CANADIAN TAX *Highlights*

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SCC Reins in REOP

On May 23, 2002, the SCC allowed the taxpayers' appeals in *Stewart* and *Walls*, both of which dealt with the reasonable expectation of profit (REOP) test (2002 SCC 46 and 2002 SCC 47). The SCC held that the REOP test should not determine whether a taxpayer's activities constitute a source of income for purposes of section 9 and recommended a new approach to assess an activity's nature as a commercial venture: if the activity is clearly commercial with no personal element involved, further inquiry is obviated because such endeavours necessarily involve the pursuit of profit. The SCC's clarification of the proper use of the REOP test and its recommended approach to determining whether activities constitute a source of income should help to resolve the confusion in the case law.

The taxpayer in *Stewart* acquired four condominium units that had no element of personal use. The taxpayer incurred losses from the outset, primarily from interest expense related to the almost 100-percent-leveraged acquisition; the deal's promoters projected negative cash flow for 10 years. The CCRA disallowed the losses, saying that the taxpayer had no REOP and thus no source of income and that the interest was not deductible under paragraph 20(1)(c). The TCC held, and the FCA agreed, that the taxpayer did not "discharge his burden of showing that the REOP doctrine was satisfied."

The SCC noted that the REOP test originated in 1978 with obiter in *Moldowan*, which dealt with a hobby farm. Since then, the CCRA and the courts had used REOP in a variety of situations to test for a business or property source of income, but the test had not been interpreted and applied consistently. The SCC said that the wide range of judicial approaches called for clarification of the test's role: REOP should not be the test for a source of income because its vagueness and uncertainty of application results in unfair and arbitrary treatment of taxpayers. Instead, the SCC recommended a two-stage approach to establish whether activities constitute a source of business or property income: (1) Is the taxpayer's activity undertaken in pursuit of profit and not a personal endeavour? (2) If yes, is the source of income a business or property? The first question is relevant only if the activity contains some personal or hobby element: an activity clearly commercial in nature is necessarily in pursuit of profit, and further analysis of the taxpayer's business decisions is not required. If elements suggest a hobby or other personal pursuit, the venture is considered a source of income if it is undertaken in a sufficiently commercial manner. The taxpayer must have the subjective intention to profit, supported by evidence of businesslike behaviour; REOP is only a single factor among others to be considered at this stage. The SCC emphasized that this assessment should not be used to second-guess the business judgment of the taxpayer; the commercial nature of the taxpayer's activity is being evaluated, not his or her business acumen.

The issue of interest deductibility, the SCC said, should not be confused with the source-of-income inquiry. Once it is determined that an activity is sufficiently commercial to establish a source of income, deductibility depends on the wording of the relevant deduction provision: the existence of excessive or unreasonable expenses has no bearing on whether a particular activity is a source of income.

In conclusion, the SCC held that the taxpayer's property-rental activity was clearly a commercial activity that lacked any element of personal use or benefit to the taxpayer; the test for source of income was thus satisfied, and the taxpayer could deduct rental losses. The hope of an eventual capital gain and expectation of deduction of interest expenses did not detract from the commercial nature of his rental operation or its characterization as a source of income. In fact, the hope of a capital gain is consistent "with the ordinary business person's understanding of 'pursuit of profit,' and may be taken into account in determining whether the taxpayer's activity is commercial in nature."

In *Walls*, the SCC considered similar issues. Two individuals were members of a limited partnership that carried on a storage park operation, an activity commercial in nature. No evidence existed of any element of personal use or benefit in the operation, and the venture was held to be a source of income.

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US Tax on Retirement Benefits

The IRS's Rev. proc. 2002-23 of March 27, 2002 offers guidance for applying the Canada-US treaty to US citizens or residents eligible to defer tax on Canadian retirement plan benefits, effective for tax years ending after 2001. For tax years ending between 1997 and 2001 inclusive, taxpayers may elect to follow Rev. proc. 89-45 instead.

The earned but undistributed income of a US citizen or resident as a beneficiary of a Canadian retirement plan is currently taxed under US domestic law (unless the plan is an employees' trust and the individual is not a highly compensated employee: Code sections 402(b) and 402(b)(4)(A) respectively). However, that income is not taxed in Canada until distribution if the plan satisfies certain requirements. The potential mismatch in the timing of US and Canadian tax may result in double taxation without treaty relief.

Former treaty article XXIX(5) addressed the timing mismatch for a US-citizen Canadian-resident RRSP beneficiary; it allowed an election to defer US tax on undistributed income earned in the RRSP (Rev. proc. 89-45). For tax years beginning after 1995, current treaty article XVIII(7) provides that a Canadian or US citizen or resident who is the beneficiary of an exempt retirement or employee benefit plan of the other country—including a US-citizen or US-resident beneficiary of an RRSP, a RRIF, an RPP, or a DPSP who may or may not have been a Canadian resident when contributions were made to the plan—may elect to defer tax in his or her country of citizenship or residence on income earned in the plan until and to the extent of distribution. A "beneficiary" as defined would be subject to US income tax on the plan's earned income if no election were made. Rev. proc. 2002-23 outlines that election procedure: the beneficiary must attach to his or her federal income tax return a statement in which he or she claims the new Revenue procedure benefit and names the plan's trustee, its account number, and beginning-year balance. A copy of the statement must also be attached to his or her timely filed (including extensions) US federal income tax return for each subsequent year until a final distribution is made from the plan. Rev. proc. 2002-23 applies to plan income, not contributions. Distributions actually received from an eligible plan are included in the beneficiary's gross income (Code section 72), subject to any other applicable treaty provision. An election made under the Revenue procedure cannot be revoked without the commissioner's consent.

If the assets are transferred to another plan in a transfer not taxable in Canada, the previous election carries over. The new plan's beneficiary must continue to include with his or her returns a copy of the statement related to the old plan and also must attach an additional statement that includes a claim for the benefit of Rev. proc. 2002-23 and sets out the names of the trustees of the old and new plans; the plans' account numbers; the amount of income earned in the old plan on which US tax was deferred (under the former or current treaty rules); and the new plan's initial balance. Both statements must be attached to the returns of each subsequent year until a final distribution is made from the new plan.

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Estimated RST Assessments

Ontario RST auditors have seemingly fallen into the practice of issuing estimated assessments at a large dollar amount, reflecting concerns identified during a usually unfinished audit. This approach staves off the imminent closing of the four-year limitation period when a taxpayer or vendor refuses to sign a non-statutory waiver. Whether the practice is legally defensible is an open question.

Ontario's Retail Sales Tax Act (RSTA) requires that all notices of objection must "clearly describe each issue raised" and "fully set out the facts and reasons relied on by the person in respect of each issue" (section 24(1.1)). However, broad language buttresses Ontario's approach. On an audit, the Ontario minister of finance is allowed to "calculate the tax collected by the vendor or payable by the purchaser . . . in such manner and form and by such procedure as the Minister considers adequate and expedient." An arguably privative clause provides that an assessment is "subject to being varied or vacated on an objection or appeal and subject to a reassessment" and is deemed "valid and binding despite any error, defect or omission therein or in any [related] proceeding under this Act" (sections 18(2) and (8)). In practice, preliminary audits may lead to quick estimated assessments for tax, in whole figures of, say, $1 million, which amounts are reassessed—usually downward—as the auditor over time finally calculates actual taxes owing. This approach poses many compliance and other problems for the taxpayer or vendor, including how to address a moving target within the 90-day objection period. It may be that the practice will only be quelled by an administrative action before, say, the Ontario Divisional Court on an application for certiorari or similar relief to declare the assessment a nullity and quash it.

The Saskatchewan Court of Appeal in *CBC* recently set aside an assessment for which the tax authorities apparently freely estimated the tax due. The court cited jurisprudence to the effect that a tax authority must apply the law but cannot "formulate the tax," because such "power is reserved to the legislature." Finance may conduct a proper audit, using appropriate methodologies, but estimation was not warranted under the Saskatchewan act. The Ontario RSTA includes some very broad-based powers, but many such provisions require special procedural steps. Section 2(9), for example, allows for a "determination of fair value" if the minister considers it necessary or advisable, but seems to require that some specific assumption be made, if not a specific assessment. The court in *CBC* examined a rule in the Saskatchewan act that contained estimating powers; such powers, the cases suggest, are used if there is a deliberate or inadvertent lack of documentation "and the Minister must clarify the facts so that a formula can be applied to them. That formula setting the tax, however, must come from legislation"; nothing in the legislation justified the assessment in question. The action of the minister was "nothing other than taxation imposed by the Minister. This is not authorized by the Act and would be of dubious validity if it had been" (2001 SKCA 133).

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Sharing the Wealth

In contrast to cities in many member states in the Organisation for Economic Co-operation and Development (OECD), Canada's cities do not participate in the high-growth income and sales tax fields, but they do enjoy a dominant position in the slowly growing property field. However, because the provinces exploit their full access to the other tax areas that are also occupied by the federal government, our tax system is more decentralized than those of other industrialized countries.

The table shows that out of all OECD member countries surveyed, the central government's share of all tax revenue in 1999 was under 50 percent only in Canada (48 percent) and in Switzerland (42 percent). Canadian provinces accounted for 42 percent of the taxes imposed by all three levels of government, well above the 32 percent collected by Swiss cantons. Canada's local governments accounted for 10 percent of all tax collections in 1999, but they took in 78 percent of property taxes. Because few countries rely as heavily as Canada does on property tax as a major source of revenue, comparisons with other countries may be misleading. Of the five countries—Canada, the United States, Korea, France, and the United Kingdom—in which property taxes exceed 3 percent of gross domestic product, only the two North American countries show local property taxes accounting for over 70 percent of all such taxes.

There is a wide variation in the extent to which local governments are key players in the tax systems of OECD countries. In federal countries, local participation ranges from a low of 3 percent in Australia to a high of 22 percent in Switzerland. In the unitary countries, the ratio varies from a low of 2 percent in Greece and Ireland to a high of 42 percent in Japan. The share of all personal and corporate income taxes imposed by local governments ranges from nil in Canada and six other countries to a high of 73 percent in Sweden and 50 percent in Denmark and Finland.

Percentage Distribution of Tax Collections by Level of Government, OECD Member Countries, 1999

Country	Central	State/ provincial	Local
Federal			
Australia	79	18	3
Austria	73	13	14
Belgium	56	37	7
Canada	48	42	10
Germany	50	37	13
Switzerland	45	32	22
United States	59	25	16
Average	60	26	14
Unitary			
Czech Republic	79	—	21
Denmark	67	—	33
Finland	71	—	29
France	81	—	19
Greece	98	—	2
Hungary	92	—	8
Iceland	77	—	23
Ireland	98	—	2
Italy	87	—	13
Japan	58	—	42
Korea	80	—	20
Luxembourg	92	—	8
Netherlands	95	—	5
New Zealand	94	—	6
Norway	77	—	23
Poland	77	—	23
Portugal	91	—	9
Slovak Republic	93	—	7
Spain	74	—	26
Sweden	66	—	34
Turkey	83	—	17
United Kingdom	95	—	5
Average	88	—	12

These comparisons do not tell the whole story. The figures separate taxes imposed independently by local and regional governments from taxes allocated automatically by senior levels of government to the local and regional levels, but do not take into account the distribution of responsibilities requiring expenditure. As always, the true measure of tax burden is the value received for the tax dollar.

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IFA Seminar Highlights

The International Fiscal Association's annual tax seminar on May 13, 2002 disclosed some interesting news.

Late-filed section 216 returns. The CCRA has been developing its position on late-filed section 216 returns. Under section 216, a non-resident may pay part I tax on net income from real property rentals or timber royalties instead of part XIII tax on gross revenue if it files a tax return within two years of the taxation year-end. Particularly if the payer (for example, a tenant) fails to withhold part XIII tax, the non-resident may discover—often when notified that a would-be purchaser of the property will withhold under section 116 unless a clearance certificate is produced—that through ignorance or inadvertence, it has failed to report its Canadian-source income and pay Canadian tax. No late-filing provision exists and the fairness rules do not apply, even though part I tax on net income is usually substantially less than even a treaty-reduced part XIII tax on gross revenue. (However, see *Wright*, 2001 DTC 437 (TCC) and *Kutlu*, 97 DTC 5180 (FCTD).) The CCRA announced that International Tax Services in Ottawa will now consider one-time-only late-filing requests, a position intended to obtain compliance but not discourage filing in a timely manner.

Technical bill. It is hoped that by the end of June or early July Finance will release a technical bill that includes items "on the list" since 1996. Comfort letters account for 80 to 90 items; another 30 to 40 items cover requests by the CCRA for reinforced interpretation.

FIE/NRT proposals. Finance has been working on the foreign investment entity (FIE) and non-resident trust (NRT) rules since receiving submissions last fall. The new rules take effect after 2002.

- Finance will look at alternatives to the proposed default regime based on mark-to-market. The Joint Committee suggested notional income recognition—a prescribed interest rate applied to cost—which benefits from ready availability of information and ease of calculation.
- The currently proposed accrual method is theoretically fair: unlike the mark-to-market method, it does not tax unrealized gains. But since numerous submissions indicate that FAPI is no more difficult to calculate, Finance is reviewing the proposal.
- Finance said that the FIE rules are needed to backstop the FAPI and NRT rules in the face of contemporary tax planning; the tracking and insurance provisions are necessary to protect Canada's tax base.
- Finance will consider a simple method of determining FIE status. The Joint Committee suggested using consolidated financials, often the only information available, particularly for small investments of less than 10 percent: a non-resident entity would be an FIE unless less than 50 percent of its assets' reported carrying value is represented by shares, debt, and property-income-generating assets, or less than 50 percent of its reported income is derived therefrom.
- In a brief discussion of the NRT proposals, Finance revealed its underlying assumptions that non-resident personal trusts involving Canadians are generally created primarily for tax-avoidance reasons and that a contributor to such a trust may retain control of the trust property, although that fact cannot always be proved. Consequently, the proposals may create very harsh results in situations where the assumptions are not founded. Finance clearly intends to shut down the use of NRTs to a large extent, but it is reviewing the arm's-length transfer definition in an attempt to determine whether the nexus to Canada is sufficient.

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The Virtues of Transparency

The Enron debacle has dampened enthusiasm for some off-balance-sheet structured financings, and more transparent structures are back in vogue. Businesses continue to monetize operating assets; income trusts are the vehicle of choice, owing to slow M & A activity and an inability to access equity. The popularity of master limited partnerships (MLPs) has also revived, owing to shaky investor sentiment toward limited partnership notes and other factors. Certain tax aspects of such vehicles are of interest.

Operational control of a business to be monetized can be diluted sufficiently to allow off-balance-sheet treatment for the vendor in return for investors' tax benefits. The vendor may use proceeds from the assets' sale to reduce debt and capital tax. Income trust units issued to many different investors raise capital to finance the assets' purchase. The investor's investment risk is mitigated where multiple business asset operations underpin cash flow. If the income trust is a mutual fund trust (MFT) for tax purposes, investors' units are liquid because they are publicly traded. The trust pays no tax if all income, including taxable capital gains, is distributed to unitholders annually; unitholders are taxed on such distributions. Non-cash deductions in the trust—such as capital cost allowance and interest (where the trust is also leveraged with debt)—reduce trust income without impairing distributable cash flow: distributions exceeding allocated income and capital gains are a return of capital and thus not taxable, but they do reduce the trust units' cost base. Although it is not possible to flow losses out of a trust, they can be carried forward to shelter trust income. Cash distributed to the investor is often tax-free for several years until the corner is turned and the units' cost base and the trust's deductions are exhausted. Marketability requires that units' return hurdle rate is comparable to benchmark rates within their industry. Investors are cautioned not to be seduced into an "apple and orange" comparison of the trust's published yields with interest and dividend yields: the former are typically quoted in terms of cash flow, which includes the return of the investor's own capital.

A public company may convert itself into a mutual fund corporation (MFC) (subsection 131(8)). The public company must generally first transfer its operating assets to a partnership or sell them; with proper structuring, tax can be deferred. A public company's holding of a limited partnership interest may be treated as passive to meet MFC requirements (section 253.1). A security law exemption from the requirement to redeem publicly listed units may also be obtained. Once the company is purified, it can merge on a qualifying exchange if the assets are transferred to an open-ended trust that is a mutual fund trust for purposes of the Act ("the Fund"). Although the Fund cannot be an operating trust, it can loan or subscribe for such units. Further financing is typically provided by the Fund as a loan to the operating trust. Accordingly, two-tiered structures have evolved, with the Fund on top over an operating trust and/or partnership; the income may flow up the chain to the Fund. Foreign property considerations may come into play—often solved by structuring the debt and equity mix at the Fund level—because investors typically want the units to qualify for RRSP investment.

In general, an MLP is a partnership in which interests are freely transferable on an established securities market. In general, MLPs were structured to raise money from large numbers of investors who wished to use the tax losses generated in the partnership's early years to offset income from other sources, such as salary and investment income; the limited liability protected the investor from liability associated with the partnership's business risks. At-risk rules introduced years ago were primarily designed to limit the practice of investors' claiming large losses based on inflated values and no-recourse financing. The CCRA has ruled that it is possible to roll a number of limited partnerships under the MLP, followed by a windup of the limited partnerships in order to create a diversified vehicle for broader market distribution. Many other tax considerations come into play for this type of merger. MLPs have been used for many years in the film and resource industries, and are now making a comeback in the United States in the energy area because they are suited to assets with long lives and slow depreciation; MLPs are favoured to draw growth-obsessed "stock investors" away from partnership notes, which attract "yield investors" whose hurdle rate demands lately have been high.

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THE ROLE OF THE COURT

Every piece of litigation establishes a learning curve as the Crown and taxpayers educate themselves about the nuances of the issues. The TCC decision in *Mathew* reflects the current state of the art on GAAR and foreshadows the platform for debate when and if the SCC hears the *OSFC* appeal. *Mathew's* 176-page length assures voluminous commentary on some of the basic questions addressed by the court: Can a court apply GAAR and maintain a judicial rather than a legislative role? Is GAAR constitutionally valid?

Mathew (previously *Gregory*) involves individuals, mainly tax lawyers, who purchased interests in a partnership to access non-capital losses from the mortgage portfolio owned by Standard Trust Company (STC). STC transferred a portfolio with an $85 million ACB and a $33 million FMV to a partnership (STIL) with its wholly owned sub at $41 million, in return for a 99 percent partnership interest. OSFC purchased STC's interest and syndicated it by a transfer to another partnership (SRMP) formed to acquire and manage OSFC's STIL partnership interest. SRMP's capital was divided into 35 class A and 15 class B units. OSFC then sold 76 percent of its 99 percent STIL interest to the other SRMP partners, some of whom were the taxpayers in *Mathew*. The partners claimed total tax losses of $52 million ($1 million per unit) for potential tax benefits exceeding 5 and 11 times the before-tax profit for class A and B unitholders respectively.

The taxpayers argued *CP*: GAAR did not apply to set aside tax benefits of impugned transactions underpinned by real and substantial commercial transactions. The taxpayers denied that there was an avoidance transaction or a misuse or abuse of the Act: they purchased an economic package, a real estate business with the historical tax attributes attached, and they intended to profit from the administration and sale of the mortgages or underlying properties and to obtain a tax benefit. Transactions undertaken by a third party before the taxpayers were identified and without their knowledge

RHYMES WITH ORANGE ® by Hilary Price

could not form part of a series, because GAAR presumes that a purpose can be attributed to the taxpayer; those upstream transactions created a package to maximize proceeds on the sale of the mortgage portfolio. Furthermore, subsection 18(13) was not misused because it contemplates a transfer to a partnership and the subsequent introduction of arm's-length members. No rule in the Act prevented a new partner from benefiting or suffering from pre-entry tax consequences or events. Nor did any general rule deny a taxpayer access to partnership losses: a general scheme for losses could not be inferred from the corporate rules in section 111. The taxpayers cautioned that GAAR should not be used to retroactively amend the law or impair the right to choose between co-existing schemes in the Act. GAAR was contrary to section 7 of the Charter and substantive requirements of the rule of law, and therefore was of no force or effect under section 52 of the Constitution Act.

The Crown repeated its *OSFC* arguments, challenging the commercial expectations alleged, and argued that tax saving was the primary purpose of the series, which need not be implemented entirely by the taxpayers. The transactions were a series under the *OSFC* tests: a transaction carried out "in contemplation of" a series included one carried out subsequently. Subsection 18(13) was not intended to be used to transfer losses to an arm's-length party. In relation to abuse of the Act, the overall scheme of the Act was reflected in the many rules that required each taxpayer's income and taxable income to be calculated separately, a system reflected in the corporate loss regime. Furthermore, vagueness is an issue under the Charter only if section 7 has been violated.

The TCC found a tax benefit—a permanent tax saving, not merely a tax deferral. (A deferral may in fact trigger GAAR.) Furthermore, the taxpayers' acquisition of their partnership interests was completed "in contemplation of" the earlier steps and formed part of a series of transactions that had as their primary purpose the spreading of losses to arm's-length parties, despite the taxpayers' "primary concern" with the commerciality of the real estate. The TCC found a misuse of subsection 18(13), but considered itself bound by *OSFC*, and hinged GAAR's application on the policy against the transfer of losses in the Act as a whole. The TCC agreed with the Crown that GAAR does not dictate the structure of a transaction or prohibit choice: GAAR merely denies a tax benefit if the transactions "contravene a clear policy of a provision or a policy of the Act read as a whole." No Charter breach arose: the right to liberty does not extend to purely economic rights, and GAAR does not deprive a person of the ability to make choices going to the core of his or her dignity and independence. The rule of law could not be used independently to strike down a law otherwise validly enacted. The taxpayers argued that GAAR applies only to flagrant abuses; the court found such abuse on the facts.

The tension between the judicial and legislative roles considered in *Mathew* appears, in part, to be sourced in Rothstein JA's comments in *OSFC*: a finding that "there has been a misuse or abuse . . . is not an exercise of trying to divine Parliament's intention by using a purposive analysis, [but] . . . rather, it is an invoking of a policy to override the words Parliament has used." In *Mathew*, the taxpayers challenged the courts' right to override parliamentary language based on a subjective perception of policy that prevented a taxpayer's free structuring of a commercial transaction in the most tax-effective way, contrary to recent SCC dicta in *Shell*, *Ludco*, and *Singleton*. Whether loss transfers between arm's-length parties abuse the Act's corporate loss scheme (or loss utilization generally) depends on whether that policy is sufficiently clearly expressed to warrant a judicial override of specific provisions otherwise permitting the transaction. Certainly the courts' role is not to override the express will of Parliament or to dictate the form of a transaction; Rothstein JA appears to say in *OSFC* that GAAR carries an additional mandate from Parliament that the courts must address if the overriding policy finds its clear expression in the evidence. Absent such clear, direct, admissible evidence, there is no "policy" to apply, and thus there can be no misuse or abuse. The SCC has a great deal of experience in applying the Charter and giving meaning to a multiplicity of statutes and specific and general provisions that affect individual rights and liberties, and should have no difficulty in putting GAAR in its proper legislative context. The basic principle of interpretation—to give meaning to the Act's provisions so that they may be applied—is the courts' role, which does not usurp but rather implements Parliament's role, although the process can be challenging at times. Ultimately, GAAR may be most limited by how the SCC indicates that the courts' mandate is to be effected. The SCC has commented in the past about the Act's lack of coherence and the relative scarcity of provable evidence of a consistent and ascertainable "policy," and it is likely to set a very high threshold for finding an overriding policy in the Act from which to launch GAAR. A conservative approach to ascertaining such policy will bolster a taxpayer's ability to plan its affairs in a tax-effective way and provide the protection and certainty that has apparently yet to materialize in the CCRA's GAAR assessment decisions. An objective standard for misuse or abuse will clarify GAAR's target and allow its more selective application.

The "void for vagueness" argument may not yet be dead, especially given the SCC's commitment to the concept of certainty, but the state of Charter analysis may foretell a tortuous route to striking down GAAR. The Ontario Court of Appeal's decision in *Arthorson* may present another avenue: the court ruled that a law was invalid because of protections in section 1(a) of the Bill of Rights if it failed to provide the right not to be deprived of enjoyment of property "except by due process of law." Leave to appeal to the SCC has been sought.

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Administration Roundup

Foreign spinoffs. Canadian taxpayers who receive shares as part of a foreign spinoff may defer tax on any resulting capital gain with an election under section 86.1, if the foreign distributing corporation and the Canadian taxpayer meet certain requirements. Inter alia, the foreign spinoff distribution must consist solely of common shares, but may also include certain "poison pill" rights, such as the right to subscribe for preferred shares in the capital stock of the parent rather than a subsidiary. During the CCRA round table discussion at the International Fiscal Association's 2002 tax seminar, the CCRA said that no administrative relief is currently contemplated if certain poison pill rights render a distribution ineligible in its view. In addition, the CCRA said that it will accept legal opinions and foreign rulings in determining whether "information satisfactory to the Minister" exists to establish that the distribution was not taxable under the foreign country's laws.

Third-party information demand. The British Columbia Court of Appeal (BCCA) in *R v. Van Egmond* recently decided that a GST consultant under investigation by the CCRA was legally obliged to hand over his client list to a CCRA income tax auditor, who could pass on materials gathered during investigation—including the client list—to GST officials for their use in enforcing the Excise Tax Act (2002 BCCA 226). The taxpayer, a GST consultant, filed seven years' personal tax returns all at once. On investigation by the CCRA, he disclosed most of his records but withheld his clients' names and addresses because the CCRA refused to assure him that it would not use the information to audit his clients. The taxpayer was charged under subsection 238(1) of the Income Tax Act for failing to provide material required under subsection 231.2(1). In overturning the lower court's decision, the BCCA held that section 231.1 permits CCRA demands for third-party information: CCRA auditors may "examine property in an inventory of a taxpayer and any property or process of, or matter relating to, the taxpayer or any other person" for purposes of ascertaining the taxpayer's income tax liability. Because the taxpayer failed to file his own returns for seven years, he was under legitimate investigation; the client list was material relating to "any other person," and because the information could be used to verify the taxpayer's own tax liability, it was therefore accessible under the authority of subsection 231.1(1).

The BCCA said that the lower court judge correctly recognized that subsection 241(1) prohibits tax officials' disclosing taxpayer information to others and its use for purposes other than for the administration and enforcement of the Income Tax Act, but did not focus on an exception in subparagraph 241(4)(d)(ii), which allows the provision of such information to other government officials for purposes of "administration or enforcement of an Act of Parliament that provides for the imposition and collection of a tax or duty." Because enforcement of the Excise Tax Act falls within this exception and because the client list met the definition of "taxpayer information" in subsection 241(10), the CCRA could provide the taxpayer's client list to GST auditors.

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Corporate Residency Traps

If a US sub's affairs are administered in Canada so that its mind and management is here, a recent TI concludes that it may need to file a Canadian corporate tax return and its income from an active business in the United States may be taxable surplus (doc. no. 2000-0054455).

USco, a wholly owned sub of Canco, purchased finished goods in Canada for resale in the United States. Canco performed USco's accounting and administrative functions in Canada, and thus USco's "central mind and management" was exercised in Canada. The CCRA said that most management activities involving corporate planning and policy making are "core" rather than "auxiliary" business activities. USco's residence is determined under article IV of the Canada-US treaty: it is deemed to be a US resident by virtue of its incorporation there, unless it is an LLC. Subsection 250(5) then deems USco to be non-resident for purposes of the Act. But, subject to the treaty, its income from carrying on a Canadian business is taxable; the regular and extended definitions of "business" and the related case law set a very low threshold.

Under the treaty, only USco's income attributable to a permanent establishment (PE) in Canada is taxable here, excluding profits attributable to a PE used merely for the purchase of goods or merchandise or the provision of executive, managerial, or administrative facilities or services for the non-resident, all of which are questions of fact. If USco carries on business in Canada, then it must file a T2 return and attach schedule 91, "Information Concerning Claims for Treaty-Based Exemptions," if it is claiming a treaty exemption. Failure to file the return may attract a penalty even if no tax applies (subsection 162(2.1) and doc. no. 2000-0055775).

Because USco's central mind and management is in Canada, the CCRA says that subsection 250(5) deems it to be a non-resident of Canada, but not a resident in a designated treaty country per regulation 5907: USco's earnings are taxable surplus, not exempt surplus. A foreign affiliate is a designated

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treaty country resident only if it resides in a country for the purposes of the relevant treaty and under the common law. A Canco with foreign subs carrying on active businesses may suffer significant adverse consequences because dividends out of taxable surplus are not tax-free in Canada.

The purpose of subsection 250(5) is to prevent the avoidance of non-resident withholding tax by a foreign-incorporated corporation that is a non-resident under the particular treaty tie-breaker rules but is a Canadian resident due to retention of Canadian management and control. The rule also prevents a Canco from continuing into a treaty jurisdiction and avoiding departure tax by the same means. It does not appear that the rule was intended to establish whether a foreign affiliate resides in a designated treaty country. The designated treaty country definition should be the sole focus of inquiry, but the CCRA's view confirms the definition's onerous dual test of residency. Taxpayers should ensure that the management of a foreign affiliate resides abroad.

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Foreign Tax News

Treaties

Three new tax treaties—with Belgium, Italy, and Mongolia—have been signed. The treaty with **Belgium** limits withholding tax on certain non-portfolio dividends to 5 percent (15 percent for all others); the rate on interest and royalties is 10 percent, with an exemption for certain interest, copyright royalties, and royalties in relation to certain computer software, patents, and knowhow. The treaty is effective 15 days following ratification, and replaces the May 1975 treaty. Withholding rates are effective January 1 in the calendar year of entry into force; all other taxes are effective for taxation years beginning on or after that day. The treaty with **Italy** limits withholding tax on certain non-portfolio dividends to 5 percent (15 percent on all others); 5 percent on royalties on computer software, patents, and knowhow; and 10 percent on interest and other royalties, with some exemptions on certain interest and copyright royalties. The treaty is effective upon ratification and replaces the November 1977 treaty. Withholding rates are effective January 1 in the calendar year of ratification; all other taxes are effective for taxation years beginning on or after that day. The treaty with **Mongolia** is new and limits withholding for certain non-portfolio dividends to 5 percent (15 percent on all others); 5 percent for royalties on copyright, patents, knowhow, and computer software; and 10 percent for all other royalties and interest. The treaty is effective upon ratification. Withholding rates are effective January 1 in the calendar year following ratification; all other taxes are effective for taxation years beginning on or after that day.

United Kingdom

New transfer-pricing proposals change the attribution of tier 1 and 2 capital to UK branches of foreign banks. All UK branches, in all industries, are allocated a share of their parent's overall equity and other capital, based on the amount of capital that would be required were it a separate UK entity operating in the same circumstances as the branch, with the same credit rating as the enterprise. These separate-entity rules are interpreted according to OECD guidelines and modifications thereof. The new rules necessitate significant changes in the reporting of cross-border income and perhaps a significant disallowance of branch interest expense.

United States

On May 22, 2002, the IRS launched its new "Advance Pricing Agreement Program" Web site. The site provides program materials, management procedures, and annual and quarterly reports. The program director advises that the site will be kept current and new training materials will be added as they are developed. To access the site, go to http://www.irs.gov; on the left-hand list, click on "business"; on the next page, click on "corporations"; scroll down the centre of the page to "transfer pricing."

Venezuela

Venezuela adopted the 1995 OECD transfer pricing guidelines and will allow advance pricing agreements (APAs) using various methods to determine arm's-length prices. New pricing methods include average export sale price for non-related parties, average wholesale price in the destination country, average retail price in the destination country, and various gain margins determinations. The tax administration (SENIAT) established a new transfer-pricing unit to monitor compliance, coordinate audits, analyze and assess information from all sources, process APAs, and advise on methodologies. This new unit will represent SENIAT at all national and international forums and will negotiate bilateral and multilateral APAs.

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