CANADIAN TAX Highlights

Editor: Vivien Morgan, LL.B.

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Loss Refreshing Abusive?

The CCRA recently issued an otherwise routine in-house loss consolidation ruling, but the document's opening summary statement of principal issues, position, and reasons indicates a shift in administrative policy (doc. no. 2001-0090213). The CCRA says that the refreshing of a loss carryforward period that would otherwise expire is abusive.

The ruling involves Lossco, with non-capital losses, lending at interest to its profitable sub (Profitco), which subscribes for preferred shares of a new Lossco sub, which on-lends the funds back to Lossco interest-free. Profitco reduces its taxable income via the interest paid to Lossco, which uses its non-capital losses to shelter that interest income. The CCRA summary of principal issues says that if an affiliated group undergoes a tax-loss consolidation and a group member (Profitco) deducts interest expense and thereby incurs a non-capital loss, the newly created loss is abusive: it "effectively allow[s] the affiliated group to refresh one of its member's existing non-capital losses, which is beyond the scope of a tax loss consolidation."

Although it is not apparent on the face of the ruling, it is understood that the CCRA was also concerned that Profitco could carry back that new loss to shelter income in earlier taxation years, a result not possible if it had merged with Lossco via an amalgamation or windup. (It is not clear why the consequences of a merger are legally relevant to a loss consolidation that does not involve a merger.) It is understood that on reconsideration the CCRA concluded that, at least if Profitco is Lossco's wholly owned sub, Profitco's ability to carry back the loss is not offensive. The extent to which this concern continues for other circumstances is not clear.

Read strictly, the CCRA's position statement may raise concerns for some historical structures, but discussions with the CCRA suggest that it may be too broadly phrased: at least some historical structures remain acceptable, even if they result in a non-capital loss, so long as Profitco's income is sheltered within Lossco's original carryforward period. The viability of previously acceptable refreshing structures, such as the shift of CCA deductions to Profitco with a step-up in UCC through a fair market value transfer of depreciables by Lossco, will be reviewed case by case. The CCRA's position on acceptable loss consolidations is in flux, and the implementation of such transactions warrants increased caution pending further elaboration.

Dean Gresdal
Osler Hoskin & Harcourt LLP, Toronto

Trusts and Treaties

A recent technical interpretation overrides a 1991 TI and concludes that a trust is not an individual for treaty purposes (doc. no. 2001-0108517 and September 1991-34, respectively). The CCRA also said that even if a trust was considered an individual under a treaty, the tie-breaker for individuals has meaning only in reference to natural persons.

The 1991 TI said that for the purposes of article XIV(5) of the Canada-Barbados treaty (alienation of property by an individual), a trust is considered an individual, contrary to the taxpayer's view: the term "individual," undefined in the treaty, took its meaning from Canadian tax law. The CCRA reviewed, inter alia, the definition of "individual" in subsection 248(1) (a person other than a corporation) and subsection 104(1) (a reference to a trust is a reference to its trustees), and concluded that under the Act a trust was a person and an individual, a term that includes both natural and legal non-corporate persons. A 1998 TI reached the opposite conclusion based on article III of that treaty, which defined "person" to include both individuals and trusts: those terms were thus distinguishable. Therefore, the tie-breaker rules (article IV(2)) for individuals could not break the tie for a trust that was resident in Barbados under trust law principles and that was also deemed resident in Canada (paragraph 94(1)(c)). The 2001 TI does not refer to the 1998 TI.

The issue is topical: rules pending enactment expand the non-resident trust pool that is taxable in Canada by imputing Canadian residence and will increase the number of dual-resident trusts. Under many of Canada's tax treaties a trust's residence is determined either explicitly or implicitly by reference to, and the agreement of, competent authorities. The 1998 TI said that it is "highly unlikely" that the CCRA

In This Issue

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would give up its right to tax such non-resident trusts if there is a potential for "tax avoidance."

Under most treaties, whether a trust is an individual is generally only of interest for the purposes of tie-breaker rules and special rules for gains that apply to individuals. Most other treaty provisions afford protection to a contracting state's resident, a term based on the definition of "person," which in most of Canada's treaties includes trusts. The US model tax convention contains similar definitions. Some of Canada's treaties include a trust in the definition of "person" for Canadian purposes only. In the Canada-UK treaty, the definition of "person"—and therefore the definition of "resident"—does not include a trust but does include an "entity treated as a unit for tax purposes," which presumably has the same effect. But there are some treaties that do not follow the pattern. A trust is not explicitly included in the OECD model treaty definition of "person" and therefore not in its definition of "resident." Treaties based on that model—such as Canada's treaties with Brazil, China, Germany, Ireland, Italy, and Japan—may or may not protect any particular receipt by a trust.

Sandra E. Jack and Wanda Rumball
Felesky Flynn LLP, Calgary

IRS on Foreign Mergers

Two private letter rulings (PLRs) dealing with Canadian amalgamations deviate from prior IRS assessing practice and may make it difficult to obtain definitive advice regarding US rollover treatment on such amalgamations. Given the prevalence of amalgamation as a reorganization technique in Canada, the PLRs may concern the many US significant shareholders of Canadian public and private corporations, especially US-controlled foreign corporations.

Most Canadian corporate law statutes provide that an amalgamated entity is a continuation of the predecessors, not a new corporation: their assets and liabilities flow through to the amalco (*Black & Decker*, [1975] 1 SCR 411). But under US rules when two US entities merge, one ceases to exist and the other survives; the merger is a sale of assets by the former to the latter.

The US Tax Court in *Sherwood Properties* first tackled the US tax treatment of a horizontal Canadian amalgamation of two brother-sister companies, one of which had a minority Canadian owner (89 TC 651). The amalco cancelled the predecessors' shares and issued new shares to their shareholders. The court rejected the Canadian legal view, saying that the predecessors and the amalgamated corporation are not the same corporation before and after; nor, the court said, is an amalgamation the readjustment of a single corporation's capital structure. The court concluded that the assets, liabilities, and business pass by operation of law, and US tax rules for classifying asset-based transactions (for example, as income-tax-free reorganizations) apply, effectively achieving parity with a US domestic merger. The IRS took the same substance-over-form approach in another domestic transaction, analyzing, for example, which charter survived and whether new shares were issued (Rev. rul. 84-104, 1984-2 CB 94). US tax practitioners were satisfied that a US domestic and foreign merger were treated comparably. In a subsequent formal ruling on a short-form vertical amalgamation of a wholly owned Canadian sub with its Canadian parent, the IRS cited the earlier ruling and concluded that the parent was the same corporation before and after (in contrast to *Sherwood*), even though the sub was not legally dissolved under Canadian law: for US tax purposes the amalgamation was a liquidation of the sub into the parent, not a reorganization (PLR 9349020, September 13, 1993).

One of the recent PLRs involves a horizontal amalgamation, the other a sale of two subs and a short-form amalgamation of three companies. In PLR 200043034, in a situation similar to that in *Sherwood*, two Canadian subs were amalgamated; minority shareholders existed, and the amalco issued new shares on the amalgamation. Without substantial technical analysis the IRS identified two assets-for-shares reorganizations: each predecessor transferred its assets, liabilities, and business to a newco for newco voting shares; then their shares were cancelled and the newco shares distributed to their former shareholders. Among other things, each predecessor—not just one—must have inside basis in its assets exceeding its liabilities to achieve a US rollover.

In PLR 200208022, a Canadian parent rolled its shares in two wholly owned Canadian subs (New Subs) to a third such sub (New Parent) for New Parent shares. Then, in a short-form amalgamation of New Parent and its two New Subs, New Subs' shares were cancelled and New Parent's corporate charter and bylaws retained. Surprisingly, with no substantial analysis, the IRS ruled that three assets-for-shares reorganizations arose: three sales to a newco, not two sales to a New Parent, as conventional wisdom would indicate. A long line of precedents analyzes the two formal steps in similar domestic transactions—ostensibly rollovers under Code section 351 or 368(a)(1)(B), and 332—as one assets-for-shares reorganization for each New Sub that transfers its assets, liabilities, and business to New Parent, which is the same company before and after. (See, for example, Rev. rul. 67-274, 1967-2 CB 141.) PLR 200208022 needlessly subjects New Parent to reorganization rules and requirements—such as inside asset basis in excess of liabilities—that do not apply if the parties are three US domestic corporations. PLRs are precedent only for the taxpayer to whom they are issued, but the new PLRs muddy the waters vis-à-vis US rollover treatment for US shareholders of Canadian companies that amalgamate, even in vertical short-form amalgamations.

Steve Jackson and John Jakolev
Ernst & Young LLP, Toronto

Not Giving Up the Day Job

The Act is almost obsessive about dividends, capital gains, and interest income. Preliminary taxation statistics for the 2000 taxation year, published in December 2001 on the CCRA Web site, show that these three forms of income constitute less than 8 percent of all income reported on personal income tax returns.

In the table, dividend income has been adjusted to eliminate the gross-up of dividends from Canadian corporations. Investment income figures are taken from the current edition of taxation statistics and include bond and bank interest, but not annuity income and rental income. Only the taxable portion of capital gains is included, and the lifetime exemption, mainly effective from 1985 to 1994, has not been deducted.

Personal Returns, 1988 to 2000

	Adjusted dividends	Investment income	Capital gains
		% of assessed income	
1988	1.6	5.6	2.2
1990	1.5	7.2	1.8
1991	1.5	6.9	1.7
1992	1.3	4.8	1.8
1993	1.3	3.9	2.8
1994	1.2	3.2	2.5
1995	1.4	4.1	1.4
1996	1.5	3.9	1.8
1997	1.6	3.1	2.3
1998	1.8	2.8	2.2
1999	2.1	2.8	2.2
2000	1.9	2.9	3.0

The table shows that from 1990 to 2000 dividend income was relatively constant at just less than 2 percent of all income, but investment income reflects the precipitate decline in interest rates, which dropped over the decade from over 7 percent of all income reported on personal income tax returns, both taxable and non-taxable, to below 3 percent. Taxable capital gains were more variable and ranged from 1 percent of income in 1995 to 3 percent in 2000.

Such income as reported represents only a small portion of return on savings because much of Canadian savings is sheltered from tax: pension plans and RRSPs are the preferred form of savings for most Canadians. Investment in owner-occupied homes, another major part of savings, is also exempt from tax. Thus, it is not surprising that the return on savings is a small part of total income. And the declining trend revealed in the last decade's figures will be exacerbated in the next few years as interest rates stay near long-term lows and stock markets rise slowly from the recent severe drop in stock values.

David B. Perry
Canadian Tax Foundation, Toronto

Reg 105 Update

A panel discussion between tax professionals and a CCRA official at a recent seminar sponsored by the Toronto Centre CCRA and professionals consultation group included regulation 105 issues.

■ **Canadian subcontractors.** Reg 105 is worded very broadly and requires 15 percent tax withholding by any person paying an amount to a non-resident in respect of services rendered in Canada. Strictly speaking, the payment's recipient need not have rendered the services and the payer need not be the services' recipient. Assume that non-resident A enters into a global services contract with non-resident B, which in turn subcontracts some services to a Canco. According to the CCRA, the portion of the fees paid by non-resident A to non-resident B that relates to the services performed by Canco is subject to reg 105 withholding unless a waiver is obtained. The CCRA will consider issuing a waiver to reduce withholding—to the extent that the fees in question are passed through from non-resident B to Canco—under the CCRA procedures for "income and expense waivers"; IC 75-6R is being updated to provide more guidelines on such waivers.

■ **Canadian branches.** Reg 105 applies to fees paid to a non-resident for services provided in Canada through a branch operation, even if it is subject to part I tax on the fees. The CCRA said that it will not grant a blanket waiver of reg. 105 withholding in such a case, even though reg 805 provides such an exception for part XIII withholding tax. However, to the extent that the non-resident must pay instalments in that year, the CCRA will consider issuing a separate waiver on a year-by-year basis under the undue hardship provisions of subsection 153(1.1), or it may administratively reduce instalment requirements by tax withheld at source under reg 105. Finance has issued a comfort letter concerning the application of reg 105 to foreign banks operating Canadian branches in recognition that those withholding requirements are "probably excessive" from a policy perspective. Finance intends to propose more moderate requirements. Details remain to be determined, but it is expected that the proposals, which may appear in the upcoming technical bill, will generally exempt the resident payer from withholding.

■ **Due diligence defence.** In some cases, the payer of a fee subject to reg 105 withholding may not know that the recipient is a non-resident or that the services were rendered in Canada. The CCRA said that there is no due diligence defence from the subsection 227(8) penalty for failure to withhold even if the payer has no reason to believe that it is dealing with a non-resident service provider; the official added that the matter might be dealt with under the Act's fairness provisions.

ORESO Credit

Ontario recently released details on its Ontario research employee stock option (ORESO) credit in the eponymous IT 6202. Eligible research employees of R & D-intensive companies may be refunded Ontario personal income tax on up to $100,000 of taxable income each year from taxable stock option benefits and taxable capital gains arising from the sale of shares acquired through exercising eligible stock options granted after December 21, 2000. No lifetime limit applies to qualifying benefits and gains.

Under the provincial tax-on-income system, individuals cannot calculate different provincial and federal taxable incomes. The 2000 Ontario budget originally proposed a deduction for the ORESO incentive, but to accommodate the tax-on-income system, the incentive now operates as a rather cumbersome "tax overpayment" mechanism. Effectively, a qualifying individual must calculate his or her Ontario "tax adjusted amount" based on hypothetical taxable income if the ORESO incentive was a deduction under sections 8.7 and 8.8 of the Ontario Income Tax Act. The difference between Ontario tax on the adjusted and actual taxable incomes is refunded as a tax overpayment. The IT includes criteria for eligible employers and employees and eligible expenditures, as well as instructions on how to calculate and apply for the credit. Application forms were also released.

Paul Hickey
KPMG LLP, Toronto

Section 116 Update

At a recent seminar sponsored by the Toronto Centre CCRA and professionals consultation group, a panel of tax practitioners and a CCRA official discussed, inter alia, some section 116 issues.

Under section 116, a non-resident that disposes of certain taxable Canadian property (TCP) must notify the CCRA thereof, either before or after, and pay the tax or provide appropriate security in order to receive a certificate of compliance. Any payments or security the vendor provides are credited to the vendor's account; the CCRA makes the final settlement of tax when it assesses the vendor's income tax return for the year. If the vendor does not comply with section 116, the property's purchaser deducts or withholds a specified amount from the proceeds of disposition to cover the vendor's tax.

■ **Comfort letter for convertible shares.** A 1997 CCRA TI said that section 116 applied to a section 51 rollover if a non-resident converts its shares of one class to those of another class of the same private Canadian corporation. Even though section 51 deems the converted shares not to have been disposed of, the corporation is not deemed to not have acquired those shares, and section 116 obligations of the transferee—the corporation whose shares are converted—arise on an acquisition of TCP. Although the CCRA's position remains unchanged, a comfort letter may be requested to eliminate the withholding requirement and ensure that interest and penalties do not apply.

■ **Comfort letter for time delays.** It is increasingly difficult to obtain a section 116 certificate within the 30-day remittance period in subsection 116(5). If the delay is due to the conduct of international anti-avoidance audit personnel as part of the section 116 review process, the CCRA will issue a comfort letter confirming that the purchaser will not be charged interest or penalties if it delays remittance of the withheld funds until further instructed by the CCRA.

■ **Put and call options on TCP.** The CCRA appears to consider a non-resident's granting of a call option related to its TCP to be a disposition of TCP for purposes of section 116. The CCRA confirmed that section 116 also applies on a non-resident's granting of a put option that requires it to acquire TCP.

■ **Amendment required for price adjustments.** Sale proceeds of a disposition may be adjusted if, for example, a working capital adjustment is calculated thereafter or the proceeds are subject to an earnout. The CCRA official said that an amended section 116 certificate should be obtained when the adjustment is known. If the transaction is treaty-protected, the purchaser might consider obtaining a certificate that sets the limit at the actual proceeds of disposition, but in the "comments" portion of the certificate state that the transaction was treaty-exempt and subject to a price adjustment clause and perhaps also set out the maximum reasonable price thereunder; the CCRA says that the purchaser is protected if the adjusted proceeds do not exceed the maximum set out in the "comments." A panel member queried whether the protection of the certificate limit includes amounts referred to in the "comments."

■ **Accounts receivable and prepaid expenses included.** TCP is now defined to include property used or held by a taxpayer with respect to a business carried on in Canada, such as accounts receivable and prepaid expenses. The CCRA official confirmed that the section 116 application forms are being amended to refer to such types of property.

Wayne Tunney
KPMG LLP, Toronto

US Tax Breaks

President Bush signed into law the Job Creation and Worker Assistance Act of 2002 (the act) on March 9, 2002 to provide tax breaks to stimulate the US economy. Most provisions relate to US business operations, such as allowing net operating loss carrybacks for five years instead of two and increases in depreciation allowances and writeoffs for some business property. The act extends an important exemption from current US taxation for US-citizen or -resident shareholders of certain controlled foreign corporations (CFCs)—the exemption from subpart F treatment for a CFC's active financing income (AFI)—for five years more to December 31, 2006.

A CFC is a non-US corporation owned more than 50 percent (by vote or value) by US shareholders who own at least 10 percent voting control (directly, indirectly, or constructively). Under subpart F, such shareholders are subject to current US tax on the CFC's subpart F income whether or not distributed to shareholders. Foreign personal holding company (FPHC) income such as dividends, interest, and royalties generally yields subpart F income. The exclusion of AFI from FPHC income is extended five years if the CFC predominantly engages in the active conduct of such business and conducts substantial activity in respect thereof. (Other requirements and limitations must also be taken into account.) For example, a CFC may qualify if more than 70 percent of its gross income is derived directly from active and regular lending or financing of transactions with customers unrelated to the CFC. The exclusion for certain insurer CFCs is also extended five years. If a CFC qualifies for the exemption, US shareholders may be able to engage in foreign banking, financing, and insurance activities through an offshore corporation without facing the US current taxation burden otherwise applicable.

Carol A. Fitzsimmons
Hodgson Russ LLP, Buffalo

Cross-Border Enforcement

A Canadian immigrant may have left tax unpaid in another country or in the course of immigration may bring assets in in violation of the other country's foreign exchange controls. Can a foreign government ask Canada to assist in the collection of information in respect of a Canadian resident, seek to enforce in Canadian courts the taxes or penalties owing to it, or even extradite the Canadian resident?

■ **Exchange of information.** Canada's income tax treaties typically provide for exchange of information between the contracting states. For example, article XXIV of the Canada-UK treaty provides for exchange of information at their disposal under their respective taxation laws in the normal course of administration as is necessary for the carrying out of the treaty's provisions, for the prevention of fraud, or for the administration of statutory provisions against legal avoidance of taxes subject to the treaty. The OECD model treaty article 26 is broader and provides for the exchange of information as is necessary for the carrying out of the treaty provisions or of the domestic laws concerning any taxes not contrary to the treaty and imposed on behalf of a contracting state, its political subdivisions, or local authorities. Article 25 of the Australian treaty is narrower: it provides for the exchange of information necessary for the carrying out of the treaty provisions or of the contracting states' domestic laws concerning taxes covered by and not contrary to the treaty. If taxes must be subject to the treaty in question, arguably the tax must have arisen after the person became a Canadian resident. Furthermore, there is no obligation to provide information related to taxes or penalties not covered by the convention, such as penalties imposed in respect of South Africa's foreign exchange controls.

A CCRA official should not knowingly provide taxpayer information to another country unless obliged to do so under, and solely for the purpose of, a tax treaty provision (subsection 241(4)); to do otherwise is an offence punishable by fine or imprisonment. Exchange-of-information articles limit more or less how the requesting contracting states can use the information. Under the Canada-US treaty, such information must be treated as secret in the same manner as information obtained under the taxation laws of that state and disclosed only to persons involved in the administration of the taxes covered by the treaty; other treaties, such as the Canada-South Africa treaty, are not so restrictive. If the CCRA requests information from a person to supply it to a foreign state, it may need to notify the person of that purpose, giving the taxpayer the opportunity to object if it thinks that the information will be used for a purpose other than the administration of taxes covered by the relevant treaty (*Montreal Aluminum Processing*, [1992] 2 CTC 358 (FCA)).

RHYMES WITH ORANGE ® by Hilary Price

■ **Enforcement of foreign tax debt.** Information requested by a foreign country with respect to a tax debt may be of limited use. A well-settled common law principle provides that Canadian courts cannot enforce the payment of foreign tax claims, directly or indirectly, based on a substance-over-form test. (Quebec enforces such judgments in Quebec if the foreign country offers reciprocal enforcement.) The Canada-US treaty recently became Canada's first treaty to provide reciprocal enforcement of tax debts. The OECD has said that it will pursue the development of a new article in its model treaty for mutual assistance of tax collection, which could ultimately be incorporated into Canada's treaties.

The common law prohibition against enforcement of a foreign revenue law also extends to a foreign penal law (*Huntington v. Attrill*, [1893] AC 150). Arguably, an amount owing under a foreign exchange control law is not a tax debt but a penalty, because it is not based on income or capital. A penalty imposed in respect of a tax debt may also be protected, subject to the wording of any particular mutual assistance clause. Furthermore, a foreign judgment may also be unenforceable if it is based on foreign public laws, such as antitrust or regulation-of-competition laws, securities legislation, price control and exchange control laws, import or export regulations, and trading-with-enemy legislation. The Ontario Court of Appeal in *Ivey* demurred on the existence of such a rule, saying that it rests on a shaky doctrinal foundation (30 OR (3d) 370).

■ **Extradition.** Extradition from Canada depends on whether the underlying conduct carries a relatively severe penalty under the laws of both the foreign country and Canada (section 3 of the Extradition Act). If tax evasion is punishable in a foreign country by imprisonment for a term that could exceed two years, extradition may be possible. Extradition is not possible for conduct that is not an offence in Canada, such as a breach of another country's foreign exchange control laws.

Jack Bernstein and Andrew Nicholls
Aird & Berlis LLP, Toronto

Provincial Revenue Ramp-Up

Recent provincial budgets in British Columbia, Alberta, and Newfoundland and Labrador (Newfoundland) perhaps indicate the sensitivity of Canada's economy to global economic conditions and various uncertainties relating to natural resource revenues. Saskatchewan's and New Brunswick's budgets continue plans for personal and corporate tax relief.

The 2002 BC budget benefited CCPC small business somewhat: effective April 1, 2002, the BC business limit for the low rate of corporate income tax increased to $300,000 from $200,000. But the 0.5 percent jump in British Columbia's sales tax rate to 7.50 percent and a significant increase in monthly health premiums increase the cost of doing business in the province.

Alberta residents have long been accustomed to lower overall taxes and rates, but were not immune from revenue increases, most notably increased monthly health premiums and provincial fees and sharply higher tobacco taxes. Cuts to general and small business income tax rates, announced in the fall of 2000 as subject to affordability, have been scaled back: the general income tax rate scheduled to fall to 11.50 percent from 13.50 percent on April 1, 2002 will only fall to 13.00 percent (12.50 and 11.50 percent as of April 1, 2003 and 2004, respectively) and the small business rate, scheduled to fall to 4.00 percent from 5.00 percent on April 1, 2002, only falls to 4.5 percent (4.00 and 3.00 percent on April 1, 2003 and 2004, respectively). Also, the originally proposed small business limit of $400,000 will take effect as of April 1, 2003 and only rises to $350,000 as of April 1, 2002. Prorated rates and thresholds apply to straddle taxation years. The targeted general rate is still 8.00 percent, but is still subject to affordability, and therefore a clear timetable has yet to be legislated.

Citing a revenue shortfall, Saskatchewan will dip into its fiscal stabilization fund and proceed with the next phase of personal income tax reductions scheduled for January 1, 2003. For taxation years commencing after 2001, the corporate capital tax exemption threshold increases from $10 million to as high as $15 million, depending on the proportion of salaries and wages paid in Saskatchewan by an associated group: the increase for corporations with multiple permanent establishments may be negligible. Higher tobacco and liquor consumption taxes offset some of the tax reductions.

New Brunswick's budget stages reductions in general and small business corporate tax rates, increases the small business limit, and offers personal tax savings for low-income individuals. Other east coast provincial governments are facing significant budgetary pressures on both revenue and expenditures. Citing a higher deficit, Newfoundland's recent budget signalled an intention to defer further cuts or threshold increases to individual income tax rates and brackets until fiscal circumstances improve. A notable reduction was made to the province's dividend tax credit (DTC)—from 9.00 to 5.00 percent—on dividends declared and paid on or after March 21, 2002 (not retroactive to January 1, 2002.) Newfoundland's small business tax rate is also 5.00 percent. The lower DTC significantly increases all marginal tax rates for Canadian dividends—the top rate increases from 31.87 to 37.32 percent—which clearly increases the incentive for Newfoundland residents to earn capital gains, not dividend income. The decreased DTC is intended to reduce the tax advantage of integration for active business income (ABI) enjoying small business rates and/or deductions (SBD). Table 1 shows that previously, strictly on rates, owner-managers

Table 1 Tax on Distribution of $10,000 of ABI, Year Ending December 31, 2002

	Nfld. pre-budget	Nfld. post-budget
	dollars	
ABI eligible for SBD		
Dividends		
Corporate tax	1,812	1,812
Individual tax	2,610	3,056
	4,422	4,868
Salary		
Individual tax	4,769	4,769
Provincial health levy	196	196
	4,965	4,965
Tax savings	543	97
Tax deferral	3,153	3,153
ABI: no SBD, no MPD		
Dividends		
Corporate tax	4,012	4,012
Individual tax	1,909	2,235
	5,921	6,247
Salary		
Individual tax	4,769	4,769
Provincial health levy	196	196
	4,965	4,965
Tax cost of dividend	956	1,282
Tax deferral	953	953
ABI: no SBD, full MPD		
Dividends		
Corporate tax	2,712	2,712
Individual tax	2,323	2,720
	5,035	5,432
Salary		
Individual tax	4,769	4,769
Provincial health levy	196	196
	4,965	4,965
Tax cost of dividend	70	467
Tax deferral	2,253	2,253

Note: The figures assume a top individual marginal income tax rate and, where applicable, a top health levy rate. The impact of CPP, EI, and other payroll taxes has not been considered.

who chose to receive their remuneration as dividends in lieu of salary could reap sizable tax savings if the underlying corporate income was ABI that was eligible for the SBD. If the ABI was not eligible for either the SBD or the manufacturing and processing deduction (MPD), a tax deferral existed, but a tax cost followed actual distribution. The reduced DTC

Table 2 Income Tax Payable on $10,000 of Investment Income Earned Through a Corporation and Directly, Year Ending December 31, 2002

	Nfld. pre-budget	Nfld. post-budget
	dollars	
Portfolio dividends		
Corporate tax	3,333	3,333
Refundable tax	(3,333)	(3,333)
Individual tax on dividend	3,187	3,732
Combined tax	3,187	3,732
Individual tax	3,187	3,732
Tax cost with Holdco	—	—
Tax deferral with Holdco	(146)	399
Capital gains		
Corporate tax	2,489	2,489
Refundable tax	(1,256)	(1,256)
Individual tax on dividend	1,201	1,406
Combined tax	2,434	2,639
Individual tax	2,432	2,432
Tax cost with Holdco	2	207
Tax deferral with Holdco	(57)	(57)
Interest		
Corporate tax	4,979	4,979
Refundable tax	(2,511)	(2,511)
Individual tax on dividend	2,401	2,811
Combined tax	4,869	5,279
Individual tax	4,864	4,864
Tax cost with Holdco	5	415
Tax deferral with Holdco	(115)	(115)

Note: The figures assume that (1) the individual is taxed at the top marginal tax rate, (2) the capital gains deductions for qualifying small business corporation shares or qualified farm property are not available, and (3) the taxable dividend paid is the net after-tax amount less any capital dividend.

markedly reduces the tax savings of integration for ABI eligible for the SBD and increases the tax cost of earning other forms of ABI through a corporation rather than directly. Unfortunately, the impact of the provincial DTC reduction on integration for property income was not addressed: table 2 shows that the cost of earning interest and capital gain income through a holdco, rather than directly, has significantly increased. Given the large spread (about 4.00 percent) between the part IV federal tax rate and the current top marginal Newfoundland dividend tax rate of 37.32 percent, taxpayers may wish to accumulate the refundable dividend on hand and part IV taxes in the holdco rather than distribute taxable dividends to generate a dividend refund. While an

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Canadian Tax Foundation
595 Bay Street, Suite 1200
Toronto, Canada M5G 2N5
Telephone: 416-599-0283
Facsimile: 416-599-9283
Internet: http://www.ctf.ca
E-mail: vmorgan@interlog.com
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investment holdco offers various advantages and disadvantages, strictly based on rates, a significant cost exists for Newfoundland residents. (See "Holdco: Future Resurrection?" *Canadian Tax Highlights*, August 28, 2001, at 59.)

Louis J. Provenzano and Donald E. Carson
PricewaterhouseCoopers LLP, Toronto

GAAR: The First Volley Back

The first few steps of a GAAR review by the CCRA may proceed quickly. The CCRA may relatively easily identify a tax benefit from a transaction. There is an inevitable credibility gap regarding the primary purposes underlying a transaction, and the CCRA relies heavily on economic equivalents to identify avoidance transactions. Thus it may seem to the taxpayer that the auditor's focus is almost immediately trained on addressing the issue of misuse or abuse. At this point, the tax professional's most productive response is to provide some level of comfort with the transaction for the auditor by showing why the transaction is not abusive.

■ The auditor perceives the transaction or step to be abusive in the context of the facts, the commercial context, and the applicable tax rules. Why? Normally, one or two facts are particularly suspect because they deviate from an assumed normal commercial transaction. Specific documentation or analyses that the auditor encountered may also raise concerns. Ask the auditor what factors are of concern, and request a review of the material together.

■ A lecture on the continued propriety of tax planning post-GAAR does not address the auditor's specific concerns. Not attending to the auditor's concerns may leave the impression that the issues are also being avoided, and visiting those concerns later may be wasted effort if the opportunity to persuade is lost because the auditor's focus is elsewhere.

■ What simple factual or legal analogy can address and neutralize the concerns expressed? A lengthy discourse or a hefty analysis of the case law to date is probably redundant and out of place: an in-depth numeric analysis has probably already been performed and the CCRA's view of the case law applied. The auditor's report is normally concise, and the analytical assistance from the tax avoidance group at Headquarters is usually only a few pages long. Be specific when addressing the auditor's concerns.

■ Most local auditors will not decide GAAR issues without input from Headquarters. Such a referral is thus not invariably the start of a lengthy and expensive contest with the CCRA. What kind and length of submission is appropriate in the circumstances? Before a final decision is rendered, ask for an opportunity to speak to the Headquarters officer who has carriage of the matter. If Headquarters decides that GAAR applies, the CCRA does not generally reconsider the validity of its initial position: its resources are spent defending its position and critiquing the taxpayer's in anticipation of the GAAR Committee's review.

Given the CCRA's success in *OSFC*, the leading authority on GAAR to date, Headquarters officials will emphasize the FCA's comments in that case. No matter how persuasive some TCC comments regarding GAAR's ambit may be in the judicial arena, the wisest counsel is to address what *OSFC* does say, what it does not say, and how the apparent breadth of its application may be undercut by *CP*. The CCRA does not regard *CP* as limiting *OSFC*, and confines *CP* to its facts and discounts it as part of the legacy of *Shell*. The review of this particular taxpayer's file may not be the occasion for the CCRA to reckon with the views expressed in *CP*.

■ Submissions to the GAAR Committee warrant particular care, because it is generally the last stop before the TCC. The committee is effectively the only available administrative avenue of recourse from Headquarters' determination of an abuse: its composition is of sufficient authority that its determinations are rarely overturned by Appeals if a taxpayer objects.

Susan Van Der Hout
Osler Hoskin & Harcourt LLP, Toronto

Foreign Tax News

Treaties

On March 28, 2002, a new Canada-Germany treaty, replacing the 1981 treaty, entered into force, effective for withholding taxes on amounts paid or credited after 2000, and in respect of all other taxes for taxation years beginning after 2000.

OECD

As of April 6, 2002, the following additional jurisdictions will be eliminated from the OECD list of jurisdictions with harmful tax practices: Anguilla, British Virgin Islands, Cook Islands, Gibraltar, Maldives, Montserrat, Turks & Caicos Islands, and US Virgin Islands. The Bahamas and the OECD are negotiating an agreement on transparency and "effective exchange of information."

Carol Mohammed
Canadian Tax Foundation, Toronto