CANADIAN TAX Highlights

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Volume 10, Number 12, December 27, 2002

GST ITCs on Takeover Fees

Whether a company is entitled to claim GST input tax credits (ITCs) is critical, and questions may arise even for a company apparently engaged in 100 percent commercial activities. The TCC recently dealt with the troublesome issue of ITC eligibility for GST paid on various services to fight a hostile takeover of the target Nowsco in *BJ Services*, a general procedure case.

Previously, concern existed because such expenses may be viewed as relating to the potential supply of shares—an exempt financial service—and as primarily directed at increasing shareholder value, not at making any particular taxable supply. The expenses at issue were primarily paid to financial consultants for an evaluation of the initial takeover proposal and solicitation of additional takeover bid offers, which were attempts to maximize shareholder value and defeat the initial takeover proposal. (The GST status of the financial advisers' services was not questioned, even though CCRA policies indicate that certain merger and acquisition services constituted an exempt supply of arranging for a financial service.) In the early 1960s, Nowsco began pumping liquid nitrogen into oil wells and evolved into a full-service oil and gas company, clearly commercial activities in the GST context. When the company went public, one of its missions was to "ensure superior growth in shareholder value."

After reviewing the section 169 ITC requirements and the definition of "commercial activity," the TCC quickly concluded that because Nowsco did not make any exempt supplies, the fees were ITC-eligible unless they had a non-business or personal element. The court did not explore the Crown's contention that GST paid in connection with the sale of shares had "no impact on the company's capacity to make taxable supplies" and thus the services were not acquired "for consumption, use or supply in the course of commercial activities." On the basis of this latter purpose test, Nowsco could not show that any taxable supplies were made as a result of its incurring the takeover expenses. However, the court thoroughly analyzed the purpose, benefit, and context of the particular inputs; on the basis of the company directors' responsibilities to the shareholders and the corporate-capital marketplace in which Nowsco operated, the court concluded that shareholder relations were an integral part of the business and not a "separate financial service business." As part of its regular and exclusively commercial business activities, Nowsco must maximize shareholder value and consider the takeover proposal and viable alternatives. The court distinguished seminal judgments of the Federal Court because the shareholders, not Nowsco, made the exempt supply of shares.

Specific ITC deeming rules in section 141.01—"simply meant to apportion inputs of a taxpayer who makes a combination of taxable and exempt supplies"—did not apply because Nowsco was only in the business of making taxable supplies and did not supply the shares. This conclusion seems correct, but section 141.01, along with sections 141 and 141.1, is an important provision and a closer analysis is essential to determining any ITC eligibility. For example, these sections are the basis for analyzing a GST registrant's business activities; they require it to look at its first-order supplies, not at the overall generic nature of the business, when addressing ITC entitlement.

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In This Issue

GST ITCs on Takeover Fees	89
Professional Incorporation	89
ORST: IT Consulting Temps	90
Westward Low	90
Fine-Tuning ECP Election	91
Replacement Property Eschewed	91
FX Losses: Full Deduction?	92
OBCA High-Low Shares	92
Capital Loss Utilization	93
New York Nexus	94
Alberta's NHL Players Tax	94
Foreign-Currency Securities	95
OID Under CCRA Review	95
Foreign Tax News	96
FIEs: Going in Circles?	96

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Professional Incorporation

Ontario Bill 198, tabled on October 30, 2002, amends the rules in the Ontario Business Corporations Act (OBCA) that allow certain professionals to incorporate their practices, effectively removing a threat to the tax benefits of incorporation. (Currently, physicians and surgeons, lawyers, chartered accountants, certified general accountants, dental surgeons, physiotherapists, psychologists, veterinarians, and others can incorporate in Ontario.)

One key advantage of a professional corporation is tax deferral: unless and until the money is otherwise needed for personal purposes, the professional may leave in the company up to $200,000 of the practice's income to be taxed at

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Pages 89 – 96

the low small business corporate rate and then reinvested. However, the legislation enabling such incorporation seemed to limit this advantage to temporary investment only:

> The articles of incorporation of a professional corporation shall provide that the corporation may not carry on a business other than the practice of the profession but this paragraph shall not be construed to prevent the corporation from carrying on activities related to or ancillary to the practice of the profession, including the *temporary* investment of surplus funds earned by the corporation. [section 3.2(2)].

Bill 198 deletes the word "temporary" effective upon the bill's receiving royal assent. The amendment seems to alleviate concerns about the investment of after-tax funds retained in the corporation.

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ORST: IT Consulting Temps

Amid the confusion and controversy over the application of Ontario retail sales tax (ORST) to software-related services, Ontario Finance attempted to tax placement agencies that supply IT consultants, apparently because they are involved in providing taxable computer services. It was not considered relevant that the services were provided through a placement agency, could be temporary in nature, and were often equivalent to those typically provided by employees. An information notice (IN) of October 30, 2002, now "clarifies" Finance's policy.

The industry objected to Finance's apparent initial position, saying that the services of placement agencies were a supply of human resources, not typically a taxable transaction, and had never before attracted tax. Furthermore, such agencies usually have no information regarding the specific nature and range of the services ultimately performed by these temporary contractors. Generally, the consultants "fill the gaps" with their specific knowledge and experience; they often work on a number of activities, only some of which are taxable.

The IN now says that the supply of an IT consultant by a placement agency is non-taxable if the documented arrangement is for the supply of human resources not directed specifically to providing taxable services and the consultant is not under the agency's direction and control. The agency need not charge ORST and the customer need not pay or self-assess the tax. In contrast, if the agency is responsible for the project deliverables or the services being provided and the agency may control or direct the consultant's work, the agency is not merely filling a temporary need for manpower and must charge ORST. Because the potential for non-taxable services is a "clarification" and not a change in policy, placement agencies or their customers currently under audit or pursuing an appeal on the issue should review their contracts and determine whether the services are non-taxable.

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Westward Low

Statistics Canada's latest annual review of provincial economic data provides a rough measure of the tax burden in each province for the calendar year 2000. Once more, Alberta shows the lowest burden, but Newfoundland and Labrador shows the most improvement. The table shows that only four provinces saw an increase since 1997 in the ratio of total tax collections to gross domestic provincial product (GDPP) for all levels of government and including the Canada and Quebec pension plans. In 1997, the national average of tax collections to GDPP hit a 55-year high of 36.4 percent; it dropped to 35.8 percent by 2000. Figures for the national aggregates indicate that the ratio will decline further to 35.3 percent in 2001. The ratio declined from 36.1 percent in Newfoundland and Labrador in 1997—the fourth highest in the country—to 31.6 percent in 2000, the eighth highest and the only province to shift its relative position. Alberta's ratio dropped from 29.0 in 1997 to 25.6 in the last year available. Alberta remains the lowest-tax jurisdiction in Canada. Quebec remains the highest: its ratio was consistently close to 40 percent over the four years 1997 to 2000. The changes in ratios are partly attributable to tax rate reductions, but increases in GDPP (the denominator) have been important in lowering ratios in the seven provinces.

Total Tax Revenue as a Percentage of GDPP

	1997	2000
Newfoundland	36.1	31.6
Prince Edward Island	37.3	37.5
Nova Scotia	35.7	36.4
New Brunswick	34.1	33.9
Quebec	40.0	40.7
Ontario	37.7	37.6
Manitoba	35.5	35.7
Saskatchewan	32.7	30.6
Alberta	29.0	25.6
British Columbia	35.2	35.0
National average	36.4	35.8

The tax ratios are lower in the three territories, where the role of federal grants in financing the public sector is more important. Tax comparisons with the provinces are also blurred by other factors, such as climate and the cost of living.

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Fine-Tuning ECP Election

For taxation years ending after February 27, 2000, a taxpayer who has disposed of eligible capital property (ECP) in respect of a business can elect to effectively remove a particular asset from the cumulative eligible capital (CEC) expenditure account and treat the related gain in the year as a capital gain from ordinary non-depreciable property (subsection 14(1.01); see "ECP Election for Capital Gain," *Canadian Tax Highlights*, February 27, 2001, at 13). Finance has said that it will recommend a change so that a non-arm's-length purchaser can obtain a step-up on such an election.

The election under subsection 14(1.01) recognizes that from time to time a taxpayer may prefer to choose to elect if it has available capital losses and wishes to conserve its ECE balance. The election cannot be used to recognize gains instead of losses; for goodwill and other types of property for which an original cost cannot be determined; or to recognize a capital gain that can be sheltered by the taxpayer's "exempt gain balance," an election regarding gains accrued to February 22, 1994.

The election can be used whether the sale is to a non-arm's-length person or partnership or to an arm's-length purchaser. However, under existing rules, if the purchaser is not dealing at arm's length with the vendor, the purchaser's cost is clearly limited to the vendor's original cost rather than the actual proceeds of disposition (subsection 14(3)). This is, of course, somewhat unfair, given that it could arguably result in double taxation if the purchaser were to subsequently sell the property for an amount exceeding its deemed cost. Finance officials agreed that this was an unintended consequence of the interaction of subsections 14(1.01) and (3) and have indicated that they are prepared to recommend to the minister of finance that an amendment be made to paragraph 14(3)(a) retroactive to the start date of the introduction of the election. Finance's recommendation will ensure that the non-arm's-length purchaser of ECP obtains a full cost base step-up to the vendor's actual proceeds of disposition, subject to the existing adjustments in subsection 14(3) for deductions under section 110.6.

If the recommended change is enacted, it may be advantageous for a parent with capital losses to file a subsection 14(1.01) election on qualifying ECP for which there is an accrued gain and sell it to another company in the group. Eligible property includes trademarks or patents, franchises, concessions, and licences that have an unlimited life used in the parent's business. The elected amount can be sheltered with the parent's capital losses and is effectively captured as ECE pool in the subsidiary that can be licensed to third parties or other group members. Other planning steps may be necessary to manage disposition proceeds, depending on the value of the ECP transferred.

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Replacement Property Eschewed

The replacement property rules in subsections 13(4) and 44(1) do not always yield the best result for a shareholder of a Canadian-controlled private corporation. For instance, a shareholder who generally draws significant salary or dividends from the business may benefit by the receipt of a capital dividend following the company's realizing a capital gain. The table shows that forgoing the replacement property rules may result in lower income taxes for the corporation and the shareholder. The corporation also enjoys a higher tax shield for the replacement property. Other considerations include the payment of a salary to offset recapture (after taking into account payroll tax); the resulting deemed

Replacement Property Election Benefits, Corporate Year-End December 31, 2002

	Election	No election
	dollars	
Corporation		
Net proceeds	1,000,000	1,000,000
ACB	300,000	300,000
Gain	700,000	700,000
Deferred gain	700,000	—
Net taxable capital gain	—	350,000
Corporate tax (@ 48.29%)	—	169,015
Refundable portion	—	93,333
Lesser of cost and proceeds	300,000	300,000
UCC	150,000	150,000
Recapture	150,000	150,000
Deferred recapture	150,000	—
Net recapture	—	150,000
Corporate tax on recapture (@ 38.62%)	—	57,930
After-tax proceeds to corporation	1,000,000	773,055
Taxable dividend paid	(1,000,000)	(516,388)
Refundable tax recovered	—	93,333
Capital dividend paid	—	(350,000)
Net proceeds to corporation	—	—
Shareholder		
Capital dividend received	—	350,000
Taxable dividend received	1,000,000	516,388
Personal tax (@ 31.34%)	(313,400)	(161,836)
After-tax income	686,600	704,552
Total tax paid by corporation and shareholder	313,400	295,448

Note: The figures assume that (1) regular Ontario corporate tax rates apply, and (2) the shareholder, an Ontario resident, is taxed at top marginal rates.

election under both subsection 13(4) and subsection 44(1) for depreciable property; and the impact of subsections 13(21.1) and 44(6) (although subsection 44(1) applies to land and buildings separately).

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FX Losses: Full Deduction?

Owing to exchange rate fluctuations, a taxpayer may realize a loss on repayment of a capital debt denominated in a foreign currency. The CCRA endorses the conventional approach, which recognizes a capital loss under subsection 39(2), and says that taxpayers cannot claim a full deduction under paragraph 20(1)(f).

Paragraph 20(1)(f) was traditionally viewed as applying to debt issued at a discount: if the amount paid in satisfaction of the obligation's principal amount exceeded its issue price, the excess was deductible in its entirety if the discount was 3 percent or less (subject to a yield test) and one-half deductible otherwise. "Principal amount" is defined in subsection 248(1) as the maximum amount that may be payable, under the terms of the obligation, on account of the obligation by the issuer (other than interest or certain premiums). In determining the principal amount of a foreign-currency-denominated debt, should the exchange rate at the time of issue or the spot rate in effect from time to time or at repayment be used? The definition of "principal amount" offers no guidance on the timing issue.

The CCRA's view expressed at the Foundation's 2002 annual conference was elaborated on in its TI of October 23, 2002, where it says that the issue date is the relevant time for determining the principal amount, the discount, and the 3 percent and yield tests (2002-013579). As a result, no foreign exchange loss is deductible under paragraph 20(1)(f): subsection 39(2) is a more specific provision governing the issue. Furthermore, the heading of paragraph 20(1)(f) is "discounts on certain obligations," and the technical notes to 1988 amendments refer to the deductibility of discounts. The CCRA also attempted to distinguish some earlier TIs and rulings that acknowledged that a debt's principal amount under paragraph 20(1)(f) could vary over time. In particular, the CCRA had accepted that the principal amount of an exchangeable debenture was the FMV of the shares delivered in satisfaction thereof, leaving any excess over the issue price deductible under paragraph 20(1)(f). The CCRA distinguished foreign-currency-denominated debt, saying that subsection 39(2) is the more specific applicable provision.

The CCRA's interpretation may give rise to an appropriate policy result, but its interpretive analysis of the legislative language and its reasons for distinguishing prior TIs are questionable. The CCRA might have taken the approach that paragraph 20(1)(f) allows a 50 percent deduction, an approach supportable if the 3 percent test is based on the ultimate and not the issue date principal amount. Alternatively, one might argue that the 3 percent or yield tests cannot be satisfied on the issue date because the maximum amount that may become payable under the obligation can be significantly higher than the issue price, depending on currency fluctuation. The courts will likely be the final arbiters on this matter.

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OBCA High-Low Shares

It appears that there are conflicting views as to whether the Ontario Business Corporations Act (OBCA) allows for a stock dividend of shares with a redemption amount that exceeds the amount added to the shares' stated capital account (high-low shares). There are strong arguments to support a conclusion that high-low shares can be issued in satisfaction of a stock dividend under the OBCA.

Section 38(2) of the OBCA requires that a corporation add the "declared amount" of a stock dividend to the shares' stated capital account. Under section 23(3), a corporation cannot issue shares until the consideration therefor is fully paid in money, property, or past service, and then it must add that full amount to the appropriate stated capital account per section 24(2). It is not clear whether sections 23(3) and 24(2) apply: are shares that are issued as a stock dividend issued for consideration? If they are, the addition to the stated capital account must equal the shares' FMV; if they are not, the stated capital account addition under section 38(2) need not bear any relation to the shares' FMV. The latter conclusion is supported by the context and history of these and similar provisions.

- Section 38(2) does not expressly require that the addition to the stated capital bear any relation to the shares' FMV.
- A 1979 amendment to a parallel provision, section 43 of the Canada Business Corporations Act (CBCA), changed the addition to the "declared amount" from the previously required "value of the dividend." The amendment was intended to allow a corporation to meet the solvency test by declaring a dividend in an amount less than the shares' FMV.
- The addition of the full consideration for a share to the stated capital account in section 24(2) was intended to avoid the creation of contributed surplus, which is not created by the issuance of high-low shares on a stock dividend.
- If sections 23(3) and 24(2) apply to stock dividends, a stock valuation is necessitated because the shares so issued must have an FMV equal to the dividend's declared amount. Such a valuation is not in accord with common practice. (For more details on the above bulleted points, see Brian Nichols, "Corporate Law Matters of Interest to Tax Practitioners," 1993 Ontario Tax Conference.)
- Section 24(6) arguably confirms that a stock dividend under section 38(2) is not issued for consideration. Section

24(6) requires a shareholders' special resolution to increase the stated capital in certain circumstances; section 38(2) is expressly excluded from this requirement, which implies that section 24(6) would otherwise apply. Inter alia, one of two tests must be met. One test applies if shares are issued for consideration and the amount thereof does not form part of the stated capital of the class of shares, a test not applicable to a stock dividend: if shares are issued for consideration, section 24(2) would require an FMV addition to the relevant stated capital account. The other test applies only to situations where amounts not received as consideration for the issuance of shares are added to stated capital and would apply to stock dividend shares if such shares are not issued for consideration. Thus, because section 24(6) can only apply to an increase in stated capital on a stock dividend if shares so issued are not issued for consideration, and because the drafters of the OBCA have expressly excluded section 38(2) from the operation of section 24(6), it appears that section 24(6) clarifies that no consideration is received for shares issued upon a stock dividend. As a result, sections 23(3) and 24(2), applicable to shares issued for consideration, should not govern the amount to be added to the stated capital account of shares issued as a stock dividend. It therefore appears that an OBCA corporation may issue high-low shares on a stock dividend.

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Capital Loss Utilization

The stock market of the last two years has set the stage for the timely crystallization of capital losses and the possible acceleration of their use.

Attempts to accelerate a loss without selling the property to an unrelated third party may be thwarted by the superficial-loss rules if within 30 days either side of a capital property's disposition the transferor (or an affiliated person) acquired the same or an identical property or a right to so acquire it. The adjusted cost base (ACB) of the substituted property is increased by the loss denied. The GAAR would likely apply if the accrued loss was thus transferred via the stepped-up ACB to a spouse in order to be realized and offset against his or her capital gains. A disposition to a parent, a sibling, a child, or a trust does not trigger the superficial-loss rules—whether a gift is made or a demand non-interest-bearing promissory note is taken as consideration—preserving in the family the potential benefit from market recovery. The accelerated capital loss may reduce capital gains in the three preceding taxation years and indefinitely into the future.

If the taxpayer disposes of property for less than FMV (as, for example, on a rollover), a gain may nonetheless be recognized at that time under subsection 69(11) if one of the main purposes of a series of transactions may reasonably be considered the obtaining of the benefit of any deduction or expense or exemption on a subsequent disposition of the property within three years by a person (other than a person "affiliated" immediately before the series if the definition was read without reference to control). Assume that a parent and a child each own 50 percent of the shares of a lossco with capital loss carryforwards. The parent rolls his or her publicly traded shares that have appreciated in value into lossco, which plans to sell them and use its loss carryforwards to shelter the gain. So that the child does not share in the gain, the child first sells his lossco shares to the parent, a transfer that does not adversely affect the loss carryforwards under subsection 256(7) because the parties were related before the transaction. But subsection 69(11) poses a problem because the parent is not affiliated with lossco immediately prior to the series.

If capital losses have been recognized, capital gains to offset them may be uncovered in a variety of situations.

- Many mutual funds allow investors to convert interest income into capital gains.
- A flowthrough share purchased from a publicly traded resource company allows an individual certain deductions renounced in his or her favour that may be used to offset, for example, employment, investment, or business income. The

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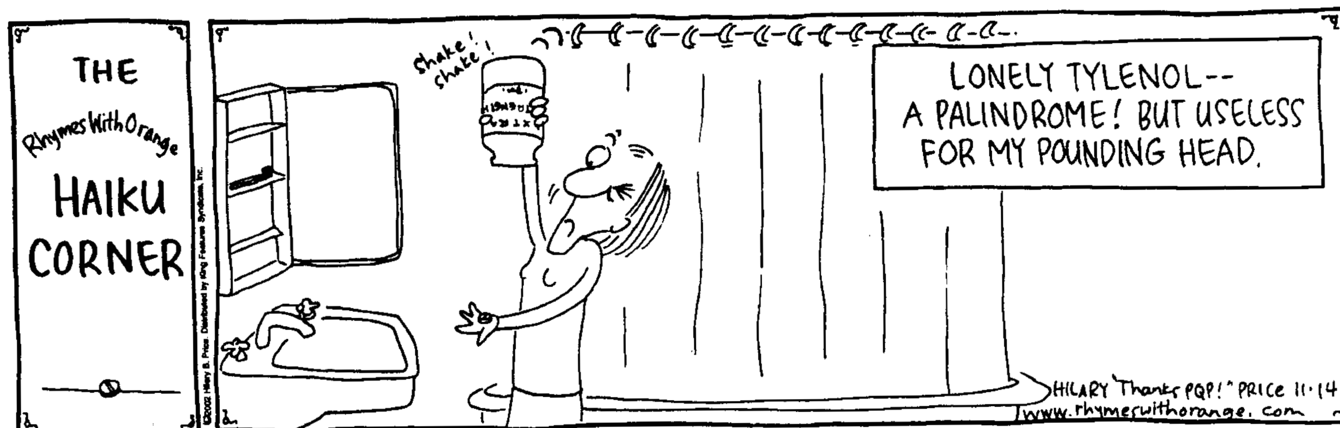

flip side is that the shares' ACB is reduced to nil and its disposition may result in a capital gain.

- An internal reorganization of a holdco or opco may generate a capital gain on an individual's shares. The sale of the shares to a new holdco for a promissory note equal to the stepped-up ACB allows the individual to subsequently withdraw funds from the corporate group up to that amount without triggering personal tax.
- Capital gains may arise on the deemed dispositions on death, emigration, or foreclosure.
- A negative ACB may arise on a tax shelter or on withdrawal of funds from a limited partnership in excess of the partnership interest's ACB. For example, a partnership's rental property may be refinanced to make additional funds available to the partners via capital distributions of the mortgage proceeds.
- Foreign-currency transactions may result in gains.
- The transfer of cottage property into a trust for children may be used to trigger a gain that previously would have caused the owner to postpone the transfer when no offsetting losses were available.

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New York Nexus

Like most states, New York requires companies with nexus—a physical presence in New York—to comply with sales tax filing and collection responsibilities. Two recent advisory opinions (AOs) from New York State's Department of Taxation and Finance highlight that even the most trivial physical presence can trigger New York sales tax obligations for Canadian companies.

In the *Yvonne Greenberg* AO, the issue was whether a Canadian company's activities in New York required it to collect sales tax on sales of its product to New York customers (TSB-A-02(49)S, September 24, 2002). The company's New York activities were limited to transportation of equipment through the state, two trade shows a year, and one or two visits by sales representatives per year; on one occasion it hired a third-party contractor to deliver to and install its product for a customer in New York. The tax department ruled that interstate transportation and trade show activities were not sufficient to constitute nexus and trigger a collection responsibility, but sales tax nexus was established simply because its employees visited New York once or twice a year.

The New York connections were less tenuous in the *Luisa Frate* AO (TSB-A-02(48)S, September 18, 2002). The National Film Board of Canada (NFB), which has an office in New York City, queried whether it must collect sales tax on sales of films and videotapes over the Internet. The tax department concluded that the office constituted nexus with New York and gave rise to a responsibility to collect sales tax on sales to New York customers, even for sales conducted over the Internet.

The use of separate but affiliated entities to engage in US and New York activities is one significant means of minimizing or possibly eliminating New York sales tax exposure. The company in the *Greenberg* AO could have reduced or altogether eliminated its New York tax responsibilities by using a separate affiliated entity operated and legally respected as such.

Both AOs underscore a few salient points. The *NFB* AO illustrates that the Internet provides no special tax protection for sales to New York businesses: companies that sell products over the Internet are subject to the same sales tax nexus rules as those that sell through the mail or retail stores. Both opinions emphasize that minimal activity may create New York sales tax nexus: one visit a year may be enough.

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Alberta's NHL Players Tax

Effective at the start of the 2002-3 National Hockey League (NHL) regular season, Alberta requires NHL players to pay a surtax for every game played in Alberta. The NHL players tax equals 12.5 percent of the athlete's game-day salary for every Alberta game involving the player's team. The tax is part of an initiative to raise funds to support the Edmonton Oilers and the Calgary Flames. Alberta expects to forward about $6 million per season to the owners of those two teams.

Alberta's politicians argue that small-market teams need financial assistance in order to be competitive: several years ago Quebec City and Winnipeg lost popular NHL franchises to US cities. In January 2000, the federal government proposed conditional financial support to Canada's NHL franchises, but retracted the offer within days in the face of backlash from media and citizen groups. Apparently undeterred by the federal debacle, Alberta agreed early in 2002 to provide revenues from its BreakAway lottery to Alberta's struggling franchises; it then introduced the NHL players tax in its March budget.

The enabling legislation is unconventional in several respects. Tax liability is triggered by a player's being on an NHL roster when the team plays in Alberta, regardless of whether he plays. The player's salary for a game is equal to his base salary divided by the number of calendar days (not games) in the NHL regular season. The base does not include pre-season games or playoffs. The legislation does not use common tax definitions such as "taxation year" and "taxable income," which would include bonuses. Most provincial income taxes are administered by the federal government pursuant to the tax-collection agreements, but teams must withhold the NHL players tax separately and remit the proceeds directly to the Alberta treasury.

The Alberta plan challenges basic principles of tax equity, neutrality, and fairness with, arguably, no public benefit. The

tax raised, net of administrative fees, will be channelled to the owners of the Flames and the Oilers. The NHL Players Association (NHLPA) claims that the tax violates the league's collective bargaining agreement. Player representatives criticized the tax plan as an "outrageous" attempt to transfer resources from a small, visible group of players to a select group of employers. However well intentioned, the Alberta proposal may jeopardize the future of the NHL's internal assistance programs that provide annual grants to the Flames, the Oilers, and other qualifying Canadian teams. Furthermore, Alberta Finance officials introduced the tax with assurances that it did not violate NAFTA because all players were treated the same. However, income tax measures are generally beyond the scope of NAFTA. The greater concern is that the diversion of government tax revenues to local private businesses violates NAFTA's national treatment principles.

On the international stage, the players tax takes advantage of foreign tax credit rules and treaty provisions to allow tax revenues to flow from foreign coffers to the Alberta treasury. As a subnational tax on income, the players tax qualifies under the foreign tax credit rules of most countries so players who are not resident in Canada will receive a credit in their home country. The amount of credit for the tax will depend on the relative tax rate and limitations of the player's home jurisdiction. Canadian-resident players cannot claim a tax credit or deduction for the tax.

Moreover, the brunt of the tax is borne by those who play most often in Alberta. The Oilers and the Flames play all home games and two or three away games each season in Alberta: thus, the new tax represents an average tax burden increase of more than 3 percent of the salary of each Oilers and Flames player. Edmonton goaltender Tommy Salo, who according to NHLPA figures will earn about US$3.5 million in 2002-3, will pay over $166,000 in players tax. By comparison, a non-Albertan goalie such as Curtis Joseph of the Detroit Red Wings, who earns US$8 million per season, will pay about $26,000, or 0.2 percent of his total salary.

The NHL market will distort the intended effects of the Alberta tax plan. In the short term, Alberta hockey players will bear the additional tax burden. As players negotiate new contracts with the Oilers and the Flames, they will demand a pay increase to offset the new tax, as undoubtedly Jerome Iginla did to cover his anticipated additional tax cost of $300,000 per season when he signed a new contract with the Flames. The professional hockey market dictates that teams pay competitive salaries or else risk attracting lower-quality players. If funds are forwarded to team owners by Alberta in order to increase player salaries, then the plan merely transfers money back and forth between players and owners with no public revenue gain, but with losses due to administrative inefficiencies. Alberta's plan could go askew if the owners are not compelled to reinvest the tax monies in team improvements and instead boost their return on capital. If owners choose not to pay for high-quality players, then presumably the lower-calibre team will lead to declining team revenues. By increasing the tax burden on Alberta hockey players without obtaining firm salary commitments from team owners, Alberta may be contributing to the deterioration of professional hockey in the province.

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Foreign-Currency Securities

The TCC in *Rezvankhah* recently confirmed the CCRA's longstanding two-step method for determining a taxpayer's capital gain or loss on the sale of securities acquired in US currency (court file 2002-2104(IT)I). The TCC followed the mechanics used in the FCA decision in *Gaynor*: the securities' ACB (proceeds) is determined by applying the average exchange rate in the year of acquisition (disposition) to arrive at the Canadian-dollar equivalent of the US-dollar cost (proceeds). (*Rezvankhah* was heard under informal procedure and has no precedential value.)

The taxpayer calculated his capital gain or loss in US dollars and then converted it to Canadian dollars. The CCRA applied the two-step calculation (also discussed in TI 2002-0118355) but allowed the $200 exemption in subsection 39(2), which applies to capital gains or losses arising from the fluctuation of a foreign currency relative to the Canadian dollar. (After deducting foreign exchange capital losses from capital gains, an individual is entitled to a further deduction of $200; an individual's losses over capital gains are also increased by a further $200.) The TCC observed that however sensible the CCRA's use of the average annual exchange rate for the year, technically the spot rate on the day of the transaction is the appropriate exchange rate. According to the TCC, there is no reason the spot rate cannot be used if it assists the taxpayer and he insists on it.

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OID Under CCRA Review

The CCRA's long-awaited preliminary review of its interpretive and administrative positions on interest deductibility was released on October 1, 2002. (See "Interest Deductibility Update," *Canadian Tax Highlights*, October 29, 2002, at 73.) The CCRA is continuing its review, inter alia, of the treatment of original issue discounts (OIDs) on short-term obligations.

As stated in former IT-114, the OID was generally regarded as interest if the debt either was non-interest-bearing or carried an interest rate substantially lower than the issue-date market rate. Such OID was subject to normal rules for

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Published monthly
Price: $13.33 per copy
Subscription rate: $160 per year

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ISSN 1192-2672 (Print)
ISSN 1496-4422 (Online)

interest deductibility or income inclusion. The 1997 withdrawal of IT-114 was generally understood to be motivated by other concerns and was not perceived as a signal of any change in view regarding OIDs. But the CCRA's October 1, 2002 review said that only financial institutions could deduct as interest the OID on non-interest-bearing debt. Commercial paper is included in this category; although arguably provisions other than paragraph 20(1)(c) afford a deduction, taxpayers other than moneylenders would be excluded from an important financial market if they were not afforded a deduction for OID. Apparently the CCRA had not focused on short-term debt obligations, but it is now reviewing the issue in depth. The position on OID in the revised IT to be issued in 2003 may be similar to that set out in the old IT-114. The Joint Committee on Taxation is providing input to assist the CCRA in its review of this and other matters.

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Foreign Tax News

Treaties

A treaty with **Gabon** was signed and will enter into force on ratification. Withholding tax is 15 percent on dividends and 10 percent on interest and royalties, effective January 1 of the calendar year following ratification; all other taxes apply for taxation years beginning on or after that day.

Brazil

In a move that may put an end to bank secrecy in Brazil, financial institutions (FIs) must report taxpayers' tax ID numbers and financial transactions in excess of a stated amount to the federal revenue department. An FI includes a bank, stockbroker, real estate credit company, credit card company, credit cooperative, stock exchange, and savings and loan association. A separate stated amount is delineated for each type of transaction in each type of FI.

South Africa

New rules attribute the income of a controlled foreign entity (CFE) to a greater than 10 percent resident shareholder. A rebate is available for foreign taxes paid by the CFE on income from a foreign country that is so included in the resident's income, unless relief is also granted, for example, under a treaty.

Australia

Two recent bills propose venture capital incentives for foreign investors investing in small and medium-sized entities, retroactive to July 1, 2002. Venture capital limited partnerships (VCLPs) and Australian venture capital funds of funds (AVCFOFs) are transparencies for tax purposes. A capital gain on the sale of an eligible venture capital investment is also exempt from tax to an investor that is a tax-exempt or a taxpayer resident in listed countries or is a VCFOF established and managed in certain listed countries; both lists include Canada, the United Kingdom, and the United States.

Hungary

To boost turnover on Budapest exchanges, tax breaks are effective January 2003 for multinationals investing in Hungarian financial securities, allowing a one-half deduction of net proceeds from financial transactions in arriving at taxable income. All transactions on the Budapest stock exchange and commodities exchange, including shares, futures, options, and bonds, are affected, but FIs cannot participate.

European Union

The European Union is forcing Eastern European countries to end tax breaks for foreign investors before entry into the EU in 2004, because such practices provide an unfair advantage. Hungary is the only country that has compliance issues: 40 percent of its exports are foreign and employ 1 in 10 Hungarians. Poland will comply and terminate incentives in its 17 economic zones.

Carol Mohammed
Canadian Tax Foundation

FIEs: Going in Circles?

In the last sentence of the first full paragraph of "FIEs: Going in Circles?" (*Canadian Tax Highlights*, November 26, 2002), at 84, the reference to the election by a non-resident entity to value at FMV the property on its balance sheet should say that the election still does not apply to items such as "internally generated" goodwill. The electronic edition of the November issue has been corrected and is available at http://www.ctf.ca.

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