Canadian Tax Highlights

Editor: Vivien Morgan, LL.B.

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Provincial Residency

For the first time, the CCRA has released guidelines for determining whether an individual is resident in one province or another. *Interpretation Bulletin* IT-221R3, "Determination of an Individual's Residence," now indicates that the IT's guidelines for residence in Canada will also be used to determine an individual's provincial residency.

With significant differences between provincial tax rates increasing as provinces gain more autonomy in their personal tax systems, an individual's province of residence is becoming more important in personal tax planning, and consequently is attracting more attention from the CCRA. (See "Provincial PIT Rates," *Canadian Tax Highlights*, July 23, 2002, at 55.) A revised draft IT issued on August 22, 2002 includes two new paragraphs to clarify how the IT's criteria apply in determining an individual's provincial residence for provincial income tax purposes. (The previous draft IT was released on December 21, 2001.)

Generally, an individual is subject to provincial tax in the province where he or she resides on December 31 of the particular year. According to the IT, an individual is considered resident in the province where he or she has significant residential ties (as discussed in IT paragraphs 4-9). In some cases, an individual is considered resident in more than one province on December 31 of a particular year, usually if an individual is physically residing on December 31 in a province other than where he or she ordinarily resides (for example, while on a temporary job posting or pursuing post-secondary education). An individual who resides in more than one province on December 31 of a particular year is considered resident only in the province where he or she has the most significant residential ties, including the location of an individual's dwelling place, spouse or common law partner, and dependants.

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CCRA's GST E-Biz Bulletin

In November 2001, a CCRA discussion paper on GST/HST and electronic commerce was circulated and public comment was invited. Recently released bulletin 090 summarizes the CCRA's final position.

One of the more significant bulletin discussions is the determination of whether a non-resident is carrying on business in Canada, which has a direct impact on GST/HST registration requirements. The discussion paper first de-emphasized the places of contract and of operations as key factors in the carrying-on-business analysis, and moved to a system that emphasizes equally other factors such as location of inventory, location of employees, and place of delivery. ("CCRA's GST E-Biz Paper," *Canadian Tax Highlights*, January 29, 2002, at 7.) Concerns were expressed at the time that this shift increased uncertainty because the weight ascribed to each factor would be subjective. The bulletin reiterates the list of factors and states that the importance of each factor varies according to the circumstances. The bulletin goes on to say that the factors are relevant to the carrying-on-business analysis in both the traditional and the electronic commerce environments, seemingly ignoring case law to the effect that, in the traditional context, the places of contract and of operations are the key determinants.

The bulletin also presents a comprehensive list of electronically delivered supplies that the CCRA has categorized for GST/HST purposes, with potential to affect where a supply is made and the rate of tax. Some supplies not definitively characterized in the discussion paper are now classified as intangible personal property, including data retrieval, the right to access an interactive Web site, and customized information delivery.

The bulletin confirms the paper's somewhat contentious characterization of the remote supply of certain services as services performed in whole or in part in Canada: if something is done to or with a recipient's equipment in Canada via access from a remote location outside Canada, the service is viewed as performed at least in part in Canada. GST/HST may be charged by a GST-registered vendor on the supply even if none of it is physically

In This Issue

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performed in Canada. Debate on this and other issues in the bulletin will no doubt continue.

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European Tax Cases

France. On June 28, 2002, France's highest tax court, the Conseil d'État, held in *Schneider* that its Swiss treaty overrules its foreign affiliate (FA) rules, which levy income tax on profits earned abroad by a French-resident company. The court said that those rules did not apply to an FA in a country with which France has concluded an OECD-model-based treaty, unless specifically so provided. Many French treaties—including those with Canada, the United States, and a dozen other countries—contain FA rule overrides. Absent such a provision in France's Swiss treaty, the court concluded that article 7 thereof did not permit France to tax the Swiss FA's business profits, rejecting the argument that the business income's deemed dividend status under the FA rules prevailed. Owing to this decision and possible infringements on EU regulations, new FA rules are expected to be drafted soon and perhaps included in the Finance Act for 2003.

Italy. The Supreme Court recently enunciated criteria to determine the existence of a permanent establishment in Italy, in the context of whether an Italian sub of Philip Morris was a PE of several non-Italian corporate group members. The matter was remanded back to the Tax Court for a decision based on the Supreme Court's criteria, which seem to support the conclusion that the Italian sub was a PE: the sub regularly engaged in activities outside its normal business on behalf of, and in the exclusive interest of, non-resident group members; its management office's activities were not preparatory or auxiliary; the Italian sub participated in negotiations between related non-resident companies and Italian governmental agencies; and its activities on behalf of foreign group entities may lead to the existence of a PE of each of these entities. The issue related to VAT, but the reasoning is likely also relevant for income tax purposes. Multinationals operating in Italy should carefully review the activities performed by their Italian subs on behalf of related entities.

Germany. The Federal Tax Court gave its first ruling on the anti-treaty-shopping provisions in the income tax code. A Dutch BV was interposed between a German GmbH and a Bermudan company that was owned by Bermudan-, Australian-, and US-resident individuals. The German GmbH distributed a dividend to the BV, which requested a refund of the difference between the 25 percent domestic withholding rate and the 5 percent rate under the Germany-Netherlands treaty (the 0 percent rate under the EU parent-subsidiary directive was not yet in effect). German tax authorities challenged the reduced dividend withholding rate on the proportion of shares ultimately held not only by the Bermudan individual, but also by residents in other countries. The court held that the general and specific anti-abuse provisions apply to holding companies situated in tax havens and in other countries such as the Netherlands if a structure is manipulative and lacks a business purpose: the mere holding of a GmbH's shares was not sufficient to constitute business or economic activity.

A subsequent lower court decision also applied substance requirements to deny reduced withholdings on payments to a Dutch BV holding company with respect to the EU parent-sub directive. These decisions serve as warnings that German courts are willing to look through holding structures that lack sound business purposes. Furthermore, contrary to what many German tax practitioners would have predicted, the earlier decision did not look through the Bermuda company but only through those entities considered abusive. As a result, the ultimate shareholders may not benefit from the withholding rate under Germany's treaty with their country of residence.

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One Size Does Not Fit All

Now that everyone has filled out personal income tax forms under the TONI (tax-on-income) system, the justification for the extra paperwork needs to be reinforced. Provincial economic circumstances still vary widely, variations inadequately reflected in the federal rate structure for many years. Surtaxes and low-income relief measures, long a feature of provincial income taxes, can now be more transparent and effective under TONI.

The table shows that 5.4 percent of all taxpayers paid the federal surtax in the 2000 tax year, a national average that hides provincial discrepancies: high-income taxpayers, as defined for the federal surtax, accounted for 2.5 percent or less of all taxpayers in Newfoundland and Prince Edward Island, but for 6.9 and 6.8 percent, respectively, in Ontario and Alberta. The table also shows the surtax payable as a percentage of all federal tax payable. Across the nation, the surtax accounted for only 1.0 percent of all collections, ranging from a low of 0.5 percent in Prince Edward Island and the territories to a high of 1.3 percent in Ontario. The variation shown at the top end of the income scale is mirrored at the bottom. Taxable returns accounted for only 59.0 percent of all returns in Newfoundland in 2000 but for 70.8 percent in Alberta. That is, 4 out of 10 Newfoundland tax filers fell below the threshold for federal income taxation, but only 3 in 10 Albertans had income too low

Taxable Personal Income Tax Returns Paying Federal Surtax, 2000 Taxation Year

		Federal surtax		
	Number	As % of all taxpayers	$ millions	As % of all federal tax
Nfld.	5,520	2.5	4,939	0.6
PEI	1,450	2.2	1,211	0.5
NS	14,960	3.5	13,675	0.7
NB	9,610	2.7	8,579	0.6
Que.	143,030	3.9	144,111	0.8
Ont.	388,340	6.9	482,637	1.3
Man.	17,420	3.2	18,364	0.7
Sask.	13,700	2.9	11,026	0.6
Alta.	101,880	6.8	120,945	1.2
BC	90,610	4.9	96,521	0.9
Territories	2,300	5.8	1,186	0.5
Total or average	790,860	5.4	908,128	1.0

to pay tax. Average income for all taxpayers in Prince Edward Island amounted to $31,900, compared with $46,300 in Ontario.

While the federal tax system can absorb such regional differences, no province can average across the country. When provincial income tax started with tax calculated under the federal rate and credit structure, considerable ingenuity was needed to produce a fair provincial tax system that raised the required revenue. With separate rate schedules and non-refundable credits, it is easier to set the tax threshold and progressivity to reflect provincial conditions.

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US Tax Shelter Rules

New Treasury regs modify rules that affect persons who participate in certain transactions and persons who are responsible for registering tax shelters or for maintaining investor lists in potentially abusive tax shelters. These regs are part of Treasury's initiative to combat abusive tax-avoidance transactions, both through administrative action and through legislation intended to enhance the current enforcement regime and detection at the earliest opportunity and to curtail the use of such avoidance transactions. Non-compliance penalties exist for the disclosure, registration, and list maintenance requirements, which are intended to maximize the sources of information about transactions in order to increase the opportunity for IRS scrutiny and challenge.

Promoters must register with the IRS transactions that either will generate a certain level of tax benefit or are corporate tax-avoidance transactions marketed on a confidential basis (section 6111). Promoters must also maintain lists of investors in registered transactions and other potential tax-avoidance transactions (section 6112). Under previous section 6011 regs, corporate taxpayers were required to disclose on their tax returns transactions that were identified by the IRS as tax-avoidance transactions or that had certain characteristics common thereto. Recent modifications to those regs, such as expanding disclosure to non-corporate taxpayers, are intended to further deter perceived efforts by promoters and taxpayers to avoid IRS scrutiny.

Now individuals, trusts, partnerships, and S corporations that have participated, directly or indirectly, in certain reportable transactions—listed transactions—must also file. A listed transaction is one that the IRS has publicly identified as a tax-avoidance transaction or a "substantially similar" transaction, a phrase that must be construed broadly in favour of disclosure. A corporate taxpayer must also report transactions that meet certain criteria and a projected tax-effect test. (Filing a disclosure statement does not affect whether tax benefits are allowable.) Disclosure statements must meet specific guidelines and must be filed even if some type of disclosure is made under other published guidance and may duplicate reporting (such as for a partnership and its partners). If a transaction becomes reportable after the taxpayer has filed a return for the first year affected, a statement must be filed with the next return.

Section 6111 requires any tax shelter organizer to register the tax shelter not later than the day the first interest is offered for sale; anyone who sells or otherwise transfers an interest must furnish the identification number to the acquiror for inclusion in the investor's return when tax benefits are claimed. In addition, registration requirements for certain confidential arrangements apply to promoters and to potential investors. A tax shelter is defined to include any entity, plan, arrangement, or transaction a significant purpose of which is the avoidance or evasion of federal income tax for a direct or indirect corporate participant that is offered to any potential participant under conditions of confidentiality, and for which the tax shelter promoters may receive fees exceeding $100,000. "Promoter" means any person or any related person who participates in the shelter's organization, management, or sales. Interestingly, if the organizer does not register a confidential arrangement as a tax shelter and no promoter is a US person, then each US person who discussed participation therein must register the arrangement, unless he or she notified the promoter in writing, no later than 90 days after such discussions began, that he or she would not participate in the shelter. The regulations describe the registration procedures.

In addition, any person who organizes any potentially abusive tax shelter or sells any interest therein must maintain a list identifying each acquiror. Such a tax shelter is one for which registration is required and any entity, investment plan or arrangement, or other plan or arrangement of a type determined under regulations to have a potential for tax avoidance or evasion.

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De Facto Control

The courts have struggled to define de facto control, and its recognition in subsection 265(5.1) has not served to lift the concept from its fact dependence or make its application any less uncertain.

Interpretation Bulletin IT-64R4 says that a de facto controller of a corporation need not own its shares. Other relevant factors are the percentage of ownership of voting shares; ownership of a large debt of a corporation that may be payable on demand; shareholder agreements; commercial or contractual relationships of the corporation—for example, economic dependence on a single supplier or customer; possession of a unique expertise required to operate the business; and the influence that one family-member shareholder may have over another. These administrative guidelines were considered by the TCC recently in *Mimetix Pharmaceuticals* in determining whether Mimetix was a CCPC—defined in terms of the de facto control rule—and could thus claim refundable and enhanced ITCs (2001 DTC 1026). The court concluded that a non-resident corporation, which owned half of Mimetix's issued shares, had de facto control: it was the only investor in Mimetix's business at the relevant time and was therefore "in a position to exert the kind of pressure that enabled it to have its will prevail with respect to that business." The TCC referred to the IT's factors; while it is not clear whether the court approved them all, the decision clearly confirms the CCRA's position on the economic dependence factor.

More recently, in *Rosario Poirier*, the TCC considered the association of Rosario Poirier (RP) and Trab, both of which claimed the small business deduction. RP was in the trucking and sawmill business, and its shareholders were Mr. Poirier and his son Luc, who was also a director and employee. With the help of his father, Luc became the sole shareholder of Trab, which owned an old truck and timber transportation permit. Mr. Poirier helped Trab find clients; Luc was not very active in its day-to-day business. RP was Trab's major client; it accounted for 88 to 100 percent of Trab's revenues in the years in dispute and paid for Trab's operating expenses. By resolution, Trab's sole director (Luc) gave Mr. Poirier and his wife authority to sign necessary documents and make decisions relating to Trab. Not surprisingly, the TCC found that RP had de facto control of Trab. The court relied heavily on the fact of Trab's economic dependence, even though RP owned no shares in Trab. The court also said that each of a de facto and a de jure controller could control a corporation, a position left open by the TCC in *Miller Estate* (2002 DTC 1228). The TCC's heavy reliance on the economic-dependence factor gives the CCRA additional ammunition to assess a broader range of taxpayers. *Rosario* also reinforces taxpayers' fears that subsection 256(5.1)'s broad reach may lead to unpredictable results and places a perhaps insurmountable burden on taxpayers to disprove an assumption that significant influence amounted to control in fact.

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Inbound Financing's Substance

An IRS field service advice (FSA) contained good news for an inbound double-dip financing technique involving hybrid debt often used by US companies to finance Canadian acquisitions directly or through their Canadian subs (FSA 200206010, November 1, 2001 [2002 TNT 28-15]). The FSA concluded that a first-tier Canadian sub's common stock given in lieu of interest to a Canadian branch of the US parent (USP) was not taxable income.

Although it is not clear from the FSA, the USP probably held all the shares in a Nova Scotia unlimited liability company (ULC 1), a transparency for US tax purposes. ULC 1's borrowings from unrelated US lenders (loan 1) were structured to qualify for a Canadian withholding tax exemption under the 5/25 rule. ULC 1 on-loaned the proceeds (the hybrid loan) to a sister Canadian sub (Canco), which used the funds to earn income from business. Interest on the hybrid loan was payable to ULC 1 in Canco common stock. ULC1 simultaneously entered into a forward purchase agreement to buy more shares of Canco in an amount equal to the hybrid loan's principal on maturity. In its US corporate income tax return, USP took the position that the hybrid loan and the forward contract between ULC 1 and Canco should be integrated, and it treated the payments in stock as non-taxable stock dividends, allowing it to deduct interest on loan 1 without recognizing offsetting income from the hybrid loan. (For Canadian tax purposes, the hybrid loan is debt; hence its name.) The IRS agreed with USP: the hybrid loan was essentially an equity contribution in exchange for Canco stock. The IRS analysis considered several issues.

■ USP met the case law standards that allowed it to disavow the form of its transactions (*Estate of Durkin*, 99 USTC 561 (1992) and *Taiyo Hawaii*, 108 USTC 590 (1997)). The IRS noted that USP was consistent in its treatment of the transactions and reported them on its tax return as though they were integrated; it was not unilaterally attempting to recast the transactions with the benefit of hindsight; and it was not unjustly enriched by disavowing the transactions' chosen form.

■ The hybrid loan's equity characteristics clearly outweighed its debt characteristics under a multi-factor test (*Estate of Mixon*, 464 F. 2d 394 (5th Cir. 1972)). Assuming that the forward purchase agreement could be stepped together with the hybrid loan, the transactions indicated an equity contribution because the funds were used to acquire additional stock in the Canadian sub at maturity. The fact that principal and interest payments on the hybrid loan were payable only in debtor stock invoked authoritative precedent to treat the purported debt as equity. (See, for example, Notice 94-47, 1994-1 CB 357.)

■ The IRS concluded that a US court would use at least one of three tests to determine whether the step transaction doctrine applied to determine the substance: (1) the binding commitment test, (2) the mutual interdependence test, and (3) the end result test.

From a Canadian income tax perspective, ULC 1 earns a small spread on which it is taxable: interest income on the hybrid loan is virtually offset by interest expense on its borrowings on loan 1. The Act does not require that interest be paid or payable in cash; rather, there must be an "amount" payable, which is defined to include money and "rights or things described in terms of money or the value in terms of money of the right or thing." A share issue can constitute payment of a corporate liability (see *Ward*, [1998] 435 ETC (TCC)). Thus, Canco should be entitled to an interest deduction for the treasury shares issued to ULC 1. However, to the extent that the shares' FMV is less than the amount of the interest payable, the forgiveness-of-debt provisions may apply to Canco; alternatively, any excess of the amount added to share capital on the shares' issuance over their FMV may reduce the interest deductible to Canco. Taxpayers that design and implement hybrid loan transactions should seek expert advice: there are many other attributes and rights built into the instruments themselves that are essential to achieve the desired income tax results.

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Non-Competes: Not Section 14?

Arguably, an amount payable under a non-compete agreement (NCA) on the direct sale of a business—an asset sale—is not taxable under section 14. The 1996 TCC *Fortino* decision, affirmed by the FCA, held that section 14 does not apply to an NCA receipt connected with a share sale because the payment is not made in respect of a business of the taxpayer. This analysis is not applicable in a sale of assets. The CCRA has consistently said that an NCA receipt on a sale of assets is taxable under section 14 as an eligible capital amount (ECA) in respect of the sale of goodwill. On closer analysis, such a receipt arguably fails the mirror-image test in section 14.

If a taxpayer receives an ECA in respect of a business, section 14 brings into income two-thirds of the amount. An ECA is generally three-quarters of the amount that the taxpayer is entitled to receive if the consideration given (for example, the non-compete covenant) was such that, if a payment had been made by the taxpayer for that consideration, the payment would have been an eligible capital expenditure (ECE). An ECE is generally a capital expenditure incurred to earn income from a business that is not otherwise deductible.

The recent TCC decision in *Toronto Refiners* cites *Goodwin Johnson* and *Pe Ben*, saying that the actual circumstances of the payer must be taken into account in

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applying the mirror-image test. When this approach is applied to an NCA receipt associated with a sale of assets, the question is: If a payment had been made by the taxpayer—notionally in the position of the payer who actually paid the amount—for the non-compete covenant, would the payment have been an ECE to the taxpayer? In order to be an ECE, this notional payment must be a capital, not a current, expense.

Jurisprudence on the capital-income distinction has long held that the issue is whether the expenditure relates to the business entity itself or to the process by which the business operates to earn a profit (*Canada Starch*). Cases such as *Oxford Shopping Centres* and *Algoma Central* held that expenses are on current account if they are made to enhance the prospects of competing by directing customers to a business. Such expenses relate to a revenue aspect of a capital asset (the business), as distinct from expenses to preserve a capital aspect of a capital asset (*Premium Iron Ores*). A payment for a non-compete covenant is not readily seen as the latter; the payer's main objective is to maximize profits by enhancing the ability of the business to compete. Accordingly, an NCA receipt arguably fails the mirror-image test for ECA characterization.

The recent FCA decision in *Gifford* does not address section 14, but holds that a one-time expenditure by one employee to another to purchase his client base is on capital account. The FCA rejected the TCC's position that the expenditure was on current account because the cost of attracting clients is part of the recurring cost of earning income and must be satisfied out of revenues generated. Notwithstanding that the agreement in issue in *Gifford* provided that the vendor of the list would not provide securities investment advice to the listed clients for 30 months, the court's conclusion should not apply to a payment under an NCA. First, a one-time payment for a client list and a one-time payment for a non-compete covenant differ. A payment for a client list relates more to the establishment or structure of a business than to the sustained effort of carrying on a business; a payment for a covenant not to compete relates more to the latter. Second, *Gifford* suggests that an agreement by the vendor of the list not to provide advice for a term is essentially an implicit endorsement of the purchaser; the value of such an endorsement may be short-lived if the clients switch to someone else, in which case expenses in the ongoing struggle to satisfy the clients are deductible. In contrast, a non-compete covenant is not an endorsement: competition is fundamental to the ongoing profit operations of a business, as distinct from a defined list of clients, which is nothing more than a starting point for generating business. Third, the facts in *Gifford* may be distinguishable from a one-time payment for a non-compete covenant because, in a long line of cases since *Canadian Deposit Insurance*, courts have consistently declined to bifurcate contracts.

The options are narrowing for the characterization of an NCA receipt as taxable. For an individual, an NCA receipt should not be income from office or employment because it is not remuneration for services. Nor should it be considered income from a business or property in the context of a business because it relates not to the business but rather to a covenant in respect thereof; it does not represent a return on this covenant but is a one-time payment in exchange therefor. *Fortino* held that if an NCA receipt is associated with a share sale, it should not be considered income from a source under section 3; consideration for warranties, covenants, or other conditional or contingent obligations under section 42; or an ECA taxable under section 14. The above analysis suggests that an NCA receipt associated with a sale of assets should not be considered an ECA taxable under section 14. What remains to be determined is whether an NCA receipt is correctly characterized as proceeds of disposition from the sale of capital property, a conclusion reached by the TCC in *Manrell* regarding an NCA receipt associated with a share sale. The FCA will soon hear the *Manrell* appeal. It is hoped that the FCA will adopt an approach similar to the TCC's in *Ipsco*, where the court found a settlement to be non-taxable and commented that "legislation weighing more than a kilogram does not have room in it for liberal, general interpretation."

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Holdco: Six Feet Under?

Jean Chrétien's desire to preside over two more federal budgets pre-retirement does not necessarily presage personal and corporate tax relief: in the creation of a legacy or the securing of leadership support, Canada's tax competitiveness does not have the same gravitas as new or enhanced social programs. Add to that diminished short-term federal surpluses—following from the economic slowdown and significant budgetary pressures on the spending side—and additional near-term federal tax relief seems unlikely. The provinces and territories, also under significant budgetary pressures, are unlikely to deliver more short-term relief. Nevertheless, compared with December 31, 2001 year-ends, general corporate income tax (CIT) rates are lower in a number of jurisdictions. Absent personal income tax rate changes, lower CIT rates generally reduce the cost of earning interest and capital gains through a holdco.

As in 2001, tax deferrals no longer exist in any jurisdiction for interest income and capital gains. In addition, the top personal marginal tax rate on dividend income for all jurisdictions (save for Manitoba and Newfoundland and Labrador) is lower than the federal part IV tax rate, creating a negative tax deferral (from a low of about 0.52 percent in Quebec up to 9.25 percent in Alberta). Accordingly, maximizing a holdco's dividend refund generally becomes an important consideration. To avoid trapped RDTOH in the corporation and to achieve the lowest overall combined tax on capital gains in most jurisdictions, it may be prudent to maximize the dividend refund by paying a sufficient taxable dividend, not maximizing the capital dividend. The use of a demand promissory note for both corporately taxed capital gains and interest income may be considered when cash is insufficient for a dividend distribution.

Only Saskatchewan will reduce its top marginal tax rate for individuals for 2003 and following years. However, taxpayers in other jurisdictions who are planning significant taxable dividends to maximize RDTOH refunds may wish to pay taxable dividends early in 2003 to allow shareholders to benefit from a personal income tax deferral and from possible reductions to provincial and territorial marginal tax rates in the 2003-4 provincial and territorial budgets.

The table shows that earning investment income in a corporation in 2002 creates a tax cost for interest income ranging from about 0.3 percent to about 4.2 percent for Ontario- and BC-resident individuals and holdcos, respectively, and one-half those amounts for capital gains. As in prior years, strictly on rates, an individual will prefer to earn investment income personally rather than through a holdco. However, as general CIT rates continue to fall in selected jurisdictions, earning investment income through a CCPC may result in future tax savings (as, for example, for Ontario residents after 2003), absent future decreases in top marginal tax rates. Numerous other factors must also be considered. (See "Holdco Future Resurrection?" *Canadian Tax Highlights*, August 28, 2001, at 59.)

Quebec-resident individuals need to consider Quebec AMT (QAMT) on their investment income. As was discussed in earlier articles, unless a Quebec-resident individual has sufficient other income taxed at ordinary rates, he or she may suffer QAMT on taxable dividends from Canadian-resident corporations and on capital gains. Because 100 percent of Canadian dividends and 70 percent of capital gains are QAMT taxable, the QAMT's cost may exceed 3.5 percent of actual dividends received and equal 2.0 percent of the capital gains realized for 2002 and following years. QAMT may become a permanent tax if the individual either does not earn sufficient income within the seven-year carryforward period for QAMT credits or relocates to a tax-friendlier jurisdiction; thus, Quebec residents should consider deferring the receipt of taxable dividends to a year when they have sufficient other income taxed at ordinary rates. The use of a non-Quebec Canadian-resident trust to reduce an individual's overall provincial tax bill for investment income was dealt a blow by the announcement in *Quebec Information Bulletin* 2002-8 (July 11, 2002) that Quebec-resident beneficiaries of such trusts are now effectively taxed at Quebec rates.

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

	Ontario	Quebec	BC
		dollars	
Portfolio dividends			
Corporate tax	3,333	3,333	3,333
Refundable tax	(3,333)	(3,333)	(3,333)
Individual tax on dividend	3,134	3,281	3,158
Combined tax	3,134	3,281	3,158
Individual tax	3,134	3,281	3,158
Tax cost with Holdco	—	—	—
Tax deferral with Holdco	(199)	(52)	(175)
Capital gains			
Corporate tax	2,414	2,615	2,464
Refundable tax	(1,333)	(1,333)	(1,333)
Individual tax on dividend	1,253	1,312	1,263
Combined tax	2,334	2,594	2,394
Individual tax	2,320	2,411	2,185
Tax cost with Holdco	14	183	209
Tax deferral with Holdco	(94)	(204)	(279)
Interest			
Corporate tax	4,829	5,230	4,929
Refundable tax	(2,667)	(2,667)	(2,667)
Individual tax on dividend	2,507	2,625	2,527
Combined tax	4,669	5,188	4,789
Individual tax	4,641	4,822	4,370
Tax cost with Holdco	28	366	419
Tax deferral with Holdco	(188)	(408)	(559)

Note: The figures assume that (1) the individual is taxed at the top marginal tax rate, (2) the capital gains deductions for qualifying small business corporation shares or qualified farm property are not available, and (3) the taxable dividend paid is sufficient to generate the full refund of the refundable tax. In addition, the Quebec combined tax amounts include the 1.60% Quebec Youth Fund corporate surtax. It is also assumed that the Quebec-resident individual has sufficient other income to avoid having a net AMT liability arising from the receipt of taxable dividends or realization of capital gains.

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FREQUENT FLYER AWARDS

If an employee or family member uses airline points earned on employer-paid business trips to obtain air travel for personal trips or other benefits, their FMV is included in the employee's income. *Interpretation Bulletin* IT-470R does not identify the "other benefits," which may include upgraded seating, discounted travel, travel-related services, or promotional benefits such as car rental or hotel points: the latter can yield a wide range of free or discounted hotel or resort accommodations and luxury room upgrades.

In *Mommersteeg and Giffen*, the TCC noted the onerous restrictions imposed on reward plane tickets and the fact that economy class prices, which fall in a broad band, vary inversely with the number of restrictions attached to the ticket (96 DTC 1011). An economy class reward ticket should be valued at the most heavily discounted economy class fare for that flight, and a first or business class ticket valued using the formula

$$\text{value of free ticket} = A \times B/C, \text{ where}$$

A equals the price of a business class or first class ticket,

B is the price of the most heavily discounted economy class fare for that flight, and

C is the full economy class fare for that flight.

In February 2002, the IRS said that it had not pursued a tax-enforcement program of frequent flyer, hotel, and car rental benefits because of numerous technical and administrative issues; the absence of official IRS guidance; and unresolved issues related to timing, valuation of income inclusions, and identification of personal-use benefits attributable to business versus personal expenses. The IRS will not assert that a taxpayer understated federal tax due to the receipt or personal use of frequent flyer miles or other in-kind promotional benefits attributable to a business. But the IRS will impose tax on the value of travel and other benefits converted to cash, compensation paid in the form of such benefits, and such benefits used for tax-avoidance purposes.

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FOREIGN TAX NEWS

Treaties

A new treaty with the **United Arab Emirates** was signed on June 9, 2002. It will come into force upon ratification, with withholding rates applying on January 1 in that calendar year and all other taxes for taxation years beginning on or after that date. A new treaty was also signed with **Norway** on July 12, 2002 to replace the existing treaty. It will come into force upon ratification; the treaty applies for withholding taxes in the next year, and for all other taxes for taxation or income years beginning in that next year. Both treaties limit the rate of withholding tax on non-portfolio dividends to 5 percent; on all other (most other, in the case of the UAE treaty) dividends to 15 percent; and on interest and royalties to 10 percent, with exemptions for certain interest, copyright royalties, and royalties on computer software, patents, and knowhow. Treaties entered into force with the **Republic of Slovenia** and the **Czech Republic** on August 12 and May 28, 2002, respectively. Both treaties are effective for withholding tax on amounts paid or credited after 2002 and for other taxes for taxation years beginning on or after January 1, 2003. The Czech Republic treaty replaces a 1990 treaty.

Saudi Arabia

To promote a friendlier atmosphere for foreign investors, the Saudi Arabian General Investment Authority (SAGIA) has amended its Foreign Investment Act, particularly respecting double taxation, property ownership, and equal treatment with national companies. Foreign investors are now allowed to invest outside their own companies; foreigners' rights to own property in Saudi Arabia and benefits to avoid double taxation are clarified. Foreign investors will be allowed to appeal, grieve, and arbitrate. A complete summary can be found at http://www.sagia.org.

Australia

On August 22, the treasurer released a discussion paper on reforming international tax arrangements to enable local companies to remain headquartered in Australia and at the same time be competitive internationally. The paper covers the dividend imputation system's treatment of foreign-source income; the foreign-source income rules; treatment of "conduit income"; and high-level aspects of double tax agreement policy and processes. Comments are invited until October 31, 2002. More information can be found at http://www.taxboard.gov.au/int_tax/index.htm.

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