CANADIAN TAX Highlights

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Tax Collection Limitations

The SCC in *Markevich* underscores an important argument in a taxpayer's arsenal and clarifies how federal and provincial limitation periods can be mobilized to avoid tax collection. The Crown was prohibited from collecting 1990 and prior years' tax debts because of non-tax statutes of limitation.

The taxpayer did not pay federal and provincial income taxes for the 1980 to 1985 taxation years; an assessment for $234,136.04 in 1986 went unchallenged and unpaid. The CCRA wrote off the amount internally without formally extinguishing the debt, and from 1987 to 1998 made no effort to collect the debt; it issued statements to the taxpayer exclusive of the 1986 balance. In 1998, almost 12 years after the assessment, the CCRA sent a statement of account to the taxpayer showing a $770,583.42 balance payable, including the 1986 amount and accrued interest. The FCTD dismissed an application for a declaration that the Crown was prohibited from collection. On appeal, the FCA held that the Crown was statute-barred from collecting the old debt: the Income Tax Act was not a complete code, and the provincial statute of limitations barred collection.

On appeal, the SCC easily concluded that the ITA was not a complete code. Section 222 authorized broad collection powers related to the federal tax debt, but section 32 of the Crown Liability and Proceedings Act (CLPA) limited collections to six years on the federal debt and to the prescribed period under provincial legislation for the provincial debt. Section 32 of the CLPA presumptively applied on a residual basis to all Crown proceedings: the ITA did not contain limitation periods for its collection powers, and thus did not oust the CLPA rule. General federal and provincial rules limited possible collection actions after certain defined periods. As a matter of broad tax policy, the minister was obliged to act diligently in collecting tax debts. The SCC also observed that "[i]n light of the significant effect that collection of tax debts has upon the financial security of Canadian citizens, it is contrary to the public interest for the department to sleep on its rights in enforcing collection. It is evident that the rationales which justify the existence of limitation periods apply to the collection of tax debts."

A seven-judge majority concluded that the federal debt was subject to a six-year limitation period in CLPA section 32, but that the provincial debt was governed by provincial legislation. The minority said that the provincial rules applied to both. In the result, two separate statute-of-limitations rules may apply to combined federal and provincial assessments and to assessments under other federal and provincial legislation, such as GST and PST. The SCC offered a template for amendment: include the words "at any time." It will be interesting to see whether Finance follows up on this prescription.

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Manrell Not Taxable

The FCA in *Manrell* recently analyzed the meaning of "property" and concluded that it does not include a right to compete; non-competition payments are thus non-taxable capital receipts.

On the sale of his shares in a manufacturing business to an arm's-length purchaser, Manrell entered into a non-competition agreement for which payment was included in the shares' purchase price. On the basis of the FCA decision in *Fortino*—that non-competition payments were not income from a productive source (section 3) and not eligible capital amounts (subsection 14(1))—Manrell argued that the non-competition payments were not taxable. The taxpayer and the CCRA agreed that the non-competition payments were on account of capital: if they were not proceeds for the disposition of property, they were thus non-taxable capital receipts. The court conceded the unfairness of the result but said that any tax policy fix could only be rectified by Parliament. However, the determination of what constitutes property undoubtedly has implications beyond non-competition payments.

In determining whether the right to compete is property under subsection 248(1)—a right of any kind whatever—the FCA considered the word "property" in its ordinary meaning, in its statutory context, and in jurisprudence.

In This Issue

■ **Ordinary meaning.** "Property" implies the exclusive right to make a claim against someone else, not a general right to do something that anyone can do or a right that belongs to everyone. Before but not after signing the non-competition agreement, Manrell had the right to carry on a business, a right that he shared with everyone: "whatever it was that Mr. Manrell gave up when he signed that agreement, it was not 'property' within the ordinary meaning of that word."

■ **Statutory context.** An exhaustive analysis of the use of the word "property" in the Act and its predecessors led the FCA to conclude that the phrase "a right of any kind whatever" does not expand the ordinary meaning of property to include a non-exclusive, commonly held right to carry on a business.

■ **Jurisprudence.** No cases have held property to include a right that is not, or does not entail, an exclusive and legally enforceable claim. The term has a broad meaning, but it does not include every conceivable right; nor is everything of value "property."

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QUEBEC PENALTY'S DEMISE

Quebec transfer-pricing legislation of 2001 mirrored federal rules (sections 1082.3 to 1082.13 of the Quebec Income Tax Act (QTA)). A 10 percent penalty applied to transfer-pricing adjustments exceeding a minimum if the taxpayer had not made reasonable efforts to establish arm's-length transfer prices, evidenced by contemporaneous documentation. Following representations that Quebec taxpayers were unjustly exposed to a potential 20 percent penalty, Revenue Quebec said that a drafting oversight in QTA section 1082.5 would be modified to apply only to the portion of the taxable income allocated to Quebec (see "Quebec Transfer-Pricing Penalty," *Canadian Tax Highlights*, October 23, 2001, at 77). After further representations and in an effort to foster interprovincial neutrality, Quebec's 2003-2004 budget abolishes the 10 percent penalty retroactive to its effective date of December 31, 1998. As a result, taxpayers that conduct business in Quebec are no longer subject to additional transfer-pricing penalties, parallelling the Alberta and Ontario transfer-pricing rules.

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TONI: NO HIDDEN AGENDA

The CCRA Web site recently and quietly posted preliminary personal income taxation statistics for the 2001 taxation year. This edition shows details of the first year of provincial income tax under the tax-on-income (TONI) system. TONI offers additional flexibility in designing provincial tax policy. In the coming years, the two tables may show more significant change, but data for the tax year 2001 prove that the switch to TONI was revenue-neutral.

Table 1 Provincial Personal Income Tax as a Percentage of Taxable Income

	Tax years			
	1998	1999	2000	2001
Nfld.	9.2	9.3	8.7	8.7
PEI	7.7	7.5	7.1	7.3
NS	7.8	7.9	8.2	8.0
NB	8.1	8.0	7.9	7.9
Ont.	7.7	7.3	7.2	7.1
Man.	9.1	8.7	9.0	8.7
Sask.	9.3	9.1	8.5	8.5
Alta.	7.6	7.6	7.5	7.4
BC	8.2	8.1	7.9	8.0
Territories	7.3	7.4	6.9	7.0
National average	7.9	7.7	7.5	7.5

Nine provinces and three territories switched from calculating their tax as a percentage of federal tax to calculating it by applying their own rate schedule to federally defined taxable income. Quebec has always used its own rate schedule, its own definition of taxable income, and its own collection machinery. The other provinces continue to contract with the CCRA to collect on their behalf.

The provinces and territories made it clear that they would not use the change to camouflage tax increases, and in some cases they combined the change with a tax reduction, adding to reductions introduced since 1996. As shown in table 1, total provincial tax (excluding Quebec's), expressed as a percentage of total taxable income, was unchanged from 2000 to 2001. Only Prince Edward Island, British Columbia, and the territories showed a slight rise in their ratios, mirroring similar changes in federal collections in those jurisdictions that year. Provincial ratios dropped in Nova Scotia and Ontario, also mirroring federal changes; but they dropped in Manitoba and Alberta as well, despite a small increase in those provinces' federal tax payable as a percentage of taxable income. From 1998 to 2001, only Nova Scotia did not reduce its tax as a percentage of taxable income. On average, provincial income tax as a percentage of taxable income for all of the provinces and territories using the federal base dropped from 7.9 percent in 1998 to 7.5 percent in 2000 and 2001.

Some of the changes in the provincial ratios can be attributed to changes in the composition of taxable income in each province. Table 2 shows the changes in provincial tax payable, expressed as a percentage of federal tax payable, from 1998 to 2001. In Ontario, for example, the provincial changes resulted in a drop from

Table 2 Provincial Personal Income Tax as a Percentage of Federal Tax Payable

	Tax years			
	1998	1999	2000	2001
Nfld.	68.5	69.5	66.0	66.2
PEI	59.7	59.5	56.6	57.6
NS	55.1	56.2	58.9	58.3
NB	60.1	60.0	59.7	59.9
Ont.	46.7	44.7	44.1	43.9
Man.	63.6	62.7	65.4	62.9
Sask.	66.9	67.0	63.1	63.4
Alta.	46.2	46.8	46.8	46.0
BC	53.9	53.4	52.3	53.4
Territories	45.9	45.6	44.9	45.3
National average	49.9	48.7	48.1	48.0

46.7 percent to 43.9 percent of the federal tax, while the Alberta changes, more radical in their redistribution of the burden, resulted in only a minor change relative to federal tax payable in that province.

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Fractional Shares: Consolidations

A recent technical interpretation (TI) says that if shareholders receive not more than $200 cash in lieu of fractional shares on the share consolidation of a taxable Canadian public corporation, the consolidation does not fall outside the circumstances described in IT-65, but the shareholders must recognize a gain or loss on the fractional shares' disposition (2002-014995).

On the TI's facts, Pubco's share consolidation results in the shares of a class being replaced by fewer shares of that class in the same proportion for all shareholders. For instance, every 1,000 pre-consolidation shares are replaced by 10 post-consolidation shares. In lieu of fractional shares, shareholders receive up to $200 cash: a shareholder who previously held 1,050 shares receives 10 post-consolidation shares and cash for the fractional half-share. Relevant corporate legislation indicates that the consolidation is not a cancellation of pre-consolidation shares or an issuance of post-consolidation shares: issued and outstanding shares are simply redefined. Predictably, the TI said that no disposition or acquisition of shares occurs on a consolidation as described in IT-65, including no change in the interest, rights, or privileges of the shareholders, in the capital structure, or in the rights and privileges of other shareholders. However, if the shareholders take cash in lieu of fractional shares, they must report any gain or loss realized on such disposition. The CCRA has a longstanding administrative position for shareholders who receive up to $200 cash in lieu of fractional shares on a share-for-share exchange under section 85.1 (IT-450R), an exchange of convertible property under section 51 (IT-115R2), or an amalgamation under section 87 (IT-474R): any gain (or loss) on the disposition of fractional shares may be deferred and the post-consolidation shares' adjusted cost base reduced (or increased) by an equivalent amount. Presumably, the CCRA's unwillingness to extend the administrative practice to the share consolidation may rest at least in part on the lack of a specific rollover applicable to it.

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Poison Pills on Foreign Spinoffs

The CCRA has softened its position on poison pill rights connected with foreign spinoffs.

To qualify as an eligible distribution under the foreign spinoff rules in section 86.1, the distribution must consist "solely of common shares of the capital stock of another corporation owned by" the distributing corporation immediately beforehand. Many US spinoffs also distribute rights to acquire additional shares under a poison pill plan. Perhaps inadvertently, the CCRA initially approved foreign spinoffs with simultaneous distribution of stock and rights under a poison pill plan created under a separate agreement. By the fall of 2001, the CCRA said that such rights tainted an otherwise eligible distribution consisting solely of common shares, a position publicly confirmed in 2002 (for example, in document no. 2002-0168455). Early in 2003, in letters regarding foreign spinoffs initially denied, the CCRA said that it is "prepared to accept that, generally, section 86.1 can apply in situations involving such rights plans, provided that the rights plan was established for bona fide commercial reasons and not to obtain a tax benefit, and provided that the rights established under the plan did not have any significant value independent of the shares being spun off at the time of the spin-off." For those companies that receive such a letter in respect of a 2001 foreign spinoff that was initially denied, it is understood that the CCRA will now accept late-filed elections under section 86.1, notwithstanding *Terrence Coster*: paragraph 86.1(2)(f) is now listed in reg 600.

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No Interest Reasonable?

Can zero interest be a reasonable rate for subsection 17(1)? Section 17 is a form of transfer-pricing provision that imputes income on certain indebtedness owed by a non-

resident to a Canadian-resident corporation (Canco). The reasonableness of an interest rate is a fact-specific assessment that should take into account factors such as the creditworthiness of the particular debtor, the nature of any security provided, and other conditions that indicate arm's-length terms and conditions in the money market. Interest at less than a reasonable rate triggers the imputation to Canco of income not otherwise recognized at the prescribed rate for the relevant period. A recent TI concluded that a nil rate of return was not reasonable.

Canco's US parent had filed for relief under chapter 11 of the US bankruptcy code. Owing to various security claims and problems in obtaining debtor-in-possession financing, a return of PUC by Canco to USco was not possible; Canco made an interest-free loan evidenced by an unsecured demand note. The loan was subject to subsection 15(2) and paragraph 214(3)(a); Canco accordingly remitted the part XIII withholding tax. Once USco was out of chapter 11 protection, Canco intended to return sufficient PUC to allow full repayment of the loan; USco would request a refund of the part XIII tax paid (subsection 227(6.1)). The loan repayment would occur before the sale of the business of USco's Canadian subs (the Canadian operations) to a third party. The exception in subsection 17(1) does not apply if part XIII tax was refunded; Canco argued that the nil rate of return was reasonable because the loan provided an indirect economic benefit to the Canadian operations by providing liquidity to USco and allowing an orderly sale of the business of the Canadian operations. An orderly sale allowed the continued operation and conduct of business without the risk and uncertainty that the chapter 11 filing otherwise might have created for its customers, suppliers, and employees. The debtor-in-possession financing, including the loan, allowed USco to market and seek out potential buyers at the highest possible price for the Canadian operations. The taxpayer was of the view that it was reasonable to conclude that the true value of the Canadian subs, including Canco, would not have been realized if the debtor-in-possession financing had not been obtained and USco was liquidated in accordance with chapter 7 of the bankruptcy code.

The CCRA rejected the position in two previously issued documents cited as support by the taxpayer because they involved arm's-length parties. USco, not Canco, benefited from the loan. The CCRA said that to meet the exceptions, paragraphs 17(9)(a) and (c) stress that the lender and borrower must not be related and that the terms and conditions must be those that arm's-length parties would willingly enter into. In the light of the borrower's potential bankruptcy, an arm's-length purchaser would not lend at no interest with no security. The taxpayer could have returned PUC, but the transaction must be assessed on the basis of what actually occurred: having PUC on hand sufficient to cover the loan is not a proxy for relief from the rules in section 17. The CCRA stressed that care must be taken in accepting an indirect benefit argument when parties are related, partly because the measurement of the benefit is so subjective. Moreover, it was not clear how Canco, a financing sub, would benefit from the loan by the Canadian operating subs.

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PRIVILEGE NOT WAIVED

Pitney Bowes recently considered whether two legal opinions written by a UK law firm and in possession of the applicants were protected by solicitor-client privilege (2003 FCT 214). The documents related to a multilateral leasing transaction in which various parties were represented by different legal counsel and one firm represented all the applicants in one way or another. The parties agreed that some or all who needed legal advice in areas where their interests were not adverse could obtain advice from one counsel. In the case of the two opinions under review, one was addressed solely to one applicant and the other to two participants jointly.

The FCTD noted that the mere existence of a commercial transaction does not insulate all shared solicitor-client communications; the parties may disclose documents in circumstances which suggest that privilege was waived. The applicants acknowledged that the parties were adverse in interest in many aspects of the transaction, but their expectation was that the opinions sought would be distributed among the parties to arrive at a common understanding of certain legal aspects of the transaction. Privilege was maintained because the opinions were prepared with distribution in mind; the opinions facilitated the completion of the transaction; and, though addressed to particular parties, the opinions were prepared with the intention that they would be shared with other parties with a like interest for their collective benefit. No evidence suggested that the privilege was waived. The court, however, cautioned that the question is one of fact that would turn on a number of factors, including the expectation of the parties and the nature of the disclosure. The court cited several cases, including the recent decision in *Fraser Milner*. (See "Common Interest Privilege," *Canadian Tax Highlights*, March 2003.)

Neither *Fraser Milner* nor *Pitney Bowes* has been appealed; it appears that the minister has accepted the principles therein. The factual foundation of these cases should be kept in mind before opinions are released to another party in the course of a commercial transaction. The common interest of the parties should be considered

and identified; the opinions should be requested in order to benefit the understanding of the parties to whom they will be distributed in order to complete the transaction; distribution should be limited to those who share that interest and require that understanding; and no circumstances should indicate that the privilege is waived. The manner of distribution must make clear the party's intention to maintain solicitor-client privilege even though the particular circumstances of the commercial transaction underway allow for limited disclosure to parties of common interest.

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ONTARIO MINI-TIS

At a recent meeting of the Toronto Centre CCRA and Professional Consultation Group, Ontario Finance officials provided updates on Ontario corporate income tax and on various administrative positions.

■ **Goodwill for capital tax.** Goodwill not eligible for the eligible capital expenditure (ECE) pool but amortized for accounting purposes must be included in PUC for capital tax purposes on a cumulative basis (section 67(7)(b), Corporations Tax Act (OCTA)). Ineligible goodwill results from corporate reorganizations, including pushdown accounting. The cumulative accounting amortization falls into PUC until the corporation can demonstrate that the goodwill has no economic value—that is, it has been fully written off for financial statement purposes under GAAP.

An administrative "deemed depreciation adjustment" concession allows the amortization for tax of three-quarters of the excess of the accounting value of goodwill acquired under federal section 85 over its elected tax cost, reducing PUC for capital tax purposes only.

■ **Corporate minimum tax (CMT) on taxable dispositions.** The officials were asked whether it is possible to recover CMT if Parentco transfers, but does not roll, shares of a company to Subco, which later sells them. Parentco realizes a capital gain for corporate income tax (CIT); for accounting and thus for CMT purposes, the transfer is recorded at cost and no gain is realized. On a sale to a third party Subco does not realize a capital gain for CIT purposes; its tax cost should equal FMV. But there is no step-up on the acquisition from Parentco for accounting and CMT purposes; CMT paid by Subco on the accounting and CMT gain is thus not recoverable in the future because the related assets have been sold, and Finance officials acknowledged that no remedy allows recovery of the CMT paid. Although OCTA section 57.9 allows a taxpayer to elect to defer gains for book (and thus CMT) purposes that were deferred for CIT purposes, as on a federal section 85 election, no OCTA election accelerates an accounting and thus a CMT gain recognized for CIT purposes. The officials said that the issue is a tax policy matter that they will refer to the Corporate and Commodity Tax Branch.

■ **R & D incentives.** In 2001, Ontario suspended its superallowance and stopped taxing federal investment tax credits (ITCs), which are usually taxed in the year following the ITC claim via an R & D pool reduction. Generally, if prior-year ITC claims reduce the current R & D pool, an Ontario tax deduction arises for the portion of the ITC related to qualified Ontario R & D expenditures. If a corporation has allocations to jurisdictions outside Ontario, the Ontario ITC deduction is grossed up to ensure that the corporation receives the full ITC amount for Ontario tax purposes; Ontario understands that the additional amount resulting from the gross-up is not subject to federal tax. CT23 schedule 161 helps corporations track qualified Ontario R & D expenditures and claim the deduction for the related portion of the ITC.

■ **Recent desk assessments.** Asked why the desk audit section of the Corporations Tax Branch has recently issued reassessments on matters such as the taxation of gains on portfolio investments and the replacement property rules under federal section 44, the officials said that the section had not been instructed to target these matters.

■ **Appeals following Ontario notice of objections.** A corporate taxpayer has up to 90 days from the day the minister responds to a notice of objection to file an appeal with the Ontario Superior Court of Justice (OCTA section 85(1)). If the taxpayer fails to serve the minister with a notice of appeal within that time as section 85(3) requires, the officials said, the appeal is invalid.

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FX AND HEDGING: FA PROPOSALS

The December 20, 2002 technical bill introduced some welcome responses to some hedging issues. But one expected fix, promised in a comfort letter, did not materialize.

A foreign exchange (FX) gain on the disposition of an FA's shares is included in a taxable capital gain; an FX loss is disallowed. That imbalance is further exacerbated by the grinding down of such a loss by dividends received on the shares. A Finance comfort letter promised to recommend a rectifying amendment, but the technical bill contains no such change; apparently Finance continues its support but has not yet settled on appropriate wording. It is hoped that a proposal allowing retroactive treatment to 1994, possibly as part of the global section 95 election, will be incorporated in the draft before enactment.

With respect to active business income (ABI), the income or loss on a hedge over paragraph 95(2)(a) deemed income is deemed ABI (new subparagraph (v)); the expanded

definition of excluded property (EP) covers a gain or loss on a hedge over the principal amount. If all or substantially all of the proceeds of an FA's debt were used to acquire EP or to earn ABI, any gain or loss on a hedge over the debt is deemed to be from the disposition of EP (paragraph 95(2)(i)). For example, if the hedge is a swap, the acquired EP generates paragraph 95(2)(a) ABI; the swap's periodic payments should be deductible or includible under proposed subparagraph 95(2)(a)(vi), although the wording needs fine-tuning. Any income, loss, or capital gain or loss on a hedge over a similar amount arising on an intercompany debt or share transaction that is deemed nil under paragraph 95(2)(g) is also deemed to be nil (proposed paragraph 95(2)(g.3), which should be renumbered (g.4)).

In what is hoped is an oversight that will be corrected before enactment, the hedging rules cover only currency hedges—not, for example, interest rate hedges. Furthermore, the hedge must reduce the FA's risk with respect to the currency in which the underlying transaction is denominated; presumably an FA can only hedge into its calculating currency but cannot hedge out of it—for example, back into Canadian dollars. The EP definition amendment also allows EP treatment for a currency hedge over any EP proceeds of disposition, such as an FA's shares; beyond this limited situation, any gain or loss on a hedge over such shares generates FAPI unless proposed paragraph 95(2)(g.3) applies. No detailed conditions stipulate when a currency swap or forward, for example, is respected as a hedge that reduces currency risk. Does a swap or forward qualify if it covers only some of the principal amount or does not have a matching term? The test is apparently met by partial hedges because they need only reduce, not eliminate, risk.

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MASSACHUSETTS DISALLOWANCE

Applicable generally to tax years beginning after 2001, broad tax legislation enacted on March 5, 2003 affects many Canadian companies doing business in Massachusetts and may eliminate Massachusetts tax benefits associated with common cross-border finance, investment, and royalty structures. Massachusetts tax law is frequently a reference point for other states' reform.

■ **Anti-PIC.** In 2002, the Massachusetts Supreme Judicial Court in *Sherwin Williams* said that the state failed to refute the taxpayer's evidence supporting the deductibility of royalty payments to an affiliated intangible holding company (SJC 08516, Oct. 31, 2002). The new legislation increases the taxpayer's burden of proof in so-called sham transaction cases: a taxpayer must establish by clear and convincing evidence that a transaction or structure has economic substance, a business purpose apart from tax avoidance, and a non-tax business purpose commensurate with the tax benefit claimed.

■ **Interest expense disallowed.** A taxpayer must now add back deductions for interest expense paid or accrued to a "related party," defined generally similarly to federal rules. Addback is not required if the taxpayer proves by clear and convincing evidence that addback is unreasonable; if the taxpayer and the state agree to an alternative apportionment method; or if the taxpayer shows that the transaction's principal purpose was not tax avoidance, the interest is paid pursuant to an arm's-length contract, and the related party's interest income was subject to tax at at least the Massachusetts tax rate. A corporate debtor can no longer deduct interest expense on a note payable or a similar obligation issued as a dividend to its parent. Interest expense paid to a third party on an acquisition of a taxpayer's stock or assets in a corporate reorganization per Code section 368 is now treated as paid to a related party, and only the first two exceptions to the addback apply.

■ **Intangible expense disallowed.** Addback is also required for interest or other intangible expenses such as royalties and licence payments that arise in connection with intangible property and are paid or accrued to a related party. An exception exists either if the first two addback exceptions above are met or if the expense was passed through by the related party to a non-related party and the principal purpose of the transaction giving rise to the expense was not tax avoidance. Such interest expense is not subject to the addback rules limited to interest expense.

■ **Massachusetts business trusts (MBTs).** MBTs that apportion less than 10 percent of their income to the state are no longer tax-exempt for taxation years beginning after 2002.

■ **Additional provisions.** Other changes are less important to Canadian companies. New rules parallel the US federal rules disallowing a deduction for REIT dividends for both corporate and financial institution tax purposes, retroactive to tax years ending after December 30, 1999. An entity-level tax applies to the portion of a qualified subchapter S sub's current tax year that includes the period after March 4, 2003. The state's ability to tax certain Massachusetts-source income of non-resident individuals is also enhanced.

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CANADA-US TAX ARBITRAGE

A transaction's different Canadian and US tax treatment can create a tax arbitrage or favourable tax result, such as the doubling up of foreign tax credits, interest deductions, or reductions in tax rates or withholding tax.

■ **Hybrid entities.** A Nova Scotia unlimited liability company (NSULC), a corporation for Canadian tax purposes, is ignored (or considered a partnership) for US tax purposes. NSULCs have been used in merger and acquisition transactions and double-dip structures, and have enabled the sale of a Canco's shares for Canadian tax purposes to be viewed for US tax purposes as an asset acquisition to a US purchaser that can write off the goodwill over 15 years.

A US limited liability company (LLC) is a corporation in Canada and is ignored (or considered a partnership) for US purposes unless it elects to be treated as a corporation. Canadian residents have used LLCs in double-dip financing structures for US or European investments. The CCRA says that an LLC cannot benefit from the Canada-US treaty because it is not liable for US tax; a new treaty protocol under negotiation may resolve this problem.

An S corporation is a flowthrough vehicle and a corporation for US and Canadian tax purposes, respectively, but if it holds at least 10 percent of a Canco's shares it benefits from the treaty's 5 percent withholding rate on dividends and the capital gains exemption.

US trusts that check the box under US rules have been used for Canadian real estate investments. Canadian partnerships that elect foreign corporation treatment for US tax purposes have been used by Americans for double-dip structures into Canada and by Canadians as pass-through vehicles that arguably avoid US estate tax and simplify US compliance. (A US return is filed by the corporation, not by each partner.)

■ **Dual residency.** A resident corporation—incorporated in, continued in, or centrally managed and controlled in Canada—is taxed on its worldwide income. A corporation resident in another country under a tax treaty is deemed resident only in that jurisdiction and not in Canada, to counter planning related to dual residence; the rule does not affect dual residents of Canada and a non-treaty jurisdiction.

■ **Double-dip financing.** Multinationals can reduce borrowing costs by claiming an equivalent interest deduction in two jurisdictions, thereby raising the policy issue of whether the domestic or foreign jurisdiction is being exploited. Canada's foreign affiliate (FA) rules appear to encourage double-dip structures. Interest received by a sole-purpose financing FA formed to finance an opco carrying on an active business in a treaty jurisdiction is deemed to be active business income, not income from property. Over the years, Canadians have used FAs in the Netherlands, Ireland, Hungary, and Iceland, and US LLCs to finance US corporations; the financing FA can pay a Canadian-tax-free exempt surplus dividend to its Canadian corporate shareholder. Notwithstanding this specific relief, the CCRA is apparently challenging some earlier double-dip structures that use Irish financing subs, arguing that they were formed solely to create a controlled FA and should be ignored. The auditor general's report of December 2002 was highly critical of double-dip structures.

■ **Hybrid instruments.** Because Canada does not reclassify a corporate share as debt regardless of its share attributes, Canada-US planning opportunities abound for both inbound and outbound transactions. For example, certain repo structures characterized as debt for US tax purposes are shares for Canadian purposes. Nor does Canada recharacterize debt as equity. However, participating interest—computed with reference to profits or income rather than the debt's principal—that exceeds a reasonable rate is not deductible (*Sherway Gardens*, 98 DTC 6121). Moreover, interest on participating debt does not qualify for the exemption from withholding tax for five-year debt even if all conditions are otherwise fulfilled.

■ **Commercial transactions.** Canadian courts generally respect the form of a legal transaction with an underlying business purpose if that form properly reflects its legal effect: the economic realities cannot be used to recharacterize a taxpayer's bona fide legal relationships. (See *Shell*, [1999] 3 SCR 622.)

However, GAAR may recharacterize an avoidance transaction that results in an abuse or misuse of the provisions of the Act not undertaken or arranged primarily for bona fide purposes other than a tax benefit: a reduction, avoidance, or deferral of Canadian income tax, not including foreign tax and arguably not including a treaty benefit.

Because Canadian courts generally respect the form of transactions, ground leases and securities monetizations or collars may avoid a disposition for Canadian tax purposes but be treated differently for US purposes. Share ownership by a Canadian subject to cross-border repurchase rights by a US counterparty may be treated as share ownership by both countries for their respective residents, thus generating interesting planning opportunities for foreign tax credits.

A sale-leaseback or similar transaction may be recharacterized as a financing transaction if the lessee retains the right to purchase the assets at the lease's termination for a bargain purchase price. It is a question of fact, based on the agreement's terms, whether a conditional sale is actually a lease with an option to buy; IT-233R, which dealt with this point, was withdrawn after the FCA questioned its technical authority in *Construction Berou* (99 DTC 5868), but the CCRA may attempt to use GAAR to recharacterize such a lease. A carefully structured lease may result in different treatment for Canadian and US tax purposes.

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Readers are invited to submit ideas or written material to *Canadian Tax Highlights*. Please write to Vivien Morgan in care of the Canadian Tax Foundation.

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FOREIGN TAX NEWS

Treaties

After an earlier notice that was subsequently withdrawn, Finance announced that a tax treaty with **Peru** entered into force on February 17, 2003, effective, for withholding taxes, on amounts paid or credited to non-residents after 2003 and, for other taxes, for taxation years beginning after 2003. Negotiations will commence with **Cuba**, **Costa Rica**, and **Bolivia** on May 26, June 6, and June 23, 2003, respectively. Persons whose interests are affected are invited to inform Finance of concerns that might be resolved in the treaty.

Australia

New laws promote investment in Australian venture capital by foreign investors, providing flowthrough tax treatment for certain limited partnerships and exemption from capital gains tax for investments in Australian companies.

New rules for withholding taxes cover income paid by Australian residents to non-residents, including gains on the disposal of assets unless there is a permanent presence in Australia. The new withholding tax is not final; the income is subject to regular corporate or individual income tax rates with relevant deductions.

Budgets

Japan's 2003 budget reforms with resulting tax reductions of about ¥1.8 trillion include new proportional tax credits and accelerated depreciation for R & D; investment incentives for IT; incentives for small and medium-sized enterprises; reduced tax rates on financial assets and stocks; reduced licence and registration taxes for land; and reduced gift and inheritance taxes. The **United Kingdom**'s 2003 budget offers no new tax policy reforms. In light of the recent slow economy, the budget favours freezing corporate, small business, and capital gains taxes; a 100 percent first-year capital allowance on investments in information and communications technology by small businesses; a petroleum revenue tax exemption for North Sea oil field operators; an increased VAT exemption threshold for companies; and increased inheritance tax exemptions. The budget also promised to simplify the capital gains taxes. Copies of the budget speech are available from the Foundation's library. **Hong Kong** increased its salaries tax by 1 percent; personal allowances and profits taxes were increased by 1.5 percent. Other changes include an exemption from the stamp duty for unit trusts, raising the ceiling for tax-exempt donations, and increasing the air passenger departure tax. In an attempt to accelerate growth, **India** increased individual and corporate taxes but did not remove the 5 percent surcharge; exempted shareholders from dividend taxes; introduced a 12.5 percent dividend distribution on domestic firms; introduced a VAT in April; provided temporary relief from capital gains taxes for one year from March 1, 2003 for certain assets; defined the "business connection" for foreign investment in Indian companies to mirror that of permanent agency in treaties; and abolished the 10 percent expenditure tax on hotel rooms in order to boost tourism. **Ireland**'s budget bill treats interest not as a distribution if it is payable to a company that is taxable in another EU state; a company acquiring shareholdings in a 25 percent-plus subsidiary in a foreign currency (FC) funded by a liability in that same currency can elect to match the FC gain or loss with the FC loss or gain on the liability, leaving the company taxable only on the real economic gain or loss and not on currency movement. **Isle of Man** introduced a 10 percent standard tax on trading profits with the threshold for the higher rate of 15 percent increased to £100 million; a standard zero rate for most businesses, excluding deposit-taking businesses; and a zero rate for third-party fund administrators of mutual funds. In order to stimulate growth, **Singapore**'s deficit budget contained no major tax initiatives: foreign income as dividends, branch profits, and service income are tax-exempt commencing June 1, 2003; some measures promote manufacturing and services or make Singapore attractive for creating and holding intellectual property. **South Africa**'s budget is designed to reduce poverty, foster black-owned businesses, and encourage foreign investment. The budget includes special depreciation allowances for urban renewal; accelerated depreciation allowances for manufacturing assets; taxation of capital gains on disposal of business assets spread across the life of the new asset; similar ratio and treatment for R & D expenses as business assets; improved incentives for small business; and an exemption for foreign dividends for taxpayers with a meaningful interest in the foreign subsidiary that pays the dividend ("meaningful interest" is yet to be defined).

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