recent EC activities within the EU include an October 23, 2001 proposal to replace its "outdated" corporate tax system—which it views as not having kept up with globalization and the EU single market—with, inter alia, a single consolidated tax base for multi-state operations. The EC also proposed a series of measures to remove taxation obstacles, including new legislation and guidance on European Court of Justice rulings.

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Unenviable Positions

In early decades, the annual release of statistics on personal income tax produced big headlines about how many millionaires paid no tax. This summer's release caused barely a ripple about such tax "cheats": tax reform has been effective in wearing away shelters, and tax planning now stops well short of eliminating tax altogether.

In 1998, only 3,230 individuals with incomes above $100,000—0.7 percent of such filers—avoided any federal or provincial income tax. In total, 6,806,890 individuals filed non-taxable returns; over 72 percent had incomes less than $10,000. Most non-taxable returns are filed by low-income individuals and families in order to qualify for the child tax benefit or the GST credit and to gain refunds of taxes deducted at source.

The table shows where the high flyers gained their income and deductions. Almost one-half were employed persons who, on average, received about $120,000 in salary. Capital gains averaging $183,200 were reported by about one-half, two-thirds of whom had capital gains deductions (relating to the sale of farms or other qualifying small business shares) averaging about $144,400. One-third of the returns showed carrying charges and interest attributable to earning investment income averaging $102,100, and over one-half had additional deductions (including capital and non-capital losses from previous years) from net income averaging $181,100.

Non-Taxable Returns with Incomes Above $100,000, 1998 taxation year

	Number	Amount ($000)
Income		
From employment	1,480	176,141
From investment and dividends	3,230	82,674
Taxable capital gains	1,390	254,675
Tax-exempt	580	70,737
Total income	3,230	765,524
Deductions		
Carrying charges and interest	1,010	103,104
Other deductions from income	800	86,133
Capital gains deduction	830	119,865
Additional deductions from net income	1,730	313,343
Total deductions	3,150	636,722

Over 3,000 people with gross incomes of over $100,000 escaped tax in 1998 because of specific provisions of the Income Tax Act, often deductions for previous years' disasters. What may be disturbing is that many federal, provincial, and local government programs are based on net income or taxable income as determined on the income tax return; our 3,000 qualified for many of these programs.

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Employee Gifts and Awards

The CCRA recently eased its policy on the taxation of gifts and awards to employees and the deductibility of such amounts to employers, retroactive to January 1, 2001.

Under the new policy, gifts for holidays, birthdays, and other special occasions are not taxable to employees and are fully deductible to employers if the employee receives no more than two non-cash gifts per year (up from one gift per year, or two in the year of marriage) and the combined cost of the gifts, including taxes, is less than $500 (up from $100). If the total cost of the non-cash gifts is more than $500, the whole amount is taxable (not just the amount over $500). Gift certificates are not considered non-cash gifts: they are treated as cash or near-cash and thus are fully taxable as employee benefits.

The CCRA says that the new position also applies to non-cash awards intended to mark special achievements such as length of service or meeting safety records. Previously, such awards were fully taxable to employees and deductible to employers. The CCRA cautions that the new policy does not apply to awards that are disguised remuneration—that is, the CCRA does not expect every employee to receive a $500 award each year. Gifts and awards are two separate categories for this purpose: employees may receive two non-cash gifts up to $500 and two non-cash awards up to $500 tax-free in the same year.

CCRA officials announced the policy change on September 25, 2001 at the Foundation's 2001 annual conference. A brief description of the new policy is available on the CCRA's Web site. The CCRA says that full details will be provided in *Income Tax Technical News* in January 2002.

The CCRA has not changed its treatment of Christmas parties and social events: generally, an employer-provided party or other social event that is available to all employees is not taxable so long as the cost per employee is not more than $100 per person. The employer may deduct the full cost of six or fewer such events a year if the event is available to all employees working at the same particular location of the employer.

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CCRA on Romkey

In a May 8, 2001 technical interpretation (TI), the CCRA clarified its assessing practice for estate freezes in the wake of the FCA decision in *Romkey* (TI 2001-0072705 and [2000] 1 CTC 390, leave to appeal dismissed). It is welcome news that the CCRA does not intend to revise its assessing practices for estate freezes as a result of the case.

In *Romkey*, two brothers attempted to implement an income-splitting structure through the issue of non-voting shares by a corporation they controlled to trusts for the benefit of their children. Voting prefs had been issued to the brothers five years before, and the company was inactive until some time after the issue to the trusts. Unfortunately, the plan was not executed exactly as intended: for example, the trusts' shares were not actually paid for with family allowance funds. The corporation paid dividends on the non-voting commons for a number of years, and the CCRA reassessed on the grounds that the dividends were attributed back to the brothers under subsection 74.1(2). A unanimous FCA applied the rule established by it in *Kieboom* (92 DTC 6381): by causing the share issue to the trusts, the brothers "effectively forewent the right to receive an increased measure of any future dividends declared and paid by the Company" and effected a "transfer of property" that triggered the attribution of the dividend income back to them.

Because the FCA did not expressly restrict its ratio to a poorly executed income-splitting structure, some practitioners were concerned that the decision could be applied to even impeccably implemented estate freezes involving shares issued to minors and/or spouses (although this is somewhat less of a concern for subsection 74.1(2) because of the kiddie tax). The new TI largely quells these concerns; although it refers only to trusts for minor children, the reasoning should apply equally to estate freezes and the spousal attribution rule in subsection 74.1(1).

> It is our view that subsection 74.1(2) will generally not apply to attribute, to a freezor, dividends paid on shares held by a trust for minor children as part of a typical estate freeze, provided that the shares held by the trust are issued for an amount equal to their fair market value and are paid for with funds that are not obtained from the freezor.

The CCRA's stance in the TI appears to rest on a conclusion that *Romkey* was fact-driven: the minors' trusts did not actually pay for the shares with funds from family allowance receipts. The Crown in *Romkey* conceded that if the shares had been so paid for, the attribution in subsection 74.1(2) would not apply because no "property" would have been "transferred" to the brothers' children, a concession that buttresses the TI's narrow but reasonable interpretation of the decision.

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Quebec Flowthrough Shares

On November 17, 2000, Quebec announced changes designed to stimulate mining activity in that province. The provincial tax incentives for flowthrough shares for exploration expenses incurred in Quebec that were due to expire at the end of 2000 were extended for one year to the end of calendar 2001. Quebec's March 29, 2001 budget announced a replacement of the flowthrough share regime, including the basic deductions of 100 percent, with a more direct assistance mechanism: a refundable tax credit. On September 14, 2001, Quebec Finance announced that the transition from flowthrough shares may have been too rapid, especially for junior companies, and extended the flowthrough regime—at the taxpayer's option—for two years to the end of 2003, when the regime is to be completely replaced by the new tax credit. Accordingly, funds may be raised using flowthrough shares as a vehicle to finance Canadian exploration expenses and expenses relating to renewable energy and energy conservation in Canada, whether incurred inside or outside Quebec, for calendar years 2002 and 2003.

The additional 25 percent deduction a corporation may claim under the Taxation Act and the Mining Duties Act, with respect to certain exploration expenses incurred in Quebec's near north and far north, will also be maintained for an additional two years and eliminated after 2003. Accordingly, for 2002 and 2003, the expenses giving rise to this additional deduction may continue to be forgone in favour of a corporate investor if these exploration expenses are financed with flowthrough shares. On the other hand, the corporation that incurs eligible expenses after March 29, 2001 may no longer claim this additional deduction if it claims the new tax credit; only the corporation that incurs eligible expenses, either directly or through a partnership, may claim the new refundable tax credit.

The tax incentives for exploration expenses incurred in Quebec are also extended for an extra two years: for Quebec income tax purposes in taxation years 2002 and 2003, individuals may continue to claim deductions equal to 125 percent or 175 percent, as the case may be, of mining, oil, or gas exploration expenses incurred in Quebec before calendar 2004 by exploration companies with no resource operating profits, subject to the stipulated 12-month period. The existing rules allowing an individual to claim an additional deduction regarding certain issue expenses may continue to apply for taxation years 2002 and 2003, if the relevant shares are flowthrough shares. In addition, an individual who is not a trust may continue to benefit from the additional capital gains exemption in respect of certain resource properties, even if the property is alienated after 2003.

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Ontario CMT

Ontario corporate minimum tax (CMT) may present unpleasant surprises for many taxpayers, including corporate owners of life insurance. (See, for example, "Ontario CMT Still Burns," *Canadian Tax Highlights*, January 25, 2000, at 6; "Ontario CMT Burns Again," March 16, 1999, at 23; and "Ontario CMT Burns Donors," July 21, 1998, at 54.) Although a corporation's life insurance proceeds from a tax-exempt policy are not subject to income tax, they normally fall into net income for accounting purposes: any resulting Ontario CMT may yield an absolute tax cost.

Assume that Mr. X and Mr. Y, who deal at arm's length, each own 50 percent of the shares of XYco, an Ontario-based holding company that owns 100 percent of Opco's shares. Opco's shares have an adjusted cost base of $1 and a fair market value of $20 million. XYco also owns and is the beneficiary of a joint first-to-die life insurance policy on Mr. X and Mr. Y with a $10 million death benefit. The XYco shareholders' agreement provides that the corporation will redeem the first deceased's shares for $10 million, using half of the capital dividend account balance created with the insurance proceeds. On the first shareholder's death, XYco receives the insurance proceeds free of income tax, but subject to $400,000 Ontario CMT on $10 million accounting net income. All or some of the CMT may be an absolute tax cost unless XYco earns sufficient income within the 10-year carryforward period. Further, if XYco is wound up or sells its Opco shares, it realizes a $20 million capital gain; if the gain is realized in 2005 or later (when the Ontario corporate tax rate is scheduled to be 8 percent), XYco suffers Ontario corporate income tax of $800,000 ($20 million × 1/2 × 8%). Ontario CMT otherwise payable is $800,000 ($20 million × 4%), and thus the $400,000 CMT carryforward from the life insurance proceeds receipt cannot reduce the Ontario income tax on the capital gain unless the Ontario CMT rate of 4 percent is reduced in proportion to the Ontario corporate income tax rate decrease (from 15.5 percent in 1999 to 8 percent by 2005).

If the aggregate total assets of the corporation and its associated corporations do not exceed $5 million (other than the insurance proceeds) at the end of the year and their aggregate revenue for the year does not exceed $10 million, Ontario CMT can be avoided by distributing the insurance proceeds before the corporation's year-end, when Ontario CMT is assessed. The distribution ensures that the $5 million asset threshold is not exceeded. The receipt of insurance proceeds should not affect the $10 million revenue threshold (unless significant related investment revenue is earned) because the proceeds are not revenue under GAAP. If the CMT thresholds may be exceeded in the year the insurance is received, the use of a subsidiary with no Ontario permanent establishment (PE) may avoid CMT, subject to the Ontario GAAR. XYco could incorporate a Subco that has only an Alberta PE and no assets but is named the beneficiary of XYco's life insurance policy. On receipt of the insurance proceeds, Subco's capital dividend account increases accordingly, but because Subco has no Ontario PE, Ontario CMT does not arise. Subco then distributes the proceeds to XYco via a tax-free capital dividend, which is not subject to Ontario CMT because capital dividends are expressly excluded from adjusted net income for Ontario CMT purposes. Alternatively, it is arguable that GAAP allows the life insurance proceeds to be booked directly to retained earnings without being included in accounting income—thus sidestepping Ontario CMT—if the insurance was acquired to fund a buy-sell arrangement and the premiums were charged directly to retained earnings.

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SECRET COMPARABLES

Revised transfer-pricing legislation was enacted mid-1998. In order to align Canada's trade and tax practices with the international community's, many of the procedures the CCRA has adopted since then reflect policies outlined in the

SHOE by Chris Cassatt and Gary Brookins

OECD's 1995 transfer-pricing guidelines for multinational enterprises. Although the guidelines do not specifically address the use of undisclosed third-party comparable transactions—secret comparables—during the conduct of an international transfer-pricing audit, the guidelines may be read as discouraging their use by exhorting tax examiners to avoid "unverified assertions." The OECD is apparently considering stronger language to further discourage the use of secret comparables, and government officials in many other jurisdictions have denounced their use. Currently Australia, France, Germany, Japan, and Mexico also use secret comparables.

Although *Information Circular* 87-2R states that only "in isolated cases" are assessments based on third-party comparable information, use of such information may be more frequent in practice, principally because of the ease with which the CCRA can secure such comparables. IC 87-2R establishes the comparable uncontrolled price (CUP) as the CCRA's preferred transfer-pricing methodology. CUP evaluates prices in comparable transactions between or with unrelated third parties, and the CCRA amasses such information through thousands of transfer-pricing examinations every year. The problem arises when the CCRA uses this information during the audit process, not simply to verify transfer-pricing methodologies but to reassess transactions. The IC states that the assessed taxpayer is advised of the use of third-party comparables, but confidential data cannot be disclosed without the third party's written consent, which not surprisingly is rarely forthcoming. The CCRA usually discloses some—but not all—third-party comparable information and will not identify the relevant organizations: subsection 241(1) prohibits the CCRA's provision of taxpayer information or access thereto or its use otherwise than, inter alia, in the course of the Act's administration or enforcement. The CCRA strictly interprets the exceptions to this prohibition and refuses to reveal all information about comparable organizations and transactions.

The CCRA's approach protects the third party from the disclosure of sensitive information to potential competitors, but it also leaves the taxpayer defenceless: the taxpayer cannot verify whether the third-party transactions are in fact comparable and whether appropriate adjustments account for the differences between the parties. The taxpayer can take several approaches to establishing the case it must meet. First, the international tax directorate permits its auditors to disclose information that does not identify the companies being compared, and may include details about the organization's activities, a list of key customers and key ratios, an outline of potential risks, and information relating to intangibles involved in the uncontrolled transactions. Second, the taxpayer may contact the international tax directorate in Ottawa, which may under exceptional circumstances overturn a Tax Services Office's decision to withhold non-public information on comparables: for example, the third party may consent. Third, the information may be accessible under the Freedom of Information and Protection of Privacy Act. Securing data following a written request to the information and privacy commissioner may take several weeks (or, more likely, months); submitting a written response to an assessment within the 30-day deadline may require a request for special consideration from the commissioner or for an extension from the CCRA International Tax Group. Finally, the taxpayer may need to resort to the increasingly common tactic of filing a motion in the Tax Court requesting an order for disclosure of the secret comparable. Historically, when faced with a court motion, the CCRA has generally chosen not to base the assessment on the comparable rather than reveal the third-party information. The use of secret comparables undermines taxpayer rights and leads to expensive legal proceedings that threaten the confidentiality of information concerning the third parties involved. It is hoped that any examination of the issues by the OECD will encourage Canada to cease to base assessments on secret comparables.

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ETA and Customs

The interplay of the Customs Act and the Excise Tax Act can prove inelegant when one assesses the GST implications of importing goods into Canada. The recent *Alveberg* case illustrates the mismatch of conceptual formats underlying the two acts.

Alveberg involved a 1935 Ford wood-bodied station wagon that had to be restored in California. When bringing back the fully restored body along with the chassis (the mechanics were stripped out prior to shipment to California) Mr. Alveberg was assessed Cdn.$2,500 in GST on labour (US$21,500) and wooden materials (US$3,000). The TCC decided that the labour component should not be included in the GST base of duty-paid value.

The TCC said that what was taxable under division III of the ETA as an imported good was not a motor car as such, but merely the "wooden part" portion of the refurbishment. However, the court then concluded that that good's value for duty did not include the labour component, which represented a contract for services and was thus somehow a separate supply. Division IV of the ETA deals with services provided outside Canada for use or consumption in Canada, and the TCC applied an exemption for services performed outside Canada in relation to tangible personal property.

The conceptual difficulty starts with the fact that the division III liability for GST on imported goods is based on the dutiable value of imported goods. The Customs Act concerns itself only with imported goods and their value, which includes the value of services reflected in the goods' value. The bifurcation of a contract into materials and labour is alien to the customs inquiry; the focus is on the goods and their value. Thus it is relatively clear that the value of the good imported, be it car or wooden part, should include the value of the labour component. Furthermore, the carve-out exception for foreign-based services in division IV relates to services in connection to tangible personal property, an assumption likely based on the premise that the value of the services will be captured for GST purposes under division III when and if the tangible item is imported. As the Crown counsel pointed out in *Alveberg*, to find otherwise would encourage Canadians to have work done in the United States GST-free, a result arguably contrary to fundamental GST policy.

The claiming of ITCs on importation raises similar difficulties involving the interplay between the ETA and the Customs Act. For example, under the so-called de facto importer rule, the CCRA attempts to limit the persons who may claim ITCs for the GST paid on importing goods into Canada. The rule is partially aimed at certain deficiencies that seem to allow for the GST-free consumption and use in Canada of certain leased goods. The CCRA has issued a series of written and oral policy statements that reflect the Byzantine meshing of the two acts. Perhaps the problem lies in the very different natures of the ETA (which levies effectively an in personam tax and carefully spells out who is required to pay, who must collect, and who is entitled to an ITC) and the Customs Act (which levies an in rem charge on imported goods and is indifferent to the identity of the party who bears the duty or tax). Thus the imposition of GST on the person liable to pay duties does not target a precise person and leaves open the prospect of ITC claims by a host of parties.

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CFC in Grantor Trust

The US Tax Court in *Textron* held that a US shareholder of a CFC had to include the CFC's subpart F income in its income even though it was forced to surrender voting control to an unrelated voting trust (117 TC no. 7, issued August 21, 2001).

In 1989, Textron acquired substantially all the stock of Avdel, a UK public limited company. The Federal Trade Commission (FTC) immediately obtained a restraining order severely restricting Textron's control over Avdel pending a review of potential restraint-of-trade issues. Textron was ordered to transfer its Avdel stock to a voting trust presided over by an independent trustee with a mandate to ensure that Avdel remained competitive with Textron and with the power to vote the Avdel stock without any influence from Textron. Textron was the sole economic beneficiary of the trust.

A CFC's US shareholder must include in its gross income its pro rata share of the CFC's subpart F income—for example, dividends, interests, rents, and royalties—whether or not distributed. A CFC is any foreign corporation if more than 50 percent of its shares' votes or value is owned directly, indirectly, or constructively by US shareholders. The court found that Avdel was a CFC of the voting trust, which owned directly 95 percent of Avdel's shares; Textron was not the constructive owner under the CFC rules. However, Textron was not insulated from the CFC tax regime: the voting trust was a grantor trust and Textron the grantor because it was entitled to the trust income without the approval or consent of any adverse party. And under the grantor trust rules, Textron must report all the trust income, including its CFC subpart F income.

Textron clearly did not intend to avoid reporting CFC income through the use of the trust mechanism forced on it. Thus any taxpayer attempting to use an intervening grantor trust will not successfully circumvent the subpart F consequences of CFC ownership.

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Ordinarily Resident

The recent TCC decision in *McFadyen* held that the taxpayer was ordinarily resident in Canada during a three-year absence from Canada. The decision has been appealed.

Interpretation Bulletin IT-221R2 confirms the principle set out by the SCC in *Thomson*: an individual is resident "where he in the settled routine of his life, regularly, normally or customarily lives" even though he lives abroad. The CCRA considers four general factors in this determination: permanence and purpose of stay abroad; residential ties within Canada; residential ties elsewhere; and regularity and length of visits to Canada. Although the IT says that a two-year stay abroad raises a presumption of nonresidence, a 1995 technical interpretation says that the length of stay abroad is not important (no. 9504125). The taxpayer in *McFadyen* lived abroad for three years with his wife and daughter, but the TCC said that his ties with Canada were significant: he returned to Canada on three occasions; maintained Canadian bank accounts; and owned two houses, maintained his professional membership, and stored personal property here. He formed an intention to stay in Japan if he and his wife found alternative work, but a few months later the family returned to Canada. The IT also states that if a Canadian dwelling place available to the taxpayer for year-round occupancy is rented at arm's length, the individual has not severed ties with Canada if

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the lease can be terminated with less than three months' notice. Mr. McFadyen was able to terminate the lease on one of his houses with only two months' notice. The good news is that the case may be distinguished because Mr. McFadyen was deemed resident as a spouse of a CCRA employee stationed abroad, under a now repealed provision.

The taxpayer tried to establish that he was a resident of Japan by virtue of his being taxed there. The TCC concluded that the taxpayer had not established that he was subject to "as comprehensive a tax liability as is imposed" in the other country, as expressed by the SCC in *Crown Forest*. A Japanese certificate of residency produced by the taxpayer was prepared by him, including an effective date, and was apparently rubber-stamped by the Japanese tax authorities without any inquiry into the facts. The application of the tie-breaker rules under the Canada-Japan treaty is determined by the mutual agreement of the competent authorities; the TCC said that it has no such authority. In contrast, the Canada-US treaty does not refer to mutual agreement unless the various tie-breaker tests in that treaty cannot be satisfied. And the rule in subsection 250(5)—which says that a dual resident found to be a resident of the other country under the relevant treaty is deemed not to be a Canadian resident—may make it easier to assert the position that a treaty-resident taxpayer is no longer subject to worldwide taxation in Canada.

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FOREIGN TAX NEWS

Treaties

Canada's treaties with Portugal and Bulgaria entered into force October 24 and 25, 2001, respectively, effective January 1, 2002. Full text is available from the Foundation's library or on the Finance Web site at http://www.fin.gov.ca/treaties/treatystatus_e.html.

India

Foreign companies may suffer a tax on fees for technical services used in connection with Indian-source income, regardless of where the services are rendered or the fees are paid. A recent case found that a Norwegian company supplying equipment and engineering services related to construction was taxable because it had not directly engaged in construction or assembly in India.

According to a clarification that was issued, the 5 percent service tax does not apply in the exclusive economic zone (EEZ), which extends from 12 to 200 nautical miles into the sea; the exemption should reduce charges by foreign service providers for consultation and construction.

OECD

In late September, representatives from 80 economies met to discuss global taxation issues, including taxation of e-commerce and the elimination of harmful taxation.

Miscellaneous

Foreign investors in **China** that reinvest profits from foreign-invested enterprises (FIEs), thereby either increasing the capital of an existing FIE or establishing a new one, are eligible for an income tax refund, except for a taxable income increase related to transfer-pricing adjustments. **Cyprus** will introduce an economic stimulus package containing tax harmonization, incentives to attract foreign investors, and possibly an exemption for Cypriot funds abroad that are repatriated. At a recent IBFD conference, Dr. Onno Ruding said that the **EU** Commission should propose the elimination of corporate tax or the establishment of a single EU-administered tax. **Russia**'s President Putin announced tax cuts, pension reforms, the liberalization of the stock market, a restructuring of the financial sector, and the creation of a financial intelligence unit to combat money laundering. **Sweden** will give SEK 9 million to assist Russia with tax reforms and enable it to join the World Trade Organization. **Taiwan** is considering a 20 percent tax increase on the net income of foreign branches, for a total of up to 40 percent, to match foreign subsidiaries and local firms. An unqualified accountant in the **United Kingdom** was sentenced to 12 months' imprisonment for falsifying a client's accounts by reporting payments to a non-existent company. **US** President Bush signed into law an anti-terrorism bill with penalties for money laundering. The bill is designed to disrupt terrorist financial networks and track foreign capital and suspicious activities. Various UK tax havens pledged cooperation with the United States to curb terrorist abuse of their financial centres.

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