CANADIAN TAX Highlights

Editor: Vivien Morgan, LL.B.

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Oral Notice of Stock Option

In *McAnulty*, the TCC held that an oral statement of commitment to issue stock options qualified as an agreement to issue the shares for purposes of the stock option benefit deduction under paragraph 110(1)(d). This decision benefits employees if there is an increase in the price of their employer's shares between the date on which they are notified of the stock option grant and the date of its formal documentation.

Ms. McAnulty was told on April 29, 1994 by Mr. Walsh, the president of her employer, Bre-X Minerals, that she would receive options to purchase 45,000 Bre-X shares at $1.50 per share, their FMV on that date. The taxpayer's testimony as to the terms of the oral commitment was confirmed by Mrs. Walsh, who was present at the time. (Mr. Walsh had since died.) The written option agreement was signed on May 19, 1994, when the shares' FMV exceeded $1.50 a share.

In 1996, when the taxpayer exercised the options, she deducted 25 percent of the resulting taxable benefit pursuant to paragraph 110(1)(d), which requires that the option price not be less than the shares' FMV "at the time the agreement [to issue the shares] was made." The taxpayer argued that the relevant time was April 29, 1994 (when she was notified by Mr. Walsh), but the CCRA said it was May 19, 1994 (when the agreement was actually signed).

The TCC said that the question was simple. Did Bre-X agree to sell or issue shares to the taxpayer on April 29, 1994, or was there no agreement until May 19, 1994 at the earliest, when the written agreement was signed by Mr. Walsh on behalf of Bre-X and by the taxpayer, and confirmed by a directors' resolution? The TCC said that the law is clear that the agreement need not be in writing. The TCC did not accept the CCRA's argument that Mr. Walsh had no authority to bind the company to issue options; the taxpayer was entitled to rely on the well-established indoor management rule, and thus did not have to look behind Mr. Walsh's putative authority to ensure that all the bylaws' formalities had been met. The TCC concluded that the later directors' resolution and the written agreement were formal confirmation and implementation of the April 29 agreement. The court said that only a broader interpretation of "agree" and "agreement" achieves the object of paragraph 110(1)(d), and that object would be destroyed by excluding an oral commitment made by a senior officer of the company with apparent authority. Such an interpretation would "create chaos in public companies . . . if when senior management tells employees that they are to be given options at a particular price, [they] had to look at the bylaws and ensure that management followed the rules." Further confusion would arise if an upward fluctuation in the share price before the date of a written agreement and a directors' resolution required an adjustment to the option price.

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In This Issue

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Non-Compete: Capital Asset

Before the recent *Manrell* decision, the correct characterization of receipts under a non-compete agreement (NCA) was uncertain: the CCRA generally viewed them as capital, but taxpayers commonly adopted the position that an NCA connected with a share sale was not itself a disposition of property, rendering the receipt a non-taxable windfall. The 1996 TCC *Fortino* decision, affirmed by the FCA, said that NCA receipts were not income from a productive source under section 3, and in the result they escaped the tax net: the Crown had not pleaded that the receipts were capital gains and was not allowed to raise the argument at trial. The TCC in *Manrell* has now said that NCA receipts connected with a share sale are properly characterized and taxable as flowing from the disposition of capital property.

Mr. Manrell and others entered into a share purchase agreement to sell their shares in a plastic-bottle manufacturing business. As a condition of that sale, the vendors entered into NCAs, for which Manrell was allocated about $1 million in four equal instalments. The NCA provided generally that the vendors would not directly or indirectly engage in any activity that was similar to or competitive with any business then carried on by the purchasers. Manrell initially reported and was assessed on the first instalment as a capital gain, but (apparently on becoming aware of the *Fortino* decision) he objected to subsequent assessments and claimed that the amounts were a non-taxable windfall.

Manrell argued that an agreement not to exercise a right to compete was not property under the Act. Subsection 248(1) defines property to mean "property of any kind whatever whether real or personal or corporeal or incorporeal and, without restricting the generality of the foregoing, includes [inter alia] a right of any kind whatever." He argued that property is defined to mean, first, property, and is thus restricted to the common law concept, from which English, Australian, and Canadian jurisprudence excludes the ability to compete. Manrell further argued that the inclusion of a "right of any kind whatever" did not expand the common law definition, and even if it did he had not disposed of his right to compete but had merely covenanted not to exercise it. The TCC said that the ability to compete may not be property at common law, but the Act's definition was broader and included the right to compete, based on a number of Canadian tax cases. The taxpayer did not dispose of his personal talent, aptitude, and knowledge used to operate a bottle-manufacturing business, but he did sell—and thus disposed of—his right to compete via a covenant restricting his actions. Otherwise limiting the meaning of "disposition" would mean that such rights, included as property, could never be disposed of under the Act.

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Amounting to Something!

The CCRA has decided to abandon its appeal of *Royal Trust* to the FCA. The TCC held that amounts reflected in the taxpayer's balance sheet under GAAP were determinative of its large corporations tax (LCT) capital tax liability: it was not appropriate to reject GAAP in favour of the legal nature of any arrangements concluded by the taxpayer.

Royal Trust treated an equipment lease as a sale for accounting purposes and accordingly recorded cash payments due to it as lease receivables and removed the tangible property from its balance sheet. Section 181.3 requires a financial institution to pay capital tax on, inter alia, the amount of the carrying value at year-end of assets that are tangible property. However, subsection 181(3) provides that that carrying value or any other amount in respect of a corporation's capital, investment allowance, taxable capital, or taxable capital employed in Canada is determined by the amounts reflected in the balance sheet presented to the corporation's shareholders and prepared in accordance with GAAP. If a bank or insurance company is required by law to report to OSFI, the capital tax base is determined by the balance sheet accepted by OSFI.

Previously, the CCRA took the position that an existing legal obligation to pay an amount that was a loan or some other form of indebtedness must be included in taxable capital even if the amount was not reflected in the balance sheet under GAAP; for example, a leveraged lease in which the debt is considered defeased does not appear on the balance sheet. Further, the CCRA took the view that the legal nature of an arrangement determined its categorization under subsection 181.2(3), a view reflected in its assessing position in paragraph 11 of IT-532. At a recent TEI conference in Vancouver, the CCRA said that the phrase "except as otherwise provided in this Part" in subsection 181(3)—words qualifying the direction to look to the balance sheet—meant that that provision described only the carrying value or amount, and subsection 181.2(3) provided for the inclusions in capital for LCT purposes. In other words, the CCRA said that GAAP was used to quantify but not to determine which items were included in capital. The CCRA's position seems to have been predicated on a passage from the *Shell* decision dealing with income tax: "absent a specific provision in the Act to the contrary, the taxpayer's legal relationship must be respected in all cases." (See "Form over Substance?" *Canadian Tax Highlights*, June 26, 2001, at 42.) However, most practitioners at the conference had difficulty reconciling the CCRA's view with the fact that very specific rules are provided in subsection 181(3) for determining the amounts used to compute LCT. Clearly, subsection 181(3) is specific statutory authority for GAAP amounts to trump the legal characterization of transactions. The CCRA's dropping of its *Royal Trust* appeal evidences waning enthusiasm for that position. In light of this development, taxpayers may wish to consider filing notices of objection to LCT assessments that oust GAAP balance-sheet principles. Further, taxpayers may wish to refile tax returns for non-statute-barred years to reduce LCT liability for items that, based on GAAP, do not fall into taxable capital.

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Setting an Example?

The annual review of international tax comparisons published by the OECD shows that Canada is one of the few industrialized countries that has reduced the burden of taxation. However, the reduction was small and Canada maintains the 13th highest tax burden among the 30 OECD countries.

The table shows that total taxes collected in Canada amounted to the equivalent of 38.2 percent of GDP in 1999, the latest year for which final data are available. This represents a slight decrease from the previous year's ratio of 38.3 percent; preliminary figures put the 2000 ratio at 37.5 percent. By comparison, the OECD average rose from 39.5 percent in 1998 to 39.9 percent in 1999; no information is available for the 2000 average. Although absolute figures are interesting, the most closely watched comparisons are those with our major trading partners. Canada remained almost 10 percentage points higher than our closest neighbour and competitor, the United States. Our ratios were below those in the Scandinavian countries, France, and Italy, but above those in Germany, the United Kingdom, and Japan.

Total Tax Revenue as a Percentage of GDP

	Average for			
Selected years	Canada	US	All OECD	European OECD
1975	33.1	26.9	31.1	32.8
1985	33.6	26.1	33.8	36.5
1995	36.6	27.6	36.1	38.7
1998	38.3	28.8	36.9	39.5
1999	38.2	28.9	37.3	39.9

It is important to put these ratios into perspective as measures of relative tax burdens. The ratios take no account of the public services financed from tax revenue, so they must be interpreted as only a small part of the evaluation of competitiveness across borders. The ratios do not distinguish between taxes raised from income (such as income from capital, in particular), taxes on labour (in the form of payroll taxes), and consumption taxes. The actual balance of taxes employed by each government can shape the impact of the public sector levies on the national economy.

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Refund Interest Is Business Income

The FCA recently heard two cases concerning whether interest on a tax refund is business income. In *Irving Oil*, the taxpayer argued for active business income treatment and resultant M & P credits. The CCRA argued that refund interest can never be business income, in apparent contradiction to its position in *Munich Reinsurance* that such interest was business income. Munich Re, a non-resident of Canada, argued that its refund interest was property income and thus the lower part XIII withholding tax applied in lieu of part I tax. The FCA agreed with the TCC that the refund interest in both cases was business income.

Irving Oil is in the active business of refining crude oil and marketing refined petroleum products in Canada. In 1978, the Crown assessed Irving Oil's 1971-75 tax years. The taxpayer was legally obliged to pay the tax in dispute or lodge security, an alternative that would have resulted in non-deductible interest expense if Irving had been unsuccessful. In 1992, Irving received about $240 million in tax refund interest, which it included in its business income, increasing its M & P tax credit. The FCA said that the tax character of income is a fact-based determination. In this case Irving simply paid an outstanding tax liability, exercising its business judgment that paying the tax was preferable to providing security. The TCC and the FCA disagreed with the CCRA's argument that a decision to pay tax in dispute is not a business activity. The FCA quoted the lower court: "When [Irving] received a tax refund . . . [it] represented a return of money that was intended for use in [its] business at the time of the overpayment and was made impossible by actions of the government." The FCA said that there was no authority for the CCRA's proposition that interest on an income tax refund can never be business income.

Munich Re is a German corporation not resident in Canada. Munich carried on an insurance business in Canada and elsewhere and was subject to part I tax on the Canadian operations' income. For several taxation years, Munich overpaid its monthly instalments to avoid the risk of non-deductible interest costs and received about $1.4 million in interest on those overpayments. The CCRA assessed the interest as taxable under part I. Munich was unsuccessful in its argument before the TCC that the interest was not part of its income from carrying on its Canadian insurance business; Munich argued in the FCA that part XIII withholding tax applied instead.

The FCA pointed out that a non-resident's income from carrying on business in Canada is taxable under part I, not part XIII, and interest may be business income in certain circumstances.

An insurer's investment activities are essential to its business, but not all its investments form part of its insurance business. However, on the facts there was no reason to conclude that Munich's right to tax refunds did not arise as part of its insurance business. Munich's asset management decisions to comply with its tax obligations in the most advantageous way involved the use of its insurance business assets, and thus were made in the course of that business. Therefore Munich's right to tax-overpayment refunds was acquired in the course of carrying on its business, and the right was property held in the course of carrying on that business.

New Ontario GAAR bulletin. Ontario is overhauling its corporate income and capital tax information and interpretation bulletins, and recently released updated IT-3007, "General Anti-Avoidance Rule and Interprovincial Anti-Avoidance." Ontario GAAR parallels the federal rule and also applies to other taxes under the Corporations Tax Act, such as capital tax, premium tax, and corporate minimum tax, and to income tax provisions that differ from their federal counterparts. For example, the bulletin states that GAAR may apply if a corporation's PUC would have been greater but for an avoidance transaction that reduced or eliminated amounts otherwise included.

The bulletin also describes Ontario's GAAR assessment process. A federal objection may cover a provincial assessment flowing from a federal GAAR assessment, but if there are provincial items in dispute along with those arising federally, both federal and Ontario objections must be filed. Paragraphs 18-25 cover specific Ontario anti-avoidance rules dealing with interprovincial asset transfers, discretionary deductions, and specified reserves.

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Corporate Tax Instalments

The federal budget of December 10, 2001 announced a deferral of corporate tax instalments for small businesses, providing much-needed cash flow relief for the many affected by the slowing economy. Ontario and Quebec had already announced tax instalment relief.

The federal proposal defers, for at least six months, the due date of an eligible corporation's federal income and capital tax instalments for January, February, and March 2002 and the income tax instalments owed to provinces and territories with a tax-collection agreement with the federal government (all except Alberta, Ontario, and Quebec). An eligible corporation is resident in Canada and does not have, in aggregate with all associated corporations, more than $15 million of taxable capital employed in Canada in the prior year. Normally, a corporation must make its final payment of taxes owing for a taxation year by the balance-due day, generally two months after year-end (three months for certain Canadian-controlled private corporations [CCPCs]). The balance-due day is extended if it would otherwise fall before a deferred instalment payment, so that all eligible corporations benefit from the minimum six-month deferral. Further, if a deferred instalment payment is payable after year-end but before the balance-due day, the payment is extended to the balance-due day to simplify administration. The table summarizes the deadlines for deferred instalments and balance-due-day payments.

Earlier in the fall of 2001, Quebec announced a six-month deferral of the income and capital tax instalments of a qualifying corporation for the months of October, November, and December 2001. A qualifying corporation does not have, in aggregate with all associated corporations, more than $15 million of paid-up capital, as shown in their financial statements, in the prior year. Normally, corporations in Quebec must make their final payment of taxes owing for the taxation year two months after year-end (three months for certain CCPCs). A corporation eligible for the instalment deferral that has a taxation year ending after September 30, 2001 and before April 1, 2002 may defer its final payment of taxes until its tax return due day (that is, no later than six months after year-end). Quebec also announced that employers with monthly source deductions not exceeding $1,000 may remit them quarterly rather than monthly as of January 1, 2002.

Ontario announced in the spring of 2001 that for taxation years commencing after 2001, certain corporations may pay their Ontario income and capital tax instalments quarterly rather than monthly. A qualifying corporation has income and capital tax payable in the current or preceding taxation year of at least $2,000 but less than $10,000.

Deadlines for Deferred Instalments and Balance-Due-Day Payments

Taxation year-end	Instalments deferred			Balance-due day
	1-02	2-02	3-02	
1-02	7-02	na	na	7-02
2-02	8-02	8-02	na	8-02
3-02	9-02	9-02	9-02	9-02
4-02	9-02	9-02	9-02	9-02
5-02	9-02	9-02	9-02	9-02
6-02	9-02	9-02	9-02	9-02
7-02	7-02	9-02 or 10-02	9-02 or 10-02	9-02 or 10-02
8-02	7-02	8-02	10-02 or 11-02	10-02 or 11-02
9-02	7-02	8-02	9-02	11-02 or 12-02
10-02	7-02	8-02	9-02	12-02 or 1-03
11-02	7-02	8-02	9-02	1-03 or 2-03
12-02	7-02	8-02	9-02	2-03 or 3-03
1-03	na	8-02	9-02	3-03 or 4-03
2-03	na	na	9-02	4-03 or 5-03

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Painting into a Corner?

The draft 2002 update to the OECD model tax convention released in October 2001 includes provisions aimed at entities benefiting from preferential tax regimes and commentary changes related to the permanent establishment (PE) definition's application, tax-collection assistance, and conduit companies. The draft also includes commentary changes adopted by the Committee on Fiscal Affairs on December 22, 2000 to clarify the PE definition's application to e-commerce: of particular interest are comments on the application and interpretation of model treaty article 5 and on the circumstances in which a PE may be created by a non-resident's use of a client's premises to render or perform services in lieu of renting separate premises. The changes should be reviewed carefully when they are finalized in February 2002.

The PE concept is used in international tax treaties to determine which business activities carried on in a particular country are sufficiently based in that country to justify taxation of the profits there. The FCA's decision in *Dudney* demonstrates that the model tax convention and its related commentary continue to be a reference point for the interpretation of Canada's treaties. Thus any amendments to the model treaty and commentary are of interest. Canada may, of course, reserve its position on any such changes.

In *Dudney*, the FCA said that then existing commentary required that a person have physical control of a space before it was a PE. No PE existed on the facts: the non-resident taxpayer had access to the Canadian entity's offices—and used them—but only during its regular office hours and only for the purpose of performing the services contracted for.

The draft now says that a PE exists if a parent company employee is allowed "for a long period of time" to use an office in the headquarters of, for example, a newly acquired subsidiary to ensure that it complies with its obligations under contracts with the acquiring parent—activities related to the parent's business—if the other requirements of paragraph 1 of the commentary on article 5 are met. The meaning of "a long period of time" is not clear.

The draft commentary seems to narrow the application of *Dudney* and supports the CCRA's past position that a PE exists if a Canadian sub makes its premises available to its US parent for a sufficiently long period (doc. no. 9333340). It will be interesting to see how the Canadian courts approach the issues if the draft commentary is finalized: *Dudney* may no longer provide reliable guidance. The draft commentary contains another example of the use of another entity's premises resulting in a PE: a painter spending three days a week for two years in his main client's office building and performing the principal activity of his business (painting) constitutes a PE for him in that building. Query whether this logic extends to, say, consulting services rendered or performed in Canada. The draft appears to require less significant presence than *Dudney*, which appeared to require the physical control of a particular space.

The draft commentary states that "through which" must be given a wide meaning to encompass any situation in which a non-resident's business activities are carried on at a particular location that is at its disposal for that purpose. For instance, a non-resident engaged in paving a road is considered to be carrying on its business "through" the location where that activity occurs.

Other examples show that a non-resident's use of its client's premises need not give rise to a PE. A salesman who visits a major customer to take orders and meets the purchasing director in its office does not constitute a PE: the customer's premises are not at the disposal of the salesman's non-resident employer and therefore are not a fixed place of business through which it carries on business. Also, a road transportation enterprise that uses a delivery dock at a customer's warehouse each day for the purpose of delivering goods purchased by that customer does not constitute a PE: the presence at the delivery dock is limited, and thus the dock is not at its disposal.

The draft commentary also includes other notable amendments.

- The term "building site or construction or installation project" now includes the renovation of buildings, roads, bridges, or canals.
- "Installation project" is defined to include the installation of new equipment, such as a complex machine in an existing building or outdoors.
- A statement is added to the effect that an enterprise's lack of active involvement in transactions may indicate a grant of authority to act as its agent.
- The commentary adds a detailed list of factors to consider in determining whether an agent is independent and does thus not constitute a PE.

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Reasonable Expectation of Profit

In *Ludco*, the SCC commented on meaning of "income," a term that appears over 2,000 times in the Act: as used in paragraph 20(1)(c), the term is not equivalent to "profit" or "net income." (See "Back to the Drawing Board?" *Canadian Tax Highlights*, October 23, 2001, at 73.) The TCC in *Brown* considered *Ludco* in the context of whether property was acquired for the purpose of earning income and whether a business existed under the "reasonable expectation of profit" (REOP) test.

Mr. Brown purchased units in a partnership that acquired computer software and was registered as a tax shelter. It incurred a loss in 1993 and 1994 and earned a profit in 1995, but Brown's related expenses outside the partnership more

SHOE by Chris Cassatt and Gary Brookins than offset any income. The CCRA denied the 1993 and 1994 losses, excluded the 1995 income, and denied all his related expenses.

On whether the partnership acquired the software for the purpose of "gaining or producing income" under CCA regulations, the TCC said:

> In *Ludco* . . . the [SCC] held that for purposes of subparagraph 20(1)(*c*)(i), "income" refers to income generally that is an amount that would be subject to tax, not net income. I do not see the reason for "income" to mean anything else in [the regulation] . . . . Subparagraph 20(1)(*c*)(i) refers to money borrowed "for the purpose of earning income" and [regulation] 1102(1)(*c*) refers to property acquired "for the purpose of gaining or producing income." In both provisions the character of the income is the same. The object of both . . . is to create an incentive to accommodate or acquire capital with the potential to produce income.

The TCC said that the partnership had a REOP, even though on the facts expenses far exceeded revenue. The TCC seemed to equate the carrying on of a business with having a source of income, apparently reflecting the SCC's words in *Moldowan* (77 DTC 5213): "[I]n order to have a 'source of income' the taxpayer must have a profit or a reasonable expectation of profit. Source of income, thus, is an equivalent term to business." Courts have interpreted this rather confusing passage as suggesting that a source of income—and thus the right to deduct expenses—flows from the realizing of net income or profit. But the TCC in *Brown* seemed to focus on the final sentence that equates a source of income with a business and to suggest that a business may comprise a source of income without reference to whether a profit was made. The TCC added:

> Subsection 9(1) of the *Act* provides that a taxpayer's income for a taxation year from a business is the taxpayer's profit for the year. The *Act* neither identifies nor describes the legal characteristics of "income." For the purposes of paragraph 20(1)(*c*), at least, income does not mean profit.

Ultimately, Mr. Brown lost his appeal because his non-cash at-risk amount was nil as a result of a revenue warranty clause. But the TCC's comments with respect to the REOP test are a big win for tax shelter investments, which historically have been vulnerable to attack if no profit arose in the first few years. *Brown* fortifies the view that a taxpayer is carrying on business if revenue is produced and that reasonable expenses are deductible even if they far exceed revenue. Although *Brown* did not expressly reject the REOP test, it is consistent with the proposition that paragraph 18(1)(a) does not disallow the deduction of expenses simply because there is no profit. The SCC is expected to hear a trilogy of REOP cases soon: it is hoped that it will extend its decision in *Ludco* and bury the REOP test.

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GST Allocation Confirmed

In *Ville de Magog*, the CCRA disputed a Quebec municipality's method of allocating overhead expenses to taxable operations to determine its GST input tax credit (ITC). (See "GST Allocation Methods," *Canadian Tax Highlights*, November 28, 2000, at 86.) The municipality allocated "mixed" expenses, which related to both its general functions and its electricity operations, using the ratio of the latter's direct expenses to total expenses. The TCC preferred the CCRA's approach; the FCA reversed on appeal (subject to an adjustment for one year).

The FCA's decision hinged on the statutory requirements for ITC allocation methods: an allocation method chosen must be "fair and reasonable"; no particular method was required; and it was not necessary to determine whether the municipality's method was better. The municipality had looked to administrative guidelines in *Memorandum* 700-5-1 for financial institutions to establish its methods. The municipality's approach appeared to be sound and to lead to a fair and reasonable allocation, as implicitly acknowledged by both the CCRA and the TCC when the auditor used the same method for some mixed expenses. The FCA also noted that the TCC concluded that the municipality's method produced distorted results that contradicted its own data, but the CCRA's approach was arrived at in "painstaking fashion" using logical, objective criteria. In fact, the FCA said, the TCC misunderstood the evidence when it concluded that the municipality's method resulted in a loss from the electricity operations; furthermore, a review of the auditor's testimony showed an approach largely based on a survey method that was no more objective or logical than the municipality's. Both methods used surveys—employee ratios and expense ratios—and thus were not basically incompatible. Thus, the municipality's method was fair and reasonable.

The FCA recognized that there may be more than one fair and reasonable method of allocating expenses for ITC purposes and that there is no obligation to identify and use the best method, conclusions recognized in CCRA *Memorandum* 700-5-1. It is hoped that these conclusions will filter down to the CCRA audit level.

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CDA on Sale of ECP

A recent amendment to the capital dividend account (CDA) definition appears to have an unexpected result. Until the matter is clarified, it may be prudent to wait until the end of the taxation year to make a CDA election with respect to eligible capital property (ECP) sold during the year.

New paragraphs (c.1) and (c.2) in the CDA definition (subsection 89(1)) include the amount in respect of ECP that is included in income under paragraph 14(1)(b). However, the preamble to subsection 14(1) provides that the amount is not included in income until the taxation year-end.

Before the amendment, the CDA addition occurred at the time of the ECP's disposition. For taxation years ending after February 27, 2000, it appears that no amount can be added to the CDA until the taxation year-end. A CCRA rulings officer has tentatively confirmed this conclusion.

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Material Adverse Effect

A recent technical interpretation (TI) clarifies whether a material adverse effect (MAE) clause is an acceptable event of default under the terms of a loan for the purposes of a subparagraph 212(1)(b)(vii) withholding tax exemption (doc. no. 2001-008718, September 17, 2001). The CCRA considered two typical MAE clauses: one clause included in its listed events of default "the occurrence or threatened occurrence of an event which, in the opinion of the lender, has a material adverse effect on the financial situation of the borrower"; the other clause omitted the words "in the opinion of the lender."

Subparagraph 212(1)(b)(vii) contains a withholding tax exemption on interest paid to non-residents for medium-term, arm's-length corporate debt if, under the agreement's terms, the Canadian borrower can never be obliged to pay more than 25 percent of the principal amount within five years of issue "except [inter alia] in the event of a failure or default under the terms or agreement." Because the provision is somewhat ambiguous and has not been judicially considered, administrative practice weighs in more heavily. The CCRA has released many pronouncements on what constitutes a so-called acceptable event of default, and says that generally an acceptable event of default must have commercial reality, must be beyond the control of the lender, and must not be contrived. In addition, the CCRA has said that defaults are not "under the terms or agreement" if they do not result from acts of a party to the agreement—for example, defaults arising as a result of currency fluctuations or commodity price fluctuations (doc. no. 9807375 and Revenue Canada Round Table, 1986 Conference Report, 51:7, respectively).

The latest TI states that the words "in the opinion of the lender" in the MAE clause allow the lender unacceptable discretion and control over when the debt could be recalled. However, both MAE clauses in question "give the lender virtually an open-ended opportunity to recall the obligation for reasons they would consider material," and thus the withholding tax exemption does not apply in either case. This conclusion is consistent with the CCRA's previous positions. Under the MAE clauses considered in the TI, a lender could potentially call the loan in any number of circumstances not resulting from an act of the borrower, such as a drop in the NASDAQ or the Canadian dollar or the insolvency of the borrower's customer or supplier. In addition, as the CCRA notes, the lender has wide discretion because the range of potential triggers for default is unlimited. Accepting this type of MAE clause would render many of the CCRA's previously published positions nugatory: the sole test would be the occurrence of an event of materially negative financial impact. Most lenders would legitimately argue that such a clause is reasonable and necessary to protect them from unforeseen circumstances that affect the borrower's creditworthiness. Careful drafting may protect a lender's business objectives without jeopardizing the withholding tax exemption, by specifically identifying appropriate indicators of financial weakness as events of default that trigger repayment at the earliest time appropriate.

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CCRA's GST E-Biz Paper

The long-awaited CCRA discussion paper on GST/HST in the electronic commerce context has been released. The paper includes some useful information and some surprises, and focuses on five areas of interest: the "carrying on business" tests; permanent establishment (PE); the place of supply and characterization rules; telecommunication definitions; and documentation concerns. This article describes the "carrying on business" test; future articles will analyze PE concepts and characterization issues.

A non-resident may be required to register for GST/HST if it carries on business in Canada, a phrase not defined in the legislation. Income and sales tax jurisprudence establish the relevant factors. The two key factors are the place of contract and the location of profit-generating activities. Non-determinative ancillary factors—such as the place of delivery, where inventory is stored, or where bank accounts are maintained—may be persuasive when taken as a whole.

The analysis is not a precise science, but the factors are more clearly salient in the traditional commerce context where they were developed; some factors are arguably less relevant or more easily manipulated in the e-commerce context. For example, structuring the terms and method of contract acceptance and incorporating a jurisdiction clause may ensure that no contracts are effectively accepted in Canada. The CCRA therefore has reinterpreted the test in the e-commerce context: its "place of operations" approach analyzes traditional "carrying on business" factors (plus any others relevant to the specific fact pattern), but no one factor predominates. Thus, the place of contract and the place of profit-generating activities have equal status with, for example, the place of payment and place of delivery, and the weight ascribed to any one factor depends on the nature of the business. The CCRA says that policy in this area will develop over time, but it is not clear that deprioritizing the

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two traditionally key factors results in a simpler, more effective analysis. The CCRA's efforts to adapt the test for e-commerce are laudable, and the paper's detailed discussion is useful, but the potentially more subjective "place of operations" approach may increase uncertainty for businesses considering their registration responsibilities.

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Foreign Tax News

Treaties

On December 20, 2001, Canada ratified new treaties with Ecuador and the Slovak Republic, effective January 1, 2002. The agreement with the Slovak Republic replaces, as far as relations between Canada and the Slovak Republic are concerned, the 1990 treaty between Canada and Czechoslovakia.

Brazil

Provisional measures to adjust personal tax brackets also introduced unexpected changes to corporate income tax and transfer-pricing definitions. Personal income tax brackets are adjusted by 17.5 percent effective for income earned as of January 1, 2002, consolidated in the 2002 tax return. The social contribution on net income (CSL) for service companies increased 166 percent, from 12 to 32 percent. To determine a low-tax jurisdiction for transfer-pricing purposes, taxation on income and capital and overall taxation of the foreign country's different dependent locations are considered separately. Thus, a country may be a low-tax jurisdiction (a 20 percent or lower rate) for corporate but not personal income tax purposes, and any of its geographical subdivisions may be separately considered as low-tax jurisdictions. Transfer-pricing rules also apply to transactions with persons resident or domiciled in a location where domestic law provides secrecy of capital ownership or where stocks can be transferred without disclosure.

Korea

As of January 14, foreign firms investing in 44 high-tech sectors—30 of which are advanced technology sectors—including information technology, biotechnology, and nanotechnology, may obtain corporate and income tax exemptions for the first seven years and a 50 percent reduction for three more years. Property tax exemptions apply for the first five years and are reduced to 50 percent for the next three years.

China

Because China cannot monitor tax-avoidance schemes, it will phase out tax breaks for foreign firms gradually to ensure the same tax treatment for domestic and foreign companies. Direct and indirect tax paid by foreign firms is one of the fastest growing sources of Chinese tax revenue.

Mauritius

Offshore and international companies legislation has been consolidated into the Companies Act, effective December 1, 2001. The new Financial Services Development Act 2001 reforms the regulation of the non-bank financial sector and assists with the integration of onshore and offshore activities. The Financial Services Commission, a statutory body, will regulate non-bank financial services and administer regulations governing offshore and international companies.

South Africa

A new investment allowance is designed to encourage investment in projects with "strategically significant" direct or indirect benefits for the country. Investors are allowed to deduct 50 percent of the cost of assets during the first year (100 percent for "preferred status" costs) in addition to existing deductions and allowances, resulting in deductions exceeding the assets' costs. The allowance is deductible only against income from a listed industrial project. Detailed criteria describe acceptable projects.

France

To discourage wealthy residents from leaving, France's 1999 exit tax applies to certain residents who emigrate while holding substantial participation in companies. The tax may be deferred if payment guarantees are posted. One such taxpayer has argued that the law is designed to discourage expatriation and violates the freedom of movement and right of establishment as enacted under the 1957 EU Treaty of Rome. France's Conseil d'État, its administrative supreme court, ruled that the exit tax has neither the purpose nor the effect of impeding taxpayers' freedom of movement; proceedings have been stayed pending disposition of an application to the European Court of Justice for a ruling.

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