Canadian Tax Highlights

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Volume 11, Number 5, May 2003

US RRSP Reporting

IRS notice 2003-25 of April 11, 2003 contains both relief procedures for US RRSP holders required to file certain US information statements and related penalties for late or non-filing. The filing requirement and the penalty provisions will not be enforced before 2002, and the filing due date for 2002 statements is automatically extended until August 15, 2003.

The duty of RRSP holders to file these statements—forms 3520 and 3520A—signals a change in the IRS's previous position. Generally, forms 3520 and 3520A must be filed with respect to certain foreign (non-US) trusts that have US owners or US beneficiaries. The IRS generally takes the position that RRSPs should be considered foreign trusts for the purposes of this reporting requirement. Prior to tax year 2001, the IRS exempted RRSP holders from the filing requirement: the instructions for form 3520 stated that "transfers to, distributions from, and ownership of a Canadian Registered Retirement Savings Plan [are exempt from the filing requirement] if the trust would qualify for treaty benefits under the United States treaty with Canada." This wording was deleted from the instructions for tax years 2001 and 2002; the April notice confirms that this change was intentional and that the IRS now wants RRSP holders to file the forms.

Form 3520 (Annual Return to Report Transactions with Foreign Trusts and Receipts of Certain Foreign Gifts) must be filed by certain US citizens and residents for each year in which they contributed to or received distributions from a foreign trust. The form is generally due by April 15 (or later if an extension is filed) after the contribution or distribution year; a hefty penalty equal to 35 percent of any distribution or contribution may apply to returns that are incomplete, incorrect, or not timely filed.

Form 3520A (Annual Information Return of a Foreign Trust with a US Owner) must be filed by certain foreign trusts that have a US owner, generally by the 15th day of the third month after the end of the trust's tax year. Filing extensions are requested via form 2758; a penalty of 5 percent of the trust's gross assets applies for non-filing or late filing. US owners of the trust are generally charged with the responsibility of ensuring that the trust files form 3520A and furnishes the required annual statements to its US owners and beneficiaries.

The notice indicates that the penalties will not be enforced for tax years before 2002. It also grants an automatic extension until August 15, 2003 for the filing of the 2002 tax year forms. If a plan beneficiary has made a tax-deferral election in accordance with Rev. proc. 2002-23, the plan is relieved of its obligation to file form 3520A (but not form 3520) for any year in which the beneficiary meets the Rev. proc.'s annual filing requirements. This deferral election generally allows an RRSP holder to defer US tax otherwise currently imposed on income accruing within a plan until the income is distributed. The election is made by the holder's attaching a statement to his or her US income tax return.

Forms 3520 and 3520A are somewhat complex, and the filing requirements can be burdensome; moreover, it may be necessary to obtain documentation from the RRSP's custodians. Nonetheless, the potential for harsh penalties on both participants and custodians for late filing or non-filing means that RRSP holders who are US citizens or residents should carefully consider the filing requirement. In the past, US taxpayers who filed late forms 3520 and 3520A routinely received IRS notices of penalties imposed that could be reduced only if the taxpayer affirmatively sought relief from the IRS. On a related note regarding RRSPs, the IRS generally takes the position that US-situs assets in an RRSP may be subject to US estate tax on the death of a Canadian-resident RRSP holder.

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In This Issue

Discretionary Trust Interest

Tax practitioners have generally taken the position that a discretionary interest in a trust carries a nil value: the interest is generally non-transferable, and there is no certainty that any distribution will be made. A discretionary interest's FMV is relevant for income tax's deemed disposition on death and, for an interest in a foreign trust, on emigration. A TI issued on April 3, 2003 assumes that for the purposes of valuing such a trust interest, distributions to contingent beneficiaries are made (document no. 2003-0181465).

At the 1992 British Columbia Tax Conference, the CCRA conceded that the valuation of a discretionary trust is problematic, but not nil. The TI refers to *Sagl v. Sagl*, a family law case that held that a reasonable approach in arriving at a valuation of such an interest is to assume full distribution of the trust assets equally among all the contingent beneficiaries. The CCRA says this approach applies unless it clearly does not yield an appropriate result given the trust's terms and conditions, in which case a discount factor may be applied in recognition of any condition precedent or subsequent that affects the interest's FMV. The CCRA will not rule on a discretionary trust interest's value.

The CCRA's reliance on *Sagl* may not be well founded. The Family Law Act (Ontario) requires a determination of fair value, not the FMV required for income tax purposes. A contingent capital interest in a trust is property for the purposes of the Family Law Act, but the detailed definitions in the relevant income tax provisions arguably lead to a conclusion that no capital interest exists unless an allocation has been made. A beneficially interested person as defined includes one who has any right, whether conditional on or subject to the exercise of any discretion by any person, to receive any income or capital of the trust. An income interest in a trust includes a contingent interest of a beneficiary to receive all or any part of the trust income. A capital interest in a trust includes all rights of the taxpayer as a trust beneficiary to enforce payment of an amount by the trust that arises as a consequence of any such right, but does not include an income interest. Arguably, a discretionary beneficiary does not have the right to enforce payment unless an allocation of capital has been made by the trustees.

In *Sagl*, the judge approached the valuation of the contingent interest in a discretionary trust for the purposes of the fair value requirement in the calculation of net family property on a "fair and equitable" basis, having regard to trust law, the definition of property, and the evidence of what the settlor's intention was at the time of the trust's creation. The judge indicated that the "compromise submission" by counsel for the defendant produced the fairest and most equitable result and treated the assets as if there were a deemed realization among all capital beneficiaries. *Sagl*'s "fair and equitable" approach and "compromise submission" should not be relevant for income tax purposes; neither the Income Tax Act nor trust law provides the basis for deeming a discretionary beneficiary to have the right to receive a proportionate amount of trust property. Although it was not mentioned in the TI, Mr. Sagl was one of three trustees on the relevant valuation date, though he resigned shortly thereafter. Under the trust deed, Mr. Sagl had the power to appoint or remove a trustee while he himself was a trustee. Mr. Sagl was also both a capital and an income beneficiary. The trustees had absolute discretion as to distributions; decisions were to be made by a majority of the trustees, provided that Mr. Sagl was part of that majority.

Concerns that the CCRA might take the approach in *Sagl* may be allayed if additional clauses are inserted in a trust indenture to reduce the alleged value of the discretionary interest. For example, trust distributions may be limited to those beneficiaries alive 30 days after the trustees' allocation. The trust document could further clarify that a beneficiary's interest ceases on death.

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Ontario Non-Filer Crackdown

As announced in a February 2003 news release and in the 2003 Ontario budget, Ontario corporations that have not filed all income tax returns or exempt-from-filing declarations may receive a "Default of Filing Returns" notice as part of an Ontario government initiative to contact all affected corporations by April 30, 2003.

Although many corporations that receive these notices will be inactive and may not owe tax or own assets, tax and legal consequences may result if they do not respond to the notice, including cancellation of their corporate charters. Ontario says that, once notified, a corporation must file the required documents and immediately remit any outstanding tax payments. The February 2003 news release said that a corporation that does not comply with the notice will have its charter cancelled; the 2003 budget is more lenient, saying that failure to respond "could ultimately result in the corporation's dissolution." According to Ontario Finance, implications of involuntary dissolution may include prosecution of the corporation's directors for failure to file tax returns, forfeiture of assets to the Crown, loss of limited liability and insurance coverage, and the inability to claim tax losses.

Under section 241(1) of the Ontario Business Corporations Act, a corporation in default of the Corporations Tax Act cannot be dissolved until the province notifies it that a dissolution order will be issued unless it remedies its default within 90 days. We understand that the default-of-filing notices that Ontario is currently sending out are not official notices of intent to dissolve a corporation.

The CCRA's IT-444R, "Corporations—Involuntary Dissolutions," provides general guidance on the tax implications of involuntary dissolution to a corporation and its shareholders. The IT says that the Act does not deal specifically with involuntary dissolution; its application will depend on the facts. In general, if it is reasonable to expect that a dissolved corporation will never be restored, the shareholders are considered to have disposed of their shares at the time of the dissolution. If the corporation's property is distributed to the shareholders, the corporation's shares are considered to have been disposed of at that time for proceeds equal to the distributed property's FMV. The shareholders must include any resulting capital gain in taxable income.

If the dissolved corporation was a member of an internal partnership structure, the structure may no longer function as intended, creating unexpected tax consequences for other corporations in the structure.

If the corporation has assets, it may be prudent to file any outstanding tax returns as soon as possible. If there is an outstanding tax balance, Ontario imposes a late filing penalty of up to 17 percent of the outstanding balance—5 percent of unpaid taxes plus 1 percent per month, not exceeding 12 months—while the failure to file continues. The penalty may rise to 50 percent for repeat non-filers. Even if the company does not have any assets or ongoing importance in the corporate structure, it may still be more efficient and cost-effective to file the outstanding tax returns before merging or winding up the corporation.

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Provincial Budgets for 2003

All provinces and territories have delivered budgets for the fiscal year 2003-4. The Quebec legislature was dissolved for a general election the day after the budget, and the new government has not yet delivered its budget. Five more provincial governments may face their electorate before they can deliver their next budgets. The table shows the anticipated surplus or deficit for the current and past fiscal years. Adjustments to the provincial numbers minimize accounting differences between provinces.

The simple bottom line—the surplus or deficit—cannot give an adequate review of the fiscal policy of each government, but it indicates the approach that they have taken to revenues and spending in the current fiscal year. More detail will be provided in the budget round-up article in a future issue of the *Canadian Tax Journal*, also to be posted on the CTF Web site. The table shows that two central provinces expect balanced budgets for 2003-4 and two more—Manitoba and Alberta—expect surpluses. New Brunswick and Saskatchewan will transfer money from fiscal stabilization accounts (previous years' surpluses) to balance their budgets this year. The remaining three provinces and the three territories expect deficits in the current year. In aggregate, provincial revenues will fall $2.2 billion short of spending in 2003-4, within $8 million of the preliminary figures for 2002-3.

Overall Budgetary Surplus or Deficit

	2003-4	2002-3
	millions of dollars	
Newfoundland	–211.9	–61.7
Prince Edward Island	–22.9	–28.1
Nova Scotia	–7.2	–6.8
New Brunswick	–101.0	–101.4
Quebec	0.0	0.0
Ontario	0.0	524.0
Manitoba	58.0	23.0
Saskatchewan	–392.6	2.1
Alberta	1,128.0	1,819.0
British Columbia	–2,300.0	–3,800.0
Yukon	–13.6	–56.7
Northwest Territories	–150.8	–248.9
Nunavut	–11.6	–82.0

Newfoundland, Nova Scotia, Ontario, and Alberta expect deterioration in their bottom line, but the other provinces and territories expect to improve on their performance in 2002-3. Budgets are usually cautious documents; ministers of finance use pessimistic forecasts for revenue and provide contingency funds on the spending side to hedge against the unexpected. Not surprisingly, the preliminary results in next years' budgets should indicate a better actual performance.

The relatively modest changes in most surpluses or deficits result from provincial policies to minimize both tax and spending changes. Only Nova Scotia provided across-the-board cuts in personal income tax. The provinces used increased federal funds to cover increased spending on health care.

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No GAAR on Land Inventory Rollover

In *Loyens*, the TCC recently held that GAAR did not apply to transactions involving the rollover and sale of real property inventory (2000-998(IT)G).

A direct rollover of real estate inventory to a corporation is prohibited on the ground that real estate inventory is ineligible property under subsection 85(1). The taxpayers, who were land developers, circumvented this limitation by rolling the land inventory to a partnership under subsection 97(2), which contains no such limitation, and in a series of transactions effectively achieved a rollover to a lossco owned by them and then used the losses to offset the income gain on the land's subsequent sale.

The CCRA argued that GAAR applied. Citing the FCA decisions in *OSFC Holdings* and *Water's Edge*, the TCC said that certain questions must be answered to determine whether GAAR applies: Was there a series of transactions within the meaning of section 245? If the answer is yes, which transactions were part of the series? Did the transactions result in a tax benefit to the taxpayers? If the answer is yes, can the transactions reasonably be considered to have been undertaken primarily for a purpose other than to obtain the tax benefit? If not, did the transactions result in a misuse of the provisions of the Act or an abuse of the Act, other than section 245, read as a whole? The taxpayers conceded the first two questions.

The TCC said that the FCA's approach in *Novopharm* makes it clear that the entire series of related transactions must be considered in determining the primary purpose, not just the one transaction that gives rise to the tax benefit. The most direct route for the transfer of the land inventory was from the taxpayers to the final purchaser corporation: the interposition of the partnership and Lossco facilitated obtaining the tax benefit. As a result, the primary purpose of each of the transactions separately and as a whole was to obtain the tax benefit.

To determine misuse, the TCC said it must first determine the policy behind the relevant provisions—that is, the object and spirit of sections 97 and 85. The CCRA's position, which was not supported by extrinsic aids or evidence of policy, was that the provisions' object and spirit was reflected in paragraph 85(1.1)(f), which clearly states that real property inventory is not eligible for rollover. The TCC disagreed and, in the absence of extrinsic evidence raised by the CCRA, accepted tax commentaries provided by the taxpayers to the effect that the purpose behind the restriction in subsection 85(1) is to prevent the conversion of income into capital gains by a real property trader. The TCC found on the facts that taxable business income was reported as a result of the transfer of the land inventory to the partnership and on the transfer of the partnership interest to Lossco; the gain from Lossco's disposition was also reported as business income. The TCC concluded that there was no misuse of these provisions because the transactions did not violate the policy against converting income to capital gains.

The CCRA further argued that the transactions were an abuse of the Act as a whole because the trading of profit or gains between corporations is prohibited. The TCC rejected the CCRA's supporting evidence and said that the principles espoused by the FCA in *OSFC Holdings* with respect to loss trading, held to be against the general policy of the Act, cannot be extended to encompass a presumed prohibition against profit trading. According to the TCC, gain trading is allowed to some degree; furthermore, profit trading is apparently not interchangeable with loss trading, because the two receive fundamentally different treatment under the Act.

In *Loyens*, the TCC found that the Act's provisions were used in conjunction with a pre-existing partnership and corporations to structure the taxpayer's transactions in the most tax-efficient manner. These transactions accorded with normal business practice and were entered into for bona fide business reasons. The TCC concluded that this use of the Act's provisions does not amount to misuse or abuse, but rather constitutes the use for which they were designed.

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LCT Long-Term Debt

The CCRA has announced a change to its assessing policy in connection with the meaning of "long-term debt" for the purposes of computing large corporations tax (LCT) for financial institutions (*Income Tax Technical News* no. 28, April 24, 2003).

The meaning of long-term debt of a financial institution for LCT purposes is discussed in *Interpretation Bulletin* IT-532. Paragraph 42 provides that a subordinated indebtedness issued for not less than five years is not considered long-term debt if it may be retired before the five-year term has expired. The CCRA has reviewed this position, and is now of the view that, although the terms and conditions of a debt may contain a provision for its retirement within five years, such debt meets the definition of long-term debt in subsection 181(1) because the debt is nonetheless issued for a term not less than five years. This revision will be reflected in the next version of IT-532.

As a result of this revised position, a financial institution that has issued a debenture for at least five years but that may be retired prematurely must include the amount of the debenture in computing its capital as long-term debt under subparagraph 181.3(3)(a)(i) of the Act. The good news is that a corporation that is not a financial institution is then entitled to claim an investment allowance in respect of such long-term debt pursuant to paragraph 181.2(4)(d). Corporate taxpayers should review their filing positions in light of this development.

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Transaction Costs Revisited

In the fall of 2002, the TCC in *International Colin Energy* held that a success fee paid by a financially troubled target to an investment bank was deductible under section 9; in obiter, the court suggested that paragraph 20(1)(e) may apply to a sale by shareholders in the course of a transaction that affects the interests of the corporation (2002 DTC 2185). Concerns over the implications of this decision are likely behind positions in recent TIs that seek to limit significantly the scope of paragraph 20(1)(e) and deductibility under section 9 in accordance with *Boulangerie St.-Augustin* (97 DTC 5012).

One TI takes the position that the cost of obtaining a fairness opinion from an investment bank is not deductible under subparagraph 20(1)(e)(i) because it is not directly related to the issuance of shares (document no. 2002-0151445). Another TI says that the source requirement in the preamble to subsection 20(1) ensures that subparagraph 20(1)(e)(i) expenses must be wholly applicable to the issuance of shares and not merely consequential (document no. 2002-0151485). However, the phrase "in the course of" that appears in paragraph 20(1)(e) has been given the broadest significance by the courts. Furthermore, the CCRA appears to confuse the source requirement related to the source of business or property income with the purpose of incurring the expense.

Boulangerie St-Augustin held that costs incurred by a target in preparing and printing a circular in response to a takeover bid in compliance with the directors' statutory obligations to provide information to shareholders were deductible under section 9 as general administrative expenses. A recent TI appears to narrow the position taken previously by the CCRA and says that the decision applies only to expenses incurred by a target (document no. 2002-0151415). *Boulangerie St-Augustin* does not appear to support such a rationale, because statutory obligations also apply to the directors of an offeror.

The CCRA has also taken a narrower view with regard to the types of expenses deductible under *Boulangerie St-Augustin*'s principles. Deductions have been denied for costs, such as due diligence and valuations, that are incurred in connection with the directors' fiduciary duties: the expenses purportedly do not relate to the furnishing of information to shareholders and those duties are not analogous to the statutory duty to so provide information (document no. 2002-01142745). However, *Boulangerie St-Augustin* does not appear to provide a clear rationale for distinguishing between directors' statutory and common law fiduciary duties. Arguably, such costs are also necessary to enable directors to fully evaluate the relevant information in order to comply with their statutory obligations to prepare information circulars and other such reporting.

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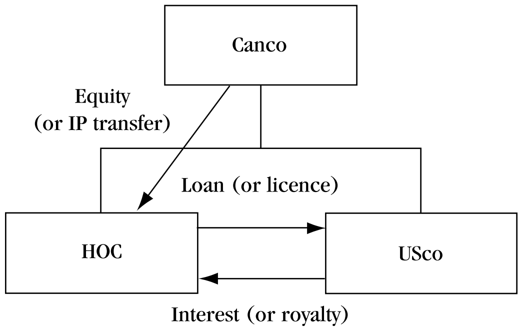
Hungarian Offshore Companies

Canadian multinationals have long used Hungarian offshore companies (HOCs) to finance their foreign—particularly US—operations. Although the HOC regime is being replaced with a new alternative, Canadian multinationals may continue to use Hungary as a low-tax operating jurisdiction. New planning opportunities can further increase benefits.



In a typical structure, a HOC lends funds or licenses intellectual property to its Canadian parent's US sub. For US purposes, the royalty or interest is deductible subject to Code section 163(j) limitations on interest. Under the US-Hungary treaty, interest or royalty paid by the sub is not subject to US withholding tax; although the HOC is owned by a Canco, the US-Hungary treaty is one of only a half-dozen US treaties that does not include a limitation-on-benefits (LOB) clause. The income in Hungary is taxed at 3 percent; the HOC's distributions to Canco as dividends are subject to a 5 percent Hungarian withholding tax or a lower effective rate if the distribution takes another form. The income of the HOC is not FAPI if it meets the deemed active business income conditions in clause 95(2)(a)(ii)(A), and the HOC's distributions to Canco are exempt surplus because Hungary is a designated treaty country.

Hungary and nine other countries are scheduled to join the European Union on May 1, 2004. As part of its negotiations to enter the European Union, Hungary agreed to abolish the HOC regime. The European Union had criticized the HOC regime's low 3 percent tax rate, because it applied only to income from outside Hungary and generally excluded Hungarian investors from owning HOCs. Existing HOCs continue to enjoy the benefits of the 3 percent rate until their last taxation year ending in 2005. However, to maintain its competitiveness as a tax-advantaged jurisdiction, Hungary has introduced new tax benefits from January 1, 2003: in addition to all regular deductions in calculating the Hungarian tax base, Hungarian companies may deduct one-half of gross royalties and net related-party interest received in an amount up to one-half the income calculated under Hungarian financial accounting rules. The amount remaining is taxable at 18 percent. As compared with the HOC's 3 percent rate, the Hungarian corporate income tax rate of a new financing entity is effectively 9 percent. This new regime addresses EU criticism of HOCs by allowing both Hungarian-controlled and foreign-controlled Hungarian companies to benefit from the new deduction, and by applying the benefit to interest and royalties received from both Hungarian and other sources.

Hungary's adoption of the EU parent-subsidiary directive as part of its EU membership also affects Hungarian financing structures. As a result, dividends paid by Hungarian companies to companies resident in an EU member state are not subject to Hungarian dividend withholding tax after the May 1, 2004 EU accession date if certain conditions are met. If, for example, Canco holds the Hungarian financing company through an EU company such as a Spanish ETVE, which can pay dividends to Canco without triggering withholding taxes, then the Hungarian financing company's earnings can wend their way to Canada free of any dividend withholding tax.

When these changes are combined, the Hungarian tax burden increases from 7.85 percent (3 percent corporate income tax and 5 percent dividend withholding tax) to 9 percent (9 percent CIT and no dividend withholding tax), allowing continued and substantial savings from the use of a Hungarian financing structure, if, for example, interest is deducted from a US company's earnings otherwise taxable at 35 percent. However, US anti-conduit rules must be observed. Further benefits may be realized through the combination of a Hungarian company with a low-tax financing branch in a jurisdiction with which Hungary has a treaty: the branch income is not taxable in Hungary even if there is little or no tax in the other jurisdiction.

The structure's benefits depend on the 1979 US-Hungary treaty, which does not include an LOB clause. The United States initiated renegotiation of the treaty in 2000. The new treaty is expected to include an LOB clause, the exact terms of which may or may not substantially erode the tax benefits of using Hungary as the financing or IP management centre for US subs of Canadian multinationals. Negotiations have been very slow to date, with only two meetings in almost three years; the time required for continued negotiations, signing formalities, and ratification means that a new treaty is still several years away. Furthermore, renegotiated US treaties generally grandfather benefit transactions undertaken before the treaty's effective date, adding another year or more to the life of this tax-efficient option for Canadian multinationals.

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UK R & D PROGRAM

The UK Finance Act of 2002 introduced R & D tax incentives for large companies, effective from April 2002, that were previously enjoyed only by small and medium-sized companies (SMEs). Now, a large company may deduct 125 percent of its qualifying expenditures; SMEs may deduct 150 percent of their qualifying expenditures and convert deductions incurred in loss years into cash refunds. All companies may deduct 100 percent of capital expenditures used in R & D. Unlike Canada, the United Kingdom has no contract payment rules: the R & D performer claims the benefits. Subsequent developments are listed below.

- Department of Trade and Industry (DTI) guidelines very closely followed Canadian practice: they incorporated the content of Canadian information circulars IC 86-4R3 (the general characterization) and IC 97-1 (administrative guidelines for software development) and were almost identical in presentation, wording, and emphasis. There were some underlying legislative differences. For example, the rules applied only to corporate taxpayers. UK qualifying expenditures include labour, consumed supplies, and, in limited cases, payments to third parties; such expenditures in Canada extend to materials consumed and transformed, overheads, subcontract costs, and, in some cases, capital. Otherwise, the UK guidelines were clearly intended to cover R & D activities accepted in Canada.
- The new guidelines of April 8, 2003 do not follow Canadian practice as closely. The UK characterization is still broadly similar; they recognize, for example, developmental work as well as pure and applied scientific research. But Canadian practice generally recognizes, for example, incremental improvements, which the new UK guidelines recognize only if intended to be "substantial," a term that must be fleshed out in practice.
- The April 9, 2003 budget introduced further changes. The existing 20 percent de minimis rule for staff costs is replaced by an apportioning of time spent on qualifying activities. Staffing costs expand to encompass workers paid by third parties such as agencies. The minimum spend cap falls from £25,000 to £10,000; the large-company scheme extends to SMEs that receive state aid. Most significantly, DTI and Treasury will consult formally on what qualifies as R & D, especially development activities such as software development, and review the meaning of "consumable stores" and the eligibility of software licences.

It will be interesting to see how the consultations and administrative practice develop. Will Inland Revenue inspectors treat the R & D program as an incentive program as their Canadian counterparts do, or as an audit program?

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CIT Due Dates Revised

The 2003 federal budget proposed several administrative changes, including changes to the due date of certain corporate taxes. (See "Budget Promises and Admin," *Canadian Tax Highlights*, March 2003.)

Section reference	Previous due date	Description of tax
Section 183.1 (part II.1)	6 months after year-end	Tax on certain corporate distributions of corporate surplus
Section 186 (part IV)	Last day of the 3d month after year-end	Refundable tax on certain dividends received by private/closely held corporations
Section 187.2 (part IV.1)	Last day of the 2d month after year-end	Tax on dividends received on taxable preferred shares
Section 187.3 (part IV.1)	Last day of the 2d month after year-end	Tax on dividends received on taxable restricted financial institution shares
Section 196 (part IX)	End of the 2d month after year-end	Tax on Canadian exploration and Canadian development expense deductions previously applied to offset petroleum and gas revenue tax
Section 204.86 (part X.3)	90 days after year-end	Tax and penalty payable by a labour-sponsored venture capital corporation required to file a return under part X.3
Section 208 (part XII)	3 months after year-end	Tax payable by tax-exempt persons for certain royalties and related payments to the government
Section 209 (part XII.1)	End of 2d month after year-end	Tax on "carved-out income"
Section 211.4 (part XII.3)	Last day of 2d month after year-end	Tax on investment income of life insurers
Section 219 (part XIV)	6 months after year-end	Additional tax on non-resident corporations (branch tax) carrying on business in Canada

Normally, a corporation must make the final payment of corporate income taxes owing for a taxation year by its balance-due day—generally, two months after year-end (three months for certain Canadian-controlled private corporations). However, several special types of corporate taxes payable under the Act have different due dates. The draft legislation released on March 18, 2003 provides that all corporate taxes imposed under the Act are due on the balance-due day, applicable for taxation years beginning after June 30, 2003. The affected taxes are shown in the table. Corporations should take care to review their liability for any such taxes and ensure that payment is made by the balance-due day, for taxation years beginning after June 30, 2003. In many cases, the new balance-due day is earlier than the original payment-due date. Failure to pay these taxes by the balance-due day can result in non-deductible interest and penalties.

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Treaty Developments

On March 13, 2003, the US Senate approved the draft tax treaty and protocol with the United Kingdom, as well as protocols to tax treaties with Mexico and Australia. Comprehensive treaty-shopping provisions are being introduced into the UK and Australia treaties. The protocol to the treaty with Mexico includes sourcing-of-income provisions for the purposes of applying the relief from double taxation article. Most significantly, each of these three treaties now eliminates withholding tax on dividend payments in some cases; the dividend withholding rate may vary and is nil on dividends received from a resident taxpayer who owns at least 80 percent of the distributing company's voting shares.

Rumours persist that the US push toward lower or nil withholding on dividend payments may have made Canada reluctant to wrap up current negotiations on a new Canada-US tax treaty protocol: Canada has yet to negotiate a zero rate of withholding for dividends in any of its treaties. Other reports of issues under negotiation include the possible elimination of withholding tax on interest paid to an arm's-length resident of the other state. Regardless of the nature of any sticking points, it appears that the window of opportunity for the protocol's ratification may have been missed for 2003. It is believed that the US Treasury has urged the Senate to swiftly approve the Australian, Mexican, and UK protocols, perhaps owing to the introduction of a zero rate of dividend withholdings; expedited ratification of the Canadian protocol this autumn may only be possible if it introduces that or another important modification. If the US and Canadian treaty negotiators agree on a new protocol's terms by the end of the current round of negotiations, its ratification may not take place until 2004, barring some significant new provision that may represent concessions on Canada's part.

A third protocol to the Canada-UK treaty, signed May 7, 2003 and effective on ratification, reduces withholding on dividends from 10 to 5 percent for shareholders that control at least 10 percent of the payer's votes and exempts certain interest and royalty payments. Exchange-of-information provisions are enhanced, and associated-enterprise rules are tightened with respect to transfer-pricing adjustments and abusive or fraudulent transactions.

Finance announced that negotiations for an income tax treaty with Cuba will begin in late May 2003. Cuba has concluded only eight tax treaties. A treaty with Canada will likely be at odds with US policy toward Cuba, but will be applauded by Canadians who invest in Cuba.

Cross-border diplomatic embarrassment arose when Finance issued a statement on December 30, 2002 that the Canada-Peru tax treaty had entered into force on December 24, 2002. However, several weeks later, Peru informed Canada that official notification was issued in error: Peru's internal ratification process was not yet complete, which forced Canada to withdraw its announcement on February 14, 2003. Three days later, Peru duly completed ratification, and on March 12, 2003 Finance announced that the treaty was effective with respect to withholding taxes on February 17, 2003. With respect to other taxes, however, the treaty is effective for taxation years beginning after 2003 (as opposed to after 2002, as would have been the case if ratification had in fact occurred in 2002). This is Peru's third concluded tax treaty.

US-Iceland and US-Hungary treaty negotiations are also worth monitoring. Those negotiations have been ongoing for some time, and new treaties or protocols may emerge in the near future. Because both non-US jurisdictions can be used in intermediary financing vehicles when US operations are funded, it is anticipated that the negotiations will result in limitation-on-benefits provisions that will limit the attractiveness of those jurisdictions for such purposes.

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Quebec GAAR and Capital Tax

The Quebec Taxation Act's (QTA's) GAAR is similar to the federal rule. The recent case of *Panneaux Chambord* and recent administrative positions clarify the Quebec GAAR's application, particularly to capital tax (court file 500-02-074316-998).

Panneaux Chambord operated a very profitable wood-processing enterprise. The taxpayer invested excess cash in non-speculative investments based on their security, with terms varying from 30 to 120 days at the best possible rate of return. At the end of fiscal years 1994 and 1995, eligible investments in the form of bonds and loans of about $32 million and $29 million, respectively, were used to reduce its paid-up capital (PUC) and thus its Quebec capital tax. Quebec's deputy minister of revenue conceded that the investments were eligible to reduce the PUC and did not constitute a year-end conversion of liquid cash into eligible investments, but rather were regular reinvestments reflecting the taxpayer's cash inflows and outflows. Nonetheless, the PUC reduction was disallowed on the basis of GAAR, because the main reason for the investments was to obtain the tax benefit of a capital tax reduction. The taxpayer countered that this was not the main objective, although it was a result.

Relying on the FCA decision in *Canadian Pacific*, the Court of Quebec (at the first level of tribunals) found that GAAR was not intended to preclude the use of legal means to reduce or even completely avoid paying income taxes. The tax benefit sought was secondary: the investments were selected because they were secure, short-term, and profitable. The deputy minister could not support his contention that the taxpayer was seeking a tax benefit other than by simply quoting one of the taxpayer's representatives to the effect that tax considerations motivated the change in the type of investment. The court stressed that the taxpayer's investment policy had not changed: to meet its objectives, the company invested available cash in financial securities throughout the year even if they were not eligible for the investment allowance. Thus, the eligible investments were not made primarily for the purpose of obtaining a tax benefit, and the concept of abuse need not be addressed.

The day after that decision, Quebec Rulings issued two GAAR technical interpretations on the investment allowance for capital tax purposes. According to the first TI, the Quebec GAAR applies to year-end transactions carried out by a company (01-010550). The taxpayer made eligible investments (short-term loans) at year-end to reduce its PUC and then sold the investments in early January; for the remainder of the year, the company invested surplus cash in bank term deposits, not in investments similar to those made at year-end. The TI said that a tax benefit arose because the capital tax otherwise payable was reduced; in addition, the investments were carried out primarily for tax reasons, because the actual rate of return on the loans was clearly lower than the rate on concurrent term deposits. It was reasonable to conclude that the transaction resulted in a misuse or abuse of the provisions of the QTA read as a whole.

The second TI found that the Quebec GAAR applied to transactions concluded by the taxpayer to reduce its PUC (02-010841). The taxpayer obtained $50 million to finance the acquisition of a company and onloaned the funds to a sub for a 30-day period (subsequently renewed). The purchase took place in February of the next year. The

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.
Published monthly

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ISSN 1496-4422 (Online)

taxpayer reduced its PUC by about $46 million. The TI said that GAAR applied because the transaction gave rise to a tax benefit; the fact that the taxpayer did not make any other loans to the sub and that the management fees charged to make the loan reduced the actual rate of return on the investments showed that the transactions were carried out primarily to obtain a tax benefit that resulted in a misuse or abuse of the provisions of the QTA read as a whole.

The position of the court in *Panneaux Chambord* is clear. The Quebec GAAR does not preclude a taxpayer from obtaining a tax benefit as a result of legitimate commercial investment transactions, even if they are carried out to allow the taxpayer to take advantage of a tax provision. The case is in keeping with federal court decisions on the federal GAAR; the deputy minister has not appealed. The TIs' facts differ somewhat, and the positions therein should be considered in light thereof. In the first TI, the relevant transaction was an isolated event, not part of a history of transactions or an ongoing or recurring series of transactions carried out as part of the taxpayer's existing investment policy or business. In contrast, the second TI involved a transaction that was part of the acquisition of an enterprise for which financing was obtained beforehand and the funds invested in the interim in financial securities that provided a tax benefit. Earlier TIs had applied GAAR when ineligible investments were converted to eligible investments at year-end and then reconverted shortly thereafter.

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FOREIGN TAX NEWS

Treaties

A third protocol to the Canada-UK treaty was signed on May 7, 2003. See page 7 for details.

OECD

Working party no. 6 of the OECD Committee on Fiscal Affairs is seeking input and comments by June 30, 2003 on transfer-pricing comparability issues encountered on the application of traditional transaction and transactional-profit methods under OECD transfer-pricing guidelines. Inter alia, various issues related to third-party data are under review. Comments on how to improve the profit split and the transactional net margin methods will be solicited later this year.

The committee formed a working group to consider improvements to the mutual agreement procedure (MAP) under the model treaty's article 25. The group is focusing on ensuring that the process can result in a satisfactory solution in a reasonable amount of time. Issues such as costs, timing, taxpayer's roles, procedure transparency, the interaction between MAP and domestic law, and the suspension of tax and interest are being addressed. The committee invites comments until September 15, 2003.

Portugal

Measures to prevent tax evasion include new reporting requirements and obligations for payments to non-residents. A form identifying non-resident payees by their tax identification number will permit the cross-checking of non-residents' tax data. A form identifying would-be individual recipients of personal income enjoying treaty benefits must be presented to and approved by the Ministry of Finance and certified by tax authorities in the non-resident's country before payment occurs. To assess beneficial ownership and discourage tax arbitrage, another form identifies a non-resident entity entitled to an exemption for interest paid on public debt securities.

Russia

New guidelines are recommended for tax authorities that deal with foreign organizations and their profits. It has been suggested that tax authorities revise their approach to dealings with both domestic and foreign citizens. Provisions for foreign enterprises' income from permanent establishments and other Russian-source income are clarified. A draft new customs code was approved by the State Duma in third reading.

Mexico-United States

Mexican tax authorities published a new rule extending previously denied tax treaty benefits to US limited liability companies (LLCs). An LLC must secure an IRS form 6166 stating that either the entity or the members are US-resident. Under US check-the-box rules, an LLC is entitled to treaty benefits even if not subject to US tax.

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