CANADIAN TAX Highlights

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AG: Fairness in Fairness

The report of the auditor general (AG) of Canada, tabled on April 16, 2002, says that the CCRA needs better controls to improve tax collection procedures and to ensure fairness and consistency in the forgiveness of interest and penalties under the fairness rules. The report is available on the AG's Web site at http://www.oag-bvg.gc.ca/domino/oag-bvg.nsf/html/02menu_e.html.

The AG notes that the CCRA waived or cancelled an estimated $185 million in interest and penalties for the fiscal year ended March 31, 2001. However, the CCRA keeps no record of the amounts of interest and penalties waived or its reasons for waiver; nor does it submit the underlying circumstances to systematic review at the national level to monitor for or confirm consistency of decisions. To improve administration of the fairness provisions, the AG recommends that the CCRA improve the information contained in its national fairness registry, record its reasons for waiving interest and penalties and the actual amounts waived, and strengthen the approval process.

The AG also made several other recommendations.

■ The CCRA should take action to reduce the risk of not collecting the estimated $2 billion in small business corporate tax instalments that were deferred under the December 2001 federal budget's instalment deferral measure.

■ The CCRA should consider a policy of obtaining via a signed statutory declaration the information required of taxpayers before the CCRA will enter into an arrangement for payment of taxes owed or waive or cancel interest or penalties because of financial hardship.

■ An enforcement response should be developed by the CCRA to deter businesses from failing to remit amounts held in trust (payroll deductions and GST). Such trust holdings rose 27 percent in the two years following March 31, 1999—from $3.7 million to $4.7 million.

■ The CCRA should take administrative action or seek legislative redress to minimize the effects of *Markevitch*, which held that provincial limitations (ranging from 2 years in Alberta to 20 years in Ontario) apply to the collection of federal income taxes (2001 FCA 144). If the CCRA appeal is unsuccessful, the decision could prevent the CCRA from collecting over $1 billion in income tax owed.

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The Chosen Ones

On April 18, 2002, the OECD published its much anticipated list of uncooperative tax havens, identifying seven offshore financial centres that have declined to meet transparency and information exchange standards required by the world's industrialized nations: Andorra, Liberia, Liechtenstein, the Marshall Islands, Monaco, the Republic of Nauru, and Vanuatu. If implemented, sanctions by the 30 OECD member states may significantly reduce the attractiveness to foreign investment of those listed countries. Such sanctions—the OECD's so-called defensive measures—are still being developed; their scheduled effective date of post-March 2003 provides an additional one-year grace period for compliance.

An OECD report in April 1998 launched the initiative to address "harmful tax practices" in member and non-member countries, and set out criteria for identifying tax havens. Before the 2000 progress report was released in June 2000, six offshore jurisdictions—Bermuda, the Cayman Islands, Cyprus, Malta, Mauritius, and San Marino—committed to cooperate with the OECD to address harmful tax practices. That report identified 35 other jurisdictions considered tax havens. The report also established a procedure to avoid the OECD blacklist by committing to address harmful tax practices, commitments that previously included specific changes to tax systems but were modified to cover only transparency and exchange of information. The OECD withdrew Barbados, the Maldives, and Tonga from the list after further study and accepted commitments from 25 jurisdictions—Anguilla, Antigua and Barbuda, Aruba, the Bahamas, Bahrain, Belize, the British Virgin Islands, the Cook Islands, Dominica, Gibraltar,

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Grenada, Guernsey, the Isle of Man, Jersey, Montserrat, the Netherlands Antilles, Niue, Panama, Samoa, the Seychelles, St. Christopher and Nevis, St. Lucia, St. Vincent and the Grenadines, Turks and Caicos, and the US Virgin Islands. The committed jurisdictions' compliance deadline for the transparency and the exchange-of-information requirements is now December 31, 2005. (OECD members, except for Luxembourg and Switzerland, have pledged to eliminate their own harmful tax practices by April 2003.)

In light of these commitments, the OECD released a model agreement on exchange of information in tax matters as both a model for bilateral treaties or agreements and a multilateral instrument. The latter is not a multilateral agreement in the traditional sense, but rather represents an integrated bundle of bilateral treaties. A party to the multilateral agreement is bound only vis-à-vis the specific parties with which it agrees to be bound; in force, the agreement creates rights and obligations only between those parties that have mutually identified each other in their instruments of ratification, approval, or acceptance deposited with the agreement's depositary. The agreement's bilateral version is intended to serve as a model for bilateral exchange-of-information agreements; textual modifications to the model's standard may be agreed upon by the parties. It is not yet clear what sanctions the OECD member states will actually impose upon the remaining blacklisted jurisdictions should they remain in default. The blacklisting procedure made low-tax jurisdictions and the multinationals that use them the focus of attention from the OECD, the European Union, public commentators, and the taxing authorities in high-tax jurisdictions, including Canada; as a consequence, it is almost certain that we have not heard the last word on the matter.

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Canada-US Treaty: Interest

The 1980 Canada-US treaty has been under active negotiation in the last few years, most recently during March 2001. Rumours persist that Canada and the United States will eliminate withholding tax on interest paid on arm's-length debt. Such a change would obviate the need for a Canco to structure US cross-border borrowings to fit within the constraints of the 5/25 rule in subparagraph 212(1)(b)(vii), the principal tool used to mitigate Canadian withholding tax.

Under the 5/25 rule, no Canadian withholding tax on arm's-length interest is payable on indebtedness by a Canadian-resident corporation if the terms of the obligation or any related agreements are such that it may not be obliged to pay more than 25 percent of the obligation's principal amount within five years from the date of issue—except, for example, in the event of a failure or default under the terms of the agreement or if the obligation's terms or any related agreement change by virtue of legislation or by a court. A treaty withholding rate of zero would render irrelevant for US borrowings all sorts of issues under 5/25 that plague tax practitioners. Typically, the problem area is whether certain trigger events for the loan's repayment within the five-year window qualify for exemption relief as "an event of default," an exemption that recognizes the lenders' need to protect their loans if, for example, an event places one of the parties in breach of the undertakings or guarantees given in the agreement. Usually, if the borrower fails to meet the repayment program or undertakes actions that materially increase the lender's risk, such as non-compliance with credit covenants, the lender may demand repayment in full. Similarly, principal and penalty payments made by the borrower to restore its financial ratios to levels agreed on in the loan agreement do not by themselves disqualify the interest payments.

The CCRA's position has been that, in order to be acceptable, the events of failure or default must have a commercial reality, must be beyond the control of the lender, and must not be contrived. The CCRA accepts that the exemption in clause C of the 5/25 rule applies if (1) a change of control of or ratings decline of the Canadian borrower or (2) asset sales are listed as "events of failure or default" under a particular loan agreement, although they may not be listed defaults that trigger acceleration of a loan repayment. Such relief is considered acceptable, but a request by the lender that the borrower prepay principal into a special fund may be problematic unless the cash collateral account mechanism is escrowed properly so that it remains the borrower's property. Relief is denied if the lender has an open-ended opportunity to call the loan. The waters are murkier if there is economic compulsion on the borrower to "early repay" for trigger events caused by a change in tax law.

Trusts are not eligible for 5/25 relief, and their financing sources have therefore been confined to Canadian markets. If the treaty withholding on interest is reduced to zero for arm's-length debt, Canadian-resident trusts may be able to finance asset acquisitions with US debt and could become more prevalent leasing vehicles. Opportunities for US financing for Canadian-based assets with an economic life of less than five years may soon be simpler. It is not expected that relief will extend to "interest equivalents" or contingent interest.

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Whose Priorities?

The current buzzword in federal-provincial relations is "fiscal imbalance." The Séquin Commission in Quebec and a subsequent meeting of provincial finance ministers stressed that, for the next two decades, the relatively strong fiscal position of the federal government will contrast sharply with the tough times facing provincial budget makers.

Federal revenue, the provinces argue, will grow strongly, and spending will not keep pace. The increasing surplus will allow the central government to reduce its outstanding debt. The provinces, on the other hand, expect spending pressures to continue unabated, but revenues will not respond as quickly to economic growth. Unless the provinces can increase tax rates, the result will be either spending restraint, which will create serious problems in such key areas as health care and education, or a resurgence of provincial deficits. Neither alternative is attractive to the provincial governments or their populations.

Ottawa is now feeling the burden of three decades of almost continuous deficits, and debt retirement is still one of its priorities. The pressure on federal spending is no less severe than that imposed on provincial spending, and tax increases may be even more difficult for the federal government to justify than for the provinces. Thus, the federal position is that there is no imbalance: federal revenues and spending should grow as predicted, reflecting federal priorities and the need for debt reduction. However, the "fact sheet" on the Department of Finance's Web site points out that the provinces have equal access to all the major areas of taxation and are in a position to raise taxes sufficiently to fund their main priorities.

Caught in the middle is the hapless taxpayer. His or her priorities remain unchanged: essential public services must be maintained and improved to keep pace with progress in the economy and expected improved standards of services. The late 1980s and early 1990s proved that sustained provincial deficits can have serious consequences for the financial stability of provincial governments. Taxpayers are increasingly sensitive to tax levels, and finance ministers must be prepared to justify any increased tax burden on individuals or businesses. The dilemma for provincial governments is clear.

Federal systems have no formal provision for balancing the priorities of the two levels of government, but in Canada a number of innovations have been devised to provide for such balancing. In the past, however, such innovation has always been accompanied by protracted and often bitter negotiation between the two levels.

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Late-Filed Spinoff Elections

Canadian taxpayers who receive shares as part of a foreign spinoff may elect to defer tax on resulting gains if the foreign distributing corporation and the Canadian taxpayer fulfill certain requirements (subsection 86.1(2)). Distributions received after 1997 are eligible. The election deadline of September 11, 2001 for 1998, 1999, and 2000 taxation years previously could not be extended. The recently amended regulation section 600 now includes the foreign spinoff election in its list of elections that the CCRA has discretion to permit taxpayers to late-file, amend, or revoke under the fairness provisions (subsection 220(3.2)). Taxpayers who wish to late-file the election may have a good argument for retroactive application of the fairness rules to 1998, 1999, or 2000 because the rules were new at the time.

To be eligible for the tax deferral, the distributing corporation must provide the CCRA with satisfactory information establishing that at the time of the distribution its common shares (the original shares) were widely held and actively traded on a prescribed stock exchange; the date of the distribution and the type and FMV of each property distributed to Canadian residents; the name and address of each Canadian resident to which property was distributed; that neither the distributing corporation nor the spunoff corporation was ever resident in Canada; and that the distribution was not taxable to the shareholders resident in the country of the distributing corporation. The CCRA requires that taxpayers confirm with the distributing corporation that it has submitted such information. The taxpayers must also elect to defer the tax on the distribution and provide the following information to the CCRA: the number, cost amount, and FMV of the original shares before the distribution; the number and FMV of the original and spinoff shares immediately after the latter's distribution; and the manner in which the distribution was reported by the taxpayer and the details of any subsequent disposition of original and spinoff shares. The CCRA Web site provides foreign spinoff questions and answers and a list of foreign corporations with distributions eligible for tax deferral: http://www.ccra-adrc.gc.ca/tax/business/taxtopics/foreign-e.html.

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"Any Form of Guarantee . . ."

Citibank is the first decision in which the definition of "term preferred share" (TPS) has been considered by the FCA. It is not yet known whether the Crown will seek leave to appeal to the SCC.

Citibank Canada acquired preference shares issued by two publicly traded Canadian corporations and received related dividends that it deducted in computing its taxable income under subsection 112(1). The minister invoked subsection 112(2.1) and denied the deductions. The minister argued that the holder's right under the share conditions to convert the shares into common shares at a ratio determined at the time of conversion fell within the words "any form of guarantee, security or similar indemnity or covenant" in subparagraph (a)(iii) of the TPS definition. The TCC disagreed and allowed Citibank's appeal, saying that those words are

to be interpreted using their legal meaning imported from the relevant context—the law applicable to commerce and publicly listed corporations, not the ordinary or everyday meaning advocated by the minister.

The FCA agreed with the TCC's words-in-context approach and noted the minister's concession that the words in issue were ambiguous. The FCA reasoned that the purpose and intent of the provision was to defeat after-tax financing techniques that use debt-like preferred shares when the borrower has no need of an interest deduction. Given this narrow purpose, and the fact that the definition applies to a narrow range of sophisticated taxpayers, the FCA found that the legal or commercial meaning of the disputed words was appropriate. The use of the phrase "any form of" required the FCA to ascertain the legal substance of a particular arrangement, but did not allow it to disregard the legal meaning of the words in favour of a popular meaning. Furthermore, the FCA said that the interpretation favoured by the minister would render inoperative paragraph 248(1)(iv) of the TPS definition—which excludes convertible shares from TPSs if they are not to be converted into such shares—because no commercially acceptable conversion formula would provide for a loss at the date of conversion.

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Provincial Government Assistance

A taxpayer must reduce its SR & ED pool by the amount of any government assistance that it has received, is entitled to receive, or can reasonably be expected to receive in respect of a current or a capital SR & ED expenditure. The pool is not reduced by provincial or territorial assistance earned in respect of the prescribed proxy amount, which is not a pool-included expenditure but rather a notional amount in lieu of actual overhead expenditures in calculating qualifying expenditures for investment tax credit purposes. Such provincial assistance is included in income under paragraph 12(1)(x) in the year of receipt, which is considered to occur at the earliest of the time when the assistance is applied to (1) reduce a tax instalment payable, (2) create or increase a refund, and (3) reduce a liability. Typically, such receipt occurs in the year after the year in which the related overhead expenditures were incurred, resulting in at least a one-year deferral of income for paragraph 12(1)(x) inclusions. The difference in timing of the adjustment may have significant impact.

There is no legislative guidance for allocating provincial assistance to current or capital SR & ED expenditures or the proxy amount. Application Policy 2000-03, "Government Assistance—Treatment of Provincial and Territorial R & D Assistance Issue," says that the fundamentals of the relevant provincial incentive program determine the proper pool reduction. For example, the Ontario innovation tax credit (OITC) is said to be earned on a pecking-order basis by type of expenditure—current, proxy, and finally capital—and that assumption, not a pro rata allocation, is used to determine the portion of the OITC that is a pool reduction or income inclusion. However, it should be noted that the OITC is determined simply as 10 percent of the lesser of the corporation's expenditure limit for the year and its year-end SR & ED qualified expenditure pool, which includes both section 37 current and capital expenditures and the prescribed proxy amount.

Assume that an Ontario corporation incurs $2,000,000 of qualifying current expenditures and has a proxy amount of $700,000; its maximum OITC entitlement is $200,000. If the OITC is earned first on current expenditures and then on the proxy amount, the full $200,000 OITC reduces the SR & ED pool. If the assistance is earned first on the proxy amount and then on current expenditures, $70,000 is a paragraph 12(1)(x) amount and the remaining $130,000 reduces the SR & ED pool. However, if the OITC is earned pro rata, the SR & ED pool is reduced by $148,000 ($200,000 × $2,000,000/$2,700,000) and the remaining $52,000 is a paragraph 12(1)(x) amount. A corporation in a loss position may not be materially affected by the allocation between the pool and paragraph 12(1)(x), but the allocation may be significant to a corporation that must bonus down to $200,000 to maximize the SR & ED expenditure limit in the subsequent period.

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15(2) Anomaly Exposed

A corporate loan to a partnership connected to a shareholder of that corporation is generally included in the partnership's income if not repaid by the end of the taxation year following the year in which the loan is made. The policy behind subsection 15(2) is that a shareholder should not be able to indefinitely avoid tax on corporate distributions by way of a loan from a corporation directly to the shareholder or to a partnership of which he or she is a partner. The recent TCC decision in *Gillette* exposes an anomaly created by a 1983 amendment extending subsection 15(2)'s application to certain partnerships (2001 DTC 895).

Subsection 15(2.1) provides that a person, not a partnership, is connected with a shareholder if that person does not deal at arm's length with the shareholder; but the subsection does not appear to deem partnerships to be connected for this purpose. A technical interpretation indicates the CCRA's disagreement: a partnership is considered to be a person when income is computed at the partnership level and is thus a person for the purposes of subsection 15(2) (Doc. no. 961068, November 18, 1998).

In *Gillette*, the TCC considered whether a deemed dividend arose under paragraph 214(3)(a) in relation to a debt

between Gillette and a non-resident partnership controlled by its US parent. That provision would not apply unless the amount would have been included in the partnership income under subsection 15(2) had part I applied. Gillette argued that subsection 15(2) did not apply because the partnership was not a person and thus could not be connected to the US parent. The TCC concluded that subsection 96(1) did not function as a definition section for subsection 15(2.1): the charging provision in subsection 15(2) distinguishes between a person and a partnership. Thus, the TCC held that subsection 15(2.1) applies only to a person, not a partnership. The TCC further said that a partnership was not connected to its partners for the purpose of subsection 15(2) under general principles of law; the court relied on the FCA decision in *Madsen*, which concluded that "the fiction of a partnership as an entity separate from the partners [created by the Act] is temporary and does not extend to colour the true legal nature of transactions at the time they are entered into by a partnership" (2001 DTC 5093).

Based on *Gillette*, a partnership and its partner cannot be connected for the purpose of subsection 15(2), and thus a loan from a corporation to a partnership with a mutual shareholder/partner is not caught by subsection 15(2). The reasoning in *Gillette* also appears to extend to subsection 80.4(2), which deems a partnership to receive an interest benefit on a loan from a corporation that has a shareholder connected to the partnership, because the term "connected" is clarified in a manner similar to that in subsection 15(2.1). *Gillette* has been appealed to the FCA.

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US Conduit Financing Rules

The US conduit financing rules permit the IRS to characterize a multi-party financing transaction as a transaction between two or more parties to prevent US withholding tax avoidance (Code section 7701(l)). The IRS recently released its best, although non-authoritative, guidance on the issues since the rules were finalized in 1995 (FSA 200206008, October 31, 2001 [2002 TNT 28-18]).

The conduit financing rules focus on the use of intermediaries in structured financings. Assume that a foreign parent lends to one of its foreign subs, which onlends to another US sub. The parent resides in a jurisdiction that does not have a treaty with the United States; but the first foreign sub's jurisdiction has such a treaty, which reduces US withholding tax to zero. Such back-to-back loans may be recharacterized as a loan directly by the parent to the US sub, leaving related interest payments subject to 30 percent US withholding tax. Reg. section 1.881-3 assists the IRS in determining the true identity of the lender.

The new FSA involved a Canadian parent that invested directly or indirectly in the common shares of a non-US, non-Canadian, wholly owned sub (Finco), probably incorporated and managed in Ireland. Finco loaned cash from CanParent to affiliated US subs under common control. In the tax years in issue, the US-Ireland treaty exempted the interest payments from US withholding, compared with the 10 or 15 percent withholding if the Canada-US treaty applied. An IRS examiner sought National Office advice on whether CanParent and Finco were parties to a financing transaction as defined in the regulations; if so, the IRS could ignore Finco and deem the structure to be a loan from CanParent to the US borrower and thus subject to US taxation.

Following seven full pages of analysis, the FSA concludes that the documented facts are insufficient to support a finding that the shares held by CanParent in Finco were a financing transaction in substance. Normally, in the anti-abuse context, common stock is not a financing transaction unless certain debt-like characteristics are present, such as a mandatory retraction feature binding on the issuer, a right to require redemption exercisable by the shareholder, or a

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put right exercisable by the shareholder. However, the FSA points out that Finco might be disregarded as a conduit entity if it could be shown that CanParent had contemporaneously borrowed the funds used to capitalize it; that CanParent's lenders knew or had reason to know that Finco's participation was part of a plan to avoid US tax; or that Finco had a pattern of directly or indirectly returning funds to CanParent.

The IRS will continue to aggressively challenge international financing structures on various grounds, including the conduit financing arrangement rules. Canadian multinationals must ensure that sufficient documentation of the business purposes for the structure is retained, and that the chosen structure conforms with the documentation both at the time of and after implementation.

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US Corporate Expats

Because the United States taxes a US corporation on its worldwide income and a foreign corporation only on its US-source income, several US multinationals have reincorporated or emigrated (expatriated) outside the United States (an outbound F reorganization). Low-tax jurisdictions such as Bermuda are favoured destinations, and substantial US tax savings may arise if foreign-source income is thus excluded from the US tax base of the newly foreign corporation.

An expatriation transaction usually can be accomplished without triggering gain at the shareholder level, but typically a gain is recognized at the corporate level to the extent that the assets' FMV exceeds adjusted basis (Code section 367(a)). Limited exceptions apply—for example, if USco is 80 percent owned by five or fewer US corporations and Forco will use its assets in an active trade or business outside the United States (but "hot" USco assets such as inventory or accounts receivable may not be excepted). In limited circumstances, USco may also defer gain recognition on a sub's stock via a gain recognition agreement with the IRS.

In the patriotic fervour following September 11, 2001, several lawmakers flagged expatriations as "un-American" or "unpatriotic," and at least three bills (HR 3884, HR 3857, and S 2119) seek to curb the practice. Each bill treats certain foreign corporations that acquire substantially all of a USco's properties as a domestic corporation if 80 percent or more (50 percent in some cases) of Forco's stock is held by former USco shareholders. In some bills, similar rules apply to partnership expatriations via the acquisition of a US partnership by a foreign corporation. Special rules may also apply, depending on the extent of activities in the new country of organization and whether the stock is publicly traded on a US exchange. The bills' effective dates vary, but each is retroactive to some extent.

The bills' domestic corporation treatment triggers the foreign corporation's liability to pay US tax on worldwide income. Because no tax-avoidance purpose underlying the expatriation is required, the bills may apply to outbound F reorganizations to any, not just low-tax, jurisdictions; this result may be of little concern to non-tax-motivated corporate expatriations because a credit for taxes paid in the country of organization should offset US tax. The proposed legislation does not apply to corporations originally incorporated in a foreign jurisdiction, only to domestic corporations relocating to foreign jurisdictions. The effective date of the proposals should concern all US multinationals that have undergone or are considering an expatriation transaction. How much support the bills will attract is unclear, especially in light of President Bush's tax-cut environment and recent rumblings that the US international framework should be overhauled.

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Valuation Penalties

Information Circular 01-1, "Third Party Civil Penalties," covers special rules for valuators activities that may affect tax professionals, advisers, business valuators, real estate appraisers, and others. A planner penalty applies to a valuator who prepares a report for a proposed scheme or shelter that could be used by unidentified investors, whereas a preparer penalty relates to a report for a specific taxpayer or identifiable persons who may, for example, invest in a proposed scheme or shelter. These rules are intended to counter the abusive use of valuation and appraisal opinions in tax shelter and other tax transactions such as inflated purchase prices of fast-writeoff depreciable property (computer software, seismic data, etc.) or in estate planning.

Before penalties are assessed, the CCRA will consider, inter alia, whether the position taken by the valuator is obviously wrong, unreasonable, and/or contrary to well-established case law; the valuator's experience with the subject matter and knowledge of the taxpayer-specific circumstances; and whether there is a pattern of repeated abuse. Business valuators are concerned about the reverse-onus rule, which deems a valuation opinion to be a false statement if the value falls outside a range of values determined by multiplying two prescribed percentages by what is subsequently determined to be the property's FMV. At that point, the onus is on the valuator to establish to the minister or the court that the stated value was "reasonable in the circumstances and that the statement was made in good faith, and, where applicable, was not based on one or more assumptions that the person knew or would reasonably be expected to know, but for the circumstances amounting to culpable conduct, were unreasonable or misleading in the circumstances." Thus it seems that in the valuation context, a misleading but not necessarily inaccurate statement is culpable. It should also be noted that the valuator's ability to exonerate himself or herself is

particularly sensitive to whether the assumptions underlying the projections used and/or made by the valuator were reasonable or not: the valuator cannot merely "assume away" responsibility for the valuation amount if it falls outside the prescribed range. Reasonableness will likely be more difficult to establish as the rift between the valuation amount and the ultimately determined FMV increases.

The acceptable range for the reverse-onus rule has yet to be prescribed. The 200 percent upper limit for section 6700 of the US Internal Revenue Code has been rejected by Finance because the penalty under that rule applies automatically unless the valuation was reasonable and bona fide and the Secretary of the Treasury waives the penalty. In contrast, "the Canadian approach favours Canadian valuators" by providing merely a reverse-onus rule. The IC gives an example that assumes that the acceptable range lies between 133 and 75 percent of the property's FMV, but is careful to note that the prescribed percentages have not yet been established. Finance has said that it will recommend that the prescribed percentages be effective only for statements made after the day they are announced.

The CCRA says that there is no intention to punish good faith opinion differences and does not anticipate imposing culpable conduct penalties if the code of ethics and the professional practice standards of the Canadian Institute of Chartered Business Valuators were followed. CCRA valuators will rely on those same standards and ethics and will invoke the reverse-onus rule only after applying such standards in arriving at their own valuation amount. In estate-planning or date-of-death valuations, the CCRA does not anticipate applying a civil penalty if a written formal valuation opinion was not obtained: a less costly "good faith" valuation estimate—or even calculations—may suffice and not trigger potential liability for a civil penalty. All potential penalties will be reviewed by the penalty review committee in Ottawa, a senior-level group that will receive input from a chartered business valuator.

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Donation of Marketable Securities

The capital gains inclusion rate on the donation of marketable securities (listed on a Canadian or the New York stock exchange or NASDAQ) to a registered charity that is not a private foundation is only one-half the normal rate. The differential between the rate implicit in the donation benefit (based on the property's FMV) and the capital gain rate makes the donation of marketable securities very attractive. Furthermore, a capital loss carryforward may offset the included gain without adjustment for the lower inclusion rate, and a corporation's capital dividend account is not reduced by the reduced capital gain included in income.

Donation by Individual or Holdco

	Gift of Holdco shares	Holdco gifts marketable securities
Individual's terminal return		
Deemed disposition (Holdco)	$1,000,000	$1,000,000
ACB	—	—
Capital gain (loss)	$1,000,000	$1,000,000
Taxable capital gain	$ 500,000	$ 500,000
164(6) loss carryback	(250,000)	(500,000)
Net capital gain	$ 250,000	$ 0
Tax (@ 46.41%)	$ 116,025	nil
Charitable tax credit	$ 232,050	na
Estate		
Windup dividend		
Capital	$ 250,000	$ 500,000
Taxable	195,917	—
Tax (@ 31.34%)	(61,400)	0
Net proceeds to estate	$ 384,517	$ 500,000
Proceeds of disposition	$ 0	$ 0
ACB	500,000	1,000,000
Capital gain (loss)	($ 500,000)	($1,000,000)
164(6) loss carryback	($ 250,000)	($ 500,000)
Holdco		
Proceeds of disposition (mktb. sec.)	na	$ 500,000
ACB	na	—
Taxable capital gain	na	$ 125,000
Capital dividend account	na	$ 375,000
Proceeds of disposition on windup	$1,000,000	$ 500,000
ACB	—	—
Taxable capital gain (loss)	$1,000,000	$ 250,000
Capital dividend account	$ 500,000	$ 250,000
Total taxable capital gain	$ 500,000	$ 375,000
Charitable tax deduction	—	($ 500,000)
Net taxable income	$ 500,000	$ 0
Corporate tax on gain (@48.3%)	$ 241,500	nil
RDTOH	$ 133,333	nil
Capital dividend account	$ 500,000	$ 625,000
Net proceeds to Holdco	$ 891,833	$ 500,000
Charity		
Marketable securities	—	$ 500,000
Dividend		
Capital	$ 250,000	
Taxable	195,917	
Total	$ 445,917	
Summary		
Individual's tax	—	—
Holdco tax	$ 108,167	—
Estate tax	$ 61,400	
Excess charitable credit (individual)	$ 116,025	—
Excess charitable deduction (Holdco)	—	$ 125,000
Net proceeds to estate	$ 384,517	$ 500,000
Net proceeds to charity	$ 445,916	$ 500,000

Note: Any capital dividend is assumed to be divided equally among shareholders. RDTOH full refund is assumed.

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An employee who exercises a Publico stock option realizes a taxable benefit from employment. Only one-half may be included in income (paragraph 110(1)(d)), making the net income inclusion comparable to a capital gain. On a donation of such shares, the income inclusion is only one-quarter of the benefit (the shares' FMV at the time of exercise net of the option price). A donation receipt for the donated shares' FMV is issued. Flowthrough shares are often used in the resource sector to raise capital, allowing investors to deduct the issue's exploration and development expenses. A donor of such a share may benefit from such flowthrough, as well as from reduced capital gains inclusions and a deduction or tax credit for the donation's FMV.

This favourable regime may affect the structure of a testamentary gift from a family holdco's marketable securities. Assume that Mrs. A owns 100 percent of Holdco, which owns $1 million of marketable securities listed on the TSE and no other assets. The cost bases of shares in and assets of Holdco are nominal. To gift $500,000 to a registered charity and $500,000 to her children on her death, Mrs. A may give one-half of Holdco's shares to each of a charity and the children and then wind up Holdco. The estate nets $384,517 and the charity $445,916. Alternatively, the executors of Mrs. A's estate may cause Holdco to give one-half of the securities to a charity and Holdco's shares to the children, followed by Holdco's windup. Each of the charity and the estate realizes $500,000.

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Customs and US Chemicals

Customs' origin and verification unit in Ottawa is responsible for reviewing and verifying the NAFTA origin of various goods for import into Canada duty-free. Currently, attention is focused on the US chemical and petrochemical industry and its products and byproducts. If such imports do not qualify for NAFTA status, the Canadian importer ultimately must pay the applicable duties.

A customs verification review begins with Customs' contacting Canadian importers of the particular imported goods and requesting copies of any certificates of origin relied upon by the importer in claiming duty-free status. After reviewing the certificates, Customs may request a NAFTA verification questionnaire from the US exporter and scrutinize the certificate's accuracy and veracity. Some significant issues seem to be developing with respect to US compliance and NAFTA qualification for chemical and petrochemical goods: in particular, improper or no tracking of originating and non-originating fungible materials, especially those obtained under so-called exchange contacts; reliance on improper or inaccurate producer's certificates; and improper accounting for foreign trade zone production. If Customs determines that the US exporter issued an improper NAFTA certificate of origin and denies NAFTA status to the goods, under US domestic law the US exporter must notify all importers within 30 days. On being so notified, the Canadian importer must voluntarily adjust the affected imports within 90 days, which usually means significant additional duties payable by the Canadian importer; in practice, Customs usually initiates with a detailed adjustment statement. With their advisers' assistance, Canadian importers may head off problems by helping to educate their US exporters about the Canadian process and about what Canada Customs will look for.

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Foreign Tax News

Republic of Korea

Tax authorities pledged to crack down on tax evasion by domestic and foreign entities by focusing on export and import price manipulations, pricing and expenses in foreign-invested companies, evasion practices of medical professionals, and illegal asset transfers to family members. Heavy capital gains taxes will apply to real estate speculation. Firms setting up factories or doing business in the Cheju-do free trade zone and investing at least $10 million will enjoy freedom from income tax for three years and a 50 percent cut for the next two years. Foreign officials and referees are tax-exempt during the 2002 World Cup of Soccer in May and June.

Germany

The tax court ruled that a server owned by a German private limited company, located in Switzerland in leased premises and operated without personnel, constituted a permanent establishment (PE). The decision is expected to be confirmed by the Supreme Court, which earlier held that a pipeline with no personnel constituted a PE.

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