CANADIAN TAX *Highlights*

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Corporate Income Tax Instalments

The CCRA recently confirmed that because its former administrative practice was inconsistent with the legislation, it has changed the way it determines the amount of corporate income tax instalments.

In recently released "questions and answers" from a Tax Executives Institute meeting in December 2001, the CCRA pointed out that subsection 157(1) outlines three options for calculating tax instalments: (1) as 1/12 of the current year's liability each month, (2) as 1/12 of the preceding year's tax liability each month, or (3) as 1/12 of the second preceding year's tax liability for each of the first 2 months of the year and, for each of the next 10, 1/10 of the difference between the preceding year's liability and the first two months' instalments. Previously, the CCRA selected the option that resulted in the least amount of instalment interest payable (the old methodology). Now the CCRA says that subsection 161(4.1) provides an additional test for selecting the correct instalment option—"whichever method gives rise to the least total amount of such parts or instalments of tax for the year"—and thus the correct instalment option is the one that results in the lowest total instalments (the new methodology). The CCRA confirmed that this change came into effect for assessments and reassessments processed after its new accounting system was implemented in October 2000.

To illustrate the difference between the two methodologies, assume that a calendar-year taxpayer had tax liabilities of $0 in 1998, $100,000 in 1999, and $99,000 in 2000 (the current year).

	Old methodology	*New methodology*
Jan. and Feb.	$0 (1/12 of the second preceding year's tax liability of $0)	$8,250 ($99,000/12) in each month
Mar. to Dec.	$10,000 [($100,000–0)/10]	

Under the old methodology, a taxpayer could choose option 3, but the new methodology limits the taxpayer to the option that requires the lowest total tax instalments. Option 1—the current tax year—requires the payment of only $99,000 of tax, and the taxpayer cannot use option 2 or 3, both of which require a total payment of $100,000: monthly instalments of $8,250 ($99,000/12) are required. If the taxpayer followed the old methodology and did not make instalments in January and February, instalment interest will be charged even though over the year the taxpayer overpaid its total instalments. In some cases, contra interest on the 10 months of overpaid instalments may not offset the interest charged on the first 2 months of deficient instalments. This policy may create practical problems because taxpayers often may not know or be able to accurately estimate their current-year tax liability until close to year-end or even later; as a result, it may be difficult or even impossible to determine beforehand which of the three methods produces the lowest tax instalment requirement.

Tips for faster corporate return processing. At a recent meeting of the Toronto Centre CCRA and Professionals Group, the CCRA offered some tips for expediting corporate tax return processing.

■ **GIFI.** Many software packages include a customized document for financial information to be used as a working document. However, the CCRA removes returns that include these documents from the fast-track path because they cannot be keyed and must be sent for transcription. To avoid this problem, ensure that summary schedules 100 and 125 are the only submissions for GIFI documentation.

■ **Schedule 3.** This schedule records dividends received or paid between connected corporations. All sections must be completed for all connected corporations. Negative dividends should not be shown because the CCRA's system cannot recognize negative figures.

■ **Foreign non-business tax deduction.** A subsection 20(12) deduction is claimed on schedule 1; schedule 21 must be submitted to substantiate the deduction and indicate where it is claimed.

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■ **Address of books and records.** If this address is not completed on a return after 1998, it is sent to Specialty Services for completion and falls out of the fast-track processing flow.

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Re-Pricing Stock Options

If a company issued employee stock options and the shares' FMV subsequently declined, it may want to reduce the option exercise price accordingly. Recent changes in the position of both Finance and the CCRA may allow the company to merely amend the exercise price without cancelling and reissuing options.

Currently, if an employer amends existing options to reduce the exercise price, the employees may lose eligibility for the stock option deduction in paragraph 110(1)(d), which requires that an option's exercise price cannot be less than the shares' FMV when the options were granted. This denial may be sidestepped if existing options are cancelled and new ones granted with an exercise price not exceeding the shares' then FMV: subsection 7(1.4) provides for a tax-deferred exchange of the old and new options. However, there may be adverse accounting implications, not to mention the administrative burden of cancellation and reissue.

A recent CCRA technical interpretation (TI 2001-010502) announced that both the CCRA and Finance are prepared to recommend an amendment to paragraph 110(1)(d) to ensure that, in certain circumstances, an employee is not precluded from claiming the deduction if the option's exercise price is reduced below the underlying shares' FMV when the option was granted. A comfort letter from Finance dated July 13, 2001 states that the recommended change applies only if the reduction in the exercise price could be accomplished by way of an exchange under subsection 7(1.4) and if the reduction in the exercise price provides no immediate increase in the net benefit associated with the options. Finance will recommend that this change apply to reductions in exercise price occurring after 1998. In the interim before the amendment is enacted, the TI indicates that the CCRA will not reassess on the basis of current paragraph 110(1)(d) except in situations of abuse. The CCRA also recommends that affected taxpayers contact their tax services office to claim a deduction.

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Identical Properties?

Were it not for the superficial-loss rule contained in paragraph 40(2)(g) of the Income Tax Act, a taxpayer could crystallize a capital loss by selling and immediately repurchasing a security. The superficial-loss rule, defined in section 54, refers to the acquisition of the same or identical property by specified persons within a certain period of time. A recent technical interpretation (TI 2001-008038) released on December 5, 2001 raises a concern with the meaning of "identical properties" in the context of index mutual funds.

The TI deals with the application of the superficial-loss rule if units of an index mutual fund from financial institution A are redeemed and replaced with units of an index mutual fund from financial institution B. The question is whether the two index funds constitute identical properties. The CCRA's *Interpretation Bulletin* IT-387R2, "Meaning of Identical Properties," states that "identical properties . . . are properties which are the same in all material respects, so that a prospective buyer would not have a preference for one as opposed to another." In the CCRA's opinion as set out in the TI, "an investment in a TSE 300 index based mutual fund with a financial institution would, in our view, generally be considered identical to an investment in a TSE 300 index based mutual fund of another financial institution."

It is difficult to accept that the units of two or more mutual funds are identical properties merely because they attempt to mimic a particular index in order to achieve a similar investment objective of the return of the underlying index. A quick review of a dozen TSE 300 index funds shows that each holds different weightings of the underlying securities. For example, in one index fund the top holding was Royal Bank of Canada shares at 6.32 percent (at September 28, 2001) of the portfolio, while in another index fund the top holding of Royal Bank shares was 5.1 percent. It will be no surprise to the CCRA if it receives queries from anxious taxpayers who feel that the position set out in the TI should be revisited.

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Participation

The CCRA released final personal income tax statistics for the 1999 taxation year late in December 2001; tables previously available in the Green Book are on the CCRA's Web site. An interesting pattern of increased taxpayer participation emerges from the table: in 1971, only 44 percent of all Canadians (about 2 in 5) filed income tax returns; by 1999, that rate rose to nearly 72 percent (7 out of 10).

In 1971, 34 percent of Canadians under 65 filed returns and paid tax, but participation rose to 43 percent a decade later and to 48 percent in 1991; after a slight decline, the ratio rose again to nearly 48 percent in 1999. There are several reasons for the long-term rise in the number of working-age tax filers and taxpayers. The most obvious is higher income levels, pushing more people into a taxable and thus a filing position. Certainly the increased participation rate for married women changed a number of Canadians from depend-

Personal Income Tax Returns, Selected Years, 1971 to 1999 (as % of population)

Year	Taxable returns: Under 65	65 and over	Average	All returns
1971	34.4	32.2	34.2	44.2
1981	43.0	32.4	42.0	61.2
1982	42.4	32.9	41.5	60.6
1983	41.2	31.6	40.2	60.3
1984	42.5	33.7	41.6	60.7
1985	44.3	37.1	43.5	61.4
1986	48.3	45.5	48.0	63.4
1987	49.5	48.2	49.4	64.5
1988	48.6	42.5	47.9	65.6
1989	49.4	46.6	49.1	66.5
1990	49.7	50.8	49.8	67.7
1991	48.4	52.9	48.9	68.0
1992	47.4	50.4	47.8	68.5
1993	46.9	49.9	47.3	69.1
1994	46.7	51.0	47.2	69.4
1995	46.9	54.6	47.8	69.9
1996	46.6	56.6	47.8	70.1
1997	46.9	56.7	48.1	70.4
1998	46.9	57.3	48.2	70.7
1999	47.7	58.0	48.9	71.7

ants to taxpayers. The rise from 1984 to 1987 can also be partly explained by the restricted indexation of brackets and allowances that was corrected in 1988, when revisions to the rate schedule removed many low-income taxpayers from the tax rolls.

The same factors are at work, but exaggerated, for seniors. In 1971, only 32 percent of all seniors paid taxes, a ratio that did not change appreciably until it jumped in 1986 to over 45 percent. In 1999, 58 percent of all seniors filed taxable returns.

The difference between the table's first three columns and the last represents non-taxable returns; the figures for this group are even more startling. The increased participation by non-taxable individuals pushed the ratio up so that nearly 72 percent of all Canadians filed returns. The increased market penetration of the income tax form was propelled by the introduction of major social programs that used the tax form and its components to determine eligibility: the child tax benefit, the refundable GST tax credit, the guaranteed income supplement to the old age security pensions, and a number of provincial programs are based on the concept of net family income as calculated on the form. To qualify for these cheques, even non-taxable individuals and families must file a return.

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CCRA Discussion Paper on Electronic Commerce

The CCRA's discussion paper on GST/HST and e-commerce, released in November 2001, addresses the meaning of permanent establishment (PE) and its impact on GST/HST registration.

Under existing GST/HST rules, a PE is defined as a fixed place of business of a person, or a non-independent agent thereof, through which the person makes supplies. If this two-pronged test is satisfied, a non-resident that maintains a PE is resident in Canada in respect of activities carried on through the PE and may need to register for GST/HST purposes. The PE issue is therefore key to analyzing a non-resident's obligation to register and merits scrutiny by the CCRA in the e-commerce context.

Recognizing the need to dovetail the GST/HST analysis with the OECD analysis for its model tax convention, the CCRA considered and effectively adopted the OECD study results. In brief, the CCRA dispels the view that a Web site can constitute a PE: it comprises software and data and is not tangible in nature. In contrast, because a server is tangible property, the CCRA accepts that a server's location may qualify as a PE if it performs functions that are a significant and essential part of the ongoing business activities; the absence of human intervention to maintain or operate the server is not determinative. With regard to third-party facilitators, the CCRA states that the fixed place of business of an Internet service provider does not typically constitute a PE of its customers. Similarly, a Web site hosting arrangement does not create a PE for the business that operates through that Web site.

These conclusions represent a reasonable compromise compared with the varying and often hard-line positions adopted by some other jurisdictions. The CCRA has also maintained consistency with some of its previously issued non-confidential rulings, which concluded that a passive server/Web site that provided only advertising information did not, in and of itself, trigger a registration requirement. Although the CCRA has added greater certainty, it should be remembered that a server can easily be moved to the jurisdiction of least resistance that possesses the most favourable tax laws.

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New IT on Residence

Interpretation Bulletin IT-221R3, "Determination of an Individual's Residence Status," has been substantially restructured and its commentary revised.

The new IT does not subscribe to the so-called two-year rule. The old IT said that if "an individual is absent from Canada for 2 years or longer, he will be presumed to have become a non-resident," provided that he did not maintain residential ties in Canada, such as a dwelling place suitable for year-round occupancy, a spouse or dependants, and personal property or social ties. The CCRA's explanation of the changes says that the new IT is intended to "clarify" the CCRA's position that "no particular length of stay abroad . . . necessarily results in an individual becoming a non-resident." The IT attributes this statement to the courts, and continues: "Generally, if there is evidence that an individual's return to Canada was foreseen at the time of his or her departure [such as 'a contract for employment in Canada if and when the individual returns to Canada'], the CCRA will attach more significance to the individual's remaining residential ties with Canada." The IT says that the CCRA will also consider whether the individual complied with rules dealing with deemed disposition on emigration, including the filing of security, and notified third parties who might have resulting withholding tax obligations following the individual's emigration.

The CCRA's position on leased dwelling places has been somewhat softened. The old IT said that leasing at arm's length with the right to terminate on short notice (less than three months) generally resulted in the individual's not being considered to have severed residential ties with Canada. The new IT says that if the dwelling is leased on arm's-length terms and conditions, the CCRA will take into account all the market circumstances and may not consider it to be a significant residential tie with Canada except when taken in context.

The new IT enumerates so-called secondary residential ties much more comprehensively than the previous reference to personal property and social ties in Canada: it lists economic ties with Canada such as employment with a Canadian employer, active involvement with a Canadian business, Canadian bank accounts, RRSPs, credit cards, and security accounts. (The reference to RRSPs is controversial because no explicit departure consequences attach.) Also listed are hospital and medical insurance coverage from a province or territory; a driver's licence or vehicle registered in a province or territory; a seasonal dwelling in Canada; a Canadian passport (Canada taxes on the basis of residency, not citizenship, and it is unreasonable to assume that citizenship will be renounced on emigration); and memberships in Canadian unions or professional organizations. Other residential ties are said to be of limited importance except in context, such as retention of a Canadian mailing address, post office box, or safety deposit box, personal stationery or business cards with a Canadian address, telephone listings, and Canadian newspaper and magazine subscriptions.

The new IT also discusses subsection 250(5), which now deems a Canadian-resident individual who is also resident in another country under a treaty to be a non-resident of Canada. The IT confirms that dual residents as of February 24, 1998 are grandfathered if the individual maintained continuous dual-resident status, and discusses the meaning of "permanent home" for tie-breaker tests in treaties.

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IRS Leading on Stock Options?

Despite the settlement in the taxpayer's favour in *Seagate Technology* (TC No. 15086-98), on January 25, 2002 the IRS released an industry directive informing its field audit specialists that US taxpayers must include employee stock option costs in qualified cost-sharing agreements (QCSAs) with foreign affiliates (FAs) for taxation years beginning after 1995, when new cost-sharing regs took effect (Treas. Reg. s. 1.482-7). The directive said that sharing of those costs will no longer be enforced for earlier taxation years and that pre-1996 related audits pending will be discontinued. Unfortunately, the directive is likely to increase domestic and international disputes in this already controversial area.

The issue attracted the IRS's attention mainly for two reasons that are reflected in major US Tax Court petitions (*Adaptec*, no. 3480-01, and *Xilinx*, no. 4142-01). Omitting any compensation from the cost-sharing pool could fail the commensurate-with-income test of Code section 482 and mismatch tax deductions and income. Also, some taxpayers were including stock option costs for the R & D credit, but not in QCSAs. The stakes are substantial: allocating stock option costs to FAs reduces their net income and simultaneously increases the US taxpayer's taxable income.

The new reg requires the inclusion of all intangible development costs in the cost pool of a QCSA, and the IRS says that that includes compensatory stock option costs attributable to the development of the covered intangibles. In accordance with the commensurate-with-income test, treating such costs as operating expenses included in the shared cost pool brings a QCSA participant's share of the costs in line with its share of reasonably anticipated benefits from the development of the intangible under the QCSA. The directive indicates that if the taxpayer has not pooled stock option costs, the IRS will adjust the cost pool, valuing the options at the difference between the value of the exercise price and the FMV of the underlying stock at the exercise date. The IRS will revalue stock option costs already pooled unless the taxpayer shows that its valuation method is reasonable and is applied reasonably and consistently.

Several criticisms have been levelled at the IRS's position on the issue—for example, the granting of stock options is costless to the corporation; in any event, the reimbursement of such costs does not constitute income to the option's grantor; and there is a dearth of comparables. The directive, which does not apply to Appeals, also eliminates the discretion of field audit specialists in adjusting for stock option costs, if, for example, the taxpayer shows that arm's-length parties do not pool such costs in similar circumstances. And a "reasonable" valuation method is not defined, an omission that will create audit uncertainty for taxpayers. The directive's most marked departure from the IRS's earlier position is in the timing and method of valuation. A field service advice dated October 18, 1999 permitted valuation on the date of the options' grant or exercise using a reasonable and consistent method, or by using a modified version of the Black-Scholes model, applied at grant. The directive's default rule values the stock options at their exercise date, which significantly reduces the value of the IRS's concession for pre-1996 years: if stock option costs were not pooled or if there was no reasonable valuation method, pre-1996 options may be valued under the new regs.

The directive clearly contrasts with the CCRA's current position set out at an IFA round table in May 2001: stock-based compensation is not an economic cost accounted for in establishing a transfer price. The amount is usually not taxed until the stock option's exercise, which may be after the QCSA's termination, or never. The CCRA also noted that, as reflected in paragraph 7(3)(b), the costs of granting options are incurred not at the corporate level but at the shareholder level to the extent that earnings per share are diluted, thus redistributing wealth from existing to new shareholders. Presumably the CCRA would disallow the deduction of stock option costs allocated under a QCSA to a Cansub for options granted to its employees by the US parent, leading to double taxation for the parent and Cansub. This issue will likely be addressed at some time by the competent authority, but recent discussions with the CCRA indicate that it has not changed its view. It is not yet clear whether the IRS's view will prevail or whether it will adopt a more flexible and less controversial approach.

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A Tale of Two Countries

In a new private letter ruling, the IRS appears to have adopted a "closest analogy" approach to interpret terms in the US-Switzerland treaty, referring to the same or similar terms in other US treaties (PLR 200201025 (2002 TNT 4-35)). For example, to interpret "ultimate beneficial owners," the IRS referred to the technical explanation to the US-Luxembourg treaty, which uses the phrase "ultimately owned."

Traditional sources such as US model treaties, OECD pronouncements, and US domestic law presumably did not offer a better analogy. The use of this approach offers some assurance to advisers who regularly use it in interpreting undefined terms in limitation-on-benefits (LOB) articles in various US treaties—such as "active conduct of a trade or business" in the US-Barbados treaty—because official guidance to date is vague.

The "closest analogy" process also apparently underpinned a recent field service advice (FSA 200147033 (2001 TNT 227-11)). (See "US Tax on Loan Guarantees," *Canadian Tax Highlights*, February 26, 2002, at 15.) No clear authority has developed over the years regarding the US taxation of outbound guarantee fees paid by US subs to their non-US parents. The IRS concluded that the guarantee fees—computed as a percentage of each quarter's average debt—were not interest or for services rendered by the parent, but were remuneration solely for the value of the guarantee itself. No Code sourcing rule explicitly applied, and the IRS used analogous case law to conclude that the fees were a type of income subject to the US domestic 30 percent flat rate tax (subject to treaty reduction) (*Bank of America v. US*, 92-1 USTC 9415 (Ct. Cl. 1982)).

Article XI of the Canada-US treaty confirms that such fees paid by a US resident are not interest because they are not interest for US domestic purposes. If the fees are business profits and the parent does not have a US PE, the income is taxable only in Canada; if the fees are not business profits, they are other income (article XXII) and may attract the 30 percent US tax. Canadian parents earning guarantee fees from US affiliates should examine their arrangements carefully in light of the FSA.

RHYMES WITH ORANGE ® by Hilary Price

Interestingly, under Canadian domestic rules, paragraph 214(15)(a), introduced in 1974, deems any amount paid to a non-resident for a guarantee to be interest on the obligation and subject to withholding. In *Melford* (SCC), the taxpayer successfully argued that a guarantee fee paid to a German bank was not subject to withholding because the 1974 deeming rule did not authorize Canada to effectively amend the Canada-Germany treaty of 1956: the treaty was not clear as to whether it was subject to the laws in force in 1956 or from time to time (82 DTC 6282). The consequent enactment of the Income Tax Conventions Interpretation Act clarified that terms undefined or not fully defined in a convention have the meaning under the ITA as amended from time to time, a change intended to bring Canadian law into conformity with the law of our treaty partners. Thus Canada charges 10 percent on a guarantee payment to the United States, but a payment into Canada is withheld either at 0 percent as business profits or at 30 percent as other income. *Canadian Pacific* clearly indicates that Canadian courts are reluctant to contradict a treaty partner's interpretation that is not "manifestly erroneous" unless there is a compelling reason to do so, but the principle of common interpretation of a treaty on both sides of the border may not prevail if there is no element of double tax (76 DTC 6120).

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No Benefit, No Doubt

Although the taxpayer in *Franklin* appropriated assets of his closely held company and did not reflect that appropriation in the company books, the FCA found that he had received no benefit under subsection 15(1).

Franklin loaned money to a corporation (HVSL) owned by him and his wife. HVSL used the money to buy a Florida condominium. Shortly afterward, HVSL sold an undivided half interest in the condo and Franklin received personally the $60,000 proceeds. At that time, HVSL owed Franklin $155,000, the credit balance in the shareholders' loan account, but it did not record the condo sale in its books nor did it reduce the balance owing to Franklin. The TCC found that these were deliberate omissions by the taxpayer, an astute businessman with an MBA from the University of Western Ontario. However, the TCC concluded that such failures were "bookkeeping errors" that did not affect the taxpayer's "total equity in his shares and his loan," which remained unchanged as a result of the receipt of the proceeds. The TCC said that Franklin did not benefit from the errors: during the years under appeal he did not withdraw funds exceeding the "correct" net credit in the shareholders' loan account, nor did he use the incorrect financials to obtain a benefit elsewhere. A majority of the FCA affirmed the TCC's decision and held that neither the overinflated shareholders' loan account nor the taxpayer's receipt of the proceeds constituted a benefit conferred under subsection 15(1).

In confirming the TCC's finding that there was no benefit, the majority in the FCA seems to have impliedly set off the proceeds Franklin received against his loan account even though the transaction was not recorded in that manner. By ignoring the financials, the majority was able to conclude that no economic benefit was conferred. In contrast, the dissent bound the taxpayer to his own dubious reporting. The TCC found that Franklin knew or ought to have known of the errors and did nothing about them; the dissent refused to characterize such inaction as a "bookkeeping error . . . I have difficulty in understanding how 'the benefit' of the [$60,000] can be said not to have been received in the taxation years in question just because by chance a Revenue Canada auditor subsequently found a failure to account for the receipt of the company property." The dissent concluded that Franklin's receipt of the proceeds with "no strings attached" was a benefit conferred.

In light of *Franklin*, it may now be possible to argue that an amount received by a shareholder is not a benefit under subsection 15(1) if the company owes a greater amount to that shareholder. This may prove useful owing to the CCRA's tendency to automatically assess a shareholder benefit in tandem with its denial of certain business expenses claimed by closely held corporations.

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Ontario Capital Tax Deduction

The May 9, 2001 Ontario budget proposed to replace the small business capital tax exemption with a taxable paid-up capital (TPUC) deduction of $5 million for all incorporated businesses. Ontario also increased the deduction to arrive at a financial institution's adjusted TPUC from $2 million to $5 million. Both new $5 million deductions are prorated for straddle taxation years; the effective due date, originally January 1, 2002, was accelerated to October 1, 2001, with a number of other corporate and personal tax changes. The budget did not contain details of the $5 million capital tax deduction formerly for small businesses; however, implementing amendments to the Ontario Corporations Tax Act may produce unanticipated results for an associated corporate group.

Under the previous rules, an associated group with aggregate TPUC of less than $3.2 million was exempt from capital tax; the limit is now $5 million for taxation years commencing after September 30, 2001. If an associated group has aggregate TPUC of $5 million or less, it is exempt; if its TPUC exceeds $5 million, a deduction applies for the first $5 million. However, unlike the $10 million federal large corporations tax (LCT) capital deduction and the $5 million New Brunswick LCT deduction, the deduction is prorated to each group member on its proportionate share of aggregate TPUC: an associated group cannot allocate the deduction to one or more corporations. For Ontario purposes, a corporation's aggregate TPUC includes the TPUC of all associated corporations for their last respective taxation years ending during the corporation's taxation year. Although the aggregate TPUC of all associated corporations must be calculated, the $5 million is prorated among associated group members with a permanent establishment (PE) in Canada—not just in Ontario—which may result in "lost" exemptions and comparatively higher Ontario capital tax if the group has non-Ontario PEs. Further, the requirement that TPUC must be calculated for all associated group members, including those with no Ontario PE, may lead to a significant administrative and logistical headache for corporations, tax preparers, and Ontario tax assessors. It is hoped that Ontario will modify the rules either to allow taxpayers to selectively allocate the $5 million deduction from TPUC or to allocate each corporation's TPUC deduction to group members based on Ontario TPUC, not Canadian TPUC.

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New US Penalty Standards

Non-US corporations and non-resident individuals may generally deduct losses and expenses on their US tax returns only if the returns are timely filed. Under current regs, this disallowance of losses and expenses can be waived only in "rare and unusual circumstances" if the non-filer can establish good cause to the IRS. The IRS has concluded that this disallowance does not violate the business profits or non-discrimination articles in treaties such as those with Canada, Germany, and the United Kingdom. (See "Treaty Fails Late Returns," *Canadian Tax Highlights*, December 28, 1999, at 94.) New IRS regs issued January 28, 2001, effective immediately for all open years, liberalize the standard for granting waivers for late-filed returns and provide examples of the revised standard's application.

The new standard allows a waiver of filing deadlines if the non-filer can establish that, on the facts and in the circumstances, it acted "reasonably and in good faith" in failing to timely file its return, unless it knew of its obligation to file and chose not to, or if it does not cooperate with the IRS. The regs identify six factors to consider in determining whether a taxpayer acted reasonably and in good faith: (1) Did the taxpayer disclose its failure before the IRS discovered it? (2) Was the taxpayer aware that it could file a protective return by the deadline for filing the original return? (3) Had the taxpayer previously filed a US return? (4) Did failure to file after exercising reasonable diligence—considering relevant experience and level of sophistication—arise because the non-filer was unaware of the need to file? (5) Were there intervening and uncontrollable events that precluded filing the return? (6) Were there other mitigating or exacerbating circumstances? The regs also provide examples of the application of these factors. For example, the regs indicate that a waiver is generally granted to non-filing non-resident individual partners in US limited partnerships that have incurred losses if the non-resident partners were erroneously advised that they need not file US returns because losses were incurred and if they promptly filed upon learning that returns were required. (Such returns are necessary to claim the losses against the partnership's future income.)

To avoid the disallowance without seeking a waiver, Canadian corporations and individuals that conduct business through a US permanent establishment should file timely US corporate or personal returns (form 1120F or 1040NR). If a corporation or individual is unsure whether its US operations constitute a PE, it should file treaty-based return statements (form 8833) attached to the form 1120F or 1040NR, generally no later than 18 months after the return's normal due date. For example, a calendar-year corporation must file its 2000 return—generally due March 15, 2001—on or before September 15, 2002.

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Fairness Review on Appeals

A notice of objection may languish in the CCRA Appeals division for months or years before resolution. Normally, an objection is assigned to an appeals officer within six to eight weeks and the taxpayer is contacted, but real work may not begin on the file for some further weeks or months, depending on the officer's work schedule. Delays may also be caused if the taxpayer cannot provide information or is slow to do so. Complex issues can retard the process, and both parties may wish to avoid the cost and uncertainties of litigation: if settlement is a real possibility because of the nature of the facts or issues, pressing the CCRA for a quick decision may only encourage a resolution that confirms the assessments. But if the taxpayer has not paid the tax in dispute, interest continues to compound. The CCRA rarely provides fairness relief, saying that the taxpayer could have paid the disputed amount. The FCA decision in *Hillier* offers a different perspective.

In 1993, the CCRA commenced a review of the taxpayer's returns for 1989 to 1992. On April 28, 1995, assessments were issued for unreported income and other matters and for penalties and interest. On June 29, 1995, the taxpayer objected and provided information requested on October

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31, 1995. Due to staff changes and reassignments at the CCRA, a thorough review of the objections began only on January 23, 1998, almost 31 months after they were filed; the CCRA completed the review in 6 months (by July 31, 1998) and on August 27, 1998 issued new reassessments for 1990 to 1992 that reduced the tax significantly and confirmed the 1989 reassessment. The taxpayer sought fairness relief for the penalties and interest (subsection 220(3.1)), alleging that the time the CCRA spent dealing with his objections was "unreasonable and excessive." The CCRA replied that the taxpayer failed to pay the tax owing when he filed his objections to avoid further accumulations of interest. The CCRA's second review of the issue confirmed its original position, and emphasized that the payment of tax balances is within an individual's control. On application for judicial review, the FCTD concluded that the time taken to complete the audit and the initial reassessment—from the fall of 1993 to the spring of 1995—was not unreasonable. On appeal to the FCA, the taxpayer sought relief on interest only and focused on post-objection delays.

The FCA agreed that no unreasonable delay had occurred during audit, but found that the delay after the objections' filing was unreasonable and warranted relief, rejecting the Crown's argument that fairness relief was not applicable to the objection process. Once a prima facie inordinate delay was established, the onus was on the Crown to offer a reasonable explanation for the delay: the explanation of staff changes did not meet that onus. The FCA noted that subsection 165(3) requires the minister to act "with all due dispatch" upon receipt of an objection, but the CCRA did not contact the taxpayer during 27 of the 31 months before a review of the objections began, a delay that was, "on its face, inordinate." Furthermore, in making his decision, the minister's delegate considered irrelevant factors: the failure to report income did not pertain to the post-audit process. The FCA emphasized that the "central error . . . was the failure to consider the processing delays": once the review began, it took only six months. The FCA remitted the matter to the minister to reconsider the request to waive or cancel interest.

Representatives of Appeals have suggested that if the CCRA had considered whether a delay occurred, and, if so, the reasons therefor, then the FCA might have accepted the refusal of relief. This reading of *Hillier* seems too narrow. The FCA concluded that the delay was prima facie inordinate, and the reasons given therefor did not meet the Crown's onus to offer a reasonable explanation. It would be anomalous if consideration of an inadequate explanation could save the decision of the minister's delegate. *Hillier* makes it clear that regardless of the taxpayer's wrongdoing—a failure to report income—he was entitled to have his objection considered "with due dispatch" and that the CCRA's staff changes could not adequately explain the inordinate 31-month delay. The courts have been reluctant to define what constitutes "due dispatch," but *Hillier* may have incidentally established a six-month benchmark for a review of a relatively simple objection filed by a cooperative taxpayer.

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Foreign Tax News

Treaties

The finance minister will negotiate a treaty with Azerbaijan in the second week of April. Concerns or comments regarding double taxation issues should be directed to the department.

OECD

About one-half of the listed low-tax jurisdictions have committed to OECD requirements for delisting by the February 28, 2002 deadline: Antigua and Barbuda, Aruba, Bahrain, Barbados, Bermuda, the Cayman Islands, Cyprus, Grenada, Guernsey, the Isle of Man, Jersey, Malta, Mauritius, the Netherlands Antilles, St. Vincent and the Grenadines, San Marino, Tonga, and Seychelles. Following the deadline, commitment was reached with Dominica, Maldives, Montserrat, St. Christopher and Nevis, and St. Lucia. Agreement is expected shortly with Bahamas, the British Virgin Islands, and Gibraltar. Nauru, Niue, and Vanuatu demonstrated commitment to the OECD principles but declined to commit fully because some OECD countries have not committed to the standards required of non-OECD states. Other countries remain listed: Andorra, Anguilla, Belize, the Cook Islands, Liberia, Liechtenstein, the Marshall Islands, Monaco, Panama, Samoa, the Turks and Caicos Islands, and the US Virgin Islands. All committed states will participate in a global forum with OECD countries to discuss implementation standards and issues raised by harmful tax practices. The deadline for fulfillment is December 31, 2005.

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