CANADIAN TAX Highlights

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Common Interest Privilege

The British Columbia Supreme Court (BCSC) has recognized common interest privilege as a basis for finding that privilege has not been waived in relation to documents given to a third party so as to effect a commercial transaction.

In *Fraser Milner* (2002 BCSC 1344), the law firm was served by the minister with process requiring production of documents under section 231.4 (the inquiry provisions). The firm claimed solicitor-client privilege on the basis of common interest privilege in relation to a complex cross-border commercial transaction. Common interest privilege is a well-established litigation privilege that attaches to legal advice and information exchanged between parties that have largely the same interest in a dispute.

Fraser Milner acted for a group of companies (group A) that was negotiating the formation of two business partnerships—one Canadian and one American—with another group of companies (group B). To advise group A properly, Fraser Milner was assisted by US and Canadian accounting firms and law firms. When legal matters arose that were of common interest to both groups, Fraser Milner was instructed to and did communicate with group B and its legal and accounting advisers via documents prepared by Fraser Milner or PricewaterhouseCoopers. The documents were made for the purpose of providing legal advice common to the interest of both groups, which clearly shared an interest in having the transaction completed. The Crown argued that disclosure to group B waived the privilege in the advice given to group A by Fraser Milner, because the promotion of the adversarial system of justice is the sole justification for privilege: thus common interest privilege can arise only in circumstances where there is common interest in actual or anticipated litigation.

The BCSC disagreed. Relying on decisions by the Alberta Court of Queen's Bench and the FCTD, the BCSC held that "the economic and social values inherent in fostering commercial transactions merit the recognition of a privilege that is not waived when documents prepared by professional advisers for the purpose of giving legal advice are exchanged in the course of negotiations. Those engaged in commercial transactions must be free to exchange privileged information without fear of jeopardizing the confidence that is critical to obtaining legal advice." The court found that all 725 pages of documents were privileged. *Fraser Milner* was recently considered in *Pitney Bowes*, which will be reviewed in next month's issue.

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US Interest Deductibility

Canadian multinationals that either loan to finance operations or guarantee the debt obligations of their US subs need to consider the impact of proposed amendments to the US earnings-stripping rules, particularly if the leverage in the United States is high relative to the worldwide debt-to-equity ratio.

Code section 163(j) contains the earnings-stripping rules and generally defers the current deduction of related-party interest to the extent that such expenses exceed 50 percent of adjusted taxable income (ATI). ATI is a cash-basis EBITDA (earnings before interest, taxes, depreciation, and amortization) figure. The limitation does not apply if the corporation's debt-to-equity ratio does not exceed 1.5:1, a safe harbour calculated on overall assets and liabilities. President Bush's proposal changes the safe harbour prospectively, calculating it on the basis of percentages of asset values in specified categories. The value of assets in a specified asset class is multiplied by its specified debt-to-assets ratio as indicated: cash, cash equivalents, and government securities (0.98); municipal bonds, publicly traded debt securities, and receivables (0.95); publicly traded equities, mortgages and other real estate loans, other corporate debt, and third-party loans (0.90); trade receivables and other current assets (0.85); inventory (0.80); land, depreciable assets, other investments, and loans to shareholders (0.70); and intangibles (0.50). Equity investments in non-subsidiary foreign related parties are not considered in calculating the safe harbour amount.

Assume that a corporation has total assets of $1,600: $100 cash, $500 inventory, and $1,000 land and depreciable assets. It appears that only related-party debt exceeding

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$1,198 ($98 + $400 + $700) triggers the earnings-stripping rules, but it has yet to be clarified whether the calculation is simply a summing up. Nor does the proposal address how asset value is determined. Many Canadian-based multinationals do not maintain US tax balance sheets, and thus clarification that US GAAP or other international standard balance sheet values may be used would be welcome. It is worth noting that in this simple example such a corporation may be a winner because of the proposed change: the current 1.5:1 safe harbour would activate the earnings-strippings rules at a $960 debt level.

The proposals amend other aspects of the rule. If interest expense exceeds 50 percent of ATI, the amount up to the excess of interest paid to (or paid on debt guaranteed by) a non-US related party is not currently deductible. The proposal reduces the ATI threshold to 35 percent. In fact, the greater of that limitation and the new worldwide disallowance under the limitation discussed below is disallowed. The worldwide limitation denies an interest deduction to the extent that the US members of a corporate group have a higher debt-to-asset leveraging than the whole worldwide corporate group. The interest disallowance under the worldwide limitation is itself limited by the asset class safe harbour rule, which apparently means that the interest disallowance does not exceed the interest in excess of the safe harbour amount. The worldwide limitation applies separately to any financial corporation in a corporate group.

Furthermore, the proposal provides a two-year carryforward for interest disallowed under the ATI limitation, but none for interest disallowed under the worldwide limitation. The current unlimited carryforward is eliminated. It is hoped that these carryforward restrictions will be loosened. Congress evidenced some openness to excluding guaranteed debt from the scope of the rules, but the proposals contain no such exclusion.

The proposal is effective for tax years beginning after 2003; the treatment of existing debt was not discussed. Planning opportunities may include leasing and factoring. (See "Strip Lease" and "IRS Smiles on Factoring," *Canadian Tax Highlights*, February 23, 1994, at 9-10 and January 2003, respectively.)

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Loans Secured by Insurance

A recent technical interpretation says that life insurance premiums incurred by a taxpayer to secure a loan from a financial institution (FI) may not be deductible under paragraph 20(1)(e.2) if the FI assigns its rights under the original loan agreement to a securitization vehicle (2002-016708). According to the CCRA, the premiums continue to be deductible after the securitization transaction only if the taxpayer continues to owe the amount to the original FI under the original borrowing. This problem could arise unexpectedly vis-à-vis the taxpayer if the FI has not informed the borrower of the securitization.

In general, paragraph 20(1)(e.2) permits a taxpayer who borrows money a deduction of premiums payable under a life insurance policy if the policy is assigned to a restricted FI (bank, trust company, credit union, or insurance company) in the course of borrowing from the FI; if the assignment is required as collateral for the borrowing; and if the interest payable on the borrowing is, or would be in specified circumstances, deductible in calculating the taxpayer's income for the year. The amount deductible is the lesser of the premiums payable by the taxpayer under the life insurance policy for the year and the net cost of pure insurance under the policy for the year that is reasonably considered related to the amount owing from time to time during the year by the taxpayer to "the institution under the borrowing," as phrased in the postamble to paragraph 20(1)(e.2).

The CCRA points out that "the institution" to which the amount must be owing is the original FI and "the borrowing" is the same original loan. Thus, for the premiums to continue to be deductible pursuant to paragraph 20(1)(e.2) after the securitization, the CCRA says that the amount owing by the taxpayer must continue to be owed to the original FI under the original borrowing.

According to the CCRA, it is always a question of fact whether a particular securitization results in an amount no longer being owed by the taxpayer to the original FI under the original borrowing. The CCRA adds that the taxpayer must make sufficient inquiries to ensure that if life insurance is used as collateral for a loan, the amount borrowed continues to be owed under the original borrowing to the original FI.

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Federal Accounting Matters

Inevitably, only one figure in the federal government's financial operations—the budgetary surplus or deficit—attracts all the attention, even though that figure is the most susceptible to changes in accounting conventions. The 2003 budget introduced yet another accounting change that affects the bottom line. The two other main indicators of Ottawa's bottom line remain unchanged but are relatively unappreciated.

The federal government had used a modified system of accounting in its budgetary accounts. A cash approach took

Comparisons of the Federal Bottom Line

Fiscal year	Budgetary balance: Previous system	Budgetary balance: Full accrual	Financial requirements	National accounts
	millions of dollars			
1993-94	−42,012	−38,540	−29,850	−39,696
1994-95	−37,462	−35,849	−25,842	−35,088
1995-96	−28,617	−29,381	−17,183	−31,700
1996-97	−8,897	−8,038	1,265	16,957
1997-98	3,817	2,771	12,729	6,476
1998-99	3,112	3,144	11,491	7,676
1999-2000	12,713	13,174	14,566	8,151
2000-1	18,148	20,193	18,991	17,750
2001-2	8,907	8,180	4,697	11,244

into account the main tax revenues as they were collected, and expenditures when the cash flowed out. Some cash inflows, notably non-tax revenues, were counted as they fell due, reflecting a true accrual approach. Spending on capital assets, such as new buildings, was recognized in budgetary spending when the asset was acquired; thus the analysis of the cost of particular services was impeded because the use of associated assets is not recognized as a part of the cost of the services during the assets' useful life. In the private sector, by contrast, the cost of such assets is amortized over the life of the asset as depreciation.

Beginning with the 2002-3 fiscal year, however, the budgetary accounts will be prepared using a true accrual accounting system, with depreciation charged for each asset. As a result, for the 2001-2 fiscal year, the table shows a change in surplus to $8.2 billion, down from the $8.9 billion in the same year under the previous accounting system. The change does not always affect the bottom line negatively. In 2000-1, for example, the effect of the shift to accrual accounting was an increase in surplus of $2 billion. Over the nine years for which the accrual figures have been calculated, the cumulative deficit dropped from $70.3 billion to $64.3 billion.

The other main indicators of the federal government's bottom line do not change with accounting systems. The financial requirements provide a better indication of the government's need for cash, or, as in the most recent years, its increased cash balances available for debt reduction; in summary, these requirements represent the government's effect on domestic and foreign capital markets. The balance on the national accounts budget is a better indication of the impact of government on the national economy. Both of these benchmarks shifted to positive numbers a year before the budgetary balance. They remain the measures of choice for the financial markets and economic analysis.

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Budget Promises and Admin

Releases promised

In the February 18, 2003 federal budget, Finance promised to release several items, including the following.

■ **Deductibility of interest and other expenses.** Finance announced that recent court decisions (presumably the SCC decisions in *Stewart* and *Ludco*) created uncertainty about how taxpayers should treat expenses, especially interest, in computing income from a business or property. Finance is particularly concerned if a taxpayer's tax loss arises from interest expense deductions when there is no reasonable expectation of earning income versus capital gains. Finance is also concerned about the gross income test, under which the presence or prospect of gross (not net) revenue is enough to lead to the conclusion that an expenditure was incurred "for the purpose of earning income" under subparagraph 20(1)(c)(i). Finance says that neither result is consistent with appropriate tax policy or expected under prior law or practice. Without giving further details or a timetable, Finance says that it will consider amendments to "provide continuity in this important area of the law." Proposals will be released for public consultation.

■ **Resource taxation.** As promised in the budget, Finance issued a technical paper on March 3, 2003 with more details on proposed changes affecting companies in the resource sector, which were effectively denied access to the five-year package of general corporate tax rate cuts announced in the October 2000 mini-budget. The following changes will be phased in over five years: reduction in the general corporate income tax rate on income from resource activities to 21 percent (from 28 percent); deduction for actual provincial and other Crown royalties paid and elimination of the 25 percent resource allowance; and extension of the 15 percent exploration tax credit—announced in October 2000 and set to expire at the end of 2003—to December 31, 2004, when it will be replaced by a new tax credit for qualifying mineral exploration expenditures.

■ **Cross-border share-for-share exchanges.** "In the near future" Finance will release draft legislation to introduce a rollover for cross-border share-for-share exchanges, following consultations announced in the October 2000 mini-budget. The rollover will apply if a Canadian-resident shareholder exchanges a domestic company's shares for a foreign corporation's and receives no boot.

■ **Tax prepaid savings plans (TPSPs).** Many submissions to Finance have said that Canada's tax system should be more conducive to saving, and some have recommended TPSPs, which, unlike RRSPs, do not provide deductions for contributions but shelter from tax withdrawals and the investment income earned in the plan. Finance will carry out consultations to assess whether

TPSPs may be useful and appropriate to provide additional savings opportunities for Canadians. No timetable for these consultations was indicated.

■ **Disability tax credit (DTC).** Finance will evaluate the DTC to determine whether it is achieving its policy purpose. The budget established a technical advisory committee with an 18-month mandate to advise the government on this matter.

Admin harmonization

The budget announced the implementation of standardized accounting, an initiative started several years ago to harmonize various accounting, penalty, and interest provisions of federal tax laws. The budget proposed that certain accounting, interest, penalty, and related administrative and enforcement provisions of the Income Tax Act ("the Act") and certain non-GST provisions of the Excise Tax Act will be harmonized first, including the following.

■ **Balance-due day for corporate taxes accelerated.** Under the existing rules, taxes under certain parts of the Act are payable on different dates. The most obvious example is part IV tax (a tax on taxable dividends received by private corporations), which is payable on or before the day that is three months after a corporation's year-end. The budget provides that all corporate taxes under the Act become due on the corporation's "balance-due day," defined in subsection 248(1) to mean, generally, the day that is two months after its year-end (or sometimes three months after a CCPC's year-end), applicable for taxation years beginning after June 2003.

■ **Timing of interest on amounts owed to a taxpayer.** Several budget measures affect the time at which interest begins to accrue on amounts owing to individual and corporate taxpayers, including the following: (1) Interest starts to accrue 30 days after receipt of a loss carryback application, a change from the date of receipt, for applications received after June 2003. (2) Interest on a refund payable to a corporation currently begins to accrue on the later of the day that is 120 days after its taxation year and the day when the return claiming the refund is filed (subsection 164(3)). If a return is late-filed, the budget proposes an additional 30-day non-accrual period, effective for taxation years ending after June 2003. (3) Effective for taxation years ending after June 2003, interest on a refund payable to an individual begins to accrue on the later of the day that is 30 days after the taxpayer's balance-due day and the day that is 30 days after the return claiming the refund is filed, a change from 45-day lags (subsection 164(3)). The measures are part of a larger initiative, currently under review, that will extend to other federal tax statutes.

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A Fresh Start

The technical amendments released on December 20, 2002 contain several changes affecting the fresh-start rules, some of which have unexpected results. The rules were designed to ensure that income or losses that accrued in a taxation year before a foreign affiliate (FA) carried on an investment or non-active business are not included in that business's income or loss.

Some changes are innocuous. For example, the fresh-start rules now apply if a particular business is carried on by a partnership of which a taxpayer's FA is a member. The term "operator" is introduced to designate such a partnership and FA. The amendments also ensure that the fresh-start rules are no longer triggered if an FA begins to carry on in a taxation year a particular business that it did not carry on in the preceding taxation year.

Amendments to the regs also affect the calculation of surplus accounts in order to better integrate the application of the fresh-start rules. New rules in the regs address deemed dispositions of eligible capital property (ECP) and resource property to ensure that on a deemed disposition of ECP the affiliate's earnings are adjusted accordingly by the amount to be included in the computation of the operator's income for the preceding taxation year from the foreign business. A correlated change increases an FA's loss to be deducted in computing the operator's income.

Several changes to the fresh-start rules provide relief to foreign insurers. An operator may now claim certain policy reserves in relation to its foreign life insurance business. Life insurance policies issued by a life insurer with respect to a foreign life insurance business are deemed to be life insurance policies in Canada if the operator would be subject to specified reporting requirements if it carried on the business in Canada. As a result, certain policy reserves are now available with respect to an insurer's life insurance business instead of (as currently is the case) with respect to non-life insurance businesses only. Finance had previously issued a comfort letter stating its intention to recommend such an amendment.

The above changes are relieving in nature, but other amendments may result in FAPI exposure if an FA's foreign business was an investment or other non-active business one year and then an active business in the immediately following year. In such a case, any accrued gains and losses are included in computing the FA's FAPI in that preceding taxation year. If new paragraph 95(2)(k.3) applies—for example, because the business is an investment business in one year and an active business in the next—the operator is deemed to have disposed of, immediately before the beginning of the specified taxation year, each property used in the business for proceeds equal to its then FMV. The deemed disposition is immediately followed by a

deemed reacquisition that is taken into account in the determination of the FA's surplus accounts. Taxpayers must therefore monitor changes in their activities with a view to the potential application of this rule, such as the hiring of a sixth full-time employee in the conduct of what has been an FA's investment business. If the property used in the taxpayer's business is thus deemed disposed of, any resulting capital gain is included in its FAPI; but because the disposition is only "deemed" to have occurred, there may be no foreign tax paid to create a subsection 91(4) deduction to shelter the FAPI inclusion. If the FMV of property such as real estate has significantly increased, the FAPI inclusion on the deemed disposition may significantly and unexpectedly affect a taxpayer. It is hoped that Finance, which is aware of this result, will amend the technical bill accordingly before enactment.

The proposed amendments apply to a taxpayer's FAs' taxation years beginning after December 20, 2002. Taxpayers can, however, elect to have the fresh-start rule amendments apply for all taxation years that begin after 1994, and to all FAs of the taxpayer. The election is distinct and separate from the global section 95 election that is available pursuant to other provisions of the technical bill. Taxpayers should carefully review the implication of the fresh-start rules to evaluate whether to make such an election.

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Discrimination and Treaties

The recent US earnings-stripping proposals extend beyond US borders to affect the global capitalization of multinationals, leading to allegations of discriminatory tax practice and questions of whether discrimination that does not violate treaty non-discrimination provisions is acceptable. The Act distinguishes between Canadian residents and non-residents by restricting certain tax expenditures and incentives to Canadian residents. Canada has carefully negotiated its treaties to preserve its right to so discriminate.

In comparing the non-discrimination article XXV of the Canada-US treaty (CUT) with that in the US model treaty (UMT), several differences are apparent.

■ The CUT deals with residents, because Canada does not tax on the basis of citizenship.

■ The CUT affords non-resident citizens the maximum protection accorded citizens of any third state, a provision not in the UMT.

■ The CUT allows a deduction for a dependant resident in the other state as if he or she were resident in the first state. The UMT is silent on the point.

■ A married Canadian-resident non-US citizen who has taxable US employment income may file a joint return. The UMT is silent on the point.

■ A company residing in one state and partly owned by a resident of the other state may not be subject to more tax than is imposed on such a company partly owned by third-state residents. Comparable provisions in Canada's other treaties extend to enterprises. The UMT is silent on the point.

■ Under the CUT, the other state may not tax a permanent establishment less favourably than it taxes its own residents who carry on the same activities. This provision is similar to those in the OECD model treaty and the UMT, except that it overrides the elimination of double taxation provisions and a specific exclusion applies for intercorporate dividends. Canada need not allow US-resident companies a deduction for dividends received from Canadian companies or exempt surplus from foreign affiliates.

■ Both the CUT and the UMT require that interest, royalties, and other disbursements must receive the same treatment as if they had been made to a resident of the country of the payer. For capital tax purposes, debts owing to US residents are treated equally to those owed to residents, a concession not found in any other Canadian treaty.

■ The CUT protects domestic tax rules relating to the deductibility of interest—thin capitalization rules—that are similar to laws in force on September 26, 1980. (See *Speciality Manufacturing*, 97 DTC 1511.) Canada and the United States may adopt measures to ensure that non-residents are not entitled to more favourable treatment than residents under the preceding rule.

■ The CUT makes specific reference to conventions and seminars. The UMT is silent on the point.

■ The non-discrimination article applies to all federal taxes, including GST and other excise taxes. Provincial or state taxes are not protected. The UMT anti-discrimination rules also apply to taxes imposed by a local subdivision or local authority, even though the treaty's application is generally restricted to federal taxes.

Canada's thin capitalization and other avoidance rules are designed to avoid the tax-free stripping of earnings. Interest-free loans between Canadian companies are allowed without adverse tax consequences. If a Canco lends to a non-resident shareholder and the loan is not repaid within one taxation year, it is deemed to be a dividend subject to withholding. For taxation years after 2000, the acceptable debt-to-equity ratio is 2:1 (formerly 3:1) for debt from non-resident shareholders owning at least 25 percent of the voting or equity shares. An interest deduction related to excess debt is disallowed. On a low- or non-interest-bearing loan (or other debt) made directly or indirectly by a Canco to a non-resident company that is not a wholly owned sub using the funds in an active business, Canco is deemed to receive interest at a prescribed rate. The rules prevent, for example, a Cansub from using its surplus cash to subscribe for shares of a US sub that in turn lends interest-free to other corporate

group members. Furthermore, section 212.1 prevents a non-resident shareholder from stripping surplus out of a Canco by selling its shares to a non-arm's-length Canadian company and thus converting what would otherwise be a dividend into a treaty-exempt capital gain. A dividend subject to withholding tax is deemed to arise to the extent that the boot received exceeds the shares' PUC.

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Treaty Income

The TCC's recent decision in *Beame* has the surprising effect of causing Irish residents to be the only taxpayers unable to benefit from the reduction in capital gains inclusion rates (2003 DTC 73). More interestingly, the decision asserts that the word "income" under the Canada-Ireland treaty is interpreted without reference to the Act.

Beame, a resident of Ireland, realized a capital gain on the disposition of taxable Canadian property (TCP) in 1997 and calculated his taxable capital gain (TCG) as 75 percent of the capital gain, the inclusion rate applicable at the time. The treaty's article VI(1) provides that the rate of Canadian tax on income derived from sources within Canada by an Irish resident shall not exceed 15 percent: the taxpayer paid 15 percent tax on the TCG and was issued a clearance certificate. The minister later assessed a 15 percent tax on the entire gain.

The treaty came into force in 1967 and is now Canada's only pre-1972 international tax treaty; it contains no provisions on capital gains. The TCC considered whether the word "income" in article VI(1) refers only to TCG or to the entire capital gain from the disposition of TCP. The treaty's drafters in 1967 probably did not intend that the word "income" include capital gains, but that possibility was not advanced before the TCC, probably because section 3 of the Income Tax Conventions Interpretation Act (ITCIA) provides that an undefined term in a treaty, except to the extent that the context otherwise requires, has the meaning it has for the purposes of the Act as amended from time to time (the ambulatory meaning). The ITCIA was enacted following the SCC decision in *Melford* (82 DTC 6281) that words not defined in a tax convention have the meaning those words had when the convention was adopted (the static meaning).

The ambulatory meaning seems implicitly recognized by the TCC's finding that the treaty reference to income includes capital gains, but the TCC did not discuss it (other than to say that the minister relied on the ITCIA). The court quoted the static-meaning rule in *Melford* without contradiction or reference to the ITCIA, which raises the concern that the ITCIA may not have been fully considered. The TCC cited long-accepted principles that a tax treaty must be given a liberal interpretation with a view to implementing the true intentions of the contracting states and said that income is to be interpreted in a "broad fashion" and without reference to the Act. The minister's assessment of the 15 percent tax on the entire capital gain was upheld.

The TCC noted that "article VI of the treaty fixes a rate of 15 percent on 'income.' It does not go further and add the adjective 'taxable' to that word." No mention was made of the fact that income under section 3 of the Act includes TCGs, not capital gains. It is, of course, not necessary to calculate taxable income under section 2 of the Act in order to take the non-taxable portion of a capital gain out of income as calculated under the Act. The absence of a technical analysis of taxable income and income under the Act is consistent with the TCC's conclusion that the treaty definitions can be determined independently of the Act. If the Act is ignored and a plain meaning is applied, the TCC's distinction between taxable income (including only the TCG) and income (including the entire capital gain) is more understandable. However, the cases relied on by the TCC—*Melford* and *Gladden Estate* (85 DTC 5188), both of which predate the ITCIA—do not suggest that the Act should be disregarded in interpreting undefined treaty terms. Although the ITCIA's plain words stipulate that an undefined treaty term has the meaning it has in the Act (unless the context requires otherwise), there is some debate over the strictness with which the Act's meaning should be applied in interpreting treaty terms. However, the position that a word such as "income" should be interpreted without reference to the Act is a substantial departure from the boundaries of this debate.

On occasion the courts have attempted to restrict the meaning of section 3 of the ITCIA, presumably because it creates a potential inherent power to override treaties simply by amending the Act. (See *Kaplan Estate*, 94 DTC 1816, effectively overruled by the FCA in *Kubicek*, 97 DTC 5454, and *Haas Estate*, 2001 DTC 5001.) However, if the Irish treaty was overridden, it was overridden in 1972 with the introduction of capital gains tax. The TCC in *Beame* only exacerbated the damage inflicted on treaty protection by applying the tax on the entire capital gain.

As a practical matter, *Beame* is likely only of concern to Irish residents who dispose of TCP. The notion that terms such as "income" in a tax treaty should be determined without reference to the Act is probably ephemeral. The taxpayer in *Beame* has appealed. The minister's argument is perhaps surprising, given his considerable victory in convincing the TCC in *Equilease* that a deemed dividend under the Act was a dividend for the purposes of the Canada-US treaty and, in obiter, that a recharacterized dividend under GAAR would also be a dividend for such purposes. The minister may have won the battle in *Beame* by eking out some tax dollars from Irish taxpay-

ers, but he may have lost the war of further ramifications if it is upheld that an undefined term in a tax treaty, which is of course relieving in nature, should be interpreted broadly and without reference to the Act.

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ECP Election Inequity

Subsection 14(1.01) of the Act permits a taxpayer to elect to report a capital gain on the disposition of an eligible capital property (ECP) for which the cost is identifiable. A draft amendment of December 20, 2002 effectively restricts the election to the disposition of acquired ECP without any apparent policy reason for excluding internally developed ECP. It is expected that submissions will be made to Finance requesting revisions to the draft legislation to correct this inequity.

The election in subsection 14(1.01) was introduced with legislation to implement the February 2000 federal budget. The accompanying technical notes state that it was intended to provide taxpayers with the flexibility to recognize the gain on disposal of ECP (other than goodwill) as a capital gain, thereby allowing for the offset of capital losses and the preservation of the cumulative eligible capital (CEC) pool balance.

As originally drafted, the election appears to apply to the disposition of all ECP (other than goodwill) whether or not acquired by the taxpayer from a third party or developed by the taxpayer in the course of its business. In informal discussions the CCRA has said that it does not agree with this interpretation. The proposed technical change replaces the reference to "cost" with references to "eligible capital expenditure" (ECE), presumably reflecting concerns that arose because "cost" is not defined and because of uncertainty whether cost could be nil. This change, in combination with the addition of the words "the amount of" in paragraph 14(1.01) (a), suggests that the election applies only if the ECP had some original positive cost. The proposed technical change retains the requirement that the ECE can be determined—a puzzling inclusion, because one might expect that the cost or the ECE should always be determinable. Furthermore, the proposed amendments add the phrase "in respect of the acquisition of," a change that may effectively restrict the election to disposals of previously acquired ECP. As noted above, there is no apparent policy reason for this restriction, and such a restriction is not equitable because it favours taxpayers who acquire rather than develop ECP. Such a restriction also favours taxpayers who acquire ECP for a nominal cost and develop it so that the increase in the ECP's value is attributable to the enhancements, not the initial cost. But the rules place such a taxpayer in a better position than a taxpayer that develops its own ECP from the outset.

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US Expat Rules May Change

Legislative amendments in 1996 changed tax rules and imposed new tax and immigration rules on persons who give up US citizenship status or green cards after a lengthy US residence period. Most commentators concluded that the tax law changes were not a significant new deterrent to expatriation, but at least some commentators viewed the immigration provision, which potentially excludes former US citizens (but not green-card holders) from re-entering the United States, as a greater deterrent to expatriation. Proposals to amend those expat rules surfaced in the fall of 2002.

The latest proposals generally impose a departure tax on an expat—a US citizen or a green-card holder of generally more than seven years—and an inheritance tax on a US person who receives a gift or bequest from an expat; the immigration exclusion is also repealed. Exceptions apply, such as for certain expats who acquired US and another country's citizenship at birth or who relinquish citizenship before reaching the age of 18½. However, the tax on the FMV of a gift or bequest received by a US person from an expat, a notable shift in policy, enjoys only fairly limited exceptions.

The proposed departure tax generally taxes expats on the net gain from a deemed sale of property on the day preceding expatriation, unless net gains do not exceed US $600,000 (US $1,200,000 for married individuals filing a joint return). An expat may irrevocably elect to continue to be taxed as a US citizen on all property otherwise covered by the expatriation tax. The types of property covered are very broad, with an exception for US real property interests that are subject to tax in the hands of non-resident non-citizens and for certain types of qualified retirement plans. Payment of the departure tax may be deferred until the property is disposed of, but interest is charged for the deferral period at a rate two percentage points higher than that normally applicable to an individual's tax underpayments.

Under existing immigration rules a former citizen may be prevented from re-entering the United States if his or her expatriation is determined to be tax-motivated: the proposals amend that rule to deny re-entry only if the individual is determined not to be in compliance with US tax obligations under the expat provisions.

Readers are invited to submit ideas or written material to *Canadian Tax Highlights*.
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The proposals apply to US citizens who relinquish citizenship and long-term green-card holders who terminate their US residence on or after February 5, 2003. The proposal must pass both the House and the Senate floor before it can be signed into law by the president, and Congress is currently engaged with other, more visible issues. However, corporate expatriation was much debated in the last Congress and received significant publicity. Furthermore, proposals for individual expat legislation incorporating a departure tax and a gift and inheritance tax continue to reappear. Thus the prospect remains that this proposal, or some form of it, may become law in the United States in the near future.

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CCRA Recruiting Valuators

In the last two years, the CCRA has expressed its commitment to abide by the standards of the Canadian Institute of Chartered Business Valuators (CICBV), partly in response to the concerns of valuators over the potential impact of the civil penalties. The CCRA has been recruiting valuators to join its Business Equity Valuation Group to provide the Appeals and Collections divisions with FMV opinions "involving complex valuations for tangible and intangible properties in arm's length and non-arm's length transfers." This represents an important and welcome step toward the CCRA's commitment.

Applicants were required to have a CBV designation or to have completed the six courses of study offered by the CICBV. The CCRA's Head Office Valuation group was also recruiting CBVs to develop national policies and procedures for the valuation program; to respond to internal and external inquiries; to serve as liaison between business valuation headquarters, the regions, field offices, and taxpayers; to coordinate training for the valuation staff; and to coordinate the mandates given to private sector valuators to serve as expert witnesses. Qualified experience must include developing and completing professional valuation reports for income tax purposes, applying the standards and practices established by the CICBV, and negotiating settlements in litigious assignments. Candidates must also be eligible for a recognized professional accounting designation such as a CA or have a university degree with an accountancy major.

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Foreign Tax News

Treaties

In December 2002, **Peru** erroneously issued notification that it had completed internal procedures to ratify its treaty with Canada. The treaty will come into effect when Peru has completed the necessary procedures.

Belgium

The list of countries deemed to have advantageous tax regimes has been finalized, strengthening the minimum taxation condition for application of the participation exemption for dividends received by a Belgian company. A Belgian holding company is entitled to the exemption only if the subsidiary is subject to a corporate tax rate equivalent to the Belgian rates and it is not resident in a country that has a corporate income tax regime substantially more favourable than Belgium's.

To make Belgium an attractive place for investment, new rules substantially expand the tax ruling and advance pricing agreement (APA) practice. The legal basis for bilateral and multilateral APAs is found in Belgium's treaty provisions corresponding to articles 25 and 26 of the OECD model treaty.

OECD

The OECD will shortly publish three reports detailing the recent changes to the model tax treaty. One report will provide background and analysis of the changes to article 5, "permanent establishment." The condensed version of the model as of January 2003 is available on the OECD site and at the Foundation's library.

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