CANADIAN TAX Highlights

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Interest Deductibility Update

On October 1, 2002, the CCRA presented its long-awaited administrative positions on interest deductibility at the Foundation's annual conference—one year less a day from the announcement of its review following the SCC's *Ludco* and *Singleton* decisions. The CCRA focused on the paragraph 20(1)(c) tests relating to the purpose of earning income: the "direct" use test, and the "exceptional circumstances" test that arises from indirect eligible use of borrowed money. A position summary provided at the conference is posted on the CCRA's Web site. Generally, the news is good. The CCRA invites further submissions on the draft positions until year-end, particularly on anomalous circumstances related to draft sections 20.1 and 20.2; distributions of capital and accumulated profits from trusts; disproportionate interest-free loans and capital contributions; the honouring of guarantees; and the treatment of premiums. A new IT early in 2003 will consolidate several existing ITs.

Tracing/linking/cash damming. Tracing is fundamental to determining the use of borrowed money. Borrowed money used directly for an income-earning purpose is deductible, and planning that assists in direct tracing, such as cash damming, is acceptable. If tracing is not possible, an indirect use for income-earning purposes generally satisfies the exceptional circumstances test, and related interest is deductible. A practical approach will be used to determine the use of borrowed money and its redeployments. As a reasonable proxy for tracing, if taxpayers can demonstrate that the aggregate eligible expenditures from a commingled cash account exceed the amount of borrowed money deposited to that account, the taxpayer generally is entitled to deduct interest.

In This Issue

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Borrowing to invest. The most dramatic change is the CCRA's acceptance of *Ludco*'s view of the purpose test and REOP: considering all the circumstances, did the taxpayer have a reasonable expectation of gross income at the time the investment was made, absent a sham, window dressing, or other vitiating circumstances? Furthermore, even if earning income is only an ancillary purpose of the borrowing of money, the related interest can be deductible. However, purpose continues to be a question of fact.

Borrowing to acquire common shares. When common shares are acquired, a reasonable expectation of earning income is presumed unless there is clear evidence to the contrary. If the corporation indicates that dividends are not expected to be paid and that shareholders are required to sell their shares to realize their value, the purpose test probably is not met; but a statement that there is no policy on dividends or that dividends will be paid as circumstances permit should not rebut presumptive deductibility.

Borrowing to redeem shares, return capital, or pay dividends (IT-80). Borrowing money to "fill the hole" on distributions to shareholders continues to be acceptable under the exceptional circumstances test, with essentially unchanged limits: capital (generally legal or stated) for reductions of capital; accumulated profits (generally retained earnings) for dividends; and an aggregate of the related capital plus accumulated profits for share repurchase or redemption. In accordance with *Penn Ventilator*, interest may be deducted on notes issued to repurchase or redeem shares because subparagraph 20(1)(a)(ii) applies on the share's acquisition, in contrast to returns of capital or payment of dividends. The "fill the hole" concept applies to partnerships but not to trusts, subject to the success of any submissions on why *Bronfman Trust* should not be followed.

Leveraged buyouts (IT-315). Interest on borrowed money used to acquire shares of a target is normally deductible and continues so if the target is amalgamated with or wound up into the acquiror; this position is not merely an administrative concession, but is supported by recent jurisprudence establishing a flexible approach to establishing a link. No arm's-length test need be met.

Loss utilization. In-house domestic loss-utilization transactions are still acceptable. A gross-income purpose is necessary, and generally such an auxiliary purpose is adequate even if the dominant purpose is loss utilization. The CCRA will use all weapons in its arsenal to challenge arm's-length and cross-border loss transactions.

Debts issued at a premium. A debt may be issued at an amount greater than its face amount—at a premium—usually because the stated interest rate exceeds the current market rate. The CCRA's preliminary position reflected significant concern about the premium's non-taxable character and is undergoing further consideration. An issuer in the lending business must include the premium in income under section 9. For other taxpayers, whether the premium merely reflects market timing or whether the debt was deliberately priced to yield a premium, the premium is generally a non-taxable capital receipt. However, the reasonableness of the interest may be challenged under paragraph 20(1)(c) if the stated rate clearly exceeds market rates.

Honouring guarantees. If borrowed money is used to honour a guarantee provided for no consideration in respect of a wholly owned corporation (or in proportion to the shareholder's shareholdings)—not a direct eligible use—the CCRA generally accedes to deductibility for related interest if the transaction serves to increase potential dividends. This treatment is intended to parallel that of interest-free loans to corporations. A guarantee provided for FMV consideration creates a source of income resulting in interest deductibility, albeit subsequent to the income-earning process. Other fact patterns may warrant interest deductibility.

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Superficial Loss: Convertible Shares

The CCRA recently released draft revised IT-387R2, "Meaning of Identical Properties." The most significant change concerns convertible shares and the definition of "superficial loss" in section 54 (paragraph 7).

The CCRA says that the IT has been revised to provide that a conversion right attached to a class of shares of the capital stock of a corporation constitutes a "right to acquire property," deemed to be a property identical to the property into which it is convertible for the purpose of the superficial loss definition. Thus, the existence of a right or privilege of conversion or exchange attached to shares in a corporation may sometimes result in a superficial loss on a taxpayer's disposition of the shares. The IT cites an example: class X and class Y common shares of a corporation are the same in all respects, except that class X is non-voting. The class X shareholders may also exchange class X for class Y shares. If an individual disposes of his or her class Y shares at a loss and acquires class X shares within the period described in the superficial loss definition—30 days on either side of the disposition—the loss is a superficial loss because the class X shares' conversion right—acquired within the prescribed period—is an identical property to the class Y shares.

Last chance for capital loss carryback to 1999 at 75 percent rate. Individual taxpayers who reported capital gains in 1999 may benefit from crystallizing capital losses before the end of 2002. The 1999 taxation year was the final year in which the 75 percent inclusion rate applied to all capital gains; because the maximum capital loss carryback is three years, the 2002 taxation year is the last chance to carry back such losses and take advantage of the higher 75 percent rate in the 1999 taxation year. The 2000 taxation year may also have a higher-than-current inclusion rate available (between 50 and 75 percent), depending on the timing of capital gains and losses in that year.

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Accrued Income on Death: Treaty

The estate of a deceased US-citizen Canadian resident is subject to US estate tax on worldwide assets; the individual is also subject to Canadian income tax on a deemed disposition of capital assets at death and on the acceleration of income from assets such as RRSPs, RRIFs, and annuities. Significant relief from potential double taxation on the individual's death was added in the Canada-US treaty's third protocol, effective November 1995. An estate may elect on its US estate tax return to claim a foreign death tax credit for "the federal and provincial income taxes payable in Canada (with respect to Canadian assets subject to US estate tax) *by reason of the death of the individual*" (article XXIXB(7), emphasis added). Until recently, however, and despite the treaty language, the IRS insisted that such a credit was available only with respect to Canadian capital gains taxes, citing the US technical explanation of the treaty provision.

At the examination level of the estate of a US-citizen Canadian landed immigrant, the IRS recently interpreted the treaty credit narrowly and imposed a substantial estate tax liability on substantial holdings of securities, RRIFs, and deferred annuities. The estate challenged that position in the US Tax Court, saying that the treaty credit also applied to the deferred income items that had triggered substantial Canadian income taxes arising on death; it asked the Canadian competent authority to support its interpretation. After one and a half years of consideration, an IRS letter dated July 31, 2002 conceded that the credit must be granted for the Canadian income tax payable on items of deferred income. Moreover, the letter reported that the IRS is "advising our Examination and Field Counsel offices of our determination and directing them to ensure that it is implemented." Because the Tax Court defers to competent authority in treaty cases, the estate's relief was granted.

The reduction of US estate taxes in such cases will enable US-citizen Canadian residents to continue to take advantage of the deferral of income taxes on their RRIFs, RRSPs, and similar assets with the knowledge that their beneficiaries will not be subject to double—or triple, if they are US taxpayers—

taxes upon death (and upon receipt). The potential tax liability remains large, but it is not increased by reason of deferral until death. Without such a ruling, it was difficult to accommodate deferred compensation assets in a cross-border plan in light of multiple tax regimes applying to different taxpayers at possibly different times. This new ruling, however, may allow maximum inter vivos deferral and eliminate double taxes at death.

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Relatively and Absolutely

Recent data from Statistics Canada confirm what federal and provincial ministers of finance have been saying for the past two years: Canadian government debt is dropping, both as a percentage of gross domestic product (GDP) and in dollar terms.

Total net debt of all three levels of government declined from $851 billion at the end of the 1996-97 fiscal year to $848 billion two years later. Figures for local governments are not available for the last two years, but, assuming that local debt remains at its 1998-99 level, all governments should show net debt of $803 billion at the end of the 2000-1 fiscal year. As a percentage of GDP, the decline has been even more dramatic: from a peak of 102 percent of GDP in 1995-96, the combined net debt has dropped to an estimated 73 percent in 2000-1, a level not seen for 11 years.

Net Debt, 1979 to 2001

As at March 31	Federal	Provinces and territories	Local	All levels	As a percentage of GDP
		$ millions			
1979	59,040	16,659	15,937	91,636	34.6
1980	72,555	17,283	16,058	105,896	35.0
1981	86,280	21,812	16,576	124,668	35.8
1982	99,600	20,862	16,969	137,431	36.6
1983	128,302	42,259	18,139	188,700	47.8
1984	164,532	51,976	18,526	235,034	53.8
1985	209,891	63,074	18,535	291,500	61.9
1986	245,151	76,065	19,020	340,236	67.5
1987	276,735	89,532	19,286	385,553	71.6
1988	305,438	97,494	20,221	423,153	71.0
1989	333,519	101,510	20,407	455,436	70.8
1990	362,920	112,015	19,575	494,510	73.1
1991	395,075	116,652	20,909	532,636	78.5
1992	428,682	143,065	22,050	593,797	85.7
1993	471,061	173,691	22,444	667,196	93.3
1994	513,219	202,446	23,457	739,122	98.5
1995	550,685	224,041	22,856	797,582	99.5
1996	578,718	235,896	22,379	836,993	102.1
1997	588,402	241,746	20,970	851,118	98.1
1998	581,581	245,223	20,514	847,318	93.4
1999	574,468	258,271	15,921	848,660	89.4
2000	561,733	256,166	15,921 est.	833,820	80.4
2001	545,300	241,813	15,921 est.	803,034	73.0

The bulk of the debt, 68 percent in the latest year available, is the federal government's. The 2000-1 federal net debt is more than six times the comparable figure of 20 years earlier, but has dropped by $43 billion, or 7 percent, from the peak of $588 billion at March 31, 1997. As a percentage of GDP, federal debt fell from a peak of 71 percent at March 31, 1996 to only 50 percent in the last year shown. Provincial debt increased even faster over the past two decades. At March 31, 2001, it stood at $242 billion, 14 times the figure of 20 years ago, and represented 30 percent of all net debt. Provincial debt peaked later, at March 31, 1999, and has declined 6 percent since then; it fell from 29 percent of GDP in 1995-96 to 22 percent in the last year shown.

Local government debt is much smaller and shows less variation over the period shown in the table. Debt at this level of government does not represent deficits, but only capital investment; the relatively stable debt level thus indicates constant investment in physical assets.

The decline in the dollar amount of government debt produces an immediate reduction in related debt charges. The approximately $50 billion total debt reduction over the last five years translates into an annual spending reduction of about $2.5 billion.

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PATA and Transfer Pricing

Around the globe, more tax jurisdictions are addressing cross-border transfer pricing as a means of protecting an important revenue base. The complexity of the laws, policies, and administrative requirements with which taxpayers must comply increases exponentially as they transact with related parties in different countries; taxpayers are forced to invest more time, money, and resources in satisfying these requirements to avoid penalties. Governments must conduct lengthier and more complex audits and juggle a growing backlog of cases. Many governments base their transfer-pricing laws and policies upon OECD pricing guidelines, but interpretations (and thus requirements) vary widely. Now the Pacific Association of Tax Administrators (PATA)—whose members include Canada, Australia, Japan, and the United States—has developed a draft multilateral documentation package to satisfy the transfer-pricing documentation requirements of member countries. PATA's attempt to homogenize requirements is encouraging, but the current proposals are more complex than Canada's six existing criteria and offer significantly less certainty. PATA's recommendations will likely be a year in the making.

The PATA proposal requires taxpayers to adhere to three operative principles to avoid penalties.

■ "Taxpayers must make reasonable efforts, as determined by each PATA tax administration, to establish transfer prices in compliance with the arm's length principle."

■ "Taxpayers must maintain contemporaneous documentation of their efforts to comply with the arm's length principle." PATA's proposal itemizes 53 specific documentation requirements under nine categories, compared with six key areas under current Canadian rules.

■ Taxpayers must produce, in a timely manner, documentation "evidencing efforts to comply with the arm's length principle."

The concept of uniform documentation is admirable, but certainty is only possible with uniform interpretation of the substantive rules. The proposal fails to clarify key factors: each PATA member may determine whether the taxpayer has complied with the arm's-length principle. There are no consistent definitions, applications, or enforcement of issues central to the arm's-length principle, such as acceptable transfer-pricing methodologies; prioritizing, selecting, and applying transfer-pricing methodologies; selection of comparables; standards of comparability and acceptable comparability adjustments; determination of arm's-length range; methodologies for year-end adjustments; acceptance of post-year-end adjustments; and use of the commensurate-with-income standard. The proposal focuses on documentation: "a multinational enterprise (MNE) will satisfy each PATA member's documentation provisions by complying with all of the principles contained in this PATA documentation package." Each taxpayer must comply with all 53 requirements, which raises the compliance standard to the most stringent among the PATA members instead of striving for compromise and simplification to ease compliance and record-keeping tasks. US-Canada business represents the highest volume of trade between PATA members, but the combined scope and amount of information reporting required under section 247 of the Act and Code section 6662 is substantially less than in PATA's proposal. Setting out such specific requirements also contravenes the spirit of the OECD guidelines in paragraph 5.16, which recognize that the diverse range of business scenarios renders an exhaustive listing of requirements impossible and provide only general guidance to help identify documentation that gives evidence of satisfying the arm's-length principle, a sentiment echoed in *Information Circular* 87-2R (paragraph 183). The proposed exhaustive list would require the production of many (perhaps irrelevant) documents at great expense. Furthermore, the lack of guidance on the size or materiality of subject transactions places an unaffordable compliance burden on small and mid-size companies with relatively minor transactions.

The proposal requires taxpayers to "make reasonable efforts to establish their transfer pricing in accordance with the arm's length principle . . . [including] analysis of controlled transactions, searches of comparable transactions between independent enterprises dealing at arm's length, and selection and application of transfer pricing methods that are reasonably concluded to produce arm's length results in accordance with applicable PATA member transfer pricing rules, consistent with the OECD guidelines." There is no standard for what is "reasonable effort," but the package "is not intended to impose legal requirements greater than those imposed under the local laws of a PATA member." Some certainty is required in a definition, a standard, or guidelines for establishing "reasonable effort."

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Administration Roundup

Third-party civil penalties. A CCRA official recently updated the Ottawa Tax Services Office (TSO) Tax Practitioners Advisory Committee on the CCRA's plans for administering the third-party civil penalty provisions in section 163.2.

■ *Penalty assessment process.* As promised, the CCRA created a third-party penalty review committee at CCRA headquarters in February 2002 to help ensure that the penalties are applied consistently in accordance with IC 01-1. Field auditors who encounter situations in which civil penalties might apply must consult with a senior audit manager in their TSO before considering a third-party penalty audit. The TSO must contact the penalty review committee's technical support group for authorization to start an audit. If the auditor recommends a penalty, the committee reviews the facts, including the third party's representations, before endorsing or rejecting the recommendation.

■ *More penalty assessments in upcoming audit cycle?* The CCRA is currently training its auditors in the application of the new rules. So far two cases have been referred to the committee, but few currently completed audit cycles include the 2000 taxation year (when the rules came into effect). In the next audit cycle, the CCRA may find more cases where the third-party civil penalties apply, and will pay close attention to situations in which taxpayers were subject to a gross negligence penalty to determine whether penalty audits are justified for the third parties involved.

New IT on deductibility of fines and penalties. At its round table at the Foundation's 2000 annual conference, the CCRA said that it accepted the SCC's decision in favour of the taxpayer in *65302 British Columbia* concerning the deductibility of fines and penalties and would amend the related IT. Draft IT-104R3, "Deductibility of Fines and Penalties," issued in August 2002, does not take the previous IT's position that fines and penalties are not normally deductible. The revised IT summarizes the SCC's decision and discusses the treatment of certain fines and penalties and several principles laid out by the SCC, including the following.

■ The deduction of a fine or penalty cannot be disallowed solely on the basis that its allowance is contrary to public policy.

■ To be deductible, a fine or penalty must be incurred for the purposes of gaining or producing income from a business or property (paragraph 18(1)(a)).

■ Paragraph 18(1)(a) does not require that a fine or penalty be unavoidable in order to be deductible.

To establish whether a fine or penalty was incurred for the purpose of gaining or producing income, the taxpayer need only establish that there was an income-earning purpose for the act or omission, regardless of whether that purpose was actually achieved: the taxpayer need not have attempted to prevent the act or omission that resulted in the fine or penalty. Fines and penalties incurred in connection with the acquisition of assets are included in the assets' capital cost.

Valuing charitable gifts of public securities. *Registered Charities Newsletter* no. 12, issued July 25, 2002, includes guidelines on valuing gifts of public securities for tax purposes. A charity can issue a tax receipt for a gift of public securities for the FMV thereof on the date that they are donated. The donation date is the date on which the transfer of ownership occurs, which is a question of fact. The CCRA says that generally the charity takes ownership of a share when it has the right to receive dividends declared or amounts on the corporation's liquidation, and that the charity has the right to exercise the votes attached to the share. The newsletter provides further details on determining the specific time at which an inter vivos gift of securities is made. In contrast, if securities are left to a charity by will, the CCRA says that their value is determined immediately before the donor's death and not when the property is actually received by the charity.

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Passing the Puck

A tax shelter targeted to close before year-end involves a tax-advantaged investment in the Ottawa Senators hockey club. The offering affords subscribers the opportunity to invest in the team and to share in any positive cash flow realized from the team's operation and any capital appreciation on the ultimate sale. The assessing policy concerning the allocation of the purchase price of a Canadian-owned sports franchise is of interest to tax practitioners and hockey fans alike.

An operating partnership (OP) purchased the team on January 2, 2002 for approximately $187 million by issuing an interest-bearing promissory note. The majority of the proceeds paid by investors for the offering partnership's units will be used to acquire units in a second OP. The OP will apply the majority of the proceeds to retire principal and interest on the purchase note. As one would expect, costs incurred by the OP must be allocated reasonably between the team and any other assets acquired. Sixty percent of the purchase price for a sports franchise is allocated to player contracts and rights; 15 percent is considered a capital receipt and forms part of the sports franchise's cost base that is not currently deductible; and 25 percent is a partially deductible eligible capital amount. The player contracts are amortized for tax purposes over the greater of two years and the weighted average remaining term on player contracts at the acquisition time. The formula is

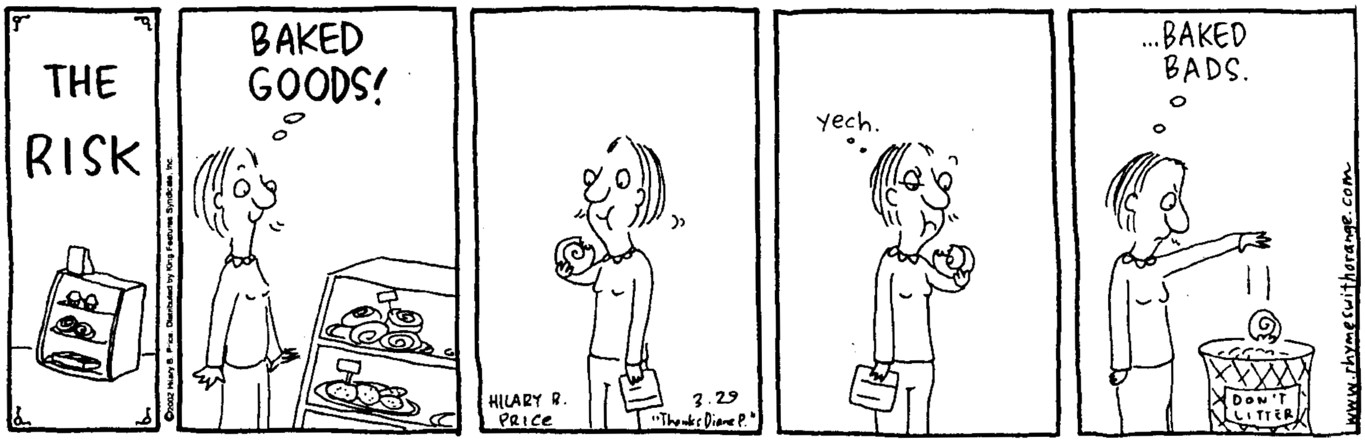
A/B, where

A equals the aggregate remaining total remuneration to be paid to the players under contract until the end of the existing contract and option years or any additional waiting-period years, including contractual salary increases or additional amounts to retain the players' rights for the relevant periods, and

B equals the aggregate average annual salary payable to the players currently under contract with reference to the remaining period of time over which the team has the right to services.

In this particular deal, the writeoff is two years because the formula yields a result slightly less than two years. If the sports franchise is disposed of, the OP's proceeds are allocated as above: 60 percent to player contracts, applied to reduce any balance remaining of the original tax cost, with recapture up to cost and excess proceeds as a capital gain, similar to a depreciable asset; 25 percent as eligible capital

RHYMES WITH ORANGE ® by Hilary Price



property proceeds; and 15 percent as cost reduction of the equity interest in the sports franchises, with any excess as a capital gain.

The CCRA's assessing policy is detailed in part in an agreement with the Canadian teams of the National Hockey League dated September 23, 1997. That agreement pertained to expansion fees earned by the incumbents when a new team was admitted to the NHL, but the CCRA has clarified in writing that its policy applies to a non-expansion team. On the basis of discussions with CCRA officials, it is unclear whether the same allocation principles apply with respect to Canadian ownership of a US-based sports franchise.

The offering is unique; it provides a private source of funds to a financially stressed vendor from investors, who then become eligible for "fast" tax writeoffs. For hockey fans, this deal has the added benefit of keeping an exciting hockey team in Canada's capital for the foreseeable future. Further, significant contributions will continue to be made to the fisc in the form of non-income taxes paid in respect of the operations. It will be interesting to see whether other Canadian-based sports franchises that are struggling to be competitive with their US counterparts choose to raise funds in this fashion.

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Competent Authority Agreement?

Canada and the United States entered into a competent authority agreement regarding mutual interpretation and application of the Canada-US treaty's article XXI. The CCRA has not publicized the fact of agreement and appears reluctant to apply it, and its disclosure has been refused under the Access to Information Act, leaving taxpayers and their advisers to decipher the agreement's intent and scope from an IRS notice.

Treaty article XXI(1) generally provides that income derived by a religious, scientific, literary, educational, or charitable organization (an "enumerated organization") is tax-exempt in the source state if it resides in the other contracting state, where the income is tax-exempt. Paragraphs 5 and 6 provide for deductions for cross-border charitable donations. Apparently, diplomatic notes accompanying the treaty provide that the competent authorities should review the procedures and requirements for establishing the status of such an organization entitled to such an exemption and of an eligible recipient of a deductible charitable donation. The intent was to avoid duplicate applications to the administering agencies of both contracting states. The diplomatic notes also apparently provide that if one contracting state determines that the other maintained rules and procedures for qualification compatible with its own, each state will accept the certification of status by the other's administering agency for the purpose of determinations under articles XXI(1), (5), and (6).

According to IRS Notice 99-47, the agreement provides that "recognized [enumerated] organizations . . . organized under the laws of either the U.S. or Canada will automatically receive recognition of exemption without application in the other country. U.S. organizations must be recognized as exempt under Code section 501(c)(3)." It would be surprising if the agreement did not contain a reciprocal provision in respect of Canadian entities. The agreement appears to mean that the CCRA should not look beyond an IRS decision that an entity is exempt under Code section 501(c)(3) to determine status under article XXI(1). However, in at least one recent case, the CCRA denied that status to a US-resident entity exempt under Code section 501(c)(3), because it was not an enumerated organization under Canadian law. When the agreement's application was raised, the CCRA initially said that the agreement was limited to paragraphs 5 and 6, a position clearly contrary to IRS Notice 99-47. (See *Registered Charities Newsletter*, Autumn 1996—Special Release.) The CCRA refused to produce a copy of the agreement to verify its interpretation of the agreement's scope. Eventually, the CCRA acknowledged that the entity was entitled to the benefit of article XXI(1), but refused to acknowledge any policy regarding Code section 501(c)(3) entities and article XXI(1).

A request for a copy of the agreement pursuant to the Access to Information Act was denied on the basis that paragraph 13(1)(a) of that statute provides that "the head of a government institution shall refuse to disclose any record requested . . . that contains information that was obtained in confidence from the government of a foreign state or an institution thereof." This provision has been interpreted by the courts as a virtual bar to disclosure (*Sherman*, [2002] FCJ no. 779). However, as in *Sherman*, one could question what "information . . . obtained in confidence" from the United States could be revealed by disclosure. The CCRA has yet to publicly promote the agreement or acknowledge its existence, but taxpayers and their advisers should keep it in mind when seeking to claim the benefits of treaty article XXI.

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Securitization: Legal Opinions

Lease securitizations may allow capital tax savings via conversion of the lease receivables or assets not eligible for the investment allowance into cash that can be used to reduce liabilities. The capital tax benefit is predicated on the lessor's being able to remove the receivable or asset from its unconsolidated balance sheet.

Since July 1, 2001, transfers—including securitizations—of receivables are subject to CICA accounting guideline 12 (AcG-12). The guideline addresses the securitization of minimum lease payments under sales-type and direct-financing leases, but not of GAAP operating leases that do not involve a sale of receivables.

AcG-12 establishes several conditions for surrender of control over the transferred assets, a precondition for off-balance-sheet treatment: (1) the assets must be isolated from the transferor (placed presumptively beyond the reach of the transferor and its creditors, even in bankruptcy and other receivership); (2) each transferee (or holder of its beneficial interests in the case of a qualifying special-purpose entity) must be able to pledge or exchange the assets or beneficial interests it received, without constraint by any condition that provides more than a trivial benefit to the transferor; and (3) the transferor cannot maintain effective control over the assets by being entitled and obliged to repurchase or redeem them before maturity or by being able to unilaterally cause the holder to return specific assets, except via a cleanup call.

The isolation-in-bankruptcy criterion is more a legal issue than one of accounting judgment. Thus, assurance guideline 28 (AuG-28) offers guidance on the auditor's need for a legal opinion and provides a sample opinion sufficient for the purpose. The sample begins with a statement that the "transfer documents validly and effectively sell" the seller's interest in the property; that wording may raise issues from a tax perspective. A lease securitization carried out as a sale of future payments under a lease results in the proceeds' being included in the lessor's income immediately because of subparagraph 12(1)(a)(i)'s closing words or general tax-accounting principles. But if an advance payment of rent or another amount for the possession or use of land or chattels received by the lessor is included under paragraph 12(1)(a), a reasonable reserve may be claimed under subparagraph 20(1)(m)(iii); this characterization is clearly at odds with the sample opinion's "effectively sell" wording.

Fortunately, the auditor is interested only in isolation in bankruptcy and not necessarily in the manner of achieving such status. In Canada isolation is achieved, for example, by using concurrent lease and sale-sale-leaseback arrangements. Such methods of transferring rights to lease receivables that are recognized on the balance sheet and isolating them from the transferor are subject to AcG-12. AcG-12 defines a transfer as a "conveyance," but a footnote points out that "the definitions do not necessarily coincide with definitions of the same or similar terms . . . for legal or taxation purposes." This nuance is driven home by the use of "posting [an asset] as collateral" as an example of a transfer. Paragraph 10 indicates that determining whether the criteria have been met "may" involve making a judgment about whether a transaction is a true sale at law, but an isolation opinion that does not include "true sale" wording apparently can suffice under AcG-12; AuG-28's sample opinion is merely an example. "True sale" wording reflects practice in the United States, where a standard similar to AcG-12 has existed for many years. But US tax laws differ from Canadian, and thus US transfers of financial assets are not frequently effected through concurrent leases or sale-sale-leasebacks. The "true sale" reference in AcG-12 merely indicates some relevant considerations and is not intended to prevent an auditor from exercising judgment in determining whether isolation has been achieved. A determination by a legal expert that isolation has been achieved in the absence of a true sale at law should satisfy the auditor in most circumstances.

The application of AcG-12 to a transaction and its treatment as a sale for accounting purposes does not necessarily affect its legal or tax treatment. If isolation is achieved—even if not through a legal sale—and the other criteria for surrender of control are met, then a transfer of receivables is a sale for accounting purposes regardless of its tax treatment. Careful structuring of the transaction and precise wording of the legal opinion can achieve both the desired tax and accounting results.

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US Distributorships in Canada

The sale and distribution of products in Canada by a multinational raises several structuring options, with the objective of minimizing the Canadian tax exposure and transfer-pricing concerns and providing a structure that is easy to maintain.

In the absence of treaty protection, a non-resident who solicits orders or offers anything for sale in Canada through an agent or servant is carrying on business in Canada; but if a tax treaty applies, the non-resident is taxable in Canada only on business profits attributable to a Canadian PE as defined in the relevant treaty.

■ **Agency** may exist if, for example, the Canadian distributor acts solely as a sales agent for the multinational (MNE) and receives commissions. A sales agent normally sells the product in the MNE's name, does not bear any financial risk, may maintain a warehouse for a treaty-country-resident MNE, may assist in the collection of Canadian accounts by maintaining a trust account in Canada, and may have some latitude in determining the goods' sale price subject to the MNE's approval. The sales agent may receive a reasonable and FMV sales commission.

A Nova Scotia unlimited liability company (NSULC) sub that acts as the Canadian distributor is taxable in Canada as a corporation on its worldwide income, but is ignored for US tax purposes and avoids the US subpart F rules. Cansub must have sufficient substance. For example, if it does not have Canadian employees or independent contractors and all services purportedly provided by it are in fact performed by the MNE, Cansub may be disregarded: the MNE is carrying on business here through an agent and is taxable on all related business profits (related to a PE if a treaty applies). A treaty-resident MNE should thus take steps to avoid a Canadian PE, such as approving all Canadian orders from its foreign location.

■ An **independent contractor** may have the exclusive right to sell the product in a defined territory in Canada at a price based on the manufacturer's suggested retail price, and may purchase the goods for resale and accept the financial risk of ownership or sell them on the manufacturer's behalf. The distributor may arrange for the goods to be warehoused, or they may be delivered directly from the manufacturer to the customer. The distributor may be responsible for receivables and bad debts; its profits should be reasonable considering its degree of risk and any value added.

Under the Canada-US treaty, a PE includes an agent of independent status that has and habitually exercises in Canada an authority to conclude contracts in the US resident's name, excluding a broker, general commission agent, or any other agent of independent status that is acting in the ordinary course of its business. The CCRA has set out some factors for determining whether a person is an independent agent, such as whether the person is dependent legally and economically (document no. 9235160). Economic dependency may exist if the agent has no risk and cannot sell other products. The principal's employees should not act as the agent's employees, nor should the agent be able to conclude contracts in the principal's name (ibid.). The CCRA will look to the OECD commentary to determine whether a wholly owned sub is an MNE's independent agent (document no. 9314270). Cansub should deal with day-to-day operations and perhaps should purchase goods for resale rather than simply act as sales agent, thus assuming financial risk. The MNE should formally approve abroad the terms of all sales contracts and ideally should be involved with negotiating the terms with customers and solicit the orders; at least the MNE should not automatically approve every sale.

■ A **stripped distributor** takes title to the product for resale and assumes minimal economic risk, such as loss from theft or shipping and insurance costs, but the MNE may repurchase unsold or returned inventory and receivables outstanding after a certain period. Profit is thus minimized. Typically, a stripped distributor does not have exclusive distribution rights and may distribute other products. Such a distributor negotiates the price and other terms of sale concluded in its name, but has no authority to conclude contracts on the MNE's behalf.

■ A **commissionaire** distributor purchases on consignment and sells in its own name, effectively as agent for an undisclosed principal and arguably as an independent agent without authority to conclude contracts. The contracts require the approval of the MNE, which may or may not be bound under the relevant contract law. The distributor incurs no liability. Care must be exercised to prevent the MNE from being regarded as carrying on business in Canada through an agent.

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Foreign Tax News

Guam

Guam and its territorial income tax are not covered under US tax treaties. The Guam Foreign Investment Equity Act, signed by President Bush on August 23, 2002, incorporates the same reduced tax rates and exemptions to foreign income applicable under the relevant US tax treaty, a change that allows Guam to compete for foreign capital.

People's Republic of China

The New Implementation Rules of Tax Collection and Administration Law contain new transfer-pricing provisions. An enterprise can now apply to the tax authority (TA) to enter into an APA, providing the TA with the principle and the calculation method of related-party transactions. The TA will supervise the APA's implementation. New provisions for transfer-pricing adjustments are limited to taxable profits in the year in question and should be made within three years. China's transfer-pricing laws are governed by the arm's-length principle; the TA may adjust for up to three years for non-arm's-length payments (10 years in some cases).

Shanghai

New municipal regulations encourage multinational enterprises (MNEs) to establish regional headquarters (RHQs) in Shanghai, especially in the Pudong New Area. Regulations not yet finalized provide incentives for import/export trading rights and VAT refunds; RHQs that provide technical training for employees or that carry out approved high-tech R & D will be eligible for tax incentives and financial subsidies. To establish RHQs, the MNE's parent must have assets of at least $400 million with accumulated investment in China of at least US$30 million; the RHQ must manage at least three enterprises within or outside China.

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