CANADIAN TAX Highlights

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PRE-BUDGET RECOMMENDATIONS

On November 29, 2002, the House of Commons Standing Committee on Finance tabled its advice to Finance Minister John Manley for the 2003 federal budget, expected in late February 2003. The report summarizes the committee's findings from its annual pre-budget consultations and makes recommendations on the country's tax system. Finance is unlikely to take up all of the committee's recommendations, but the report is a good indication of some of the issues on the table. Highlights of the committee's corporate tax recommendations follow.

Large corporations tax. Many submissions to the committee called for the elimination of the federal large corporations tax and the part VI capital tax on financial institutions. Various groups pointed out that no other major industrial country imposes a capital tax, which is largely insensitive to profits and thus functions as a form of corporate minimum tax. In the event of an economic slowdown, some companies may need to borrow cash to meet their capital tax obligations, even if they face losses. The committee recommends the complete elimination of capital taxes rather than a phase-out in the next federal budget.

Corporate tax cuts. The committee recommends that corporate tax cuts announced in the October 2000 mini-budget proceed and be fully phased in by 2004-5. More immediate cuts are not recommended, but Canada's corporate tax rates should be monitored to ensure that they remain competitive with rates in other G7 countries, especially the United States.

Updating capital cost allowance rates. The committee heard that many capital cost allowance (CCA) rates no longer reflect the actual economic life of equipment due to rapid technological change, thus hampering a company's ability to replace aging equipment and invest in new technology. Comprehensive reform of CCA rates is recommended to better reflect the pace of technological change and the shorter economic life of modern machinery and equipment.

R & D tax credits. The application process for R & D tax credits should be simplified, and companies should be allowed to use such credits during unprofitable periods to act as a continuing incentive; for example, credit refundability could be broadened.

Other recommendations. Some other narrowly targeted measures proposed for consideration should be implemented when feasible and not necessarily included in the 2003 budget.

- Information and technology companies should be able to recognize revenue from maintenance contracts as services are provided rather than when payment is received.
- The minister should publicly state that a recent SCC decision—presumably that in *First Vancouver Finance* (2002 SCC 49)—will be followed so that factoring firms are not liable for unremitted GST owed by manufacturers in financial distress that sell their accounts receivable to the factoring industry. The government should also consider creating a "public record for consultation" that identifies financially troubled manufacturers that owe GST.

Corporate rollover elections

On another front, the CCRA confirmed in a recent letter that a rollover election under subsection 85(1) was valid even if a purchaser corporation did not issue shares in exchange for certain properties until after their transfer was complete. The election was valid because the shares were issued before the election's filing deadline in subsection 85(6). Although the taxpayer was able to make the election, this situation illustrates the importance of making sure that both parties are prepared before they make such exchange transactions.

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In This Issue

PERSONAL TAX RECOMMENDATIONS

The House of Commons Standing Committee on Finance also made several recommendations for personal tax changes for the 2003 federal budget, highlights of which follow.

RRSP and RPP limits. RRSP contribution limits have been frozen at $13,500 per year since 1996 and are scheduled to rise to $14,500 in 2004 and $15,500 in 2005 (indexed for inflation thereafter). The committee recommends raising this limit for several reasons. Raising limits will provide taxpayers with greater flexibility in their retirement planning, especially self-employed individuals and small-business employees who do not benefit from registered pensions plans (RPPs). Raised limits will also increase tax revenues when baby-boomer beneficiaries retire and begin RRSP withdrawals: the greater tax revenue will more readily match anticipated increased health-care spending. Canada will also be able to attract and retain skilled workers if tax-assisted retirement savings plans contribution limits are brought in line with other countries': the UK annual contribution limit, for example, is $45,000. The committee calls for an increase in RRSP and RPP contribution limits to $19,000 for 2003 (indexed for inflation in later years) to allow those in the top tax bracket to shelter 18 percent of earnings.

Previously announced tax cuts. The committee says that personal tax cuts announced in the October 2000 mini-budget should proceed and be fully phased in by 2004-5. The committee recommends no further personal tax rate reductions at this time but says that the government should consider further reductions as resources permit.

Other recommendations.

- Provide a full exemption from capital gains taxation for all charitable donations of publicly traded securities, including donations to private foundations. The feasibility of extending capital gains tax preferences to donations of real estate should be studied.
- Increase the Canada educations savings grant contribution to 30 percent (from 20 percent) for the first $1,000 of annual contributions to an RESP, and permit the provinces to set up similar programs.
- Reduce EI premiums, commence public consultation on the development of a new premium rate-setting process, and introduce a yearly basic EI premium exemption.
- When feasible, consider a 15 percent tax credit to promote the use of employer stock ownership plans to match the tax incentive for labour-sponsored venture capital funds.

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SR & ED Developments

The 1998 SR & ED conference entitled "Building Partnerships" established several goals, including the development of industry/sector guidelines, codes, and standards to reflect industry differences. In 2002, the CCRA released a number of new publications co-written with industry groups (go to http://www.ccra-adrc.gc.ca; follow the "tax credit—business" link to "SR & ED"). Participating with industry in the formulation of the guidance was a bold step for the CCRA, but the quality of the results speaks to the success of the partnership. Three of the new publications primarily target specific sectors but have some wider application; two others provide cross-industry guidance. The titles are as follows:

- *Chemicals Guidance Document 2—Qualifying Work*
- *Textile Industry Guidance Document*
- *Information for Agricultural Organizations and Farm Producers on Access to SR & ED Investment Tax Credits*
- *Guide to Supporting Technical Aspects of a Scientific Research and Experimental Development (SR & ED) Claim*
- *Cross-Sector Shop Floor Guidance Document*

Three other recently released publications deal with expenditure issues:

- *Experimental Production: Allowable SR & ED Expenditures*
- *Expenditures Incurred for Administrative Salaries or Wages—"Directly Related" Test*
- *Recapture of Investment Tax Credit*

A consolidated draft version of the principal costing guidance, *Interpretation Bulletin* IT-151R5, was also released. The changes are primarily technical, such as the deletion of outdated references to the Ontario superallowance and the Atlantic Canada rate. The CCRA's opinion on foreign travel expenditure in connection with SR & ED appears to have solidified: such amounts will be recognized as subsection 37(1) costs (and thus as qualified expenditures for ITC purposes) only if the travel is for the acquisition of equipment or material used in SR & ED in Canada; for training related to SR & ED carried on in Canada; or for visits to foreign customers in respect of SR & ED carried on in Canada to update the customer on the SR & ED project's status.

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Personal Income Tax Goldmine

Federal and provincial governments in Canada continue to rely on the personal income tax as their main source of revenue, despite significant rate reductions over the past six years.

The first table shows that federal personal income tax collections on a national accounts basis reached a peak of 8.7 percent of gross domestic product (GDP) in 1998. Recent rate cuts reduced this ratio to 8.5 percent in 2000, and a slight decline in total collections in 2001 lowered the ratio to 8.2 percent. Provincial collections dropped further in relative importance. In 1991, provincial personal income taxes represented 5.6 percent of GDP, but only 5.0 percent by 2000 and 2001. The effect of provincial rate reductions is evident in the growth rates for 1997 to 2000; provincial collections grew substantially more slowly

Personal Income Tax Collections as a Percentage of Gross Domestic Product

	Federal	Provincial	Combined
1981	6.4	4.3	10.7
1982	6.8	4.6	11.3
1983	6.5	4.6	11.1
1984	6.3	4.6	10.8
1985	6.6	4.3	11.0
1986	7.4	4.6	12.0
1987	7.5	4.9	12.4
1988	7.6	5.1	12.7
1989	7.8	4.9	12.7
1990	8.6	5.5	14.1
1991	8.6	5.6	14.2
1992	8.6	5.3	13.9
1993	8.0	5.2	13.3
1994	7.6	5.4	13.0
1995	7.8	5.3	13.1
1996	8.1	5.5	13.6
1997	8.4	5.3	13.7
1998	8.7	5.3	14.1
1999	8.4	5.3	13.7
2000	8.5	5.0	13.5
2001	8.2	5.0	13.2

Personal Income Tax Collections as a Percentage of GDPP, 2000

	Federal	Provincial	Combined
Nfld.	6.8	4.7	11.5
PEI	7.7	4.7	12.4
NS	8.7	5.4	14.1
NB	7.9	4.8	12.7
Que.	7.3	7.9	15.2
Ont.	9.6	4.1	13.8
Man.	8.0	5.3	13.3
Sask.	6.4	4.1	10.5
Alta.	7.2	3.5	10.7
BC	8.7	5.0	13.7
Yukon	6.4	3.3	9.7
NWT and Nunavut	5.1	2.2	7.2
National average	8.5	5.0	13.5

than federal. Total collections fell from a peak equivalent to 14.2 percent of GDP in 1991 to only 13.2 percent in 2001.

The second table shows provincial detail for 2000, the latest year available from Statistics Canada's Provincial Economic Accounts. Because of differences in average income levels and in the composition of taxable income, the uniform federal income tax system produces ratios of federal personal income taxes to gross domestic provincial product (GDPP) that vary from province to province. The highest ratio was in Ontario, where federal income taxes were equivalent to 9.6 percent of GDPP. The lowest federal ratio was in Saskatchewan at 6.4 percent, although the territories showed the same or lower ratios. The ratio of provincial personal income taxes to GDPP ranged from a high of 5.4 percent in Nova Scotia to a low of 3.5 percent in Alberta. The federal ratio is low in Quebec and the provincial ratio high—higher than the federal—partly because of the federal abatement for opting out.

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AG on Foreign Affiliate Rules

The auditor general's (AG's) report, released on December 3, 2002, focuses on two specific areas of Canadian tax: the CCRA's audit practices related to international transactions and the erosion of tax revenue related to the foreign affiliate rules.

Chapter 4 of the report examines the CCRA's administration of the tax rules affecting Canadian residents in their international transactions; it is the mirror image of last year's examination of tax rules applicable to Canadian-source income earned by non-residents. This report takes aim at the resources, or lack thereof, available to the CCRA, including the absence of a risk identification model to assess non-compliance risks in international transactions; the fact that over one-third of international tax auditors have less than one year's experience; the difficulty of recruiting auditors in the Toronto area; and the inadequate fulfilling of auditors' basic training requirements. The AG observed that the exchange-of-information provisions in Canada's tax treaties are rarely used, even when taxpayers fail to respond to information requests. The AG recommended the involvement of economists in the audit process at a much earlier stage in order to reduce delays related to transfer-pricing matters, which often extend audits to more than three years.

In the context of the foreign affiliate rules, the AG drew Finance's attention to tax arrangements that have eroded hundreds of millions of dollars from tax revenues over the past 10 years.

- Currently, double-dip financing structures encourage foreign-based multinationals to shift debt into Canada in order to benefit from a deduction in Canada and abroad. The AG took particular offence at foreign multinationals' borrowing through their Canadian subsidiaries to capitalize controlled foreign affiliates (CFAs), especially Barbados-resident CFAs, that on-lend to related non-resident companies.
- A recent SCC decision (probably *Ludco*) undermined the CCRA's ability to argue that interest expense is not deductible if the overriding purpose of the loan was not to earn income, but rather to make a capital gain.
- Barbados IBCs and US-resident LLCs are entitled to exempt earnings treatment even though they may have borne little or no tax in their country of residence.

■ Dispositions of taxable Canadian property (TCP) are structured by setting up corporations in Malta or Barbados that dispose of such property. In one case, a non-resident who held TCP became a resident of Barbados; the gain on the sale of the property was exempt from Canadian tax under the Canada-Barbados treaty and was not taxed in any other country.

■ Canada's rules that allow tax-free repatriation of exempt surplus dividends should be re-examined in light of the low rates of tax imposed by certain treaty partners, including Barbados, Belgium, Cyprus, Hungary, Ireland, Luxembourg, Malta, the Netherlands, and Switzerland.

■ Foreign affiliates of foreign-owned Canadian corporations have shifted gains from Canada to low-tax jurisdictions on a tax-free basis. One such transaction shifted a $500 million capital gain to Barbados.

■ The exemption from the "investment business" classification where more than five full-time employees are employed in the conduct of the business can be exploited by large multinationals if the benefit of eluding the FAPI rules far exceeds the costs associated with employing five individuals.

■ To avoid the rules dealing with the reinsurance of Canadian risk, taxpayers have set up captive offshore insurance companies in which they each own less than 10 percent. Furthermore, corporations such as financial institutions are avoiding the rules by exchanging comparable risk portfolios with foreign insurers.

The AG also noted that many of the practices that erode Canada's tax base, such as the exploitation of Canada's exempt surplus system, have been identified before but remain intact. Finance responded that new foreign reporting requirements, improved transfer-pricing rules, proposed FIE and non-resident trust rules, and participation in OECD work have contributed to a reduction in the abusive use of tax havens. Finance also believes that the government's staggered tax reduction plan, coupled with provincial tax cuts, will reduce tax rates below US rates and reverse the benefits that result from multinationals' locating their debt financing and interest expense in Canada. Finance does not seem inclined to follow the report's recommendations; it will "continue to assess the rationale and operation of Canada's system for taxing foreign affiliate and foreign source income," but it notes that the system serves certain policy goals, including the support of Canadian businesses' international competitiveness. While both the AG and Finance recognize the importance of these rules to ensure competitiveness abroad, there seems to be no consensus when the rules' benefits extend to foreign-based multinationals; this aspect of the rules may be scrutinized in the future.

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ORST Appeal Time Extended

The facts in *Helou* were unextraordinary: Ontario assessed RST based on a comparison with an unrelated business; the minister gave the notice of objection perfunctory consideration; and the taxpayer missed a statutory deadline for appeal ([2002] OJ no. 3973). The Ontario Superior Court's decision extending the time to appeal, however, is a wake-up call for Ontario tax administrators.

Helou was assessed for RST allegedly collected but not remitted; the calculation was based on nominally similar businesses. After failing to file a notice of appeal within the 90-day time limit in the Retail Sales Tax Act, the taxpayer brought a motion to extend that time. The taxpayer argued that only after numerous phone calls to Ontario Finance requesting further details regarding its notice of decision could he determine the basis for the actual assessment and understand that the decision was based on a comparison of the assumed operation of a third-party business that was in fact significantly different. The initial assessment was thus grossly excessive, but by the time the taxpayer was given the information necessary to file an appeal, the 90-day limit had expired. Somewhat surprisingly, the court allowed the taxpayer's motion and ordered the minister to serve and file a reply to the notice of appeal. The court concluded that the Retail Sales Tax Act granted the court jurisdiction to extend the time for appeal "in order to allow justice to be done." Alternatively, the court concluded that the minister's purported notice of decision did not constitute a "reconsideration" in any meaningful way of the initial assessment as required to trigger the beginning of the time for appeal; the court thus effectively treated the notice as a nullity. The minister was estopped from arguing that time had expired.

Helou indicates the extent to which Ontario courts may assist Ontario taxpayers faced with RST audits that the court perceives as high-handed. A precedent has been set for a taxpayer blocked from crafting a notice of appeal (and probably a notice of objection). The court's primary approach of "reading in" specific overrides to further the "apparent purpose of the Act" may be suspect, but the observation that a notice of decision must contain some meaningful consideration of the case at hand is an important and welcome conclusion. Trying to decipher the basis for Ontario RST notices of assessment and decision—often inscrutably brief explanations of relevant facts and conclusions—is a common problem. Such notices also often lack the information necessary for a taxpayer to set out its factual and legal position as required under the new RST rules in section 25. The court also berated Ontario's counsel for its apparently one-sided presentation at the hearing. The court itself had to raise an earlier decision in *Molson Ontario Breweries*, "a case which ought to have been, and was not, included in the minister's factum in the hearing" ([1985] OJ no. 295). Significantly, the court was of the view that the minister was obliged to bring all relevant authorities to the court's attention, whether or not they were helpful to the minister's position.

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Audit or Investigation?

The minister has the right to audit and to conduct an investigation of a taxpayer's affairs. But when does an audit become an investigation so that the ordinary audit tools under the Act cannot be used and a proper warning and a warrant become mandatory? Superior courts across the country have answered that question differently. Some cases fixed the triggering event as the CCRA's turning its mind from mere administration or regulation to prosecution and bringing Special Investigations into the picture (*Norway Insulation*). Others found that approach too narrow and simplistic: the line was crossed when there were reasonable and probable grounds to believe that an offence had occurred (*Bjellebo*, *Pheasant*, and *Chusid*). The SCC in *Jarvis* recently addressed the issues (2002 SCC 73; see also *Ling*).

In *Jarvis*, the SCC answered three questions: (1) Is there a distinction between the CCRA's audit and investigative functions under the Act? (2) When does it exercise those functions? (3) What are the legal consequences to the taxpayer when the investigative functions are used?

(1) The SCC said that a complaint and a tax-evasion investigation differ and must be treated differently. If the "predominant purpose" of a particular inquiry is the determination of a penal liability, CCRA officials must relinquish the authority to use the inspection and requirement powers under sections 231.1 and 231.2 to compel oral statements or written production for the purpose of advancing the criminal investigation. The CCRA must give the taxpayer a proper warning and must obtain a warrant.

(2) An audit becomes an investigation when there is an adversarial relationship between the CCRA and the taxpayer, a change indicated by a number of factors, including the following:

   (a) Did the authorities have reasonable grounds to lay charges? Does the record show that a decision to proceed with a criminal investigation could have been made?
   (b) Was the general conduct of the authorities consistent with the pursuit of an investigation?
   (c) Did the auditor transfer his or her files and materials to investigators?
   (d) Was the auditor's conduct indicative of his or her effectively acting as the investigators' agent?
   (e) Did the investigators appear to intend to use the auditor as agent for the collection of information?
   (f) Is the evidence sought relevant to the taxpayer's liability generally or only to his or her penal liability, such as mens rea?
   (g) Is there other evidence that the audit has become an investigation?

(3) When the investigative function is underway, the SCC said, the taxpayer is protected by the Charter right to liberty (section 7), protection against self-incrimination, and the Charter rights against unreasonable search and seizure (section 8, the protection of informational privacy).

With an eye to the multifactored test for determining whether an investigation has begun, a taxpayer's tax manager may best protect its interests and rights by asking questions during the course of the audit and then dating and recording the answers given. Asking simple questions can force the CCRA to map the progress and destination of the audit. Keeping an audit diary puts the CCRA on notice that the taxpayer is monitoring the process and reinforces the taxpayer's entitlement to know and understand the audit's direction. Recommended questions include the following.

■ **What is the purpose of the inquiry?** This question may illuminate areas under examination and also assist in determining whether the examination has passed from an audit into an investigation.

■ **When does the auditor expect to complete the audit? Has the audit been or will it be referred to anyone else for review or consideration prior to finalization?** Other groups such as Valuation, Avoidance, and SI may be engaged in the review. Non-disclosure of a decision to refer to SI will be relevant to a later determination of Charter breach and the admissibility of subsequent evidence.

■ **Has the auditor arrived at a preliminary or final conclusion?** An auditor often reaches a conclusion but continues the audit to build evidence for the file; it is then time to redirect him or her to the client's perspective on the relevant facts, documents, and issues.

■ **Who are the decision makers on behalf of the CCRA? Can a meeting be arranged with the taxpayer?** Identifying others involved in addition to the case manager and the audit team will determine with whom the taxpayer is really negotiating.

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IRS Smiles on Factoring

A recent IRS field service advice (FSA) deals with offshore factoring transactions (200224003, issued March 19, 2001, released June 14, 2002). The IRS National Office recommended that the field examination team not pursue whether factoring activities conducted by a non-US corporation constituted the taxable conduct of a US trade or business, but did recommend that pricing and valuation matters be scrutinized.

US subs of Canadian companies can save significant amounts of regular US tax by factoring their US receivables with a related company owned by the Canadian parent. Typically, the Canadian parent and a Canadian sub form a Barbados entity (Barco) and capitalize it with shares. Barco purchases the US receivables at an appropriate discount from the US subs. Sales of the receivables to Barco from the US subs must be on a non-recourse basis, or else the IRS will regard the transaction as a secured loan. If factoring receivables is Barco's principal business, income so derived from receivables acquired from a related party is deemed to be active business income if Barco and the factoring party are related throughout the year and the receivables arose in the course of an active business carried on outside Canada. The extended FAPI rule in paragraph 95(2)(a.3) does not apply if all of Barco's income derives from non-Canadian sources. Barco can send home its earnings to Canada as exempt surplus dividends. On the US side, the discount is deductible as an ordinary business loss. US withholding does not apply because discount is not considered interest.

The USco in the FSA, a Delaware corporate parent that was itself wholly owned by a foreign Parentco, filed consolidated returns for a consolidated USco group. Parentco also had a country A sub, A Co. Some USco group members ("the US companies") entered into factoring contracts with A Co to factor their account receivables. A Co bore the risk of default on all the accounts, and the US companies paid A Co a percentage of the purchase price of each account as commission. The US companies were also required to staff a credit and collection department to maintain all customer accounts. They could perform necessary actions to collect on the accounts, but could not settle outstanding balances without A Co's approval. The US companies were compensated with an annual administration fee.

The IRS concluded that A Co did not perform any substantial activities through its employees' acts: the US companies performed the factoring functions. Accordingly, the IRS National Office recommended that the field examination team not pursue whether A Co was engaged in a US trade or business; thus the permanent establishment issue did not need to be addressed. But the IRS recommended that the economic substance and transfer-pricing issues of activities between the US companies and A Co be considered. On the facts, the IRS found that the US companies performed all the material functions—although A Co assumed the credit risk—and it was appropriate to evaluate the amount of discount deduction that the USco group should be able to claim.

Offshore factoring presents an excellent opportunity for Canadian multinationals to reduce their overall tax burden, but determining an appropriate discount rate that is factually based and economically justified is critical to reducing potential controversy with the IRS.

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Donations and Stock Options

Pursuant to paragraph 38(a.1), a taxpayer's inclusion rate for capital gains is generally one-quarter if securities listed on a prescribed stock exchange or shares or units of a mutual funds are donated to a charity (other than a private foundation) that meets the requirements of a "qualified donee." In spite of the taxpayer's having to include only one-quarter of the capital gain in income, the related charitable tax credit is based on the security's FMV at the time of the donation. Securities with an accrued capital gain can thus make a tax-efficient charitable donation. Subparagraph 38(a.1)(ii) clarifies that the reduced one-quarter inclusion rate applies to a qualifying donation made by way of a testamentary bequest in a will. Thus the reduced one-quarter inclusion rate can be accessed by donating publicly listed securities with accrued capital gains to charities either inter vivos or under a will. A bequest of stock from an employee stock option exercised after death may not yield the same result.

If securities acquired under an employee stock option agreement (or proceeds from the sale thereof) are donated to a qualified donee (other than a private foundation), a one-quarter deduction from the paragraph 7(1)(a) benefit included in income on the securities' acquisition applies under paragraph 110(1)(d.01), provided that (1) the security is a publicly listed security or a share or unit of a mutual fund described in paragraph 38(a.1); (2) the donation is made in the same year as, and within 30 days of, the acquisition; and (3) the acquisition resulted in the taxpayer's entitlement to a paragraph 110(1)(d) deduction (generally available if the security is a plain vanilla common share and the option's exercise price equals the underlying share's FMV). A qualifying donation of securities acquired on an employee stock option's exercise thus enjoys deductions under both paragraph 110(1)(d.01) and paragraph 110(1)(d). The net income inclusion is only one-quarter of the paragraph 7(1)(a) benefit, but the tax credit is based on the donated securities' FMV.

However, the additional one-quarter deduction does not apply to a donation made by a will. Upon the death of an individual who holds an employee stock option, a deemed benefit is included in his or her income equal to the amount by which the option's value immediately before death exceeds any amount paid to acquire it. Thus the benefit on death arises not under paragraph 7(1)(a) but under paragraph 7(1)(e); this latter rule is not referred to in paragraph 110(1)(d.01). The additional one-quarter deduction is not available for a security acquired under an employee stock option agreement after a taxpayer's death and then bequeathed to a qualified donee. Therefore, a taxpayer who is considering such a donation should ensure that it is made inter vivos so that he or she can access the additional deduction available under paragraph 110(1)(d.01).

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Purchases by Income Trusts

Sales of businesses to income trusts must be structured to comply with the mutual fund trust (MFT) rules and foreign property limits for registered investments. Structures may thus be fairly complex, especially if a vendor seeks a tax deferral on the sale.

For example, an MFT cannot directly carry on any business: its activity must be investment. Consequently, income trusts frequently establish captive corporations to acquire and hold business assets, although captive trusts and limited partnerships are frequently preferred because their underlying business profits can flow up to the income trust and because they pay no provincial capital tax or federal large corporations tax. An interest (or a right to acquire an interest) in a trust or partnership is considered foreign property; thus an income trust typically finances the captive trust or partnership primarily through debt—not equity—which is not within the definition of foreign property; several CCRA technical interpretations confirm this.

Operating activities must sometimes be carried on in a corporation owned by the income trust, typically if the vendor shareholders demand a sale of shares in lieu of assets to maximize after-tax proceeds. To minimize corporate income taxes and maximize distributions to the income trust's unit holders, the income trust typically establishes a captive Buyco and funds it primarily with interest-bearing debt. After Buyco purchases Targetco, the two companies' operations are combined in some fashion and the interest on Buyco's debt shelters operating profits.

There is no straightforward way to effect a tax-deferred transfer of property to an income trust. If a vendor intends to acquire a participating interest in the income trust, a corporation or partnership is established that issues to the vendor as part consideration exchangeable shares or partnership units that are the economic equivalent of income trust units. Such securities are exchangeable for trust units according to a predetermined ratio, and the amount and timing of distributions is linked to those on the income trust units. Exchangeable shares are usually term preferred shares or short-term preferred shares, making part VI.1 tax an issue. To surmount this problem the vendor may sometimes acquire a "substantial interest" in Buyco as per subsection 191(2). In other cases no dividends are paid on the exchangeable shares, and the exchange ratio is increased accordingly. Such strategies require consideration of specific and general anti-avoidance provisions. Part VI.1 tax is usually not an issue in exchangeable partnership unit transactions, another reason why captive partnership structures have recently gained prevalence.

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Cross-Border Acquisitions

Because of declining interest rates and a loss of confidence in the stock market, Canadian investors have turned to publicly traded Canadian income trusts (unit trusts), which offer the monthly distribution of available cash flow of 8 to 14 percent per annum on the units' subscription price. This year there have been very few North American IPOs, but more than Cdn$8 billion was raised by income trusts in the first 10 months of 2002, and another $3 billion is apparently in progress.

Real estate investment trusts and royalty trusts for the resource sector proved to be popular as publicly traded income trusts. The trusts acquired and operated a variety of businesses with stable and sustainable cash flow, reasonable capital expenditures, and solid management. More recently, Canadian income trusts have been used to purchase US businesses carried on outside Canada. The Canadian income trust may be a useful exit strategy for a US venture capital fund that wants to sell shares in a US company. The market price of an income trust interest tends to be higher than for shares because it is based on cash flows (yield) as opposed to earnings, and thus may present a leveraged buyout opportunity for US management or merely a higher price for a business's US vendor.

In addition to the relative ease of raising funds in Canada, the sale may occur at a premium due to the

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modest yield required by the unitholders (compared with a competitor or venture capitalist). About 40 percent of existing units have been acquired by pension funds. Unlike a cross-border IPO, in which the owner may be required to retain at least 40 percent of the shares, a complete sale may be effected to an income trust.

Two structures have been used recently: one acquired a US business to be carried on in a partnership or an LLC, and the other appeared designed to acquire a US shareholder's company. In the first structure, the trust capitalizes with equity and interest-bearing debt a Canco that invests in the US partnership or LLC. Canco files both US and Canadian tax returns. Interest paid is deducted from US partnership income. US withholding tax on partnership income applies (Code section 1446), and Canco is entitled to a refund if the interest expense reduces or eliminates US income. If no unitholder owns more than 25 percent of the units, the portfolio interest US withholding exemption may apply. The income trust is structured to qualify as an investment trust and a grantor trust for US purposes: the trust is not regarded as an entity, and the unitholders are treated as owning pro rata shares of fund assets because the trust has one class of ownership interests and no power to vary the unitholders' investment. The units are also redeemable at the unitholders' option.

In the second structure, the trust forms a Canco that forms a US acquisition company (Buyco). The trust also forms a Nova Scotia unlimited liability company (NSULC) that is disregarded for US tax purposes and to which it lends at interest about 75 percent of the investment; NSULC invests in Buyco's non-voting preference shares with a cumulative dividend. Buyco completes the purchase and merges into Targetco to form US Opco. US Opco files a US return reporting the business's income and deducting reasonable interest paid by the NSULC to the trust. (Payments by US Opco to the NSULC are ignored for US purposes.) The portfolio interest exemption results in no US withholding tax. For Canadian purposes, the distributions are a tax-free dividend out of exempt surplus, and the NSULC accumulates losses. US dual consolidated loss rules and thin capitalization and earnings-stripping rules must be considered; the latter do not apply if there is no loan to a related foreign person—a test that is met because the trust is ignored.

To ensure that the IRS does not recharacterize the debt as equity—making the interest non-deductible—the debt must have a reasonable term and interest rate; the debt-equity ratio must be reasonable; and the debt should not be convertible into shares. If the fund is not a fixed investment trust, the interest attracts 10 percent US withholding tax; each unitholder must comply with US reporting to preserve the portfolio interest exemption and verify a less than 10 percent holding. Potential adverse changes in Canadian or US tax rules and foreign exchange fluctuations also pose risks.

Dividends paid by US Opco to Canco are subject to 5 percent US withholding tax (not creditable in Canada), but should qualify as tax-free exempt surplus dividends in Canada. Dividends paid by Canco to the trust are taxable to non-pension-fund unitholders on distribution by the trust. Such a unitholder is also taxable in Canada on the gain realized on the units' disposition: a subsection 39(4) election may ensure capital gains treatment. Because the mutual fund trust (MFT) units were not offered to US residents, compliance with US securities law is obviated. A 15 percent Canadian withholding tax would also apply on income distributions to a US resident, and a US foreign tax credit might not be available if the income is regarded as US-source because the MFT and the NSULC are ignored for US tax purposes.

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FOREIGN TAX NEWS

Treaties

Several treaties entered into force in December 2002: with **Peru** (December 24), **Norway** (December 19), **Moldova** (December 13), **Mongolia** (December 20), and **Australia** (a protocol, December 18), effective for withholding taxes, for amounts paid or credited to non-residents after 2002, and for all other taxes for tax years beginning after 2002. Negotiations were slated to commence with the **Sultanate of Oman** on January 11, 2003; any comments or concerns should be communicated to Finance. For an up-to-date treaty chart, contact the Foundation's library or the Finance Web page. (See "Foreign Tax News," *Canadian Tax Highlights*, August 27, 2002.)

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