Canadian Tax Highlights

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Split Receipt Guidelines

The December 20, 2002 technical bill introduced welcome new provisions that allow charities and political parties to issue tax receipts to donors for the difference between the value of their gift and any consideration received in return. Currently, a donor who receives consideration such as a dinner or a golf game cannot (except in limited circumstances) receive a tax receipt even if the donation's value significantly exceeds that of the consideration. Such "split receipting" applies to individual and corporate gifts and political donations made after December 20, 2002.

The CCRA announced its guidelines on the proposals in draft *Income Tax Technical News* no. 26 (December 24, 2002). In determining whether an eligible gift exists, (1) there must be a voluntary transfer of property to the charitable or political organization with a clearly ascertainable value; (2) any advantage the donor receives must be clearly identified and its value ascertainable; and (3) the amount of the advantage generally should not exceed 80 percent of the donation's value; the eligible gift is the difference between the two amounts.

A de minimis rule applies for all fundraising events and activities; no advantage is conferred unless the sum of the value of any complimentary benefits for all participants (including small items such as key chains and t-shirts) and the value of all door prizes for which all attendees are eligible, divided by the number of tickets sold, exceeds the lesser of 10 percent of the ticket price and $75. The value of the activity that is the object of the event—such as the value of the meal at a fundraising dinner—is factored in in determining the eligible gift, but not for purposes of the de minimis rules.

Assume that 500 tickets to a fundraising dinner are sold for $200 each. A comparable meal could be purchased for $100 (before GST, PST, and tips). Attendees may also win door prizes (a trip worth $3,000 and jewellery retailed at $500) with a total value of $3,500, or $7 per attendee. Each attendee receives a logo pen and a key chain with a combined retail value of $10, for a total of $17 per donor. The eligible gift is $100 per ticket (the $200 ticket price minus the $100 dinner). Under the de minimis rule, the door prizes and complimentary items are not an advantage: their $17 value is less than the lesser of 10 percent of the $200 ticket ($20) and $75. The value of the $100 meal is less than 80 percent of the ticket price ($160), and thus a tax receipt for the eligible gift of $100 may be issued. The guidelines also include details on how the split receipt policy applies to charitable annuities, donations of mortgaged property, charity auctions, lotteries, concerts, shows, sporting events, golf tournaments, and membership fees.

R & D filing deadline crackdown. The CCRA announced in the December 2002 newsletter of the Toronto Centre CCRA and Professionals Consultation Group that as of January 15, 2003, claims for SR & ED expenditures that are not complete by the filing deadline will be rejected. SR & ED claimants have 18 months after year-end to file a prescribed form containing prescribed information (12 months after the corporate return's filing due date, which is 6 months after the year-end). Some CCRA offices accepted late-filed prescribed information—for example, by issuing "30-day" letters requesting information missing from claims filed on the due date; CCRA Headquarters and Legal Services determined that the filing deadline was effectively waived. In order to treat all SR & ED claimants consistently and stay within the legislative intent, the CCRA says that claimants must file a complete claim in prescribed form within the 18-month window unless they qualify under the fairness provisions. A 30-day letter for an incomplete file may be issued as a courtesy when possible, but the deadline will not extend past 18 months. Filing timely claims is now even more important: ideally, claims should be filed with the T2, but no later than 16 months after the year-end to allow for any 30-day CCRA letter request to be issued and then satisfied by the claimant.

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Income Trust Units and Interest Expense

A recent technical interpretation (TI) says that a portion of the interest on original money borrowed by a unitholder to acquire income trust units is not deductible under

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paragraph 20(1)(c) if the unitholder receives a capital distribution from the trust that is not used to reduce the original loan (doc. no. 2002-0142475).

In the example given in the TI, the individual borrows $10,000 at an interest rate of 4 percent per annum to invest in income trust units. In year 1 he or she incurs interest expense of $400 ($10,000 × 4%) and receives distributions of $1,400 in cash—$500 other income and $900 capital—which is used for personal use. The individual reports $500 income and deducts $400 interest expense. Asked whether all or only some of the interest expense is deductible, the CCRA, relying on the SCC decision in *Bronfman Trust* ([1987] 1 CTC 117), said that the current, not the original, use of the borrowed money determines deductibility under paragraph 20(1)(c). Apparently no distinction is made between a trust unitholder's disposition of some trust units for proceeds and his or her continuing to hold the same number of trust units after a capital distribution. If the $900 capital distribution came at year-end, the current use of the borrowed money was to earn income for the entire first year, and related interest is generally deductible. But in year 2, interest on the borrowed money related to the return of capital is not deductible because its current use is personal. Of the $400 interest expense in year 2, $36 ($900/$10,000 × $400) is not deductible because $900 of the original $10,000 investment is no longer used for income-earning purposes.

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US Voluntary Disclosure

On January 14, the IRS announced a program for taxpayers who underreported their US income tax liability using offshore financial arrangements. Such persons have until April 15, 2003 to identify themselves as having unreported income or false deductions associated with the use of offshore payment cards issued by foreign banks or other offshore financial arrangements, including those with foreign banks, financial institutions, corporations, partnerships, trusts, and other entities.

In September 2002, the IRS set new audit priorities and identified an approach that focuses on high-risk areas of non-compliance: offshore credit card users; high-risk, high-income taxpayers; abusive schemes and promoter investigations; high-income non-filers; and unreported income. The IRS determined that there is reason to believe that some taxpayers were using offshore credit cards and other financial arrangements to evade US tax. The IRS has issued summonses to credit card companies to identify US citizens with debit and credit cards issued by offshore banks; the number of individuals identified greatly exceeds the number of reports of foreign banks and financial accounts, which US citizens are required to file annually. Hundreds of cases for civil audits or potential criminal investigation have been developed.

An eligible participant must voluntarily disclose to the IRS in writing before it initiates an investigation, receives third-party information concerning the non-compliance, or acquires information relating to the liability from a criminal enforcement action. Furthermore, the taxpayer must not have promoted or solicited arrangements to avoid taxation by using offshore payment cards, offshore financial arrangements, or any other abusive transactions, domestic or offshore, and must not have derived income from illegal sources or used offshore payment cards or financial arrangements to facilitate illegal activities unrelated to taxes.

A participant must pay back taxes, interest, and, in certain circumstances, delinquency and accuracy penalties, but will not face civil fraud or information return penalties, which can be substantial: the former is up to 75 percent of unpaid tax attributable to fraud. Participants are considered to be voluntarily disclosing for the purposes of the criminal voluntary disclosure procedures revised in December 2002. Civil penalties for failure to file a report of foreign bank and financial accounts will not be imposed by the Financial Crimes Enforcement Network (FinCEN). A participant must comply with the application process, which includes submitting complete information about his or her introduction to offshore payment cards and other financial arrangements; identifying the promoters of offshore payment cards or offshore financial arrangements; and submitting all promotional materials, transaction materials, and other related correspondence or documentation received.

The IRS has also said that it will closely monitor amended returns; taxpayers who simply file without complying with other requirements may face penalties for civil fraud or penalties connected with information returns, such as returns of officers, directors, and shareholders or personal holding companies and those returns relating to certain non-US trusts, non-US corporations, and partnerships. The IRS also noted that it can obtain information relevant to US taxpayers' taxes via the worldwide US treaty network. Information requests by other treaty countries such as Canada are important in identifying taxpayers who attempt to hide income offshore.

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Canada-US Rate Comparisons

In the Economic and Fiscal Statement of October 2000, the then minister of finance announced a plan to gradually lower the top rate of corporate income tax from 28 to 21

Canada-US Corporate Tax Comparisons

	Taxation year				
	2000	2001	2002	2003	2006
Canada					
Basic federal top rate	28.0	28.0	28.0	28.0	28.0
Surtax	1.1	1.1	1.1	1.1	1.1
Reduction to basic rate		1.0	3.0	5.0	7.0
Average provincial rate	12.0	12.0	12.0	12.0	9.8
Allowance for average capital tax	3.4	3.4	3.4	3.3	3.1
Total	44.5	43.5	41.5	39.4	35.0
United States					
US federal	35.0	35.0	35.0	35.0	35.0
Average state rate	4.0	4.0	4.0	4.0	4.0
Allowance for capital taxes	1.0	1.0	1.0	1.0	1.0
Total	40.0	40.0	40.0	40.0	40.0

percent over the years 2001 to 2004. In January 2002, Finance launched the publication of a series of comparisons of statutory rates in Canada and the United States for 2000 to 2006. The federal government intends to make Canada's rates competitive with US rates before 2004. Recent Finance press releases relying on updated versions of that 2002 comparison have made the same point: as of January 2003, Canada's rates are below comparable US rates.

The table shows how the numbers have been developed. Because the provincial and state rates shown are weighted averages of the many available rates, the averages seldom reflect the rate applicable to a particular corporation. The US state average is adjusted to reflect the fact that state tax is deductible for federal tax purposes. The allowances for capital taxes are also averages. Finance's comparisons go no deeper than the basic rate structure, although the more favourable Canadian treatment of dividends and capital gains is noted. For any particular corporation, however, the devil is in the details: the specific tax treatment of capital expenses and depreciation, interest expense, and income from abroad can create significant shifts in the comparison of tax payable on each side of the border.

The comparisons exclude other taxes, such as payroll taxes for social security and workers' compensation. Ultimately, any comparison done by a particular corporation and its advisers will account for the particular circumstances and applicable tax incentives. However, the cost of other factors such as labour, transportation, and health services for employees, and the size of the market available, will often override tax considerations.

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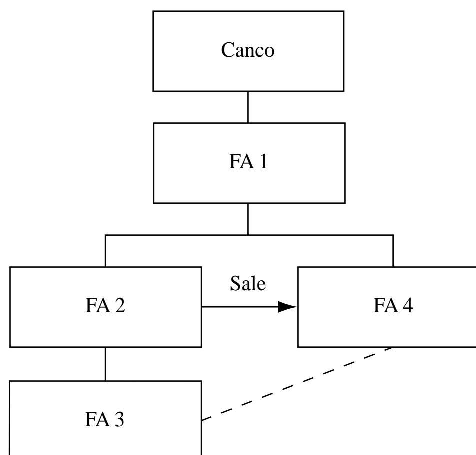
FAPI on Reorgs

The long-awaited technical amendments of December 20, 2002 include many relieving recommendations in the foreign affiliate (FA) area that were previously published as comfort letters. However, some proposals significantly alter the course of FA restructuring and disposition planning. Finance officials have indicated that some proposals may be softened.

Assume that FA 2 sells to FA 4 for cash its FA 3 shares, which were excluded property since acquisition.



At present, such a disposition does not trigger FAPI. Any gain is computed in the calculating currency of FA 2. To the extent that FA 3 and its FA subs have net surplus, FA 3 is deemed to pay an equivalent amount as a dividend to FA 2 before the disposition, thus reducing FA 2's proceeds and gain (subsection 93(1.1)). Any capital gain is split 50-50 between FA 2's exempt surplus (ES) and taxable surplus (TS), and the deemed dividend increases FA 2's and reduces FA 3's surplus accounts accordingly.

Effective for post-December 20, 2002 dispositions that do not arise from previous commitments, proposed subsections 93(1.4) to (1.6) recharacterize the FA 3 shares as non-excluded property, rendering FA 2's gain FAPI, and redetermine FA 4's cost as FA 2's proceeds net any section 93 dividend. The new rules apply only if an FA of a Canadian-resident corporation (Canco) directly or through a partnership disposes of another FA's shares to a specified purchaser—Canco or a non-arm's-length Canadian-resident corporation or an FA of either or a partnership of which any of them is a member. Thus, a disposition to an arm's-length person does not give rise to FAPI, but a redemption or repurchase for cancellation of an FA's shares as well as paragraph 95(2)(c), (d), and (e) transactions appear to be caught in this basis adjustment. The rule that flows the vendor's proceeds to the purchaser as cost appears to be at odds with a similar deeming rule for

such transactions if the taxpayer has elected under subsection 93(1) in respect of a gain: under the new rule, the tax basis for a subsection 93(1) dividend is reduced (new subsection 93(1.4)).

Losing excluded-property status (which does not occur in paragraph 95(2)(c), (d), or (e) transactions) has other implications. The subsection 93(1.1) election, unlike the subsection 93(1) election, applies to excluded property only. The gain or loss computation to FA 2 is based on Canadian currency, not on FA 2's calculating currency, and if certain conditions are not met, then any foreign exchange element is deemed nil. At present, if FA 2 has borrowed in a non-Canadian currency to acquire the FA 3 shares, any gain or loss on the debt is deemed to be from the disposition of excluded property; new subsection 93(1.4) appears to characterize it as being from non-excluded property. Furthermore, if FA 2 borrowed from another FA, the interest paid may be recharacterized as active business income if the FA 3 shares are excluded property. But if a transaction causes FA 3 to lose excluded-property status under the new rules, previous interest payments' recharacterization may be jeopardized.

The new rule's impact is reduced or eliminated if FA 2 pays sufficient foreign tax entitling Canco to a deduction from FAPI under subsection 91(4). However, such a sale usually does not attract current foreign tax—for example, a sale within a US consolidated group or a sale of a qualifying sub in other jurisdictions. A lack of sufficient foreign tax makes material gain transactions prohibitive.

The explanatory notes indicate that the new rules are intended to prevent duplication of surplus amounts and of the FA shares' cost bases. At present, the rules do not result in any doubling up of surplus or cost bases unless such a sale is followed by another transaction. Doubling up is a valid concern, but more focused rules—such as expanded rollover-type rules—may be preferable. Moreover, other proposals are aimed at preventing the duplication of surplus accounts. For example, proposed reg 5902(7) limits the subsection 93(1) amount of electable net surplus on a subsection 93(1.4) transaction to the net surplus of the disposed FA; deficits on a paragraph 95(2)(e.1) liquidation flow up; and the basis rollover provisions of reg 5907(5.1) are broadened.

Reg 5907(5.1), which effectively rolls over the tax cost of assets for surplus purposes, applies to capital property used in an active business, but not to group company shares held as part of an investment business even if they are excluded property. The proposed reg applies to all excluded property, and the transferee need not be another FA or an FA not at arm's length with Canco. Thus FA 4's cost of FA 3 stock for surplus purposes is currently the full FMV price; but because the FA 3 shares are excluded property under subsection 95(2), the proposal appears to apply if FA 2 is not taxable in its jurisdiction on the sale and is relevant in computing FA 2's earnings from carrying on an active business. Such FA 3 shares would generally be held as part of an investment business, not an active business, and thus would not normally be carved out of the reg simply because FA 2 is taxable on the transaction.

Under the proposed reg, FA 2's proceeds are its tax cost, stripping FA 2 of the one-half ES entitlement for any FAPI gain under new subsection 93(1.4). The same amount is FA 4's cost of the FA 3 shares, not a reduced amount under proposed subsection 93(1.4) where FA 2 has made an election under subsection 93(1). In the broader context, the same denial of ES and TS occurs if FA 2 sells FA 3 to an unrelated party. The surplus account and basis impact of this proposed reg seems to undercut the need for proposed subsections 93(1.4) to (1.6) if the justification for the latter is to prevent the doubling up of such amounts.

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Holdco Disintegration

To avert US federal and state estate tax, a Canadian-resident individual who is not a US citizen or green-card holder may hold US securities and/or real property investments in a Canadian holdco. The structure may reduce a taxpayer's overall tax burden and avoid double tax, but it may also involve markedly higher annual Canadian income tax and ongoing compliance costs. Moreover, if Holdco disposes of a US-situs real property interest, the aggregate tax may be about double that on a direct sale. Using Holdco also generally precludes efficient loss utilization and can attract capital taxes.

Theoretically, a top marginal rate Canadian-resident individual is almost indifferent to whether investments are held in Holdco or directly: integration holds for top marginal rate individuals who receive dividends from a taxable Canadian corporation and generally also for interest income and capital gains. Although the taxpayer's and Holdco's province or territory of residence is important, the refundable dividend tax on hand (RDTOH) account and dividend refund mechanism for Canadian investment income largely alleviates double taxation. Unfortunately, integration of foreign-source non-business income is not as smooth. If Holdco claims foreign non-business income tax credits, the refundable portion of part I tax is reduced significantly, and the resulting tax cost of earning such income through a Holdco increases as the foreign tax rate increases. Integration fails primarily because the various RDTOH reductions are too high.

Embedded in the December 20, 2002 draft legislation is a proposal to modify adjustments that reduce the RDTOH addition for foreign non-business income to better reflect

Income Tax Payable on $10,000 of Foreign Investment Income Earned Through a Corporation and Directly, Ontario-Resident Individual and Corporation

	Foreign non-business income tax credit		
	10%	15%	25%
		dollars	
Existing legislation			
Corporate tax	4,829	4,829	4,829
Refundable tax	(1,926)	(1,555)	(815)
Individual tax on dividend	2,224	2,108	1,876
Combined tax	5,127	5,382	5,890
Individual tax (including withholding tax)	4,641	4,641	4,641
Tax cost with Holdco	486	741	1,249
Tax deferral with Holdco	(188)	(188)	(188)
Proposed legislation			
Corporate tax	4,829	4,829	4,829
Refundable tax	(1,778)	(1,333)	(444)
Individual tax on dividend	2,178	2,038	1,760
Combined tax	5,229	5,534	6,145
Individual tax (including withholding tax)	4,641	4,641	4,641
Tax cost with Holdco	588	893	1,504
Tax deferral with Holdco	(188)	(188)	(188)
Net increase in overall tax under proposal	102	152	255

Note: The figures assume that (1) the individual is taxed at the top marginal tax rate, (2) Holdco earns only foreign investment income, (3) the taxable dividend paid is the net after-tax amount, and (4) for the 25% column, the foreign non-business income taxes relate to a disposition of real property so that subsection 20(11) does not restrict the individual's credit.

the underlying corporate tax rates, effective for 2003 and subsequent taxation years. Why such changes are required is not clear: the Canadian federal tax on Holdco's Canadian and foreign investment income remains at about 35.79 percent (28 percent plus 1.12 percent federal corporate surtax plus the additional 6.67 percent tax applicable to a CCPC's investment income). Under the proposals, foreign non-business income is taxed at even higher integrated tax rates; the table shows that the newly higher tax cost of corporately owned investment income continues to increase as the foreign tax credit increases. The current and proposed cost of Holdco's holding foreign investment and/or real property subject to foreign tax may force a re-examination of the merits of such a structure. It is hoped that Finance will reconsider and rework the RDTOH formula to mitigate double taxation on foreign non-business income.

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SR & ED Developments

The December 20, 2002 draft legislation contains two significant relieving measures related to the SR & ED program: expansion of the costs that can be claimed when taxpayers utilize the proxy method and a fix to an anomaly in the ITC recapture rules. A third change increases exposure to the ITC recapture rules. The CCRA is expected to announce soon whether it will treat the relieving measures as law pre-enactment.

■ **Overheads.** A taxpayer using the proxy method could only claim materials consumed, but under the traditional method of claiming overheads could claim both materials consumed and materials transformed; the policy behind the distinction is not clear. Materials transformed are subject to the ITC recapture rules. A proposal includes materials transformed for proxy method purposes, retroactive for costs incurred after February 23, 1998 if the 18-month filing deadline has not passed (subclause 37(8)(a)(ii)(B)(V)).

■ **ITC recapture.** If a taxpayer disposes of shared-use equipment or transfers it to commercial use, ITC recapture may exceed the original ITC claimed, an anomaly the proposals correct. The recapture calculation, previously based on the proceeds or FMV respectively, is now based clearly on 25 and 50 percent thereof for first- and second-term shared-use property, respectively, effective for dispositions and conversions after announcement (subsection 127(27)).

Other proposals flow from the recapture changes. Recapture related to qualified expenditures, formerly triggered by "the cost" of a particular property, is now triggered by "the cost or portion of the cost" thereof. Potential ITC recapture is also expanded to cover a cost that failed to be a qualified expenditure or was not included in the ITC calculation because subsection 127(26) disallows amounts unpaid 180 days after the taxation year-end, effective for dispositions and conversions after the announcement date (paragraphs 127(27)(b) and (c)).

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A New Lease on Life?

A recent English Court of Appeal (CA) decision in *Barclay's Mercantile Business Finance* is of interest to arrangers and Canadian taxpayers in cross-border leveraged leases of assets such as software and railcars ([2002] EWJ no. 5727). It will be interesting to see whether Canadian tax courts will refer to the CA's insightful comments in their deliberations on similar transactions challenged by the CCRA.

BMBF explores a lessor's (BMBF) entitlement to capital allowances (referred to herein as CCA) on a gas pipeline

acquired for the purpose of its trade under a highly structured sale-leaseback, choreographed in usual Astairean fashion.

■ BMBF, a UK company in the Barclay's group, leased a pipeline acquired under a sale-leaseback with BGE, an Irish company owned by the Irish government. BGE was responsible for the distribution, supply, and transmission of natural gas in Ireland. BMBF was principally in the business of asset-based financing.

■ BMBF borrowed the full price (about £92 million) from a related Barclay company (BB) to finance the purchase. The interest rate and the substantial head-lease rents were fixed for the initial 12 years; the rent was stepped up 5 percent a year. The rent for the next 25 years was much less but not insignificant. BMBF had the right to put the pipeline to a BGE company. Rents were adjusted if UK tax law and rates changed ("the UK tax risk").

■ BGE leased the pipeline to a wholly owned UK sub (BGE UK) for payments that mirrored those in the head lease except for the UK tax risk adjustments.

■ Under the assumption agreement, BGE UK settled invoices from BMBF to BGE on the head lease, thus exchanging obligations under the head lease and sublease.

■ On the sale of the pipeline to BMBF, BGE deposited the proceeds with a Jersey company (Deepstream), which agreed to prepay the deposit in three layers: the "A" payments matched rentals due during the initial term, and the "B" and "C" payments represented BGE's benefit from the transaction.

■ Deepstream deposited the BGE deposit with BB's Irish company and assigned the interest to BB, giving it a 0 percent risk rating for capital adequacy purposes.

■ Several other key defeasance and security agreements normal for such financing arrangements ensured that the parties could meet their obligations and limited the lessor's credit risk.

Citing *Ramsey*, the lower court denied BMBF CCA because it did not incur an expenditure for the purpose of its trade. (Under *Ramsey*, in a series of preordained transactions or a single composite transaction, steps of no commercial non-tax-avoidance purpose are disregarded; recharacterization hinges on the terms and intent of the taxing statute.) The transactions were a "complicated, convoluted, tax avoidance transaction." The interest that BMBF paid on its loan to finance the purchase amounted to more than the rent it received; only after CCA benefits were baked in was a positive return achieved, which effectively downloaded CCA on a foreign asset and eroded the UK tax base. Payment of sales proceeds achieved no commercial purpose: BGE received no upfront benefit because the funds looped back to the lender BB through a series of circular deposits; its only benefit was deferred and limited to the B and C payments, which were conditional on BMBF's successful CCA claims. Credit risk was so comprehensively limited by the lessor that it expended no funds to acquire the pipeline.

The CA allowed the appeal: the transactions were quite normal in the leasing industry and not an abuse of the tax system. BMBF's CCA relief enabled it to receive group relief payments from other Barclay's group members and enter into an attractive commercial transaction. It is a bedrock principle of the leasing industry that lessors pass along to lessees the value of CCA via lower lease payments. The B and C payments to BGE were not documented as being linked to the CCA claims. The lack of upfront cash to the lessee was irrelevant: the test for CCA is the purpose of the lessor's expenditure, not the financing's benefit to the lessee. BGE's choice to deposit the lease proceeds did not mean that it received no benefit: it effectively purchased three annuities, including the A payments to match the head-lease obligation. Interest on the deposit is implicit in the payments, and thus BGE benefited from the A payment; its passing over to BMBF to discharge the rental obligation was irrelevant. The circularity of cash flow did not defeat the intended tax results: each discrete step was legally effective and not self-cancelling. The looping of funds back to achieve a 0 percent risk rating for capital reserve purposes lowered the implicit rate of interest to BGE and was driven by normal banking considerations; lessors always wish to eliminate credit risk. BMBF invested a substantial sum; the pipeline was its only security for strip risk of about £25 million (the difference between the maximum payable by BMBF on the head lease's termination and the BB guarantee). BMBF leased a new, unproved pipeline on an unusually long lease to a non-UK corporation. BGE was also exposed to risk: it would receive no return if CCA was denied or reduced or if tax rates were changed. All steps and transactions were negotiated in ordinary commercial terms, and complexity does not equate to an avoidance transaction. The lower court decision reflected "an incorrect appreciation of the facts."

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Kiddie Tax Proposal

Effective after 2002, a proposed amendment to the definition of "split income" expands the so-called kiddie tax to include income from providing property to or in support of a business carried on by a related individual, by a corporation owned at least 10 percent by a related individual, or by a professional corporation of which a related person is a shareholder.

"Split income" currently includes trust or partnership income if the source of income is the provision of goods or services by a trust to or in support of persons or corporations as described above. As confirmed in a June 20, 2002 technical interpretation, the mere rental of property does not constitute the provision of goods and services for purposes of the split-income tax if no services were provided in conjunction with the lease.

Furthermore, the kiddie tax does not apply to other income from property such as interest or royalties. Thus, subject to the other income attribution rules, a trust formed for the benefit of minor children could own real property or intellectual property and derive rentals or royalties from a related unincorporated or incorporated business, or loan funds at interest to a related business, without the rentals', royalties', or interest's being subject to the kiddie tax. The low prescribed interest rate and the exception in section 74.5 from attribution for FMV loans prompted some individuals to loan funds to a family trust at 2 or 3 percent and to have the trust loan the funds at a higher interest rate to the family business.

In 1999, the government indicated that it would monitor the effectiveness of the tax on split income and take appropriate action if new income-splitting techniques developed. Now the phrase "goods and services" in the definition of "split income" is being replaced with the phrase "property or services" to extend the split income rules' application to income from property such as rental income.

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TCP Redefined

A recent CCRA technical interpretation (doc. no. 2002-015179, dated December 18, 2002) clarifies its view on the meaning of taxable Canadian property (TCP) in the context of interests in and options to acquire property: a person that holds 20 percent of the publicly listed shares of a corporation and options to acquire another 5 percent does not meet the 25 percent TCP ownership threshold, and thus neither the shares nor the options are TCP.

IT-176R2 says that such options are considered shares, and the 25 percent threshold is met on the basis of former subsection 115(3), which deemed an interest in, or an option to acquire, a property described in the TCP definition to itself be that property. However, the rule's current version deems TCP to include an option to acquire such property, but does not deem the option to be a share (paragraph (l) of the TCP definition). Thus, as the TI acknowledges, options to acquire shares do not factor into the 25 percent test, do not affect whether the shares are TCP, and are TCP only if the shares by themselves are TCP. It is not clear that Finance intended to change the law when the TCP definition was moved to section 248. (The same change was inadvertently proposed in 1996 and then withdrawn.) If the TCP definition is not amended, IT-176R2 should be revised to reflect the changes in the definition since the date of the IT's issue.

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PST Due Diligence

The TCC in *Pillar Oilfields* first recognized a due diligence defence against a penalty imposed on a supplier for failing to remit GST. Now the defence has been recognized in the provincial sales tax (PST) context, where the supplier penalty is higher.

Pillar, confirmed by the FCA in *Canadian Consolidated Contractors*, held that a supplier is not liable to pay the 6 percent penalty automatically assessed under section 280 of the Excise Tax Act if an error occurred despite the supplier's due diligence. However, the supplier must bear the tax that it failed to collect if the customer no longer exists or for any other reason cannot be compelled to pay.

The PST situation differs. All PST provinces—British Columbia, Saskatchewan, Manitoba, Ontario, and Prince Edward Island—impose non-compliance penalties. A vendor that fails to collect Ontario or BC PST is assessed a penalty equal to the uncollected tax. It is not assessed the tax due because a province is constitutionally empowered to impose only direct taxation: assessing a vendor for tax due may be indirect taxation because the vendor will attempt to pass the tax on to its customer. The Supreme Court of Ontario in *Syroco* held that such an assessment was in the nature of a penalty rather than a tax, but the due diligence defence raised in *Pillar* has been taken up in two recent BC PST cases.

In *Kemp Concrete*, a small business expanded its product line. In response to the taxpayer's query, the BC Consumer Taxation Branch advised in writing that no tax was collectible on sales of "installed" septic tanks, which were sales of improvements to real property rather than tangible personal property. Several years later, the branch said that the ruling was invalid because the activities fell short of "installing" the tanks and assessed a penalty for failing to collect PST on sales. On appeal to the BC Supreme Court, the Crown accepted that a due diligence defence existed, but not in this case; ultimately, the Crown consented to the appeal, but no reasons for judgment were given.

In December 2002, the BC Supreme Court examined the issue in *Grant Thomas and Exotic Car* (2002 BCSC 394). Three motor vehicles were sold by a leasing business

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whose principals did not regularly engage in such sales. If a vehicle's vendor is not a registered dealer, the provincial Motor Vehicle Act provides for the collection of the sales tax by an agent of the Insurance Corporation of British Columbia (ICBC), which administers the registration of motor vehicle transfers and licensing: the ICBC receives a $1 fee for every transaction in which it collects PST. The vendors had not charged PST on the sales, assuming that the ICBC agent would collect it, but the agent collected tax at the general 7 percent rate on two luxury vehicles and no tax on another. The branch did not pursue the purchasers, but it assessed the vendors a penalty equal to PST unpaid. The court said that the Motor Vehicle Act did not oust the vendors' obligation to collect PST. The court broke new ground in accepting the existence of a due diligence defence, opening the door for other claimants. However, it found that in *Thomas* the requisite level of care had not been made out on the facts. Reliance on common knowledge among car sellers was insufficient: something more was required, such as the obtaining of a legal opinion or, as in *Kemp*, inquiries to appropriate government officials.

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Foreign Tax News

OECD

The OECD is exploring corporate governance issues with international organizations for a review at its annual meeting in May 2003. Proposed transparency standards are similar to those established in the harmful tax practice initiative. The OECD is also focusing on the exchange of information, which requires transparency. A bilateral counterstudy on regulating corporate vehicles in cross-border transactions has also been released. See the OECD Web site or contact the Foundation's library for reports to date.

North America

At the 2002 Annual International Tax Institute, held at George Washington University, competent authorities from Canada, the United States, and Mexico said that they take a principles approach to resolving mutual agreement cases that is not revenue-driven. Each case is resolved on its own facts, and there are no "safe harbours."

Australia

The Australian Taxation Office ruled that on or after July 1, 2003, "assets" and "liabilities" under the thin capitalization rules have accounting and not legal meanings. Under "statement of accounting concepts," "assets" means "future economic benefits controlled by the entity as a result of past transactions or other past events," and "liabilities" means "the future sacrifices of economic benefits that the entity is presently obliged to make to other entities as a result of past transactions or other past events."

Sweden

The abolition of capital gains taxation is proposed for corporations, including foreign corporations' PEs, on the disposal of "shares held for business reasons," effective July 1, 2003. Shell companies are excluded if the marketable assets other than such shares exceed 50 percent of the consideration paid for the shares. New controlled foreign corporation rules will work in concert with the exemption.

Israel

Tax reform effective in 2003 imposes an exit or migration tax on a deemed sale of capital assets on an individual's giving up residence. The deemed sale occurs on the day before departure; failure to pay the tax is seen as a request to defer payment. Capital gains tax applies on the actual disposition.

Mexico

Activity in maquiladoras will be stimulated by legislation effective after 2002. Foreign companies from treaty countries doing business with maquiladoras are exempt from income tax because the processing arrangement with the maquiladora constitutes a PE. Refinements include transfer-pricing alternatives; elimination of the need for an advanced pricing agreement (APA) to establish a PE; elimination of the value of foreign-owned inventory in establishing a transfer price; a new transfer-pricing standard; and revisions to APAs. VAT changes also cover maquiladoras' goods, including zero-rating for sales outside the country. Details are available from the Foundation's library.

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