CANADIAN TAX Highlights

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Income Funds

Income funds have become very popular with investors as a result of low interest rates and recent declines in Canadian and foreign equity markets. The demand for new product has spawned several dozen initial public offerings in the past few years, and the search for new candidates does not appear to be slowing down.

Income funds are publicly traded mutual fund trusts that undertake to distribute most of their free cash flow to the investing public. Recent initial public offerings show that almost any business with a history of stable or increased earnings is a candidate for an income fund, including businesses involved in electricity generation, generic product manufacturing, chain restaurant supply, energy production, mineral production, and real estate management. Startup businesses on that earnings path may also attract investor interest.

Income funds hold debt or equity interests in the underlying business(es). The governing trust documents generally require that most available cash flow from the underlying business be distributed to unitholders. The cash flow imperative dictates a structure that minimizes the double taxation at the corporate and shareholder levels inherent in publicly traded corporations: the holding of debt on which interest is deductible to the underlying business or through direct investments in flowthrough entities such as partnerships or operating trusts. All income funds have Canadian headquarters, but many have significant foreign (typically US) operations. Most income funds are structured so as not to be foreign property for the purposes of the deferred income plan rules.

Business owners may establish or sell their interests to income funds in order, for example, to monetize their investments in private corporations in preparation for retirement; to sell a non-strategic division of a Canadian sub; to boost equity values via conversion of a public corporation to an income fund; and to obtain liquidity for expansion. A full or partial tax deferral to the vendor on the business's sale may be structured via a sale for corporate shares or partnership units that are exchangeable for and generally provide for distributions equivalent to those of publicly traded units. But a sale to an income trust does not necessarily result in the vendor's loss of control: a management agreement to provide managerial and administrative services to the fund frequently procures the vendor a future source of income and an ongoing and active role in the business.

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Bonusing Down

Payment of salary and bonus to owner-managers is a common method of addressing the lack of integration in corporate and individual tax rates for corporate income that does not qualify for the small business deduction. Strict application of section 67 requires that such a payment be reasonable before the payer corporation can deduct it; double taxation results if a shareholder benefit is assessed for any excess. Fortunately, for over two decades the CCRA has adopted an administrative policy designed to reduce the uncertainty posed by section 67: the reasonableness of salary and bonuses is not challenged if (1) the corporation's general practice is to distribute profits to its shareholder-managers as a bonus or additional salary, or (2) the company has adopted a policy of declaring bonuses to shareholders to remunerate them for corporate profits attributable to their special knowhow, connections, or entrepreneurial skills. Over the last two years, the CCRA has elaborated on the policy's application, including whether it applies if the owner-manager indirectly holds an interest in Opco and if the salary or bonus is paid out of specified investment income.

Many commentators viewed a 2000 technical interpretation as a narrowing of the policy (doc. no. 2000-0013085). On the TI's facts, Opco's shareholder was a corporation owned by a family trust whose income beneficiaries were the manager's spouse and children and whose capital beneficiaries were the manager and the spouse. The CCRA said that the normal test of reasonableness applied to a bonus paid to the manager, leading to speculation that the policy no longer applied if the owner-manager held no direct interest in the Opco. The CCRA allayed these fears somewhat by denying a disavowal of the bonus policy in cases of indirect ownership, saying that the complex nature of the TI's fact pattern precluded certainty that the policy applied (doc. no. 2001-0064055). In consider-

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ing the policy's application to bonuses paid by Opco to an active manager if he or she and family members owned shares in a holdco that owned Opco, the CCRA observed generally: "Where a corporation pays a salary and/or bonus out of business profits to a manager who is actively engaged in the business of the corporation, it is unlikely that the reasonableness of the deduction will be questioned unless it results in an undue tax advantage." At the Foundation's 2001 annual conference, the CCRA was more direct: it would not question the reasonableness of salaries and bonuses paid to managers who either alone or with other family members are a CCPC's shareholders, whether directly or through a holdco. The general concession is still of comfort even though the CCRA has not opined on a more complex indirect ownership structure.

The CCRA also said that it will not normally challenge the reasonableness of salaries and bonuses paid to a Canadian-resident active shareholder-manager from a CCPC's "non-active business income," a phrase later clarified as including income from a specified investment business (doc. nos. 2001-0092515 and 2002-0128875). The benefit of paying a bonus from investment income varies from province to province. In 2002, such a manager resident in Ontario enjoys integration of tax rates on investment income earned personally or through a corporation as dividends, but a British Columbia resident who was paid a salary or bonus out of corporate investment income may benefit by about 3.4 percent relative to a dividend's receipt. However, the policy applies only if the shareholder-manager is active in the business: this raises the difficulty of assessing a level of activity acceptable to the CCRA. A recent TI said that a shareholder is not considered active in the day-to-day business operation if a corporation's only business activity is holding investments managed by a third party, and that "active" is a question of fact if a shareholder-manager personally manages the corporation's investments (doc. no. 2002-0128875). The extension of the policy to non-active business income may be of little practical effect in light of the uncertainty that surrounds an acceptable level of activity, the modest tax savings to be gained from paying a bonus out of investment income, and the onerous consequences if section 67 pre-empts deductibility.

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Customs: Missing AMPS

On October 7, 2002, Canada Customs finally implemented its much-heralded administrative monetary penalty system (AMPS), a comprehensive civil penalty regime aimed at securing compliance with customs legislation that drastically changes the way customs penalties are imposed. Most importers are unaware that even after an extended implementation period, AMPS apparently remains under development: significant penalties such as C003 and C153 are still suspended from the current AMPS master penalty document (MPD).

C003, one of the more significant AMPS penalties for importers, appeared in the May 2002 draft MPD but has apparently been suspended for at least a year as Customs wrestles with its final format. The May 2002 draft provided for a flat-rate penalty of $100 for each B3 Canada Customs coding form that contained incorrect data in any of nine specific fields in the B3, the main customs accounting document used to account for duties and GST owing on imported goods. The nine specific data fields include such commonly required information as country of origin (field 12), place of export (field 13), tariff treatment (field 14), tariff code (field 28), and value for duty code (field 31). Errors often occur in coding those fields, even in the hands of the most experienced importers, and C003 thus represents serious potential liability for importers. For the time being, however, importers will enjoy a further grace period from full compliance. (Customs has also indicated that related AMPS penalties such as C005 and C348 will not apply to B3 errors.)

These omissions may reflect Customs' realization that a $100 penalty for every B3 with an error in these fields would generally amount to significant and virtually unavoidable costs—perfect customs compliance is impossible for all but the smallest importers—and would likely bring Customs to a virtual standstill as it dealt with all the consequential B2 adjustment requests. Another AMPS penalty, C153, imposes a penalty on any importer that claims NAFTA status without a NAFTA certificate of origin on hand. C153 is also missing from the final MPD, an omission that may be also be grounded in the currently high level of non-compliance in that area.

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International Tax Comparisons

Canada's tax load shrank again in 2001, according to the annual comparisons of tax burdens recently released by the Organisation for Economic Co-operation and Development (OECD): the ratio of total tax collections to gross domestic product (GDP), still the best measure of the overall tax burden, dropped from 35.9 percent in 1999 to 35.2 percent. Not all countries were able to provide information for those 2001 provisional estimates, but many OECD member countries experienced a similar drop.

From 2000 to 2001, 15 of the 25 countries reporting 2001 figures showed lower ratios in that year, but most countries increased over 1995 figures despite widespread tax rate cuts. The growth in corporate profits and personal incomes that accompanied the strong international economic recovery was more than sufficient to offset the reductions in rates.

Canada's ratio increased slightly to 2000, from 35.6 percent in 1995, but the US ratio rose substantially, from 27.6 percent in 1995 to 29.6 percent in 2000.

Tax Collections as a Percentage of GDP, OECD Member Countries, 1999 to 2001

	1999	2000	2001 (provisional)
Canada	35.9	35.8	35.2
United States	28.9	29.6	na
Japan	26.1	27.1	na
United Kingdom	36.4	37.4	37.4
Germany	37.8	37.9	36.4
France	45.7	45.3	45.4
Italy	43.3	42.0	41.8
OECD average	37.1	37.4	na
OECD Europe average	39.8	39.9	na

na Not available.

Canada maintained its position among the OECD members—the 18th highest ratio of tax to GDP—still below Germany, France, and the United Kingdom, but still above Japan and the United States, despite increases in the last two countries in 2000. The average for all G7 countries in 2000 was 36.4 percent, above Canada's ratio. As is shown in the table, Canada's ratio of tax collections to GDP remained below the ratios for all OECD members and for the European members.

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The Scope of Fiction

A recent technical interpretation concerning section 84.1 may have bypassed the radar screen of most tax practitioners because it was rendered in French (doc. no. 2002-0128955). The TI says that a dividend deemed paid under section 84.1 is not eligible for a subsection 83(2) election as a capital dividend. The CCRA has also withdrawn its position that a dividend deemed paid can trigger a dividend refund and refundable tax to the purchaser corporation (doc. no. E9729855).

In the TI, Mr. and Mrs. A, residents of Canada, are sole shareholders of Opco 1 and Opco 2, respectively. Mr. A sells his shares to Opco 2 in exchange for a note, resulting in the deemed payment of a dividend under paragraph 84.1(1)(b). Opco 2's capital dividend account (CDA) is sufficient to cover the deemed dividend. Subsection 83(2) provides for an election if "a dividend becomes payable by a private corporation to shareholders of any class of shares of its capital stock." Subsection 84(7) provides that a dividend deemed paid under section 84.1 at a particular time is deemed to have become payable at that time for the purposes of subdivision h, which includes section 83. Can the capital dividend election be made even though section 84.1 does not specifically relate the dividend deemed to have been paid and received to a particular class of shares?

The TI says that the wording of subsections 83(2) and 84(7) and section 84.1 does not permit a CDA election: section 84.1 deems the dividend to have been paid, but not to a shareholder "of any class of shares of its capital stock." In the absence of more specific wording, no election can be made. Furthermore, subsection 84(7) merely provides that a dividend deemed paid has become payable at that time; it does not deem the dividend payable on a particular class of shares. The CCRA relies on the history of section 84.1 in support of its interpretation. The original section 84.1 explicitly stated that section 83 applied as though the persons receiving the dividend were shareholders of a class of shares of the corporation's capital stock; an amendment effective March 1977 deleted that reference, and there were no accompanying technical notes. Other provisions that deem dividends to have been paid, such as subsections 84(1) and 84(3), state clearly that such dividends are considered paid on a class of shares.

The interpretation raises the question whether a dividend can be deemed paid and received in the abstract. Can a dividend paid (or deemed paid) to a taxpayer by the purchaser corporation and received (or deemed received) by the taxpayer from the purchaser corporation be so paid and received other than on a class of shares? The FCTD in *Derlago* concluded that Parliament intended certain logical, although unexpressed, details of deemed circumstances ([1988] 2 CTC 21). It is also interesting that the income inclusion in paragraph 12(1)(j) includes in income only "a dividend . . . on a share of [a corporation's] capital stock." The TI seems to ignore the impact of the subsection 84(7) deeming of a dividend paid to be payable at that time, although the TI acknowledges that 1998 technical notes to subsection 84(7) say that its deeming is relevant for the CDA election. The TI takes a strong position on the issue, saying that the CCRA has no intention of adopting a favourable administrative position permitting subsection 83(2) elections under such circumstances.

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FIEs: Going in Circles?

In the 1999 federal budget, Finance said that Canadians were significantly increasing their holdings in foreign-based investment funds because of tax advantages over Canadian-based funds. Finance also acknowledged that section 94.1—intended to remove that advantage—was deficient in two respects: (1) the difficulty in demonstrating that one of the main reasons for acquiring, holding, or having the interest in such property was to avoid Canadian tax, and (2) the annual imputation of an arbitrary income inclusion that need not bear any relation to the fund's accruing income. On October 11, 2002, after two earlier drafts and two deferrals of the effective date and public consultations, Finance released revised draft foreign investment entity (FIE) legislation, effective for taxation years beginning after 2002.

However, the draft still requires a tax-avoidance motive for certain investments, and an annual income imputation system still exists as a default regime. The draft also significantly affects corporate taxpayers with non-controlling interests in foreign joint ventures and certain other investments.

A non-resident entity is generally an FIE unless (1) the carrying value of its investment property does not exceed 50 percent of the carrying value of all its property at its taxation year-end (the asset-based test), or (2) its principal business is not an investment business (the business-based test). Determination of an entity's principal business is fact-based or, if so elected, is based on whether its net accounting income from investment property and businesses exceeds that from other businesses. Investment property for the asset-based test includes shares of a corporation, interests in trusts and partnerships, cash, indebtedness (but not certain intercompany debt), real estate, commodities, and derivative financial products, but excludes exempt property, such as that used or held principally in a non-investment business. Carrying value is computed under Canadian GAAP or substantially similar accounting principles (deemed to include US and EU member countries' GAAP). If available and prepared according to satisfactory accounting principles, the entity's consolidated financial statements are deemed to be the entity's financials, unless the taxpayer elects to rely on non-consolidated financials, which was the default rule under the previous draft. If so elected, a lookthrough rule applies to significant interests—25 percent of votes and value for shares—in underlying entities. Alternatively, the taxpayer may elect to value at FMV all the entity's property shown on its balance sheet, which election still does not apply to items such as internally generated goodwill.

Under the previous draft, if a Canadian taxpayer or its controlled foreign affiliate (CFA) owned a non-exempt interest in an FIE at its taxation year-end, a mark-to-market regime—an income inclusion of the annual increase or decrease in the interest's FMV—applied unless the taxpayer elected the accrual method. The accrual method has been eliminated. Mark-to-market must be used for interests in tracking entities and foreign insurance policies but otherwise only applies by election if the interest has a "readily obtainable FMV." The revised draft's default method is an income imputation regime—the "prescribed rate of return" regime—that requires an income inclusion equal to the interest's designated cost times a prescribed interest rate. (The income inclusion is added to the taxpayer's ACB.) If a taxpayer's interest acquired before 2003 was not subject to existing section 94.1 but is an FIE under the new rules, the designated cost of the FIE interest must be stepped up to FMV, but no step-down applies for a lower FMV. The FIE income of a CFA is FAPI under both primary and default methods.

As in previous drafts, an exempt interest in a non-resident entity includes an interest in a CFA and, if no tax-avoidance motive exists and the interest is widely held and actively traded, an interest in a foreign entity resident in a treaty country and shares listed on a prescribed stock exchange. In certain circumstances a taxpayer may irrevocably elect to treat its interest in an FIE that is also an FA as an interest in a CFA, thus making it subject to the FAPI—not the FIE—regime.

Despite Finance's previous comments, the integration of the FIE and FA rules is a continuing issue. Assume that Canco owns an FIE interest in its FA, Forco. In 2003 Canco has imputed income of $100 on that interest; Forco pays a $100 dividend to Canco out of exempt surplus in 2004. No relief is provided for the $100 of FIE income even though Canco receives the $100 dividend tax-free in 2004, an inequitable result given that no Canadian tax would have arisen in either year in respect of Canco's interest in Forco if it had not been an FIE. The revised draft is an improvement because it moves away from the sometimes virtually impossible compliance burden of the mark-to-market method. But a significant administrative and compliance burden remains for Canadian companies, some of which have hundreds of foreign affiliates, including many joint ventures. In certain cases, financials must be redone under Canadian or substantially similar GAAP. Furthermore, the current FMV of an existing FIE investment must be determined; detailed information about the underlying corporate structure must be compiled; and the underlying assets may require valuation. Financial accounting rules will have a major impact on the determination whether an entity is an FIE. Perhaps most important, in many cases it will be extremely costly and difficult, if not impossible, to obtain all information necessary to determine whether an entity is an FIE.

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NON-RESIDENT TRUST UPDATE

On October 11, 2002, Finance released the third version of non-resident trust rules, with some noteworthy changes, effective for 2003 taxation years.

The rules continue to deem a non-resident trust (NRT) to be resident if it has either a resident contributor or a resident beneficiary (except, for example, NRTs used to administer benefit plans for non-residents, true charitable trusts, and trusts established to assist in cases of marital breakdown). The definition of "contribution" includes any transfer or loan of property to an NRT. (The definition no longer includes enabling language and may thus be wider.) The term "transfer" is substantially enlarged by rules that deem a transfer to be made to a trust or to an entity owned thereby. A resident contributor does not include any person not resident for 60 months from the end of the taxation year of transfer: pre-immigration trusts continue to be viable and may be simplified because no intermediate corporation is required to avoid subsection 75(2) attribution. A resident beneficiary must be a resident and the trust must have a connected contributor—generally speaking, an entity who made a trust contribution other than one made 60 months before or after the entity became a resident or made by an individual who has not been resident for more than 60 months since the contribution was made.

Thus, a trust is deemed resident if (1) a Canadian resident made a contribution to the trust, or (2) a person made a contribution to an inter vivos trust within 60 months of becoming a resident or within 60 months (18 for testamentary trusts) of leaving Canada. Trusts established for the benefit of Canadian residents by persons who were never Canadian-resident or who ceased to be resident 60 months after settling the trust—so-called granny trusts—are thus preserved. However, if a Canadian resident makes a contribution to a trust for the benefit of non-residents, it is deemed to be a resident trust.

A transfer or loan is not a contribution if it is an "arm's length transfer," a term now modified to exclude the transfer of restricted property: (1) a share, or right to acquire a share, of a closely held corporation that was acquired as part of a series of transactions under which a non-prescribed share (essentially a preference share) was acquired by any entity, or (2) debt owing by a closely held corporation acquired under such circumstances if interest thereon is fixed to productivity of or income from the issuer's property. A corporation is not closely held if its shares are widely held and actively traded as per the FIE rules.

The issue of shares continues to be deemed a transfer; thus, a preference share issued (or a common share issued as part of a series of transactions) by a closely held corporation to a trust in exchange for trust property is a transfer of restricted property and thus is not an arm's-length transfer, no matter how remote the NRT's connection to Canada. A transfer is arm's-length only if it is reasonable to conclude that none of the reasons (determined by reference to the trust's terms, letters of wishes, etc.) for the transfer is the acquisition at any time by any entity of a beneficial interest in an NRT. A transfer must also be, for example, at an arm's-length return on investment, a reduction of paid-up capital, a transfer on arm's-length terms, or a transfer to satisfy an obligation that arose on a transfer or loan on arm's-length terms other than a paragraph 94(2)(g) transfer. A de minimis rule prevents nominal settlements by residents from being a transfer if the settlor or issue does not benefit from any offshore estate freeze associated with the trust.

A trust's deemed residence applies for purposes of computing income and reporting obligations, except withholding of and liability for part XIII tax; the contributor and beneficiaries are generally jointly and severally liable for the trust's income tax. There may be little Canadian tax cost if the deemed resident trust has non-resident beneficiaries and the trust income, which is not Canadian-source, is paid or made payable annually—a requirement that may frustrate the trust's purpose and the trust must still file a return. Canadian-source trust income payable to non-resident beneficiaries is partly deductible, therefore approximating withholding tax on payments directly to the beneficiary; a revised formula appears to impose an effective 15 percent rate on treaty-country residents and 25.75 percent otherwise.

New rules exclude certain transfers from being characterized as tainting contributions; the acquisition of trust interests required under securities laws by promoters or sponsors is, for example, deemed not to be a transfer. If an NRT is deemed resident in 2003 because of a deemed transfer of shares by a private Canco and if the NRT then sells the shares at arm's length, another rule appears to ensure that Canco's liability for the trust's tax ceases. But the explanatory notes clarify that the original share issue continues to be treated as a transfer, ensuring the trust's deemed resident status.

The definition of "entity" now includes a natural person; this phraseology deviates from the Act's references to "an individual other than a trust." A lengthy discussion in the explanatory notes regarding the treaty applications to trusts

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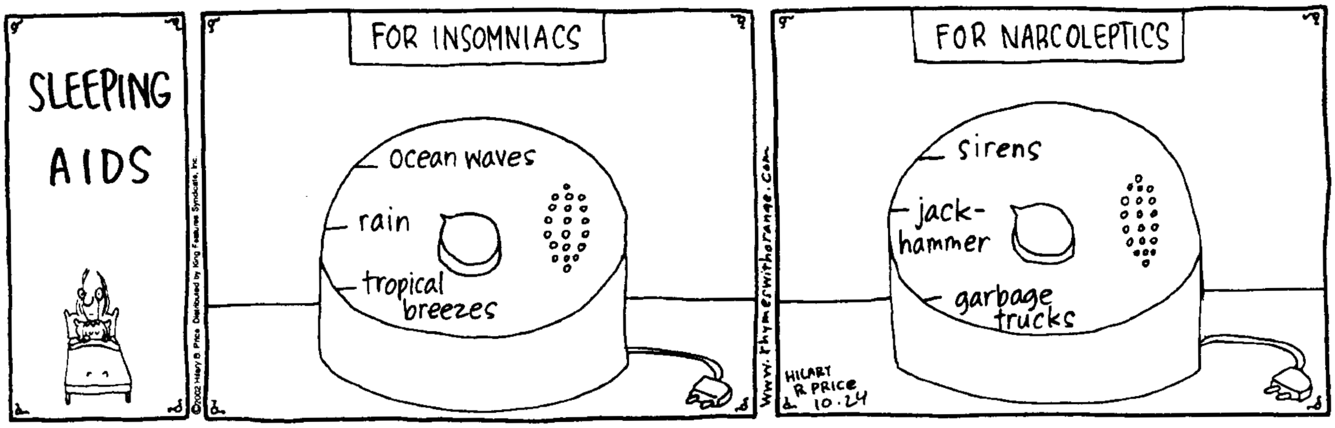

may be intended to bolster the potential application of GAAR to treaty shopping and trusts.

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Legal Costs of Support

The CCRA recently endorsed the deductibility of legal costs incurred to establish the right to spousal support and to obtain an increase in spousal or child support amounts. This change in position is effective for future (re)assessments and will not apply retroactively, although a refund may be claimed for legals paid in a prior year if a notice of objection can still be filed or was filed and is still outstanding.

Interpretation Bulletin IT-99R5 said that legal costs incurred to establish the right to spousal support amounts were not deductible, being on account of capital or personal or living expenses. Legal costs to obtain an order for child support were deductible because children have a pre-existing right to support arising from legislation, but legal costs of seeking to obtain an increase in spousal or child support or to make child support non-taxable under the federal child support guidelines were not deductible (paragraph 17).

Income Tax Technical News no. 24, dated October 10, 2002, says that following the TCC's informal procedure decision in *Gallien*, legal costs incurred to obtain spousal support under the Divorce Act or under applicable provincial legislation in a separation agreement are deductible because they are incurred to enforce a pre-existing right to support, similar to child support payments ([2001] 2 CTC 2676). The CCRA also accepts deductibility for the legal costs of seeking to obtain an increase in support or to make child support non-taxable under the federal child support guidelines.

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Comfort Letters Released

Finance recently released a batch of comfort letters from July and August 2002. Finance often took more than a year to publicize comfort letters; this more prompt response may reflect a March 2002 CBA-CICA Joint Tax Committee recommendation. Highlights of selected letters follow.

■ **Section 17 amendments.** A September 3, 2002 comfort letter concerns the connection between subparagraph 17(1)(b)(iii) and subsection 17(2) if a Canco makes indirect loans to a controlled foreign affiliate (CFA) that onlends the funds to another non-resident. Amendments are proposed to ensure that the loan amount subject to the subsection 17(2) anti-avoidance rule is the actual amount owed to the CFA by the non-resident borrower, assuring availability of the FAPI reduction (subparagraph 17(1)(b)(iii)). The change also affects back-to-back loans under subsection 17(11.2) and applies to taxation years beginning after February 23, 1998.

■ **Tax factors for TPSs.** An August 2, 2002 letter concerns the tax rates imposed under part VI.1 on corporations that pay dividends on taxable preferred shares. Finance will recommend the reduction from 66⅔ to 50 percent for the tax imposed under subparagraph 191.1(1)(a)(i) (on the amount by which taxable dividends paid by the corporation on short-term preferred shares exceed its dividend allowance for the year) and an adjustment from 9/4 to 3 in the factor applied in computing the part I deduction, effective for 2003 and subsequent taxation years.

■ **"Share of the capital stock of a family farm corporation."** The definition in subsection 110.6(1) will be amended to include a reference in paragraph (a)(i) to a related corporation the shares of which would also qualify under the definition, enabling the related corporation to qualify as an eligible user of the farm's property. The change applies to share dispositions after 2001. (Letter dated July 29, 2002.)

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Too Close to the Edge

The facts in *Water's Edge* (2002 FCA 291) have attracted GAAR for the third time. (See "More Questions Than Answers," *Canadian Tax Highlights*, April 24, 2001, at 29.) Even though the Act did not contemplate the transaction, and even though a specific anti-avoidance rule (SAAR) was subsequently enacted, the FCA has confirmed the TCC's denial of the terminal loss claimed.

The original partners of Klink, formed in 1979 in Ohio, were all US citizens and residents. In 1982, Klink purchased a computer for US$3.7 million and rented it out under long-term leases ending December 31, 1991. By 1991 the computer was fully depreciated for US accounting and tax purposes and was obsolete in North America. In December 1991, a British Columbia promoter and his company acquired a 98 percent interest in Klink for $51,500 and later that month sold most of that interest to the taxpayers and three other individuals for $320,000. The computer's FMV was then US$7,000. On the same day, Klink acquired a 50 percent interest in a British Columbia limited partnership (ILP) to which it conveyed the computer for a capital account credit of $50,000 and assigned its rights under the outstanding lease, the term of which had been extended to March 31, 1992. Efforts to lease the computer in Eastern Europe and Venezuela at a cost of about $20,000 were unsuccessful. Over $45,000 of income was earned from pre-existing leases.

The more than $4 million terminal loss that was recorded by the partnership in 1991 and flowed out to the partners was denied by the minister: either the partnership ceased to exist with the promoter's involvement or GAAR applied. On the basis of SCC decisions in *Backman* and *Spire Freezers*, the FCA said that the TCC erred in not concluding that the taxpayer's secondary or ancillary intention to earn income—evidenced by attempts to lease the computer abroad and the receipt of lease payments until December 31, 1991—was a sufficient intention to carry on business in common with a view to profit. The FCA agreed, however, that the facts could not withstand GAAR scrutiny. The loss of over $4 million (which cost 13 cents on the dollar) was clearly a tax benefit, which, it was "plain and obvious," was the "only reason why the transactions unfolded as they did." In assessing misuse and abuse, the FCA characterized the CCA system as recognizing over time the costs of capital assets actually used to earn income, with adjustments (recapture and terminal loss) for over- or under-depreciation. The decrease in value that gave rise to the terminal loss occurred when the computer was neither used to earn income nor a depreciable property under the Act. A technical reading of the provisions permitted the 1991 deduction for the 1982 historical cost as if the computer had always been used to earn income under the Act, even though the scheme of the CCA provisions and their object and spirit are limited to capital cost writeoffs for costs incurred for the purpose of earning income under the Act (paragraph 18(1)(a)). Preserving the historical cost of the computer and then triggering the terminal loss exploited an "obvious loophole." The celerity of the SAAR's enactment demonstrated that Parliament moved as swiftly as possible to close the loophole because the result achieved was "anomalous" vis-à-vis the Act's object and spirit; the prospectivity did not indicate the absence of offence. Because the relevant statutory provisions were not ambiguous, normal rules of interpretation could not be used to effect the object and spirit, nor could the FCA interpret the provisions to provide a result that conformed with that object and spirit, as did the SAAR. But the FCA could intervene by applying GAAR.

The significance of *Water's Edge* lies in the FCA's willingness to recognize that a loophole in the legislation can and should be GAARable, notwithstanding the introduction of an amendment to close an obvious legislative gap. Section 45 of the Interpretation Act clarifies that an amendment does not imply a change in the law, give rise to an inference that the amended provision means something new, or suggest deficiency in the previous law. Perhaps this decision merely imports and applies those principles to the GAAR context. But predicting when the object and spirit requisite for GAAR's application will be found creates uncertainty that is exacerbated when Parliament deems it necessary or expedient to target an obvious legislative gap with a SAAR.

Water's Edge reveals the tension between the plain meaning rule of interpretation; the principle that a taxpayer may rely on the words used; the import and impact of legislative amendments; and the prerequisite to GAAR's application, the object and spirit test. *Water's Edge* affirms the *OSFC* principle that "object and spirit" exists over and above explicit provisions, notwithstanding clear language therein to the contrary or a subsequent SAAR. Herein lies part of the GAAR conundrum. Is the object and spirit sufficiently clear if it is contrary to unambiguous language that otherwise permits the transactions; if the lack of clarity in statutory language is highlighted by a SAAR's subsequent enactment; and if the tax policy and extrinsic aids supporting the presumed object and spirit are minimal, ambiguous, or absent? If (as in *Water's Edge*) the statutory principles are basic, the statutory context is pedestrian, the policy is clear, and the abuse is blatant, it is within the interpretive function of the court to find a breach of the object and spirit. But absent such conditions, the boundary between interpreting the law and making it may itself be breached.

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US Basis-Shifting Regs

On October 18, 2002, the IRS issued proposed regs dealing with "unutilized basis" in redemptions treated as dividends for US tax purposes, modifying existing rules that taxpayers have relied on to take tax losses in stock attributable to redemptions that shift basis from one taxpayer to another. Some transactions involve shifting basis from stock of a non-US person to a US person, allowing the US person to use the shifted basis to reduce the gain on the stock's disposition. The regs apply to transactions that occur after their finalization, but the IRS continues to challenge adjustments claimed in basis-shifting transactions under other current authority (see IRS Notice 2001-45). The new regs further complicate attempts to harmonize the US and Canadian tax treatment of redemptions, particularly for US citizens resident in Canada.

The regs also apply to Code section 304 transactions giving rise to deemed dividend treatment. Commonly, a shareholder (say, Canco) owns the shares of two brother-sister subs (USco 1 and USco 2) and sells its shares in one USco to the other for cash or other non-stock consideration. Under section 304, the sale is not a capital gain transaction but is treated as a redemption/dividend from the acquiring USco to Canco to the extent of either sub's earnings and profits. Special rules apply to transfers made for retractable preferred stock of the acquiror.

These transactions may have adverse cross-border implications because US-Canada tax treatment is not harmonized. Canada generally treats redemptions and Code section 304 transfers as a return of capital and/or a capital gain, not as dividends. Assume that USco 1 has an FMV of $10 million and Canco's basis is $10 million. USco 2 has $10 million of earnings. Canco transfers the USco 1 shares to USco 2 for $10 million. If Canada treats the transfer as a sale, no gain or tax arises; but on the US side, a $10 million deemed dividend flows from USco 2 to Canco, triggering 5 percent US withholding tax of $500,000. Obviously, Canco would prefer that the transfer qualify for return of basis or capital gain treatment in the United States and thus be exempt from US tax (unless USco 1 is a US real property holding company).

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Code section 302 attempts to distinguish between redemptions with capital gain characteristics and those with dividend characteristics. A redemption is generally treated as a dividend unless it qualifies as a redemption under Code section 302(b) or 303: it is not (1) essentially equivalent to a dividend (Code section 302(b)(1)); (2) a substantially disproportionate redemption (Code section 302(b)(2)); (3) a complete termination of the redeemed shareholder's interest (Code section 302(b)(3)); (4) a redemption in partial liquidation of a non-corporate shareholder (Code section 302(b)(4)); or (5) a redemption to pay death taxes (Code section 303). If the stock is a capital asset, a redemption that satisfies any of these tests is treated as a sale or exchange giving rise to capital gain treatment. Otherwise a redemption is treated, in order, as a dividend (up to the redeeming corporation's earnings and profits); as a reduction in basis (tax-free return of capital); and any balance generally as a capital gain.

If a stock redemption is treated as a dividend, Code section 302 does not address its unutilized basis—the basis not used due to the dividend characterization—although reg. 1.302-2(c) says that "proper adjustment" will be made of the remaining stock's basis. Examples in the regs and IRS rulings shift basis from the redeemed shares to other shareholders—typically, related persons whose shares are attributed to the redeemed shareholder under the constructive ownership rules. The new regs jettison that standard and any basis shift, and instead allow the redeemed shareholder a loss for the unutilized basis—up to the redeemed stock's adjusted basis—on a disposition of that stock on the redemption date. Such a loss may be subsequently taken into account on a final inclusion—for example, at the shareholder's death or upon a sufficient reduction of his or its actual and constructive ownership interest in the redeeming corporation. If that shareholder is a Canco, the final inclusion date is normally when it transfers its assets to a USco in a section 332 liquidation or a Code section 368(a)(1) reorganization to which Code section 381 applies.

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FOREIGN TAX NEWS

Germany

The advocate general (AG) of the European Court of Justice (ECJ) issued an opinion that German thin capitalization law that disallows a deduction for interest paid by a resident sub to a non-resident parent violated the EU treaty, which prohibits restrictions on "freedom of establishment" within the European Union. The rule treated resident and non-resident parents differently, a result contrary to article 43 of the EU treaty, and there was no overriding reason of general interest to justify the distinction. An ECJ ruling accepting the AG's opinion is expected before year-end. International corporate groups affected by thin cap restrictions between EU-located countries should review their positions immediately. The AG's opinion is available on the ECJ's Web page in five languages, including French, but not yet in English: http://www.curia.eu.int/index.htm.

United States

Treasury says that proposed section 482 transfer-pricing regs on related-party services and cost-sharing rules will be issued by the end of this business plan year. Further refinements to the cost-sharing regs issued in July 2002 will be aimed at ensuring that such arrangements are not used to facilitate a disguised transfer.

Republic of China (Taiwan)

To stimulate economic activity, a draft bill has been endorsed that would exempt businesses in the free trade port zones (FTPZs) from all forms of indirect taxes, including customs, VAT, excise taxes, and wine and tobacco taxes. Qualifying FTPZs must be established near international airports and harbours on at least 30 hectares of land. Businesses located in an FTPZ may conduct any economic activity, including trade, manufacturing, and assembly. Quarantine on imports is limited to the minimum allowable time, and goods may be freely exported. Goods may be imported into FTPZs duty- and business-tax-free, and those duties and taxes may be imposed only if the goods are sold domestically.

Portugal

Effective in 2003, capital gains on the disposal of shares in joint stock companies held for more than 12 months, and debt securities regardless of holding period, are tax-exempt. Capital gains on other shares and on joint stock company shares held for lesser periods are taxed at a 10 percent flat rate. Anti-avoidance rules such as the disallowance of capital losses realized in black-listed tax havens continue.

Australia

To attract skilled overseas workers to Australia, temporary residents are exempt from tax for income or capital gains earned overseas for up to a maximum of four years.

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