Canadian Tax Highlights

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Incorporation by Reference

The FCA in *Olsen* has reversed the TCC and upheld the CCRA's longstanding administrative position that the extended meaning of control in subsection 186(2) applies when determining connectedness for the purposes of the anti-surplus-stripping rules in section 84.1 (A-421-00).

Subsection 84.1(1) applies where, inter alia, a taxpayer sells shares of a (subject) corporation to a (purchaser) corporation with whom the taxpayer does not deal at arm's length and, immediately after the disposition, the subject corporation is connected—within the meaning of subsection 186(4)—with the purchaser corporation. Subsection 186(2) provides an extended meaning of controlled "for the purposes of this Part," being part IV. The TCC concluded that that meaning applied only to part IV and was not included in subsection 84.1(1)'s incorporation by reference of the subsection 186(4) definition of connectedness. (Section 84.1 is in part I.) In contrast, the FCA reasoned that because subsection 84.1(1) does not modify the meaning of the word "controlled" under subsection 186(4), the word must have the meaning attributed to it under part IV, including subsection 186(2). The FCA noted that both paragraph 110.6(15)(a) and subparagraph 110.6(15)(b)(ii) also incorporate the subsection 186(4) definition of connectedness, but the latter specifically excludes subsection 186(2). Accordingly, the court concluded that Parliament must be taken to mean that an unqualified incorporation by reference of subsection 186(4) includes subsection 186(2). The taxpayer argued that a slight variance in phrasing between those two provisions in subsection 110.6(15) and subsection 84.1(1) distinguished them, but the FCA noted that the French versions were identical and "the meaning which is common to both the English and the French text must be taken as the intended meaning." As a result, Olsen was unable to avoid the deemed dividend provisions of paragraph 84.1(1)(b). Finance introduced the "for greater certainty" subsection 186(7) amendment, effective March 16, 2001, to foil certain tax-planning arrangements in reliance on the TCC decision. Tax-planning arrangements undertaken in reliance on the TCC decision should be re-examined.

Reg 105 waiver form. The CCRA recently released the first reg 105 waiver application form, comprising three pages and 24 questions. Reg 105 requires 15 percent withholding on payments to non-residents for services rendered in Canada. A non-resident that believes the withholding exceeds its actual Canadian tax liability may apply for a waiver or reduction of tax and file a Canadian tax return to determine the actual liability. Applications should be received by the appropriate tax services office 30 days before the start of the services in Canada or 30 days before the first payment therefor. However, the CCRA has indicated that it may review later applications.

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Ontario Equity-in-Education Tax Credit

The 2001 Ontario budget announced a new refundable equity-in-education tax credit (EETC) for tuition fees paid to independent schools in Ontario commencing in 2002. Ontario Finance has now released the related tax provision, regulations, and a bulletin.

Only the parent or legal guardian who paid tuition fees for an eligible child and was an Ontario resident on December 31 may claim the EETC: the credit cannot be claimed by the child or another family member, a corporation, a charity, a trust, or an estate that pays tuition fees on behalf of the child. A child is eligible from the September of the year he or she turns 4 until July 1 of the year he or she turns 21. The credit is a percentage of net eligible tuition fees paid per child. Fees are capped at $7,000 per year, $700 per month of attendance at an eligible school ($3,500 and $350 respectively for a child under 6). Excess fees paid for one child cannot be claimed for another child. The percentages and maximums are phased in until 2006.

An eligible independent school generally (1) is in Ontario; (2) is registered as a private school under the Education

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Ontario EETC

	Credit as % of eligible tuition paid	Maximum credit per child: Per year		Per month of attendance	
2002	10%	$ 700	[$ 350]*	$ 70	[$ 35]*
2003	20%	$1,400	[$ 700]*	$140	[$ 70]*
2004	30%	$2,100	[$1,050]*	$210	[$105]*
2005	40%	$2,800	[$1,400]*	$280	[$140]*
2006 and later	50%	$3,500	[$1,750]*	$350	[$175]*

* The smaller limits apply if the child is less than six years old.

Act; (3) has at least five eligible students; (4) follows at least 75 percent of the normal course of studies at Ontario schools; and (5) carries out criminal-record reference checks on staff and others who have regular contact with its students. By the end of February of each year (March 31, 2002 for January 2002 to August 2003), each such school must also provide a statement of information to parents, legal guardians, Ontario Finance, and the CCRA that describes its operations and credit eligibility; otherwise, tuition fees paid to it for the following September are not EETC-eligible. Eligible courses of study are at the junior and senior kindergarten (JK and SK), elementary, or secondary school level. University, college, technical, or trade school level courses are not eligible. An eligible course of study must be at least as long as a public school program: 12.5 hours per week for JK and SK, 25 hours for others.

Fees for accommodation or boarding and child care and separate charges for meals, computers, books, clothing, travel, sports, and equipment are not eligible. Scholarships and bursaries received must be netted against the tuition fees eligible for the credit unless deducted from tuition fees before paid. Some independent schools are eligible to issue charitable donation tax receipts for tuition fees related to religious studies. To avoid both a charitable donation credit and an EETC on the same tuition, EETC-eligible tuition paid is reduced by 40 percent of tuition eligible for the charitable donation credit, whether or not claimed in the year. Similarly, some tuition fees qualify for the medical expense tax credit; EETC-eligible tuition paid is reduced by the product of fees so eligible, and the lowest combined federal and Ontario tax rate (16% + 6.05% = 22.05% for 2002.)

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Prescribed Rate Opportunity

Taxpayers who may benefit from family income-splitting arrangements or employee loans have until March 31, 2002 to take advantage of the first quarter's prescribed interest rate of 3 percent, the lowest rate in several years.

Locking in a family loan at this low rate may shift significant investment income from the loaned funds to a spouse or another family member who has little or no other income and thus little or no tax; investment income over 3 percent is effectively taxed indefinitely at the latter's tax rate. In the strategy's simplest form, a higher-income spouse agrees in writing to lend money to the lower-income spouse at 3 percent interest, which must be paid by the following January 30 of each year. If the funds are invested at a greater rate—say, 5 percent—the 2 percent differential is taxed in the lower-income spouse's hands: a $100,000 loan shifts $2,000 of income annually. More complex variations on this strategy may be appropriate, depending on a family's circumstances. To maximize tax benefits, interest payment terms and other loan arrangements must be properly structured and other requirements met.

It is also a good time to consider taking out or renegotiating employee home purchase loans. An employee who receives low- or no-interest loans from an employer receives a taxable employment benefit at the current prescribed rate, minus any interest actually paid during the year or within 30 days thereafter. The benefit rises with quarterly prescribed rate increases, except in the case of home purchase loans, for which the prescribed rate in effect when the loan is made applies for the loan's first five years. At the end of the five years the loan is considered a new loan, and the then prescribed rate sets the maximum for the next five years.

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At Whose Expense?

Recent information from Statistics Canada shows how dramatically at least some Canadian governments turned deficits into surpluses. The federal, provincial, and local governments combined ran up a $66 billion deficit, the equivalent of 9.3 percent of gross domestic product (GDP), in the fiscal year 1992-93. By 1997-98, the books were balanced; the table shows an estimated 2000-1 surplus of $25.7 billion, the equivalent of 2.3 percent of GDP.

Over the period, spending dropped from 52.7 percent of GDP to 40.1 percent. Revenues (including non-tax sources but excluding intergovernmental grants) also slipped a little, from 43.5 percent to 42.4 percent of GDP. The provinces' relatively lower revenue is more than explained by a drop in transfers from Ottawa from 4.6 to 3.0 percent of GDP. Local revenue declined from 9.6 percent to 7.2 percent of GDP, partly because of reduced transfers, but also because property tax is an inelastic tax source and other sources of local revenue failed to keep pace with the economy's growth.

Expressed as a percentage of GDP, some of the change in government revenues and expenditures over the period

Government Surplus/Deficit and Revenue Growth 1992-3 to 2000-1

	Estimates	
	1992-93	2000-1
Surplus or deficit (billions of dollars)		
Federal	–40.6	9.1
Provincial	–24.5	11.4
Local	–1.0	–0.4
All levels*	–66.4	25.7
Surplus or deficit (as a percentage of GDP)		
Federal	–5.7	0.8
Provincial	–3.4	1.0
Local	–0.1	<0.1
All levels*	–9.3	2.3
Percentage growth in revenue (1992-93 to 2000-1)		
Federal	45.4	
Provincial	44.8	
Local	14.4	
All levels*	49.1	
Percentage growth in spending (1992-93 to 2000-1)		
Federal	6.2	
Provincial	19.2	
Local	13.4	
All levels*	16.1	

* Includes Canada and Quebec pension plans.

reflects increases from a recession-low GDP to the relative boom times of the turn of the century. But there is no doubt that much of the improvement in the public sector's bottom line is attributable to significantly lower rates of growth in spending. The local level's revenues and spending grew in lockstep over the period, but provincial revenue growth exceeded spending, despite federal transfers' declining from nearly 21 percent to 14.4 percent of all provincial revenue over the period.

As the economic slowdown shows up in government financial reports for 2001-2 and future years' estimates, the growth in federal and provincial revenues will be less pronounced and spending's relative importance will rise. However, because the provinces account for well over half of all public sector spending, and because they showed substantial revenue growth despite deep personal income tax cuts and smaller transfers over the period, the consolidated bottom line should not deteriorate substantially to the point of crisis as it did in 1992-93.

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Evidently a Challenge

The recent FCA decision in *OSFC* provided the CCRA with a reprieve from a string of GAAR losses in the TCC. But in the long run, the FCA's remarks regarding the Crown's onus of proof for "misuse and abuse" may create a significant evidentiary hurdle.

The FCA said that the minister must "set out the policy with reference to the provision . . . or extrinsic aids upon which he relies." And because GAAR is mobilized only if the particular provisions applicable to a transaction have otherwise been strictly complied with, the court said that in order to deny the tax benefit the relevant policy must be clear and unambiguous. The FCA pledged that it will not leap to conclusions regarding misuse or abuse. The court said that a determination of policy requires a thoughtful analysis of the provision itself (a process generally involving consideration of context and analogous or related provisions in the Act) and a review of other acceptable kinds of proof that demonstrate clear and unambiguous parliamentary intention. The court said that extrinsic evidence such as technical notes, writings, *Hansard*, and enacting notes may be referred to in proving the purpose of the statute, its attendant misuse, and the policy of the Act as a whole.

A 1997 decision of the FCTD, *Prodor*, noted that extrinsic materials can be helpful in inferring legislative purpose, and quoted from Driedger's text on interpretation to the effect that the courts have shifted from an exclusionary mode and now tend to "look at any material that meets the minimal threshold of relevance and reliability" (97 DTC 5472). The TCC noted in *Glaxo* that the practice of admitting "virtually anything that may have some bearing" is "now too well entrenched to be revised," but said that such materials' reliability and utility must be put in perspective: the court said that "ultimately, the interpretation must be based upon the court's reading of the legislative language itself," citing the SCC's warning in *Morgentaler* that *Hansard* evidence is of limited reliability and weight (96 DTC 1159). The FCA in *OSFC* echoed this sentiment by its reference to SCC dicta in *Shell* to the effect that "the courts must . . . be cautious before finding within the clear provisions of the Act an unexpressed legislative intention . . . under the guise of purposive interpretation." The tensions created between the recognized limitations of extrinsic evidence, the mandate to apply a provision's clear and unambiguous terms, and the requirement to resolve uncertainty in the taxpayer's favour make the Crown's policy battle an uphill one in many cases. It seems likely that the pre-GAAR interpretive principle will prevail: greater weight is to be given to clear words supported by their immediate context than to larger assertions of parliamentary intention (see *BC Telephone*, 92 DTC 6129).

Often, what drives the Crown's reassessment of an "avoidance transaction" at audit, at the GAAR Committee, and through the appeals stages is the perception of abuse by virtue of a transaction's departure from a so-called normally intended tax result. Typically, the tax result of a transaction labelled as dividend stripping, loss sharing, avoiding the "intended consequence under the Act," etc. is compared with that of its economic equivalent. This approach

is hazardous because it solidifies the Crown's commitment to attacking the scheme without having developed a methodical, principled analytical basis for demonstrating misuse or abuse. *OSFC* makes it clear that the minister bears the burden of setting out the relevant policy with reference to the underlying provisions of the Act or extrinsic aids, but the case does not address the timing of disclosure. From the standpoint of fairness and to promote efficiency of process, the entire foundation of a GAAR attack should be brought to the taxpayer's attention at the earliest reasonable point—perhaps when the GAAR Committee renders its decision—and should be continuing. An access-to-information request could confirm that disclosure is complete and comprehensive and fully discloses the sections, statutory references, analogies, and materials. This transparency will effectively limit GAAR attacks to cases in which Parliament's intention or policy is clear. The Crown devotes considerable resources to such cases, and a taxpayer should not have to bear the costs of defending an otherwise technically defensible transaction without a clear idea that the Crown's initiative rests on a strong evidentiary foundation. Failure of full and timely disclosure could then support a pre-trial attack on the reassessment or possibly factor into an award of costs.

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CCRA's GST E-Biz Paper (2)

The CCRA discussion paper on e-commerce for GST/HST purposes explores the concept of carrying on business. (See "CCRA's GST E-Biz Paper," *Canadian Tax Highlights*, January 29, 2002, at 7.) The paper also characterizes supplies as services or intangible personal property (IPP), key to determining the tax's application and timing, and the availability of zero-rating on supplies to non-residents.

The discussion paper accepts the OECD-endorsed principle that the supply of digitized goods is not a supply of tangible personal property (TPP) and then focuses on factors relevant to determining whether an electronic supply is one of services or IPP. Some factors indicating an IPP supply include the grant of a right in a product or a right to use a product (for example, a copyright); whether or not the product already exists; the retention of ownership rights by the vendor in any product created for a specific customer; and the supply of a right to make a copy of the digitized product. In the supply of a service, the CCRA expects some human involvement and specific work performed for a specific customer; such a transaction should only incidentally involve a transfer of rights. The paper analyzes and characterizes for GST/HST purposes the 28 transactions denoted by the OECD technical advisory group (TAG) on treaty characterization, and reaches consensus with the Canadian GST TAG in 23 cases. Interested parties should carefully review the categories and related discussion to ensure consistency with previous rulings.

CCRA Characterization of Supplies

E-business	TPP	IPP	Service
E-order processing of tangible products	✓		
E-ordering and downloading of digital products			
— Not for copyright exploitation		✓	
— For copyright exploitation		✓	
Updates and add-ons delivered electronically		✓	
Limited-duration software and other digital information licences			
— Delivered electronically		✓	
— Delivered on tangible medium	✓		
Single-use software or other digital product		✓	
Subscription to Web site allowing downloading of digital product		✓	
Application hosting:			
— Separate licence			✓
— Bundled contract		✓	
Application service provider (ASP)	depends on whether right to use software or data processing		
ASP licence fees		✓	
Web site hosting			✓
Software maintenance (principal object is software updates)		✓	
Data warehousing			✓
Customer support over a computer network	depends on whether advice or online documentation/database		
Data retrieval		✓[a]	
Delivery of high-value data		✓[a]	
Advertising			✓
E-access to professional advice			✓
Technical information	depends on nature of contract		
Information delivery		✓[a,b]	✓[b]
Subscription-based interactive Web access		✓[a]	
Online shopping portals			✓
Online auctions			✓
Sales referral programs			✓
Carriage fees			✓
Content acquisition transactions			
— Right to use copyrighted material by way of licence		✓	
— Creation of new content to be owned by Web site operator			✓
Streamed (real-time) Web broadcasting		✓[a,c]	✓[c]

[a] No consensus between the CCRA and Canadian TAG. [b] Depends on the facts per CCRA; TAG concluded that it was a service. [c] The CCRA concluded that the category was two supplies: provision of content database was IPP. Consensus was reached that advertising by a broadcaster is a service.

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Exempt Securities Distribution

A new Ontario regime for private placements and exempt distributions that took effect November 30, 2001 affects, inter alia, the classification of a private corporation and exemptions from filing a prospectus.

Formerly, corporations typically contained provisions in their articles of incorporation—the private company restrictions—to satisfy the Securities Act exemption from prospectus and registration requirements on the issuance of securities: for example, limiting the number of shareholders to 50 (excluding current or former employees), restricting the transfer of the company's shares, and prohibiting an "invitation to the public" to subscribe for the company's securities. Private company status in Ontario was generally considered achieved if the articles contained these restrictions, whether they were complied with or not. When securities were issued to the public, the restrictions were removed; an issuance might be made under the prospectus exemption for securities of $150,000 or more issued to a purchaser as principal (the private placement exemption) or via an offering memorandum soliciting no more than 50 prospective purchasers with sales to no more than 25 (the seed capital exemption). Such exemptions were used to establish or finance startup companies, to establish family businesses, and to implement internal reorganizations. Exemptions also applied on trades to exempt purchasers and to certain financial institutions. All of these exemptions are now eliminated.

Under OSC Rule 45-501, exempt distributions may now be made to accredited investors (AIs) or under certain conditions by closely held issuers (CHIs). A company is a CHI if, inter alia, its securities are beneficially owned by not more than 35 persons (down from the old 50 shareholders, direct or indirect) other than persons who are AIs (or were at the time of acquisition) and certain directors, officers, and employees. The transfer of shares must also be restricted—requiring approval of either the directors or the shareholders (or non-corporate equivalent)—in its constating documents or in agreements with its shareholders. Constating documents are generally considered to include articles of incorporation, bylaws, and unanimous shareholder agreements.

A corporation, partnership, trust, or other entity is generally considered to be one beneficial owner, but a lookthrough rule catches each beneficial owner of an equity interest or a beneficiary in the entity if it was created or is being used primarily for the purposes of acquiring or holding securities of the issuer. Potential transfers of beneficial ownership by the registered holder must also be examined: for example, a discretionary family trust may be established to purchase securities of a CHI for several potential beneficiaries, or an individual may transfer beneficial (but not registered) ownership of securities to a spouse and two children. Accordingly, the constating documents should restrict the transfer of registered and beneficial ownership, although enforceability vis-à-vis beneficial ownership may be an issue and the breach may give rise to a cause of action but not invalidate the transfer. (Former) directors, officers, employees, or consultants of the issuer or its affiliate are excluded from the "35" if their securities were issued only as compensation by, or under an incentive plan of, the issuer or an affiliate.

A CHI issuing to non-AIs under the section 2.1 CHI exemption must be a CHI after the trade; the proceeds received by the issuer and any other issuer engaged in common enterprise with it must not exceed $3 million; any promoter cannot have acted for another issuer under the CHI exemption in the last 12 months; and no selling or promotional expenses may be paid or incurred except for a registered dealer's services. The $3 million threshold is a lifetime limit.

The former private placement, seed capital, exempt purchaser, and financial institution exemptions have been

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replaced with an AI exemption without limits on the subscription amount. An AI includes 27 categories of persons, among them banks, trust companies, and registered charities; a company, limited partnership, LLP, trust, or estate with net assets of at least $5 million as shown in its most recent financials; and an entity whose interest holders (direct, indirect, legal, or beneficial) are themselves AIs. An individual is generally an AI if he or she (1) beneficially owns, alone or with a spouse, financial assets (cash, non-group RRSPs, securities, insurance) with aggregate realizable value before tax exceeding $1 million (significant valuation issues may arise); (2) has annual net income before taxes exceeding $200,000 ($300,000 with a spouse) and a reasonable expectation of such in the current year (tax shelter investments may disqualify investors); (3) is a promoter of the issuer or an affiliate; (4) is a spouse, parent, grandparent, or child of an officer, director, or promoter of the issuer (siblings, cousins, nieces, or nephews are not AIs, nor are officers, directors, or employees); or (5) is part of a control block. The OSC may recognize other individuals as AIs.

If a CHI will have more than 5 beneficial security holders after an offering to non-AIs, it must provide an information statement in prescribed form at least four days before the trade. An offering memorandum (including a business plan) is not required, but if provided must include a reference to the statutory right of action for damages or rescission. The OSC has not clarified the application of national policy 48 on future-oriented financial information.

A CHI's securities may be resold under the section 2.1 exemption without affecting the $3 million threshold. Alternatively, the purchaser may be an AI, or another exemption may apply, such as the takeover bid exemption on a sale of a business and involving previously issued securities of either public or non-public companies (private companies and CHIs.) A takeover bid is an offer to acquire equity securities from a person in Ontario, bringing the offeror's holdings to at least 20 percent of the subject class.

A prospectus exception exists for the issuance of securities reasonably necessary to facilitate the incorporation or organization of the issuer if traded for nominal consideration to not more than five incorporators. The incorporators may constitute a control block and thus be AIs and not use up any of the CHI $3 million threshold. Internal reorganizations may frequently use the AI exemption or the exemption "incidental to a good faith reorganization," which covers securities distributed by the issuer that are not of its own issue. Trades in previously issued securities under a reorganization may be exempt under the takeover bid exception, the AI exemption, and/or section 2.1.

There are no filings or fees for trades under section 2.1 or on delivery of the information statement, but filing requirements apply if an offering memorandum was delivered. Trades to AIs under, for example, the $5 million, income, or asset test require the filing of a form and a fee (the greater of $100 and 0.02 percent of the proceeds raised in Ontario.) No fee applies to issuances to a control block, promoter, or "family" AIs. If a form is not filed, the OSC says that the trade is presumed made under section 2.1 and applies toward the CHI $3 million threshold.

The private company regime, including prohibitions on offering securities to the public, continues in all other Canadian jurisdictions; if securities may be issued into other provinces, the constating documents should be drafted accordingly. Changes to take advantage of Ontario's more flexible new rules may be deferred until a new issuance, at which time, for example, the restriction of offering securities to the public and of the limit on the number of shareholders may be deleted. Transfer restrictions should continue in order to control the number of security holders and maintain CHI status.

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Charter Breach Remedies

If a taxpayer's Charter rights are violated, it may be possible to obtain a remedy from the TCC in a subsequent civil tax appeal. The how and when of obtaining a TCC order for sanctions in a tax appeal must be given careful consideration.

The TCC may entertain a pre-trial motion for a determination of a question of law under section 58(1)(a) of the TCC rules. The FCA in *Jurchison* said that the rule provides relief if the determination "may lead to a more efficient use of the court's resources" or, in the rule's wording, if it "may dispose of all or part of the proceeding, substantially shorten the hearing or result in a substantial saving of costs" ([2001] 3 CTC 33). The court held that the question of law must be raised by the pleadings, and on the facts it was not so raised. Evidence obtained in violation of the taxpayer's right to be secure from unreasonable search and seizure had been excluded on his criminal trial, but the FCA said that such evidence may conceivably be admissible in a civil trial. Normally, the admissibility of impugned evidence is best determined by the trial judge, who may examine the evidence and the method by which it was obtained, inquire into the seriousness of the Charter breach, and consider whether the evidence was already in the Crown's possession or would have been discovered in any event. The FCA quoted from *Carma Developers* to the effect that the rule "is not intended as an easily accessible alternative to a trial for the disposition of complex and contentious disputes about the rights and liabilities of litigants" ((1995), 96 DTC 1803). The Charter breach was said to be no reason to deprive the Crown of its examination for discovery: the taxpayer could object to answering any questions if their apparent genesis rested in impugned evidence. More recently, in *Warawa*, the absence of any

agreement as to facts between the parties doomed the taxpayer's motion under this rule for an order vacating assessments that it said were based on evidence obtained in violation of the Charter or, alternatively, for an order excluding such evidence (2000-155(IT)G, December 20, 2001).

Under section 173 of the Income Tax Act, if the minister and the taxpayer agree in writing, the TCC may determine a question of law, fact, or mixed fact and law in respect of any existing or proposed assessment or determination. On such an application, supported by an agreed statement of facts, the FCA in *O'Neill Motors* concluded that the assessments should be vacated: it was inappropriate and unjust to require that the taxpayer defend against them because information obtained in breach of Charter rights was fundamental to their successful enforcement after the normal three-year limitation period and to support penalties ([1998] 3 CTC 385).

If pre-trial motions are not available under section 58(1)(a) of the rules or section 173 of the Act, a motion for a remedy under the Charter can be made before the trial judge. In *Norwood*, a CCRA auditor at the offices of the taxpayer's accountants entered a private office to use a telephone; he discovered and then surreptitiously photocopied notes relating to the year under audit ([2001] 1 CTC 299). The information so obtained in breach of the Charter was not relied on by the minister to support his civil assessments. The FCA concluded that the harm caused was minimal: the appropriate remedy was to exclude the notes from evidence, although such exclusion might have little practical effect at trial.

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GST Stuck at the Border?

When a registrant makes a supply of property or services in Canada to a non-registered non-resident (NR2) that is not immediately exported, the registrant must collect GST; but under the general rules, the NR2 involved in commercial activities cannot recover it as an input tax credit (ITC). Special rules in section 179 of the Excise Tax Act address this issue in a range of situations, including the classic drop shipment. Section 179's complexity may be daunting, but the diligent are rewarded by the removal of GST from certain cross-border transactions.

Assume that a Montreal manufacturer (M Co) sells a machine to an NR2 wholesaler in Boston (B Co) that does not carry on business in Canada. B Co resells the machine to a Calgary company (C Co) and instructs M Co to ship the machine directly to C Co. Under the general rules, M Co must collect GST from B Co, which cannot recover it directly; a section 180 flowthrough of the ITC to C Co is often cumbersome in practice. Alternatively, C Co can provide a drop shipment certificate to M Co to relieve it of collecting and remitting GST; resulting GST obligations on C Co generally arise only if it ceases to use the machine exclusively in commercial activities.

Drop shipment rules also apply if a registrant performs a commercial service in Canada with respect to an NR2's goods, including any service in respect of tangible personal property (TPP) other than a financial service or a carrier's supply of the service of shipment. In the above example, if M Co first ships the machine to a Winnipeg machine shop (W Co) to have it altered to B Co's specifications, M Co need not collect GST if it receives a drop shipment certificate from W Co. W Co need not collect GST on the value of its service if it receives a drop shipment certificate from, and ships the altered machine to, C Co. Alternatively, W Co need not collect GST if it exports the machine and certain evidentiary and other conditions are met.

Sale-leasebacks may also benefit from the drop shipment rules, provided that NR2 does not carry on business in Canada. Assume that Canco, a Canadian-resident corporation and GST registrant, owns a commercial aircraft. To generate capital, Canco sells the aircraft to Ireco, an Irish-resident NR2 that does not carry on business in Canada, and immediately leases the aircraft back. In most such transactions GST is automatically relieved, and Canco is deemed to have received a drop shipment certificate with its attendant GST obligations.

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US Tax on Loan Guarantees

A November 23, 2001 IRS field service advice (FSA) underscores the complexity of determining the US tax treatment of a foreign parent's guarantee of its US sub's bank debt. The FSA addresses the question of the proper characterization of any payment made by the US sub to its parent for the guarantee as interest, business profits, or something else, depending on the facts.

In the FSA, a foreign parent in a treaty jurisdiction guaranteed a US sub's performance in connection with its assumption of another related company's bank indebtedness. US Sub paid fees to the parent for this activity, treating them on its US tax return as remuneration for personal services. Because the services were rendered outside the United States, the parent claimed that the fees were exempt from US tax. The IRS disagreed, saying that the parent's guarantee was extended for US Sub's financial performance and not for the initial negotiation of the bank borrowing; the guarantee payments were intended to compensate the parent and thus were not for services under US principles. Nor were they interest, not being for the use or forbearance of money. Rather, the payments were "other" income under

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Code section 881(a) and deemed US-source—they did not meet any exceptions under Code section 861(a)(1)—and subject to 30 percent US withholding tax. The IRS said that there was insufficient information to support the taxpayer's position that the payments were treaty-exempt "business profits." Several key factors in such a determination were identified, such as the scope and regularity of the parent's provision of guarantees and whether its customers included unrelated parties. The FSA lists factors to consider when structuring financial transactions in order to optimize US tax results by, for example, establishing guarantee fees as payment for services rendered outside the United States that are deductible to a US sub and tax-exempt to the parent.

The FSA does not address whether US Sub must pay the parent a fee under general US transfer-pricing principles. Previous rulings, which dealt with guarantees related to US Sub's initial borrowing, said that the parent should be viewed as performing services for US Sub and arm's-length charges must be reflected under transfer-pricing regs; but if the guarantee activities were not an "integral part" of the parent's business activity, the appropriate measure was the parent's actual cost incurred—in some cases only out-of-pocket expenses—and need not reflect a risk factor. Under this analysis, if the parent incurred no costs, no payment would be required.

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Foreign Tax News

Treaties

A protocol between Canada and **Australia** was signed on January 23, 2002, effective in the calendar year following the year of ratification. The withholding tax rate is reduced to 5 percent on dividends between affiliated companies, to 10 percent on interest, and to 0 percent on certain payments for the use of computer software. A treaty with **Kuwait** was signed on January 28, 2002. Withholding tax is 5 percent on certain non-portfolio dividends and 15 percent for others, 10 percent on interest and royalties. The effective date for withholding is January 1 in the year the treaty enters into force, on or after that date for other taxes. Two new treaties are to be negotiated: with the **People's Republic of China** in the third week of March and with **Azerbaijan** in the second week of April. Comments or concerns should be addressed to the Tax Legislation Division, Department of Finance, fax (613) 992-4450.

Germany

Relief from corporate income tax is now available for non-resident companies that transfer a German permanent establishment (PE) in a merger-like transaction, provided that Germany does not lose the right to tax the PE's hidden reserves. German assets held outside a PE are not eligible. The new rule partially implements the new EU directive on cross-border mergers of EU companies.

Thailand

Foreign film production is becoming a large part of the local economy: a new 10 percent flat tax replaces progressive rates for foreign actors working in Thailand in order to maintain its competitiveness and attract more film production to the country.

Barbados

The OECD and Barbados agreed, one month before the February 28, 2002 deadline, that Barbados will no longer appear on the OECD's list of tax havens. Barbados has not signed a memorandum of understanding on tax competition, financial privacy, and fiscal sovereignty, indicating a softening in OECD attacks on the policies of sovereign countries. Barbados has willingly entered into exchange-of-information agreements with OECD countries.

Japan

A new "business-friendly" tax reform package allows corporations and their subsidiaries to pay tax separately or consolidate if approved by the national tax administration; once made, the election is permanent. A consolidated group is a parent and its 100 percent domestic subsidiaries; the tax base is the group's total taxable income. Tax-avoidance provisions have been built into the system. For the first two years after election, a 2 percent surtax will help cover the loss of tax revenue. The additional tax on undistributed profits of family corporations is reduced by 5 percent. Deductions for business entertainment expenses are enhanced to encourage business consumption. The exemption from withholding tax for seniors on certain interest income on financial assets reaching ¥3.5 million will be gradually phased out until 2006. Reforms are expected to continue through 2003 and beyond.

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