CANADIAN TAX Highlights

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US RRSP Reporting Update

IRS Notice 2003-25, issued on April 11, 2003, imposed new US filing requirements for certain US RRSP holders on forms 3520 and 3520A. (See "US RRSP Reporting," *Canadian Tax Highlights*, May 2003.) Subsequent developments indicate that the IRS may soften those requirements.

In response to numerous inquiries from practitioners and taxpayers who are concerned that the new filing requirement may be unduly complicated, duplicative, and/or burdensome, the IRS is considering possible modifications. It is not yet clear whether or when changes will be made, but taxpayers who are required to file for the 2002 year by the automatically extended August 15, 2003 filing date may wish to adopt a wait-and-see stance in the next few months.

Clarification of reporting requirements. It should be noted that form 3520 must generally be filed by US RRSP holders if (1) there were distributions made from the RRSP during the year, or (2) the taxpayer did not attach a deferral election to his or her US tax return in accordance with Rev. proc. 2002-23. The transfer of funds to an RRSP that qualifies for benefits under the US-Canada treaty generally continues to be exempt from reporting. Although this exemption is not referred to in IRS Notice 2003-25, it has been confirmed in the 2002 instructions to form 3520 and in discussions with IRS representatives.

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Underwater Stock Options Sink

Finance has officially decided not to provide relief for adverse tax consequences suffered by employees who exercised stock options to acquire shares that later declined in value. A letter issued May 7, 2003 to this effect responds to a request made as early as mid-2001 to consider relief, when Finance had said it was examining the tax treatment of employee stock option benefits generally. Though it was seemingly sympathetic then, Finance bypassed later opportunities to provide relief, and its final decision is not surprising.

In the past few years, many employees in the high-tech and other sectors exercised stock options; because the value of their employers' shares so acquired had increased significantly since the options were granted, those employees reported a substantial income inclusion under section 7. In many cases, however, the shares' value later sank suddenly (hence the name "underwater shares"). But the large tax liability remains intact: the section 7 income inclusion is not offset by a capital loss on the shares. And because the shares' value has decreased, such employees usually do not have the means to pay the related tax liability. In its March 15, 2002 submission to Finance on an upcoming technical bill, the joint committee on taxation recommended an amendment for an income deduction to offset the stock option benefit by any capital loss realized on the disposition of such shares.

Finance's refusal to provide relief is premised on its equating employees who exercise stock options and decide to hold the shares with individual investors who acquire shares with after-tax dollars or borrowed money. Each employee who continues to hold stock option shares after exercising the option accepts a market risk as an investor in the expectation of a return on investment that includes the future appreciation in the shares' value. Therefore, those individuals are subject to the same general income tax rules respecting capital gains and losses on the underlying shares as other investors, who generally may not deduct capital losses from other income. Finance concludes that it is difficult to justify special retroactive relief to individuals who choose to accept that market risk, but not to other investors who suffer the consequences of a stock market downturn. The analysis does not seem to attribute weight to the fact that an employee's decision to exercise stock options and hold the shares may not be merely an investment decision: stock options often have an expiration period, requiring an executive to exercise the options to avoid losing them. In contrast, individual investors may buy shares at any time solely on the basis of investment considerations. Furthermore, after exercising the stock options, an executive is often expected to hold the shares to demonstrate his or her commitment to the company: such holding does not reflect merely an expectation of future appreciation.

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OECD Model Treaty Update

On January 28, 2003, the OECD approved an update of its model treaty and commentary derived from an October 2, 2001 draft. Three background reports (restrictions on entitlement, e-commerce characterization, and PEs) are available in the OECD publication "2002 Reports Relating to the OECD Model Tax Convention." Of particular interest are amendments to the permanent establishment (PE) commentary.

■ **Article 1: Persons covered.** The commentary now extends to tax avoidance, conduit companies, treaty shopping, and preferential tax regimes.

■ **Article 5: Permanent establishment.** The expanded commentary now states that a formal legal right to use a place is not required to constitute a PE, apparently addressing a *Dudney*-like situation.

The commentary also takes a "spatial delimitation" approach to places of business that move between neighbouring locations: a single place of business generally exists if, in light of the nature of the business, a particular location within which the activities are moved constitutes a coherent whole commercially and geographically vis-à-vis that business. The "coherent commercial whole" test requires sufficient connections between the commercial activities at different locations to consider them one unit. The "coherent geographic whole" test requires that the activities be undertaken in a limited geographic area. Examples include a very large mine that may constitute a single geographic and commercial unit of the mining business. An "office hotel" in which a consulting firm regularly rents different offices is considered a single place of business for that firm, because the building constitutes a whole geographically and the hotel is a single place of business for the consulting firm.

It may prove challenging to apply the tests in practice. Consider the example of a painter: work performed in a large office building (a geographically limited area) under a series of unrelated contracts for a number of unrelated clients may lack commercial coherence and therefore not constitute a PE, but work performed under one contract for one client constitutes a coherent whole commercially and geographically, and is therefore a PE if the time threshold is met. Furthermore, a consultant on a single project (training bank employees) must consider each branch separately if he or she is working at different branches in separate locations, but has only one place of business if he or she moves from one office to another within the same branch location: the single branch location possesses geographical coherence that is lacking in the different branches. The commentary's time frames for establishing a degree of permanence are amended: a PE normally does not exist if a business is carried on through a place of business that is maintained for less than six months, but in many cases is considered to exist if the place of business is maintained for a longer period. Exceptions include activities of a recurrent nature.

The commentary on agents is amended, and a discussion on e-commerce is added.

■ **Articles 10-12: Dividends, interest, and royalties.** The commentary now provides more detailed discussion of beneficial ownership, conduit companies, and certain abuses. The article 12 commentary acknowledges practical difficulties in distinguishing between payments for the supply of knowhow and the provision of services, and sets out relevant criteria. E-commerce commentary is also included.

■ **Article 27: Assistance in the collection of taxes.** This new article provides for comprehensive collection assistance.

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Small Numbers

Preliminary statistics for the 2001 taxation year indicate that despite continuing efforts on the part of the federal Department of Finance to reduce or eliminate tax shelters and loopholes over the last decade, about one-tenth of 1 percent of all tax filers with incomes over $100,000 continue to have no tax payable.

Of the 21.4 million people who filed income tax returns in 2001, 6.5 million paid no tax. Many of these non-taxable individuals filed returns in order to apply for or qualify for such assistance programs as the guaranteed income supplement to the old age security pension, the child tax benefit, the refundable GST credit, and a number of provincial programs. Only 2,760 of the 6.5 million non-taxable returns—less than four-tenths of 1 percent of all non-taxable returns—showed incomes over $100,000.

Non-Taxable Personal Income Tax Returns Reporting Income over $100,000: Preliminary Figures for 2001 Tax Year

	Number	As a percentage of all returns	Averages
			$
Income			
From employment	1,130	0.007	177,673
From investment and dividends	750	0.007	25,308
Taxable capital gains	1,190	0.050	101,240
Tax-exempt	290	0.009	97,441
Total income	2,760	0.013	179,219
Deductions			
Carrying charges and interest	870	0.034	53,000
Other deductions from income	560	0.061	63,579
Capital gains deduction	650	1.068	155,877
Additional deductions from net income	860	0.021	134,678
Total deductions	2,040	0.013	173,819

Total income reported on all returns in 2001 amounted to $672 billion; non-taxable returns accounted for 4.5 percent and non-taxable returns with incomes over $100,000 for seven-tenths of 1 percent.

In 1991, the first $100,000 of capital gains was exempt from taxation; 75 percent of any excess was taken into taxable income. The recession of 1990-91 had devastated many business incomes. A decade later, the capital gains inclusion rate had been reduced to 50 percent, and most individuals had used up their lifetime exemption before it was repealed in 1996. Business income was benefiting from an unprecedented period of recovery. Despite these significant differences in tax structure and economic circumstances, the number of non-taxable returns with incomes over $100,000 in 2001 was unchanged at one-tenth of 1 percent of all returns. Over the decade, the proportion of non-taxpayers among those with incomes over $100,000 declined from three-quarters of 1 percent to less than one-half of 1 percent.

The numbers do not offer an obvious explanation for the non-taxable status of a few high-income individuals. As shown in the table, deductions for carrying charges and interest and the capital gains exemption were important to a limited number of taxpayers. Because these tax statistics round every number to the nearest 10 and withhold some numbers where the numbers are so small as to jeopardize confidentiality, it is unwise to attach too much importance to the reported average dollar amounts. Nevertheless, the average claimed for the capital gains exemption and other deductions, which include losses from prior years, are significant for at least one-half of the favoured few.

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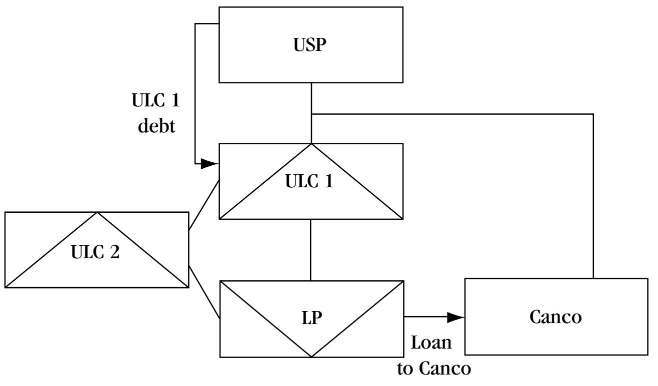
NRO Replacement

US parent corporations (USPs) have long used NROs as an effective strategy to finance their Canadian subsidiaries and have been seeking replacements since the NRO's demise in the 2000 federal budget. The CCRA has given several favourable rulings on the so-called synthetic NRO replacement structure, which employs a provincially formed partnership of only US partners as the lending entity. (See document no. 2000-0054593.) A recently issued tax ruling smiles on a similar partnership financing strategy and the steps undertaken to migrate into the new structure (document no. 2003-0005273).



Pared down to its essentials, the structure in the ruling comprises a USP-owned NRO that holds a loan receivable from its sister Canadian operating company (Canco). USP incorporates a Nova Scotia unlimited liability company (ULC 1) that in turn incorporates ULC 2. ULC 1 and ULC 2, each disregarded entities for US tax purposes, form a provincial limited partnership (LP) that elects to be taxed as a corporation for US tax purposes. After NRO has paid dividends equal to its income and has renounced NRO status, USP sells the NRO stock to ULC 1 for an interest-bearing note (ULC 1 debt) and ULC 1 stock. ULC 1 transfers, perhaps, 1 percent of the NRO stock to ULC 2 for ULC 2 stock. ULC 1 and ULC 2 then roll the NRO stock to LP for partnership capital under subsection 97(2). NRO then liquidates into LP.

Under this strategy, unlike the NRO structure, the thin capitalization exposure shifts from interest paid by Canco to the NRO to interest paid by ULC 1 to USP. Presumably, to boost ULC 1's equity, USP transfers its preferred shares in Canco to ULC 1. The transfer of NRO stock to ULC 1 for consideration including ULC 1 debt would normally be offside under section 212.1, but because NRO paid out all its income annually via full PUC stock dividends to trigger the refundable NRO tax, USP had PUC up to FMV in the NRO stock. The ruling is helpful because of its blessing on GAAR and on interest deductibility to ULC 1.

From a US tax perspective, this new strategy produces a similar result as the NRO, and it is assumed that the restructuring of NRO into LP has been achieved on a tax-deferred basis relative to the NRO. LP's interest income on the Canco loan is, presumably, covered by the same-country exception to subpart F and is thus not subject to immediate US income tax. Because ULC 1 and ULC 2 are disregarded, so is the ULC 1 debt; the only income to USP is composed of LP distributions. Deferral of income on an LP distribution could be achieved for US tax purposes by ULC 1's borrowing to make interest payments on the ULC 1 debt. USP incurs tax costs in the form of creditable foreign tax on ULC 1 dividends (5 percent withholding), Canadian regular tax paid by ULC 1 and ULC 2, and Canadian withholding tax on interest on the ULC 1 debt (10 percent).

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Ontario Cap Tax Election

Ontario's 2001 budget generally replaced the small business capital tax exemption with a $5 million taxable paid-up capital (TPUC) deduction for all incorporated businesses effective October 1, 2001, spearheading Ontario's commitment to eliminate its uncompetitive and job-killing capital tax. Then a controversial March 2003 budget proposed to reduce the current capital tax rate by 10 percent—from 0.3 to 0.27 percent—effective after 2003 and prorated for straddle years. Ontario's stated goal is to ensure that its capital tax's demise occurs by the time the federal large corporations tax (LCT) is eliminated after 2007, but specific information on capital tax rates and TPUC deduction amounts for post-2004 taxation years has not been announced. Moreover, owing to the imminent provincial election and both opposition parties' proposals to roll back any corporate tax relief, there is no certainty that even the planned 2004 capital tax rate reduction will materialize. Nonetheless, a new elective allocation of the exemption is now in place.

The so-called $5 million TPUC deduction is actually a deduction of up to $15,000 (0.3 percent of $5 million) from a corporation's capital tax liability. Unlike the current federal $10 million LCT capital deduction and New Brunswick's $5 million LCT deduction, which can be allocated among members of the related group (or associated CCPCs), Ontario's deduction was automatically prorated to each group member with a permanent establishment (PE) anywhere in Canada—not just in Ontario—proportionate to its share of aggregate TPUC. The existence of associated group members with no Ontario PE, which are not subject to Ontario capital tax, means that the full $15,000 pre-tax benefit is not realized.

Elective Allocation of Net Deduction in an Associated Group

Associated member	Ontario allocation factor[a]	Total assets[b]	Percentage of total assets	Net deduction
	J		K	J × K × $15,000
Corporation A	100.00%	$3,518,375	4.9096	$736.44
Corporation B	48.00%	$19,265,825	26.8839	$1,935.64
Corporation C	64.00%	$8,395,482	11.7152	$1,124.66
Corporation D	18.00%	$26,790,328	37.3837	$1,009.36
Corporation E	39.00%	$11,379,030	15.8785	$928.89
Corporation F[c]	0.00%	$2,314,000	3.2290	—
Corporation G[d]	0.00%	—	0.0000	—
		$71, 663,040	100.0000	$5,735.00

[a] The allocation factor is for the last taxation year ending in the calendar year preceding the calendar year in which the taxation year ends. [b] Total assets of the corporation as recorded in its books and records for its last taxation year ending in the calendar year preceding the calendar year in which the taxation year ends. [c] A Delaware corporation; PEs in Montreal and Vancouver and some assets in Vancouver. [d] A Bermuda corporation with no assets in Canada.

For Ontario purposes, a subject corporation's aggregate TPUC includes the TPUC of each associated corporation for its latest taxation year that ends during the subject corporation's taxation year. This method of allocating the exemption should be easy to apply, but the determination of aggregate TPUC in large corporate groups and groups with no-Ontario-PE members is an onerous and sometimes difficult task. Heeding taxpayer desire to allocate the deduction, Ontario enacted late in 2002 a new elective method available for 2003 and later taxation years. While the associated group's aggregate net deduction is determined by formula (section 69(2.4) of the Ontario Corporations Tax Act), the deduction need not be allocated in proportion to each member's share of the group TPUC. An allocation agreement supporting the election must be filed with each member's Ontario corporate tax return.

Calculating the associated group's deduction requires somewhat less information than the current proportionate allocation. The member's total assets per its books and records and Ontario allocation factor are required; for non-Canadian incorporated corporations, only total assets in Canada are included. To mitigate difficulties in obtaining current financial information, the amount of each member's total assets and the Ontario allocation factor are based on the amounts for its last taxation year that ends in the calendar year preceding that in which the subject taxation year ends. Total assets include the proportionate share of partnership assets according to its share of the partnership's income or loss for the year ending in the corporation's taxation year.

The table provides a sample calculation of an associated group's net deduction under the elective method. On the facts assumed, the net deduction is $5,735, less than the $15,000 tax saving if $5,000,000 was deducted from the TPUC of an Ontario-resident corporation with a 100 percent allocation factor. However, that total net deduction may be allocated between group members as they agree. For example, a simple holdco with a full investment allowance will usually not receive any allocation. The new elective method may be easier to calculate and generally fairer; but if information is readily accessible, calculations should be made under both the existing and the new elective methods to determine the optimal choice.

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Cross-Border Sale Leasebacks

The Canadian cross-border leveraged lease market appears to be alive and well as a consequence of the recent TCC decision in *Canada Trustco* (2002-1155(IT)G). *Canada Trustco* also further shapes the body of law on GAAR.

As part of a cross-border sale leaseback, Canada Trustco (CT) purchased $120 million worth of trailers (subject to operating leases) from US-resident Transamerica Leasing (TL), using a $98 million limited-recourse loan from the Royal Bank (RBC) and $25 million of its own funds. (Transaction costs amounted to $3 million.) The interest rate on the loan was 7.5 percent; principal and interest payments were due semi-annually. CT then entered into a head lease with a "third party" limited liability company incorporated under UK law (UKco), with an initial lease term of about 18 years; rent was due semi-annually based on an 8.5 percent effective rate. UKco had a fixed-price option to acquire the trailers for $84 million after about nine years (the first option) and a second option at FMV at the end of the initial term. UKco entered into a sublease with TL at terms that more or less mirrored the head lease, but on closing TL was required to prepay all rents: $120 million less the lease benefit it derived of $3 million. Of the $117 million prepayment, UKco placed $98 million on deposit with RBC, an amount equal to the loan. To defease the loan, CT entered into a security agreement with RBC and irrevocably assigned to it rents due from UKco. The rents matched the loan's amounts and timing, and CT achieved off-balance-sheet treatment for the loan. UKco paid the balance of TL's prepayment ($19 million) to RBC Jersey (a wholly owned sub of RBC and a Jersey resident) as trustee of a charitable trust formed by UKco to purchase Ontario bonds maturing on the first option date. CT, UKco, and RBC Jersey as trustee agreed to pledge the bonds as security in support of UKco's obligations beyond the ninth year: to fulfill continuing payment obligations under the lease, including the purchase option payments or any termination payments for early unwinding. Various other agreements normal for transactions of this type were entered into.

The CCRA said that CT did not acquire the assets, and it applied GAAR to deny CCA on the trailers; the minister did not assert that the transactions were shams or legally ineffective, nor did he question the FMV of any elements. The TCC referred to the FCA decisions in *OSFC* and *Water's Edge*, and said that GAAR can be viewed as "an endorsement of the grand old Duke [of Westminster], except for those transactions that clear the considerably higher abuse and misuse hurdle." Although the transactions in issue were a profitable investment in a commercial context, the tax benefit drove the deal; the transactions were thus an avoidance transaction.

The key was whether there was a misuse or abuse of the Act as a whole. The CCRA posited that CT had "no real cost" for the trailers: the prepayment was used to economically defease the loan, and CT's equity investment was ultimately secured by the bonds. The TCC eschewed this approach, which effectively recharacterized the legal form of the transaction for the purposes of determining whether there was a misuse or abuse, saying that the recharacterization permitted by paragraph 245(5)(c) operates only at the later stage of determining the tax consequences. *Canadian Pacific* and *Consumers Gas* established that the cost of property does not turn on "economic burden." *Gelber* held that "just because a lessor/purchaser provides as a condition of the purchase, for a leaseback under which he is assured of revenue that will cover his investment cost and a return of capital, does not make the purchase price any less a true capital cost of the property."

Absent a specific provision, the degree to which an investment is at risk is not a valid criterion by which to judge capital cost. *Singleton* also confirmed that a true economic purpose test in the context of paragraph 20(1)(c) is not the correct legal test—a conclusion echoed in *Shell*, which said that the courts have never held that a transaction's economic realities can be used to recharacterize bona fide legal relationships in the absence of sham. Specific provisions require an investigation into a transaction's economics, such as the at-risk rules and tax shelter rules, but no specific rules oust an asset's legal cost for CCA purposes in favour of an economic reality test. CT also traced the leasing rules' legislative history. In the result, the arrangement in *Canada Trustco* was an avoidance transaction that was not GAARable because there was no misuse or abuse. *Canada Trustco* reinforces the notion that GAAR must be applied with utmost caution; legislative intention must be ascertained in order to override otherwise applicable rules, an approach that differs from the use of policy to assist in statutory interpretation.

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Income Trusts: US Pensions

One consequence of converting a Canadian corporation to an income trust such as an income fund, REIT, or royalty trust is seldom discussed: such a trust's income distributions to exempt US pension plans, including IRAs, are not exempt from Canadian non-resident withholding tax.

Article XXI(2) of the Canada-US treaty exempts US pension plans from non-resident withholding tax on dividends and interest only. Consequently, a US pension plan is probably not exempt on income distributions from an income trust even if the distribution relates to a dividend received on shares held by the trust and the distribution is treated as a dividend for US income tax purposes.

US pension plans hold shares of Canadian companies, particularly those in the resource sector, with the expectation that related distributions are exempt from Canadian withholding tax. Generally, information circulars describing the conversion of existing Canadian corporations to a form of income trust and prospectuses for income trust units sold to US residents merely indicate that income distributions are subject to withholding tax: the disclosure discusses the reduced treaty rate, but not the loss of article XXI(2) protection for US pension plans. The disclosure may leave the impression that a US resident is no worse off because a 15 percent withholding tax rate applies to a trust's income distributions and dividends alike. However, Canadian withholding tax is a real cost to a US pension plan, which is exempt from US tax and thus unable to benefit from a tax credit.

Although there is no indication that an amendment to article XXI(2) is being considered by Finance or is part of recent treaty protocol negotiations, from a policy perspective income distributions on listed mutual fund trust units may warrant the same treatment as interest or dividends under the treaty. This would be consistent with Finance's December 11, 2002 comfort letter, which expands the scope of the securities lending arrangement rules to cover listed mutual fund trust units, facilitating short sales of income trust units. Until an amendment is forthcoming, US pension plans should cautiously participate in Canadian income trusts and consider appropriate planning.

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US Tax Bill: Dividends

On May 23, 2003, with US Vice-President Dick Cheney casting the deciding vote in a deadlocked Senate, Congress approved the Jobs and Growth Reconciliation Tax Act of 2003. The bill provides for $330 billion in tax cuts and $20 billion in fiscal aid to state and local governments—the third largest such package in US history—and no revenue offsets. President Bush signed the bill into law on May 28, 2003.

The cornerstone of the legislation is reduced rates for capital gains and dividends. Under prior law, dividends received by an individual were taxed as ordinary income at rates up to 38.6 percent (for 2003); adjusted net capital gains were generally taxed at a maximum of 20 percent (10 percent for low-income taxpayers). In tax years beginning after 2002 and before 2009, dividends received by an individual from domestic corporations or certain qualified foreign corporations are taxed at capital gains rates, for both regular tax and alternative minimum tax. For sales and exchanges and payments received after May 5, 2003 and before 2009, the current adjusted net capital gains rates of 10 percent for taxpayers in the 10 and 15 percent brackets and 20 percent otherwise are reduced to 5 percent (0 percent in 2008) and 15 percent, respectively. Thus dividends are taxed at a maximum rate of 15 percent (5 percent for low-income taxpayers).

The term "qualified foreign corporation" includes a foreign corporation that (1) is incorporated in a US possession, (2) is eligible for benefits under a comprehensive US income tax treaty that the Treasury Department determines satisfactory for this purpose, including the US-Canada treaty, or (3) has stock readily tradable on an established US securities market. Legislative history indicates that the current US-Barbados treaty is not satisfactory for this purpose, because it may provide benefits intended for the purpose of mitigating or eliminating double taxation to corporations not so at risk. Until Treasury issues guidance on satisfactory treaties, Congress intends that a foreign corporation qualifies if the relevant comprehensive US treaty (but not the Barbados treaty) has an exchange-of-information program. Legislative history also indicates that a company must qualify for treaty benefits with respect to substantially all of its income in the taxable year in which the dividend is paid. An important exclusion has been carved out: dividends received from a foreign investment company (Code section 1246(b)), a passive foreign investment company (section 1297), or a foreign personal holding company (section 552), in either the taxable year of the distribution or the preceding taxable year, do not qualify for the reduced dividend tax rate.

Special rules apply in determining a taxpayer's foreign tax credit limitation under section 904: rules similar to the section 904(b)(2)(B) rules—dealing with adjustments to the foreign tax credit limitation to reflect any capital gain rate differential—apply to any qualified dividend income. It is also anticipated that regulations will be issued to coordinate the operation of the rules applicable to qualified dividend income and capital gains. Senate proposals with significant international tax implications, such as a mark-to-market regime for individuals who expatriate and a repeal of the foreign earned income exclusion for citizens or residents living abroad, were not included in the final tax bill.

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Withholding Grandfathered

A comfort letter of May 14, 2003 from Finance concerns the effective date for changes to subsection 212(13.2) proposed in the December 20, 2002 technical bill. These changes could increase withholding tax requirements for a non-resident company that carries on business in Canada and pays amounts such as interest and royalties to other non-residents in connection with its Canadian business.

Subsection 212(13.2) deems certain non-resident persons to be Canadian residents for the purposes of part XIII non-resident withholding tax if the non-resident carries on business principally (generally, more than 50 percent) in Canada. Generally, if such a non-resident pays or credits an amount to another non-resident that is deductible in computing the payer's taxable income earned in Canada, the payer is deemed to be resident in Canada, and part XIII withholding tax applies.

The proposal extends the deeming rule to any non-resident that makes a payment to another non-resident that is deductible from income earned in Canada from a source that is not a treaty-protected business or property (as defined in subsection 248(1)). Finance acknowledges that the proposal applies potentially to any non-resident that is resident in a treaty country and that is carrying on business through a Canadian permanent establishment.

The CBA-CICA Joint Committee on Taxation pointed out in a recent submission to Finance on the technical bill that without the ameliorating effect of any grandfathering of existing arrangements, this amendment may impose an inappropriate burden on a non-resident that is already obliged to make a payment to another non-resident. A borrower that knew when the debt was negotiated that withholding tax might apply might have structured it to conform to the subparagraph 212(1)(b)(vii) exception or borrowed from a Canadian lender; renegotiating now could be expensive and difficult for both parties. The comfort letter agreed that the application to previously outstanding obligations could unduly inconvenience some taxpayers. Finance said that it will recommend that the amendment submitted to Parliament apply to obligations entered into after December 20, 2002.

Ontario tax-exempt bonds. In late April 2003, Ontario introduced a new series of Ontario Opportunity Bonds, on sale until mid-May 2003. Interest paid on such bonds purchased by Ontario residents is exempt from Ontario personal and corporate income tax over their five-year term. Regulations under the Corporations Tax Act and Income Tax Act (Ontario) provide that such interest is not subject to Ontario income tax, but under the federal-provincial tax collection agreement Ontario technically must conform to the federal computation of taxable income. To skirt this roadblock, Ontario regs provide, for individuals, a deemed overpayment of Ontario income tax and a resulting tax refund entitlement, a mechanism burdened with negative cash flow implications. About six to eight months after the April 30 filing date in the year after the bonds' year of purchase, Ontario will automatically process a payment equivalent to the tax exemption. For example, an individual in the top marginal bracket who earns $1,000 of Ontario tax-free interest in 2003 pays federal and Ontario tax of $464 thereon in his or her return filed by April 30, 2004. Sometime between October and December 2004, Ontario will repay the $174 in "overpaid" Ontario income tax.

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Software Tax Shelter News

The unprecedented growth experienced in the high-tech sector until the last few years, particularly in computer software, resulted in a plethora of software tax shelters that enticed investors with significant tax deductions relative to cash injections required. Now the CCRA has reassessed most software tax shelters, and has been successful before the FCA in the recent test case of *Peter Brown*.

Peter Brown involved a typical computer software tax shelter. Mr. Brown purchased units in a general partnership that was registered as a tax shelter for US$10,000 per unit: cash of US$4,000 and a promissory note for the balance. On the same day, the partnership acquired 11 computer programs from American Softworks Corporation (ASC) for US$8,170,000 (cash and a promissory note). In 1993 and 1994 the partnership wrote off those costs, creating losses; it earned a small profit in 1995. On December 31, 1995, the partnership and ASC entered into an amending agreement: for 1995 to 2003, ASC guaranteed US$300,000 minimum in annual partnership revenue, and the partners could retract their units for US$8,000 each plus ASC shares with financial assistance from ASC if it became publicly traded. In reassessing the partners, the CCRA disallowed the 1993 and 1994 losses and deleted the negligible 1995 income.

After losing in the TCC, Mr. Brown appealed to the FCA. The FCA said that whether parties are at arm's length depends upon whether the directing mind of the partnership and of the other party to the transaction is the same; in fact, the terms of the software agreement were agreed to when the partnership and ASC were not at arm's length, and Mr. Brown entered the partnership when it was already a party to a non-arm's-length transaction. Thus paragraph 69(1)(a) deemed him to have acquired his share of the programs at a FMV of Cdn$4,128,000 as found by the TCC, and not the acquisition cost. The FCA held that there was no palpable and overriding error in the TCC's reasoning on the valuation issue and refused to interfere with its finding.

The TCC said that Mr. Brown had a US$4,000 per unit at-risk amount—the cash component of the purchase price—and he could not claim losses in excess of that amount. The Crown cross-appealed to the FCA, saying that none of Mr. Brown's US$10,000 per-unit contribution was at risk and therefore he was not entitled to deduct any losses. The FCA concluded that the retraction rights in the amending agreement entitled Mr. Brown to receive US$8,000 per unit, making the at-risk amount US$2,000 per unit (US$10,000 less the US$8,000 retraction right), and leaving Mr. Brown a net loser on his appeal.

Peter Brown gives the CCRA significant ammunition to aggressively pursue software tax shelters even though the case is riddled with bad facts. On the bright side, the TCC found that the partners had a reasonable expectation of profit: although the tax aspects of the transaction were a significant factor in Mr. Brown's decision to invest, a bona fide business was being carried on and the partnership did have a source of income. The FCA did not challenge that finding. Unless Mr. Brown obtains leave to appeal to the SCC—a very unlikely prospect, given that the case is mainly fact-driven—*Brown* is the current state of the law with respect to software tax shelters, which run an even greater risk of reassessment now that the CCRA has the decision in its arsenal.

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PROFESSIONAL NEGLIGENCE

The recent decision of the Ontario Superior Court of Justice in *Turi v. Swanick* involved a negligence claim against a solicitor who had incorporated a corporation for the plaintiff as part of a tax and asset protection plan (61 OR (3d) 368). The corporation was to be used to carry on the plaintiff's retail clothing business and insulate his personal assets from any related liability. The corporation became insolvent. A supplier successfully sued for damages against the plaintiff, saying that its supply contract was entered into not under the corporation's name but by the plaintiff personally. The plaintiff in turn sued his solicitor for negligence in failing to appropriately advise him of the consequences of not properly using the corporation's name when entering into contracts.

On the facts, the solicitor had orally told the plaintiff how to properly use the corporate name, but not of the consequences of a failure to do so. The court said that in ascertaining the standard of care, the level of the client's sophistication must be considered; the plaintiff was an unsophisticated businessman, and thus the standard of care required that he be advised both of the proper use of the corporate name and of the consequence of a failure to do so. Further, the court said that such advice should be in writing.

The decision is a helpful reminder that a tax adviser should assess the knowledge and business acumen of each client and tailor his or her responses and advice accordingly. Oral advice is not adequate if the matter at issue is significant or complicated, a point of special importance for advisers who regularly assist clients in implementing plans that require ongoing maintenance. In addition, an adviser who regularly incorporates corporations for clients' tax plans may wish to review standardized reporting letters to ensure that they clearly set out not only the proper use of a corporate name, but the implications of an improper use.

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CANADIAN TAX Highlights

Readers are invited to submit ideas or written material to *Canadian Tax Highlights*.
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Foreign Tax News

OECD

Further amendments to the OECD model tax treaty under consideration would focus on the determination of permanent establishment status on an entity-by-entity basis. Other areas to be reviewed and defined are the recent European cases that suggest that operations of a domestic business may give rise to multiple PEs of foreign related parties, a notion contrary to conventional doctrine, and local authorities' disregarding a domestic sub and attributing its tax characteristics to a foreign parent. The condensed version of the treaty as of January 2003 is available from local publishers.

United States

A Senate bill aims to attract foreign headquarters to the New York Liberty Zone surrounding the former World Trade Center. Headquarter activities will be treated as if conducted abroad for determining taxes and withholding rates, and whether a permanent establishment exists for treaty purposes. Office space must be contracted for before September 11, 2007, and all activities transferred before September 11, 2009. At least 200 employees must be relocated (or the greater of 10 percent of its employees and members of its expanded affiliated group and 50 employees), including at least 50 percent of the firm's senior officers and senior business personnel. Current US employees are excluded from these figures. PDF copies of the bill may be obtained from the Foundation's library.

A new bill that curbs tax evasion through the exploitation of tax treaties and the manipulation of transfer pricing is available in the Foundation's library.

Tax cuts to provide fiscal aid to state and local governments include a two-year increase ($400) on the child tax credit, on standard deductions for married couples, and on taxable income brackets, and a reduction of capital gains tax by 5 percent from May 5, 2003 to December 31, 2008. New withholding rate tables appear on the IRS's Web page.

Russia

The Taxes and Levies Ministry issued an order enacting methodical recommendations to ensure uniform application of the tax code and treaties and to enhance compliance control. Two of the main topics addressed include corporate income tax on foreign entities operating through permanent representative offices and Russian-source income not connected therewith.

New proposals envision low-tax special economic zones (SEZs): industrial and production and technical and implementation zones. SEZ residents are tax-exempt for three years, and they are taxed at a reduced rate of 3.75 percent for the next four years if more than 80 percent of their income is invested in the diversification of their SEZ production facilities (12 percent otherwise).

Sweden

CFC rule change proposals attempt to head off abuse of the new exemption from tax of capital gains and dividends on business shares by shifting business income to low-tax jurisdictions and repatriating dividends and realizing capital gains.

New rules on participations are expected to make Sweden a prime location for holding companies. A Swedish holdco suffers no duty or incorporation tax, no tax or duty on sales of shares in subs, and no tax on ingoing and outgoing dividends. There are no thin capitalization rules or capital duty, and there may be no holding period or minimum ownership requirement. An overview of the changes is available from the Foundation's library.

People's Republic of China

Foreign investment entities (FIEs) may requalify for a second round of tax exemptions, including the two-year exemption and three-year 50 percent reduction; new rules apply to determine whether the requisite US$15 million capital increase has been met.

Korea

A large area outside Seoul will be turned into a free economic zone in which foreign companies will be exempt from rent and may qualify for up to 50 percent of initial construction costs. The general 15 percent corporate tax rate will be lowered over the next few years.

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