CANADIAN TAX Highlights

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US Inversions and Interest

US policy makers are focusing on corporate inversion transactions—reincorporation abroad—involving US-based multinational corporations. (See "US Corporate Expats," *Canadian Tax Highlights*, May 28, 2002, at 38.) Recent rumblings suggest that a legislative fix may involve further restrictions to interest-stripping rules. A preliminary Treasury report on inversion transactions dated May 20, 2002 said that the "prevalent use of foreign related-party debt in inversion transactions is evidence that [interest-stripping] rules should be revisited." In a hearing before the House Ways and Means Committee on June 6, 2002, Treasury specifically suggested tightening those rules as a solution. Committee chairman Bill Thomas adopted that proposal in a new bill, the American Competitiveness and Corporate Accountability Act of 2002, introduced on July 11, 2002.

To limit a USco's stripping of earnings out of the United States on foreign related-party debt, current law denies related-party interest expense deductions to the extent that USco's debt-equity ratio exceeds 1.5 to 1 and its otherwise deductible net interest expense exceeds 50 percent of its adjusted taxable income (ATI). ATI is computed without regard to deductions for net interest expense, NOLs, depreciation, amortization, and depletion (Code section 163(j)). Such disallowed interest may be carried forward indefinitely; unused excess limitation—the excess of 50 percent ATI over interest expense—may be carried forward three years.

The Thomas bill modifies existing rules and adds a new interest disallowance rule. The bill includes measures to (1) eliminate the 1.5:1 debt-equity safe harbour; (2) reduce allowable interest from 50 to 35 percent of ATI; (3) limit carryovers of disallowed interest to five years; and (4) eliminate the excess limitation carryover. A new interest disallowance rule precludes related-party interest expense deductions to the extent that a US sub of a foreign parent is more highly levered—has a higher debt-equity ratio—than the worldwide corporate group. Such disallowed amounts cannot be carried over. As between the new and modified interest disallowance rules, the rule yielding the greater disallowance applies.

Although the interest-stripping proposals were introduced in response to inversion transactions, they apply to all foreign-owned companies operating in the United States except for taxable REIT subs. Various effective dates apply. For companies involved in certain inversion transactions completed after 1996, the proposal applies to taxable years ending after March 20, 2002. For non-inverted companies, the proposal is effective for taxable years ending after July 10, 2002 for debt subsequently incurred, and for taxable years beginning after December 31, 2003 for existing debt; the delayed implementation for existing debt allows companies time to adjust debt structures to reflect the new law.

Aside from interest-stripping rule changes, the bill enacts other measures designed to stop inversion transactions, including (1) imposing a three-year moratorium on inversions completed after March 20, 2002 by treating inverted companies as US companies; (2) disallowance of foreign tax credits, NOLs, and other tax attributes to reduce or eliminate the corporate-level gain on the transfer of assets to a foreign entity as part of the inversion transaction; and (3) imposition of a 20 percent excise tax on the value of specified stock-based compensation held by insiders, top executives, and directors when a company inverts (but generally only if US shareholders otherwise recognize a gain on the inversion transaction).

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In This Issue

Please note: Beginning in January 2003, *Canadian Tax Highlights* will move to all-electronic publication. Each month a new issue will be published on the CTF Web site at http://www.ctf.ca. To receive an e-mail notice every time a new issue is published, send your e-mail address to nforrester@ctf.ca.

JCT: Interest Deductibility

The CBA-CICA Joint Committee on Taxation (JCT) recently completed submissions to the CCRA on two key topics relating to interest deductibility: interest on borrowed money used to redeem shares or to pay dividends (IT-80) and interest expense incurred for the purpose of windup or amalgamation (IT-315).

The JCT's submissions conclude that the case law supports the CCRA's administrative positions but not, emphatically, any differentiation between arm's-length and non-arm's-length in the application of IT-315. The JCT submissions add to the CCRA review of its interpretive and administrative positions on interest deductibility, which was recommenced after the SCC decisions in *Singleton* and *Ludco* in late September 2001. Many other decisions have been rendered since then, including *Stewart* and *Walls*. A special JCT subcommittee has been actively involved from the start in the public consultations related to the review. The CCRA is expected to announce the results of its review at the Canadian Tax Foundation's annual conference in September 2002. The JCT submissions will soon be available on the following Web sites: http://www.ctf.ca; http://www.cba.org; and http://www.cica.ca/ga.

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Out of Quebec

Quebec *Information Bulletin* 2002-8, dated July 11, 2002, details proposals that target the use of non-Quebec trusts by Quebec residents to minimize Quebec provincial tax.

The proposals apply to non-Quebec Canadian-resident trusts (designated trusts) and to their designated beneficiaries: beneficiaries who have either alone or with non-arm's-length persons 10 percent or more of the capital or income interests, or income interests of $5,000 or more for the particular year. The proposals' design ensures that a disparity in provincial tax rates does not reduce the provincial tax payable by certain trusts and their beneficiaries. Specifically, Quebec no longer recognizes a federal election made by the trustee to have a designated trust pay tax on income otherwise taxable in the beneficiary's hands: the income attributed to a designated beneficiary by a designated trust for the year is included in his or her income as if such an election had not been made (subsections 104(13.1) and (13.2) of the federal Income Tax Act). To prevent double provincial taxation, the beneficiary may claim a non-refundable tax credit for tax paid to another province by the trust on such income.

Quebec-resident beneficiaries of a designated trust are also subject to new information-reporting requirements in their income tax returns—they must disclose the designated trust's name, the trustee's name and address, the date the taxpayer became a beneficiary, changes in trustee(s), and amounts payable in the year and in respect of which the trustee elected under federal subsection 104(13.1) or (13.2). The proposed trust rules and related information-reporting requirements apply to the 2002 taxation year for individuals and to taxation years ending after July 11, 2002 for corporations.

Quebec emphasized that it will maintain its current administrative position concerning the residence of a trust: if the facts show that Quebec residents exercise a significant portion of the trust assets' control and administration, Quebec will treat such a trust as resident in Quebec, even if those persons are not trustees and the named trustees reside outside Quebec. The proposed reporting requirements will alert Quebec to trusts that may be exposed to being thus deemed resident in Quebec. Quebec will pay particular attention to non-Quebec Canadian trusts with Quebec taxpayer beneficiaries.

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Some Progress

Last year, corporate income tax rate reductions were proposed across the country ("A Work in Progress?" *Canadian Tax Highlights*, May 29, 2001, at 35). This year's budgets introduced two new players—New Brunswick and Nunavut—and slowed the anticipated progress of Ontario and Alberta.

The tables show present and announced rates for the corporate income tax in general and for small business. New proposals for 2003 and 2006 may not be ultimately confirmed by legislation and so are subject to change: revenue considerations may force postponement or permit acceleration. The tables do not show the thresholds below which the low rate of tax is applicable, but, significantly, the rate reductions have usually been accompanied by increases in the amount of income that is taxed at the preferred rates.

In addition to rate changes, a number of governments have introduced or are contemplating reductions in their capital tax rates and increases in the exemption levels.

The rates for 2002 are firm. The rates shown for 2003 may change, and those for 2006 reflect commitments for change made by some provinces; other provinces have yet

Income Tax Rates on General Profits by Calendar Year

	2001	2002	2003	2006
Newfoundland	14.0	14.0	14.0	14.0
Prince Edward Island	16.0	16.0	16.0	16.0
Nova Scotia	16.0	16.0	16.0	16.0
New Brunswick	16.0	15.3	13.0	13.0
Quebec	9.0	9.0	8.9	8.9
Ontario	13.6	12.5	12.5	8.0
Manitoba	17.0	16.5	16.0	15.0
Saskatchewan	17.0	17.0	17.0	17.0
Alberta	14.0	13.2	12.6	8.0
British Columbia	16.5	13.5	13.5	13.5
Yukon	15.0	15.0	15.0	15.0
Northwest Territories	14.0	12.0	12.0	12.0
Nunavut	14.0	12.0	12.0	12.0
Federal	28.1	26.1	25.1	22.1

Income Tax Rates on Small Business Profits by Calendar Year

	2001	2002	2003	2006
Newfoundland	5.0	5.0	5.0	5.0
Prince Edward Island	7.5	7.5	7.5	7.5
Nova Scotia	5.0	5.0	5.0	5.0
New Brunswick	4.0	3.8	3.0	3.0
Quebec	9.0	9.0	8.9	8.9
Ontario	6.4	6.0	5.5	4.0
Manitoba	6.0	5.0	5.0	5.0
Saskatchewan	7.0	6.0	6.0	6.0
Alberta	5.3	4.6	4.1	3.0
British Columbia	4.5	4.5	4.5	4.5
Yukon	6.0	6.0	6.0	6.0
Northwest Territories	5.0	4.0	4.0	4.0
Nunavut	5.0	4.0	4.0	4.0
Federal	13.1	13.1	13.1	13.1

to announce their policy for the next three years. As noted last year, further reductions are almost inevitable, given the competitive nature of business taxation.

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ORST on Software

As promised in the 2002 Ontario budget, the government released draft changes to the Ontario retail sales tax (ORST) rules on computer programs and related services, effective as of their release on July 19, 2002. The changes focus on three key areas—industry-specific definitions, the treatment of modifications, and a new de minimis rule.

The existing definition of "taxable service"—including installation, assembly, repair, and maintenance—is not readily adaptable to software-related services. A software-specific definition of taxable services is proposed: the installation, configuration, modification, or upgrading of a taxable computer program. Each such activity is also defined. A short list of non-taxable services is included for clarification, but is not intended to be exhaustive: it is intended that other non-taxable services listed in ORST Guide 650 retain that status.

A series of fair value provisions is also proposed. Essentially, the fair value of a service contract is the price paid for all the services unless the vendor specifies a separate and reasonable charge for non-taxable components. Under the de minimis rule, the entire contract is non-taxable if its taxable service component measured by the vendor's time spent or cost is 10 percent or less of the non-taxable services. Modifications (defined as changes to the source code) of a taxable pre-written computer program on or after July 19, 2002 to meet a particular customer's requirements are tax-exempt if the cumulative price exceeds the price of the original program. This rule benefits modifications made over an extended time, supplied on a time and material basis, or provided by more than one vendor.

The government's efforts are laudable, but the proposed definitional changes may not offer the simplicity and certainty that businesses need. However, the de minimis rule and changes to the treatment of modifications are definitely steps in the right direction. Many believe that further changes are necessary to protect the IT industry in Ontario. Comments on the draft legislation may be provided to the Corporate and Commodity Taxation Branch of Ontario Finance by August 30, 2002.

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Not Soft on Software

There had been some hope that the Ontario government's support of high technology in Ontario augured well for the elimination of RST on software, or at least on related services. Notwithstanding tax policy considerations, recently announced proposals signal an end to any optimism.

RST is usually unrecoverable, and thus drives up the cost of goods and services sold by Ontario businesses and makes competing in an increasingly global market more problematic. Every dollar of RST collected on computer programs and related services reduces commensurately the ability of Ontario businesses to compete globally or nationally with businesses not subject to unrecoverable taxes. To allow its businesses to remain competitive, Ontario should consider expanding the exemptions available for services to offset an apparent expansion of RST to cover various services. Currently, RST relief is available only for tangible personal property that is acquired for purposes of "being processed, fabricated or manufactured into, attached to, or incorporated into tangible personal property," with no similar relief for purchases (or sales) of services. Furthermore, unlike tangible personal property, services are not easily acquired for "resale"—the acquired services are generally used to provide a more comprehensive service—and often the result is the cascading of RST.

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Blowin' in the Wind

On July 26, Finance announced two proposed changes to the income tax rules affecting Canadian renewable and conservation expenses (CRCE).

Under amendments to income tax regs, the cost of acquiring and installing more than one "test wind turbine" as part of a taxpayer's wind farm qualifies as CRCE for expenses incurred after the announcement date; CRCE status may be elected for previously incurred expenses. A second change is designed to promote the raising of financing for wind electricity projects and qualifying renewable energy and energy conservation projects and the efficient spending of such funds: corporations that incur CRCE pursuant to flowthrough share investments may renounce such expenses to the subscribers on a one-year lookback basis not available under existing rules. Such flowthrough share rules for CRCE projects parallel those for oil and gas and mining, for CRCE incurred after 2002 under flowthrough share agreements signed after July 26, 2002. Enabling legislation will be introduced at the earliest opportunity.

Flowthrough lookback rules allow the corporation one full year to incur expenses renounced and claimed by investors in a previous year under a flowthrough share agreement. The company incurs no penalty if such expenses are incurred before the March following the end of the calendar year in which the renounced expenses were deemed incurred; otherwise, a monthly tax applies on the unspent but renounced amount, probably under part XII.6. Part XII.6 tax is a pseudo-interest charge to the corporation in the form of a tax to compensate the fisc for the accelerated deductions provided to the flowthrough investors in the previous year: renounced but unexpended funds on hand at December 31 of the following year are subject to a 10 percent penalty, and investors are exposed to reassessments eliminating the CRCE claimed.

The 1996 federal budget granted CRCE full deductibility and eligibility for flowthrough share treatment, parallelling Canadian exploration expense in the non-renewable energy sector. The 1997 federal budget expanded the CRCE definition to include the costs of acquiring and installing a "test wind turbine," but only for the "first device at a taxpayer's site." As a result of consultations with industry representatives, the departments of Finance and Natural Resources, and the CCRA, several changes are proposed to the definition of test wind turbines qualifying as CRCE (defined in regs 1219(3) and (1)(g), respectively). The government is also revising the technical guide to CRCE and clarifying the process by which a taxpayer may obtain an advance opinion on whether a device is considered to be a test wind turbine.

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Poison Pills to Boot?

Shareholder rights or "poison pill" plans are a popular means for a corporation to discourage a hostile takeover bid and ensure that its board of directors has sufficient time to obtain the best price for its shareholders. Such rights plans typically take effect only on a triggering event, such as a takeover bid, that allows shareholders to acquire additional common shares at a price that dilutes the hostile acquiror's share position. Until the triggering event, the rights are generally viewed as having nominal value because the strike price for the additional shares exceeds their FMV. Nor do the rights trade apart from the shares until the trigger event; they often expire unexercised. The CCRA's preliminary view is that the receipt of such rights taints a section 86.1 distribution, which must consist "solely of common shares" of the capital stock of another corporation. If the shareholder rights are boot, a rollover is denied on such a foreign spinoff transaction.

In the absence of an opportunity to review a "live file" in an advance ruling request, the CCRA has refused to establish a firm position on the issue. In TI 2002-0122665 and in response to questions at the IFA conference in May 2002, the CCRA indicated that "the receipt of rights under a shareholder rights plan means that such a distribution consists of something other than common shares and is therefore not an 'eligible distribution' under section 86.1." The CCRA also said that, in this determination, unless there is legal support that either the rights are not property separate from the common shares or their issuance is not part of a particular distribution, the rights are separate property; and if they are put in place before a distribution, they are issued as part thereof. Consequently, neither exclusion is met, and the shareholder rights are boot received on the distribution, albeit of nominal value. While recognizing the different wording of section 86.1, the CCRA says that this reasoning may apply to other provisions. Of particular interest are subsections 51(1) and 87(4) and section 85.1, which also do not permit the receipt of boot: for example, subsection 51(1) refers to "no consideration other than shares." Query whether shareholder agreements cause similar concerns.

Arguably, there is no tax mischief: a shareholder rights distribution has a purely commercial purpose and is not an attempt to strip out value to shareholders on a tax-deferred basis, because the rights have no or nominal value and normally expire before exercise. On the separate property issue, the CBA-CICA Joint Committee on Taxation's (JCT's) technical amendments submission to Finance this spring recommended, for greater certainty, that the definition of "share" be amended to include rights under a shareholders' rights plan that do not trade separately from the share itself. Arguably, a shareholder right is simply one in the bundle of rights that constitutes a share: the right cannot be separated from the share and has nominal value until it takes effect on the trigger event. Until the shareholder right exists separately from the share, it is difficult to view it as a separate property. With respect to the timing of the distribution, if the rights plan cannot be implemented immediately after the share distribution, the distribution of shareholder rights arguably follows and is not simultaneous with the share distribution, which is rather the cause of the rights issue. Thus, rollover status is preserved. The CCRA indicated that it would want to understand why the rights are created immediately before a particular distribution and that a review of the ordering of the transactions will take into account any relevant foreign considerations.

The CCRA says that it will provide no administrative exception for poison pill rights in the context of section 86.1. The CCRA encourages taxpayers who are contemplating such transactions to apply for an advance ruling and promises to give such requests high priority. Then the CCRA can examine the shareholder rights plan and the reasons for and mechanics of its implementation, and conclude on the basis of the legal merits of whether the rights are property separate from the share. Until the CCRA obtains a legal opinion in connection with an advance ruling request, or until the definition of "share" is amended, the CCRA will consider the distribution of shareholder rights along with common shares in an otherwise tax-deferred exchange under section 86.1 to be a fully taxable event. The JCT would like the CCRA to review the matter more fully even in the absence of an advance ruling request, and expects to follow up with the CCRA in the fall of 2002.

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Doing Business in Canada

Withholding waiver for PE. A recent technical interpretation (TI) states that the non-resident part XIII tax waiver under regs 805(1) and (2) is required even if the non-resident is subject only to part I income tax because it carries on business through a Canadian permanent establishment (PE) (2002-0132815). Under section 215, a person who pays or credits to a non-resident an amount subject to part XIII must withhold and remit tax to the CCRA. Under reg 805(1), amounts reasonably attributable to the non-resident's business carried on through a Canadian PE do not attract part XIII tax because such income is taxable under part I. Despite this, the TI confirms that only a waiver releases the payer from its obligation to withhold; otherwise, the payer is liable for the unremitted tax and related penalties. Under reg 805(2), the minister "may" permit non-withholding if the non-resident is not taxable under part XIII: the CCRA says that the legislative intent is to allow the minister discretion in granting a waiver, even if he or she is satisfied that part XIII tax does not apply. Parties who make payments such as management fees, rents, and royalties to non-resident corporations operating in Canada through a PE should review whether a waiver is required. The TI may also cause concern if payments for such items as management services, rental premises, or intellectual property are made between corporate group members within Canada—for example, a US parent company with a Canadian branch that provides services to a separate related Canadian corporation.

Selecting a fiscal period for a Canadian branch. Another recent TI deals with the commencement of a foreign bank branch's fiscal period for Canadian tax purposes, but appears to apply to other foreign corporations' startup branch operations in Canada as well (2001-0086027). The TI states that for Canadian tax purposes a non-resident generally need adopt neither the fiscal reporting period used in its home jurisdiction nor a fiscal period commencing with the anniversary of its date of incorporation. Its fiscal period for Canadian tax purposes must commence no later than the day it begins activities in Canada or at any earlier time when the corporation existed. For some Canadian branches of non-resident corporations, an inaugural fiscal period that begins before the commencement of business in Canada may be preferred because some deductions, such as capital cost allowance, are prorated for short taxation years, but any capital tax is payable as if for a full 12-month period without proration. However, a Canadian branch that filed a Canadian tax return for an earlier taxation year may not choose a different taxation year if it resumes business in Canada after a hiatus.

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RHYMES WITH ORANGE ® by Hilary Price

DIVIDENDS PAY DIVIDENDS

The June 17, 2002 Ontario budget marked the end of the 2002 provincial and territorial budget season. As in recent years, the trend toward lower provincial tax rates for individuals and small businesses continues for 2002 in most provinces and territories, but generally at a slower pace.

Top marginal tax rates on employment and other income and capital gains are lower in 2002 than in 2001 for individual residents of British Columbia, Saskatchewan, Quebec, Nunavut, and Yukon. Adjustments to provincial dividend tax credit rates in Manitoba and Newfoundland and Labrador to match their provincial small business tax rates yield higher marginal tax rates on Canadian dividend income in 2002 than in 2001 for those provinces' residents.

Crediting small business as a catalyst for much-needed employment, provincial governments of all political stripes lowered the tax burden for CCPCs earning active business income (ABI). Compared with December 31, 2001 year-ends, small business ABI tax rates are lower in the prairie provinces, Ontario, New Brunswick, the Northwest Territories, and Nunavut. Provincial small business limits are also higher in British Columbia, the prairie provinces, Ontario, and New Brunswick. In Alberta and Ontario, which led a number of provinces in announcing general corporate income tax (CIT) rate reductions in 2001, such decreases will proceed at a slower pace than originally scheduled. Nevertheless, compared with December 31, 2001 year-ends, provincial CIT rates are noticeably lower in British Columbia, Nunavut, Ontario, and the Northwest Territories—by 3, 2, 1.12, and 1.01 percentage points, respectively—with less markedly lower rates in Alberta, Manitoba, and New Brunswick. Measures aimed at reducing corporate capital tax and/or payroll tax burdens were announced by British Columbia, Saskatchewan, Ontario, Quebec, and Newfoundland and Labrador.

February 2000 federal budget proposals (accelerated in the October 2000 mini-budget) eliminated the 5 percent federal deficit surtax for individuals after 2000 and reduced the general federal CIT rate on ABI from 28 to 27 percent for 2001 and a further 2 percentage points each January 1, to 21 percent by 2004. No adjustments have been proposed to the 4 percent federal surtax, the 16 percent federal small business deduction (SBD), or the $200,000 federal maximum business limit. A separate but complementary rate reduction effective for 2001 reduced CCPCs' ABI CIT rate on income between $200,000 and $300,000 to 22.12 percent, the rate that already applies to taxable income that exceeds the $200,000 business limit earned by a business qualifying for the full M & P deduction. As noted in previous articles, the introduction

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

	Ontario	Quebec	BC
		dollars	
ABI eligible for SBD			
Dividends			
Corporate tax	1,912	2,216	1,762
Individual tax	2,535	2,554	2,602
	4,447	4,770	4,364
Salary			
Individual tax	4,552	4,624	4,370
Provincial health levy	191	409	0
	4,743	5,033	4,370
Tax savings of dividend	296	263	6
Tax deferral	2,831	2,817	2,608
ABI: no SBD, no MPD			
Dividends			
Corporate tax	3,862	3,516	3,962
Individual tax	1,924	2,128	1,907
	5,786	5,644	5,869
Salary			
Individual tax	4,552	4,624	4,370
Provincial health levy	191	409	0
	4,743	5,033	4,370
Tax cost of dividend	1,043	611	1,499
Tax deferral	881	1,517	408
ABI: no SBD, full MPD			
Dividends			
Corporate tax	3,312	3,116	3,562
Individual tax	2,096	2,259	2,033
	5,408	5,375	5,595
Salary			
Individual tax	4,552	4,624	4,370
Provincial health levy	191	409	0
	4,743	5,033	4,370
Tax cost of dividend	665	342	1,225
Tax deferral	1,431	1,917	808

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.

of the CCPC rate reduction, combined with assorted provincial changes to small business tax rates, business limits, and clawback thresholds (Ontario only), significantly increased the complexity of determining the appropriate corporate taxable income after reasonable bonuses to active owner-managers. Although the matter is not specifically illustrated in the table, generally a significant deferral now exists for corporately taxed income between $200,000 and $300,000; however, based on current top marginal tax rates, a tax cost attaches to such income distributed to the owner-manager as taxable dividends.

As in prior years, strictly on rates, in 2002 owner-managers benefit from a significant tax deferral and some tax savings on the payment of dividends in lieu of salary if the underlying corporate income is ABI eligible for the SBD. If the ABI is eligible for neither the SBD nor the MPD, a deferral exists in all jurisdictions except Alberta. Generally, following the actual distribution, a significant tax cost arises that varies by province or territory; however, a prolonged deferral may outweigh the ultimate cost. Numerous other factors must also be considered in deciding an owner-manager's salary-dividend mix. (See "Dividends Still Preferred," *Canadian Tax Highlights*, July 24, 2001, at 54-55.) As capital gains are taxed more favourably than dividends for top marginal rate individuals, converting dividends into capital gains may increase the tax savings, or decrease the tax cost, of distributing corporately taxed ABI.

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A New Obligation

In *General Electric Capital Equipment Finance*, the FCA decided that new agreements were so materially altered that they created new obligations (2000 DTC 6734).

IHCC financed retail sales of a related company, International Harvester. To raise capital, IHCC issued four subordinated promissory notes, with terms of at least five years in favour of three foreign corporations that were, like IHCC, members of the IHco group. Because the noteholders were non-arm's-length with IHCC, the withholding exemption in subparagraph 212(1)(b)(vii) was not met. IHCC did not withhold on the interest, but paid the withholding tax on reassessment. In agreements dated February 18, 1985, each noteholder sold its note to a Netherlands company, Harneth, which the minister did not dispute was at arm's length with IHCC. The agreements varied each note's interest rate so that net of withholding the yield equalled the rate on the note's face; each principal amount was reduced by the withholding tax paid by IHCC following the reassessment; and each maturity date was extended.

In December 1986, IHCC's shares were sold to an arm's-length party. IHCC paid Harneth all interest without withholding. The CCRA assessed IHCC (now known as GEC), which argued that the interest was paid to an arm's-length party and the notes' original terms qualified for exemption under subparagraph 212(1)(b)(vii). GEC also argued that an existing obligation can be superseded only by way of novation. The CCRA said that the 1985 amendments rescinded the original notes; the new obligations were not exempt because they matured less than five years after the fresh start. According to the FCA, of the fundamental terms—the identity of the debtor, the principal amount of the note, the amount of interest thereunder, and its maturity date—all but one were changed. IHCC was also obliged to pay more than 25 percent of the principal within five years of the 1985 issue date. When "substantial changes . . . materially alter the [fundamental] terms of [an] obligation, then a new obligation is created within the meaning of subparagraph 212(1)(b)(vii)." The provision does not refer to novation, and the FCA noted that "because novation is an issue of fact, whether or not a new obligation has been created is also, by analogy, a question of fact."

Both the FCA and the FCTD attached importance to the fact that the principal amount was reduced to offset withholding taxes paid, but neither court discussed subsection 215(6), which allows the payer to "deduct or withhold from any amount paid or credited" to the non-resident in order to collect withholding tax paid. *GEC* seems to confirm the CCRA's position in IT-448 and *Technical News No. 14*: "[A] rescission of a debt obligation will be implied when the parties have effected such an alteration of its terms as to substitute a new obligation in its place, which is entirely inconsistent with the old, or, if not entirely inconsistent with it, to an extent that goes to the very root of it." Taxpayers should be wary of changes to the terms of a loan even if the obligor remains unchanged.

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Vendor Collection of RST

Some question has always existed as to whether a vendor can collect retail sales tax (RST) from a purchaser long after the RST-taxable sales transaction occurred.

Typically, a vendor has failed to collect RST at the time of the sale as required by most retail sales tax acts and is assessed for a non-collection penalty (see, for example, sections 2(6), 10, and 12, and section 20(3), respectively, of the Ontario act). The purchaser is often unsure whether to reimburse the vendor, especially if the purchaser is also running close to the four-year limitation period for assessment and will be able to defend against any assessment to recover the RST unpaid. Ontario's administrative policy of assessing only one of the vendor and purchaser also works in the purchaser's favour, because the purchaser may be generally confident that it will not be assessed if the vendor is assessed a non-collection penalty, which is equal in amount to the original RST. Thus the purchaser often need only concern itself with whether it must now pay the vendor the amount of RST that should have been collected at the time of sale if the vendor has

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been assessed a non-collection penalty. It appears that the purchaser is under no obligation to indemnify the vendor, barring a contractual obligation to do so. This is especially true if the vendor is trying to force reimbursement of the penalty rather than the tax.

A recent case in British Columbia deals with this issue directly and seems to suggest that there may well be a hiatus in the Ontario act. In *IRL Truck Centre Ltd. v. Troga Contracting Ltd.*, the British Columbia Supreme Court considered an action brought by a vendor to recover a non-collection penalty imposed under section 115(5) of the BC Social Services Tax Act ("the BC act"), which is similar to section 20(3) of the Ontario act. In *IRL*, the vendor sold two trucks to Troga and neglected to collect the RST: the fact that Troga's principal was a status Indian suggested to the vendor that the exemption for status Indians applied to the corporation too. IRL paid the penalty and brought an action against Troga for reimbursement thereof. A newly enacted provision of the BC act allows such actions and was in force when the penalty was assessed: persons subject to such penalties could, "in a court of competent jurisdiction, sue the person who was liable to pay the tax in order to recover the amount imposed [as penalty]" (section 115(7)). The BC Supreme Court concluded that the new provision applied and that IRL could collect the amount of the penalty from Troga.

The decision in *IRL* leaves the impression that absent the new express provision in the BC act, IRL would not have been successful. As a consequence, Ontario vendors trying to recover amounts paid under section 20(3), or perhaps trying to collect RST from purchasers well after the time it was due to be collected under the statute, may find themselves without a remedy. It is certainly noteworthy that British Columbia has seen fit to amend its legislation. Similarly, the federal government expressly dealt with this issue in the GST legislation and included a statutory claim-over right to suppliers for uncollected GST (section 224 of the Excise Tax Act).

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Foreign Tax News

Treaties

A treaty with Moldova, signed on July 4, 2002, enters into force on the day the last notification of ratification is received. Withholding rates are 15 percent for dividends and 10 percent for interest and royalties. Withholding rates are effective on January 1 in the calendar year following ratification; other taxes are affected for taxation years beginning on or after that day.

Status of Canada's Tax Treaties

In force (76)

Algeria
Argentina
Australia
Austria
Bangladesh
Barbados
Belgium
Brazil
Bulgaria
Cameroon
Chile
China (PRC)[1]
Croatia
Cyprus
Czech Republic[2]
Denmark
Dominican Republic
Ecuador
Egypt
Estonia
Finland
France
Germany
Guyana
Hungary
Iceland
India
Indonesia
Ireland
Israel
Italy
Ivory Coast
Jamaica
Japan
Jordan
Kazakhstan
Kenya
Korea, Republic of
Kyrgyzstan
Latvia
Lithuania
Luxembourg
Malaysia
Malta
Mexico
Morocco
Netherlands
New Zealand
Nigeria
Norway
Pakistan
Papua New Guinea
Philippines
Poland
Portugal
Romania
Russia
Singapore
Slovak Republic
Slovenia[2, 3]
South Africa
Spain
Sri Lanka
Sweden
Switzerland
Tanzania
Thailand
Trinidad & Tobago
Tunisia
Ukraine
United Kingdom
United States
Uzbekistan
Vietnam
Zambia
Zimbabwe

Signed but not yet in force (12)

Australia
Belgium[2]
Italy[2]
Kuwait
Lebanon
Moldova[2]
Mongolia[2]
Norway[2]
Peru
Senegal
United Arab Emirates[2]
Venezuela

Under negotiation/renegotiation (17)

Armenia
Azerbaijan
Barbados
China (PRC)
Colombia
Egypt
Gabon
Greece
Ireland
Mauritius
Mexico
Norway
Romania
Saint Lucia
Turkey
United Kingdom
United States

[1] This convention does not apply to Hong Kong. [2] Recent change. [3] Expected to enter into force on August 12, 2002.
Source: Finance Canada, 2002-07-23.

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