CANADIAN TAX Highlights

Editor: Vivien Morgan, LL.B.

Volume 11, Number 7, July 2003

US Non-Filers' Reprieve

The IRS has announced a new voluntary compliance program for non-resident aliens and foreign corporations that have not timely filed US tax returns. Under this limited-time program, the IRS will waive certain timely filing requirements, and program participants may claim otherwise unavailable deductions and credits in determining taxable income. This new program creates an important opportunity for non-filers because significant tax benefits may be lost if returns are not timely filed.

If a non-resident individual does not file a tax return on a timely basis, the individual is not entitled to the benefit of deductions and credits related to income effectively connected with a US trade or business. Whether a current year's return is filed on a timely basis depends in part on whether a return was filed for the immediately preceding taxable year. A non-US corporation that does not file on a timely basis is similarly disentitled. The IRS may waive a filing deadline only in rare and unusual circumstances. Additional penalties, such as for late filing and late payment, are imposed.

Under the new program, the IRS will waive the filing deadlines if by September 15, 2003 a taxpayer files all required US federal income tax returns for every year for which a waiver is requested. In addition, the taxpayer must pay the reported income tax liability, statutory interest, and penalties determined by the IRS. However, the IRS will waive the "fraudulent failure to file" penalty. The taxpayer must also cooperate with the IRS upon request in determining and satisfying its income tax liability for any taxable year for which the waiver is requested. IRS Notice 2003-38 outlines the detailed requirements. The compliance initiative is not available if the taxpayer has previously filed a US federal income tax return or a protective return for any taxable year prior to a taxable year for which the waiver is requested, or if the IRS has contacted the taxpayer concerning a failure to file US federal income tax returns, initiated an examination or investigation of the taxpayer, or notified the taxpayer that it intends to begin an examination or investigation. If the non-resident alien or foreign corporation has previously requested that the IRS waive the timely filing requirement and the IRS has not yet made a decision on the pending request, the taxpayer may participate in the compliance initiative, so long as the eligibility criteria are otherwise met and the procedural requirements are satisfied.

If a non-resident alien or foreign corporation that has been in a non-filing status for many years files all required returns for taxable years ending in 1996 and later years, the IRS will not examine potential US federal income tax liability with respect to past years ending prior to 1996. This treatment is consistent with a longstanding IRS policy.

Alice A. Joseffer
Hodgson Russ LLP, Buffalo

In This Issue

Changing Small Business Thresholds

To avoid double taxation arising from earning high-tax-rate income through a corporation, CCPCs not subject to large corporations tax generally pay a bonus on their active business income to reduce their taxable income to the federal $200,000 limit for the lower small business tax rate. Distributions to shareholders are dividended out of after-tax funds. However, with the increase in the federal small business limit for 2003 and changes in certain provinces, CCPCs may be able to reduce the bonus that must be paid for 2003 to draw down income to the newly higher small business limit and thus keep more income in the corporation.

The federal small business limit increased to $225,000 from $200,000, effective January 1, 2003 and prorated for off-calendar taxation years. As a result, the limit increases each month, and the amount of bonus required to reduce taxable income to the limit decreases commensurately.

As table 1 shows, the federal small business limit for a CCPC with an October 31 year-end is $220,822 for its 2003 taxation year; if pre-bonus taxable income is $500,000, it must pay a bonus of $279,178 to bonus down to taxable income of $220,822 ($500,000 less

Table 1 Year-Ends and Federal Small Business Limits

Year-end	Pre-bonus income	Federal small business limit	Bonus down to small business limit
		dollars	
January 31, 2003	500,000	202,123	297,877
June 30, 2003	500,000	212,397	287,603
October 31, 2003	500,000	220,822	279,178
December 31, 2003 . . .	500,000	225,000	275,000

Table 2 Small Business Thresholds and Rates, 2003

Jurisdiction	Threshold	Rate
	dollars	*percent*
Federal	225,000	13.1
British Columbia	300,000	4.5
Alberta (to March 31)	350,000	4.5
Alberta (after March 31)	400,000	4.0
Saskatchewan	300,000	6.0
Manitoba	320,000	5.0
Ontario	320,000	5.5
Quebec	300,000	9.04/8.90*
New Brunswick	400,000	3.0
Nova Scotia	225,000	5.0
Prince Edward Island	200,000	7.5
Newfoundland	225,000	5.0

* 1.6% surtax ended on March 15, 2003.

$279,178). The table shows various year-ends and the corresponding federal small business limits.

Table 2 shows the small business income thresholds and rates for 2003 for all provinces.

Wayne Tunney
KPMG LLP, Toronto

TILL DEATH DO US PART?

The SCC in *Markevich* and the FCA in *Ross* and *McKinnon* have settled the application of general limitation periods to tax debts ([2003] SCJ no. 8, 2002 DTC 7462, and 2003 FCA 158, respectively). Collectively, those decisions stand for the following legal principles:

■ The Crown's ability to collect tax debts under the federal Income Tax Act and the British Columbia Income Tax Act is subject to the limitation periods in section 32 of the Crown Liability and Proceedings Act and section 3(5) of the British Columbia Limitations Act.

■ The Crown can extend the limitation period applicable to a tax debt by registering a certificate of debt with the Federal Court in accordance with subsection 223(3) of the federal Income Tax Act.

■ A tax debtor can extend the limitation period by acknowledging the indebtedness or by making a partial payment of the tax debt.

However, the question whether the minister can extend indefinitely the limitation period for collecting a tax debt by re-registering multiple section 223 certificates for the same debt has not been addressed directly. *Ross* supports the conclusion that the minister may refresh a tax debt in perpetuity, a result apparently inconsistent with the doctrine of merger and the SCC's policy rationales behind applying general limitation periods to tax collection.

In *Ross*, in contrast to *Markevich*, the minister took steps to collect the tax debt within the six-year limitation period, registering a certificate of debt with the Federal Court and eventually issuing a requirement to pay. The taxpayer brought an application for judicial review of the requirement to pay and denied liability for the debt, which he said was statute-barred. The FCTD concluded that although a certificate is not a judgment of the court, its registration has the same force and effect and the same proceedings may be taken upon it. The certificate is thus capable of supporting the issuance of writs of execution and the resulting seizure of a debtor's property. In reaching this conclusion, the court stated that the minister had preserved the debt by filing a certificate. The taxpayer remained liable to pay monies owing under the Act, and the minister could use his self-help remedies to collect the refreshed debt.

The decision in *Ross* has a dual effect: registration of a section 223 certificate refreshes the underlying tax debt and avails the minister of the Federal Court procedures when executing on the debt. New limitation periods thus begin under both the Crown Liability and Proceedings Act and the Limitation Act when a certificate of debt is registered. However, this conclusion is inconsistent with the court's apparent embrace of the doctrine of merger as a justification for its conclusion that the deemed judgment refreshes the debt. The doctrine of merger dictates that a judgment merges with the original cause of action in the judgment, and thereafter suit must be brought on the judgment, not on the original claim. A judgment, which is "of a higher nature," extinguishes or replaces the debt, and then the creditor can make no further claim upon the debt. The doctrine developed because courts were not prepared to allow a debtor to sue repeatedly on the same debt: as a matter of policy, once the creditor carried the action to judgment, the creditor should be prohibited from further action on the debt.

The consequence of *Ross* is far-reaching if it stands for the proposition that the underlying tax debt can be preserved solely by the operation of section 223 of the Act. The minister may thus refresh the limitation period in perpetuity because the tax debt supports the issuance and registration of a certificate of debt, which registration preserves the debt owing under the Act. The minister may therefore refresh a tax debt without limitation by registering multiple certificates for the same tax debt within the six-year limitation period. Not only is the result inconsistent with the doctrine of merger, but it also offends the policy rationale underpinning the SCC's decision to extend general limitation periods to tax debts. The SCC in *Markevich* said that limitation periods provide taxpayers with a sense of finality, allow them to conduct their affairs in accordance with that expectation, and force the minister to exercise diligence in collecting tax debts.

If *Ross* supports the premise that the underlying tax debt is refreshed when a certificate is registered, it is open to criticism. The better interpretation is that the tax debt is extinguished after six years, before which time the minister can commence court proceedings and obtain a judgment or register a certificate of debt with the Federal Court. If a judgment is obtained, the minister then has an additional six years to realize on the judgment. Once the minister obtains a section 223 certificate, he has an additional six years to obtain a writ of execution and another six years to realize on the writ. The better view is that the tax debt is extinguished with the expiry of the initial six-year limitation period, thus limiting the minister's remedies to those available on the section 223 certificate.

Robert Nearing
Thorsteinssons LLP, Vancouver

A Modicum of Relief

New information from Statistics Canada confirms the fact that our total tax burden rose during the economic recovery and has begun to drop as growth slows. Using fiscal-year data, calculated on a basis close to the public accounts published by the two senior levels of government, total taxes dropped from 36.4 percent of gross domestic product (GDP) in 1994-95 to 34.7 percent in 2002-3, after peaking at 37.7 percent in 1998-99.

Using these numbers instead of the more traditional national accounts figures has the advantage of making trends in later years more visible. The combined federal and provincial collections of personal income tax as a percentage of GDP dropped by two percentage points from 14.2 percent in 1999-2000 to 12.2 percent in 2002-3, but by only one percentage point measured from the 13.2 percent recorded in 1994-95. The drop from 2001-2 to 2002-3, as a percentage of GDP (shown in the table) and in absolute numbers, is attributed by Statistics Canada to weakness in the stock market and federal rate reductions. Interestingly, the provincial rate reductions introduced from 1996 to 2000 did not prevent collections from increasing either in absolute numbers or as a percentage of GDP.

Taxes as a Percentage of Gross Domestic Product, All Levels of Government, Fiscal Years 1994-95 to 2002-3

Year	Income tax: Personal	Income tax: Corporate	Consumption taxes	Property taxes	CPP and QPP	Total taxes
1994-95	13.2	2.5	8.5	4.2	1.8	36.4
1995-96	13.4	2.9	8.2	4.1	1.7	36.3
1996-97	13.6	3.2	8.3	4.0	1.8	36.9
1997-98	13.9	3.8	8.3	4.0	1.9	37.6
1998-99	13.9	3.7	8.4	3.8	2.1	37.7
1999-2000	14.2	3.7	8.2	3.7	2.3	37.6
2000-1	13.4	4.0	8.1	3.4	2.5	36.8
2001-2	13.0	3.5	8.0	3.5	2.7	35.7
2002-3	12.2	3.0	8.4	3.4	2.8	34.7

The Statistics Canada numbers show the volatility of corporate income tax collections over the period shown in the table. Combined federal and provincial collections increased from 2.5 percent of GDP in 1994-95 to 4.0 percent in 2000-1. Since then, they have declined by a full percentage point as profits declined.

Consumption taxes—including the GST and taxes on retail sales, alcoholic beverages, tobacco products, and motor fuel—have stayed relatively constant, ranging from 8.5 percent at the beginning of the period to a low of 8.0 percent in 2001-2. Provincial and local property taxes declined in importance over the period, from 4.2 percent of GDP in the first year to 3.4 percent in the last.

The phase-in of increases in the Canada and Quebec pension plan rates was almost complete by 2002-3, explaining the steady increase in these levies, from 1.8 percent of GDP in 1996-97 to 2.8 percent in 2002-3.

David B. Perry
Canadian Tax Foundation, Toronto

Technical Bill and FAs

The December 20, 2002 technical bill contained several relieving provisions anticipated in various comfort letters issued by Finance. The bill was, by and large, intended to be relieving, but it contained several unpleasant surprises in the foreign affiliate area. Following representations by taxpayers and tax practitioners, we believe that Finance will release revised draft legislation this summer and a revised bill this fall that may be combined with the anticipated foreign investment entity (FIE) bill.

An update was presented at the joint session of the Canadian and American branches of the International Fiscal Association in Washington, DC on June 5 and 6, 2003. The following summary comments are the author's views only; Finance has made no announcements in connection with the rules.

■ The provision that creates FAPI on internal transfers of shares that are excluded property is likely to be replaced with a surplus suspension rule that, absent a taxpayer election to trigger FAPI, prevents the recognition of gains or losses until the shares are disposed of to an arm's-length person or until the relationship becomes arm's-length. Amendments to the regs that restrict the ability to access surplus to that of the top-tier affiliate on a deemed dividend may also be replaced with rules that ensure that surplus adjustments are made in the course of a section 93 election.

■ Finance is examining proposals that deny the recognition of surplus on other transfers of excluded property, including sales to arm's-length purchasers, unless the income is from an active business and is subject to tax in the foreign jurisdiction. Changes being sought restrict the new rules to internal transactions and exclude transactions carried out in the ordinary course of business. It is also anticipated that the active-business requirement will be modified.

■ The so-called reverse fresh-start rules provide for a deemed disposition and reacquisition of all of a passive business's assets if it becomes active. Finance may respond to representations and defer the attribution of any FAPI until the assets' actual arm's-length disposition. Other representations seek relief for startup operations and newly acquired affiliates for gains accrued prior to December 20, 2002.

■ Although Finance believes that an "all or nothing" general election is appropriate, representations suggest that the rules should be softened to allow certain exceptions, such as removing the holding company rule discussed below. In a welcome move, Finance is also considering allowing taxpayers to revoke in its entirety a previously made general election, either at the taxpayer's discretion or with ministerial permission. Finance previously said that taxpayers should not end up worse off for having made the election.

■ The holding company rule, which provides an exception to the FAPI rules for certain intercompany loans to holdcos that purchase operating subsidiaries, has been problematic ever since its introduction. Draft amendments intended to relieve were in some cases more restrictive. The proposal to replace the excluded-property test for each group affiliate with a consolidated income-based test will likely be abandoned. Finance is also considering the elimination of the requirement that the amount paid by a holdco be relevant in computing a consolidated group's income tax liability. However, such amendments would probably be accompanied by a requirement to push down the deficit or surplus reduction related to the expense of the holding company to reduce the surplus of the affiliate that is acquired; the affiliate would be resident in the same country as the holdco and might be required to have earnings or losses from carrying on an active business there.

■ It is believed that the language of the tracking share provisions in the FIE rules is being redrafted and that the so-called accrual method of calculating FIE income inclusions will be reintroduced on an elective basis. It is believed that taxpayers so electing would need to file all necessary supporting documentation with their tax return.

■ The draft technical bill legislation is effective for most dispositions that take place after December 20, 2002, which creates considerable uncertainty. A number of taxpayers that postponed the implementation of internal reorganizations are awaiting the next draft to assess the impact of the bill on post-December 20, 2002 transactions. The draft FIE legislation is still expected to be effective for taxation years beginning in 2003.

Albert Baker
Deloitte & Touche LLP, Montreal

In a Heart Drop

Heart Drop 2000 Distributors involves an interesting interpretation of the documentation requirements necessary to support input tax credit (ITC) claims, in the context of GST audits of prior periods (2002-3335 (GST) I, April 4, 2003). The TCC also applied the due diligence defence to penalties that was developed in *Pillar Oilfields*.

Heart Drop was a direct seller of herbal products: it bought and resold "heart drops" and similar herbal products from Strauss Herb Co. Heart Drop's owners thought that the products were all zero-rated, and they did not pay GST on the company's purchases or charge GST on sales. The CCRA audited and assessed, saying that the products were taxable. Heart Drop appealed, saying that after having accounted for the GST that should have been collected on its sales of the products, it should be allowed to take ITCs to offset most of that liability. Heart Drop pointed out that subsection 296(2) of the Excise Tax Act requires that the CCRA assess a net tax, and in that process it "shall," under section 225, take into account any available ITCs in calculating net tax. The Crown argued that the "stringent" requirements for allowing ITCs were not met, and therefore ITCs were not available. Subsection 169(4) of the ETA and the Input Tax Credit Information (GST/HST) Regulations set out the documentary requirements necessary for an ITC claim, such as availability of proper receipts from the supplier. Although available records accurately depicted Heart Drop's purchases ($213,482) and sales ($276,286), no GST was in fact charged because the parties believed that the product was zero-rated and no GST registration number appeared on Strauss Herb's invoices, as required by subsection 169(4). In an informal decision, the TCC allowed the ITCs and characterized the situation as falling outside the "normal rules of collection and remittance of GST." The relevant question, the court said, was whether an honest but reasonable mistake had been made regarding the products' GST status. In taking this approach, other cases that found these documentation requirements to be mandatory may have been overlooked. (See, for example, *Helsi Construction Management Inc. v. R*, [2001] GSTC 39; aff'd. [2002] GSTC 113.)

The decision may at first appear to be a reasonable and proper interpretation of the interaction of subsections 296(2) and 169(4). Although some of the technical requirements in subsection 169(4) were clearly not met, the decision is consistent with a view that, rightly or wrongly, the provision was not meant to apply to situations where the minister must apply subsection 296(2). The facts in *Heart Drop* illustrate the dilemma well: if the products were understood to be zero-rated and no tax was payable on sales or purchases, there was no reason to attend to the technical requirements in subsection 169(4). The court was also undoubtedly motivated by an impression that the Crown's case "smack[ed] too much of having its cake and eating it too," inclining the court to "go directly to the right result without getting tied up in the legal niceties of whether a provision is mandatory or directory." However, it is also clear that the CCRA is then out of pocket a significant amount of GST: ultimately, the CCRA collected only about $18,000 in GST on Heart Drop's gross margin (the selling price less the cost of goods sold), a result clearly inconsistent with the GST framework. Heart Drop received full credit for the GST payable on its costs without its ever having been paid or remitted. Although the CCRA may assess Heart Drop's own supplier, Strauss, it would still be difficult to collect all the tax, especially in multi-level distribution chains. Furthermore, because Heart Drop did not actually pay the GST—the ITC was created merely because the GST became payable per subsection 169(1)—other provisions seem to dictate that the CCRA should have also assessed Heart Drop for not paying that GST. Given the requirements of the Act, the *Helsi* decision, and the anomalous result of giving credit for GST that was never paid or remitted, the decision may not withstand scrutiny. However, *Heart Drop* is an interesting example of how informal decisions will stretch to reach an equitable result.

On the due diligence defence, Heart Drop's owners had not paid GST when buying the product personally before assuming a distributorship. All but one of the hundreds of other distributors and Heart Drop accepted the supplier's assurances that the goods were zero-rated; the practice was widely accepted in the industry. Nonetheless, Heart Drop's owners contacted the CCRA by telephone twice and were informally advised that the product was zero-rated. Although Heart Drop did not seek independent professional advice, the court concluded without analysis that the due diligence defence against penalties was met, perhaps also a surprising result.

Robert G. Kreklewetz
Millar Wyslobicky Kreklewetz LLP, Toronto

2003 Quebec Budget and Ontario Double Tax Penalty

Quebec's newly elected Liberal government delivered its first budget on June 12, 2003. The budget reduces or eliminates many corporate tax credits and holidays and indicates the government's intention to retain certain measures announced in the previous government's budget of March 2003. Selected highlights of the new 2003 budget follow.

■ **Capital tax.** The capital tax rate reduction planned for calendar year 2004 and after is suspended. Rates remain at 1.2 percent for financial institutions and 0.6 percent for other corporations, but the general paid-up capital deduction of $250,000 increases to $600,000, effective after 2003.

■ **M & P equipment.** Incentives for new M & P equipment, computers, and certain other items used in Quebec are eliminated, as is the related two-year holiday from capital tax, for equipment acquired after June 12, 2003, with certain transitional relief. Those incentives included a special 100 percent accelerated depreciation writeoff, an additional 20 percent deduction, and a 25 percent supplementary deduction.

■ **Employee stock options.** The Quebec employee stock option deduction is reduced from 50 percent of the benefit to 37.5 percent for options exercised after June 12, 2003.

■ **Entertainment expenses.** The 50 percent of entertainment expenses deductible in calculating business income is capped at 1 percent of a taxpayer's annual sales, effective for tax years ending after June 12, 2003 and applying to all taxpayers. For income earned through a partnership, the 1 percent cap applies to the partnership.

Double tax problem for Ontario non-filing corporations. Corporations operating in Ontario 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. (See "Ontario Non-Filer Crackdown," *Canadian Tax Highlights*, May 2003.) Double taxation may result if a recipient corporation also operates in another province.

Assume that an active corporation (Opco), a CCPC with a December 31 year-end, established a permanent establishment (PE) in Manitoba in 1992. Over the years, Opco's business activities expand somewhat into Ontario. Opco is always profitable and always bonuses down to the $200,000 small business limit. Because Opco's activities are primarily in Manitoba and income allocable to Ontario represents a small portion of its annual $200,000 taxable income, Opco does not pay proper attention to whether an Ontario PE exists; in each year's federal tax return, Opco reports only Manitoba as a province in which it has a PE. Opco never files an Ontario tax return. In 2003, Opco receives an Ontario default-in-filing-returns notice for its 1996 to 2001 taxation years. Opco concedes that it had an Ontario PE during that period.

Opco's 1996 to 1998 taxation years are statute-barred for federal purposes and in the agreeing provinces; its 1999-2001 years remain open. When Opco files its Ontario returns, double taxation may result because some of the income taxed in Manitoba for its 1996 to 1998 taxation years is also allocated and taxed in Ontario. Double taxation relief may not be available because the CCRA cannot reassess to reduce Manitoba tax in statute-barred years.

Some double taxation disputes can be solved by the Tri-Party Review Allocation Committee (TRAC), which consists of the CCRA and the Ontario and Alberta ministries of finance. Quebec participates in the semi-annual meetings as an observer but generally adheres voluntarily to the committee's decisions. According to a CCRA technical interpretation (2002-0156735), the TRAC was established to prevent and resolve disputes caused by an allocation or reallocation of taxable corporate income earned in a province. The TRAC guidelines provide that none of the CCRA, Alberta, and Ontario may propose a reassessment based on a reallocation of taxable income earned in a province by a corporation for a taxation year that is statute-barred in the other relevant jurisdiction. Generally, Ontario does not assert its right to tax for statute-barred years if double taxation would arise, but it is not clear how this general policy applies on an original assessment if the problem arose from the taxpayer's failure to file returns.

Paul Hickey
KPMG LLP, Toronto

A Lease Is a Lease?

Editor's note: This article was originally published in slightly different form by Goodman & Carr LLP as a client advisory, and is reprinted here with permission.

In *Mimetix Pharmaceuticals*, the FCA recently concluded that it could not recharacterize a lease as a purchase because the lease in question did not contain an option or any other provision indicating such treatment (2003 DTC 5194). The FCA cited *Shell*, which held that there is no substance-over-form doctrine.

Mimetix leased a new Collette mixer from the manufacturer for over one year before acquiring it. The lease was a bare lease: there was no option to purchase or any other provision in the agreement that would allow it to purchase the mixer. The court found that the taxpayer was not entitled to a refundable scientific research tax credit, because the lease expense was not a prescribed expenditure, which includes a capital asset not used prior to its acquisition: the execution of a lease did not qualify as an acquisition.

The FCA seemed to imply that a court could recharacterize a lease as a purchase if the lease did contain an option to purchase or another provision lending itself to such a conclusion, a practice confirmed in a number of Canadian cases. The characterization of a lease option arrangement as a purchase transaction should be contrary to the basic principles of statutory interpretation, which emphasize reliance on the actual wording of the statute. As an example of such statutory interpretation, in *Darngavil Coal Company* ([1913] SC 602; 7 TC 1), for example, a British court held that each "rent payment" under a lease with an option to purchase that was not an FMV option should be broken down into a payment for the option to purchase, which was a capital payment, and a true rental payment, which was a deductible expense.

Shell was also cited by the CCRA as the reason for the 2000 withdrawal of *Interpretation Bulletin* IT-233R, which outlined assessing practice concerning when leases are considered sales. Many of the IT's comments directly conflicted with *Shell*; in particular, paragraph 3 set out four examples of supposed lease transactions that would be considered sales, of which the last two suggest a substance-over-form doctrine:

- the lessee automatically acquires title after payment of a specified amount in the form of rentals;
- the lessee is required to buy the property before or at lease-end or at the termination of the lease, or is required to guarantee that the lessor will receive the full option price from the lessee or third party (except where such guarantee is given only in respect of excess wear and tear inflicted by the lessee);
- the lessee has the right during or at the end of the lease to buy the property at an option price that at the lease's inception is substantially less than the probable fair market value at the time the option is exercised; or
- the lessee has the right during or at the end of the lease to buy the property at an option price or under terms

and conditions that at the lease's inception are such that no reasonable person would fail to exercise such option.

Under the CCRA's administrative practice, operating lease treatment was possible only if the option price estimated at the inception of the lease was representative of the property's FMV at the option date. Lessors and lessees had to be sure that the value was able to withstand scrutiny by the CCRA into the substance of the transaction. CCRA officials have indicated that the legal relationship between the parties to the contract determines whether there is a lease or a sale, not simply the document's self-referencing as a lease or a sale. Automatic ownership of the property after some rent is paid is viewed as a conditional sale or instalment sale and not as a lease. The CCRA states that its policy remains unchanged, and that it will continue to apply GAAR in circumstances viewed as abusive.

To date, reaction of industry groups to the IT's withdrawal has been mixed. Proponents suggest that the income tax classification will be more certain and less arbitrary, reducing pricing risk; opponents say that the removal of the bulletin's "bright line" rules creates more uncertainty and pricing risk. There will be a lengthy hiatus before a body of case law develops, and even then the emergence of practical, useful classification guidelines is not guaranteed. Costs for technical advice will mushroom, and a contrary interpretation could easily rupture the economics of a transaction. The lack of guidelines will increase the risk of uneven audit practices across the country. Transitional administrative costs to lessors may be significant in cases where the lease agreements are regularly customized and many different types of leases with different combinations of variables are written. Concern has also been expressed that the CCRA's position should be uniform across Canada vis-à-vis common law and civil law. *Mimetix* represents a first step in the development of a body of case law for the leasing industry since the withdrawal of IT-233R.

John Jakolev and Wolfe Goodman
Goodman & Carr LLP, Toronto

Income Deposit Securities

Over the last two years, Canadian publicly traded companies have acquired all or part of various US businesses using the tax-effective Canadian income trust structure. Concerns relating to US tax aspects motivated the development of income deposit securities (IDSs), a structure that may replace the income trust in the acquisition of US businesses. It is likely that IDSs will be used to sell primarily or entirely to US investors: a cross-border offering by a Canadian income trust would only add unnecessary complexity.

Canadian income trusts. To acquire a US target C corp such as Specialty Food Group or Axia, a Canadian mutual fund trust is formed and its units are listed on a Canadian stock exchange. About one-quarter of the trust's funds are invested in common shares through a string of corporations: a new Canco, a C corp (US Acquisitionco), and a new Nova Scotia unlimited liability company (NSULC). NSULC borrows the trust's remaining funds, generally at 12 to 14 percent. The trust distributes its income annually, eliminating its taxable income; the unitholders pay tax on the income received. NSULC invests in preferred shares of US Acquisitionco that yield dividends that are ignored for US tax purposes. NSULC ensures that the trust's loan is not a foreign investment for the Canadian pension fund investors.

US Acquisitionco generally borrows from a bank an amount equivalent to the funds raised by the trust, and then purchases and merges with the US target company. US Acquisitionco deducts the interest paid to the trust by NSULC (ignored for US purposes). For US tax purposes the Canadian trust is arguably a fixed investment trust or a grantor trust—also an ignored entity—because there is only one class of trust units and the trust cannot vary its investment in Canco. Because these entities are ignored and the Canadian mutual fund trust is widely held, no unitholder owns 10 percent or more of the trust; the US portfolio interest exemption is applicable to avoid US withholding tax. The earnings-stripping rules should not apply because the interest is not paid to a related person.

If a US partnership or LLC such as Heating Oil Partners or ACS Media LLC is acquired, the structure is simpler. The trust raises the funds in Canada and invests them in a Canco, one-quarter in shares and three-quarters in debt. Canco purchases the partnership or LLC membership interest and files both Canadian and US tax returns, deducting interest paid to the trust. The US withholding tax portfolio interest exemption applies, although in the case of a partnership or an LLC with more than one member, a 35 percent withholding is refunded if the interest expense eliminates Canco's income for US tax purposes.

These structures may attract IRS recharacterization of the debt as equity using the 15 or so factors established by US jurisprudence. Currently, US law firms are issuing opinions that the debt "should" be respected because that is the parties' intention and the form of the document; the debt's terms and the debt-to-equity ratio are not unreasonable; the debt is non-participating and non-convertible and does not entitle the holder to voting rights; and the trust has a creditor's rights. (Some trusts also may satisfy the redemption required to satisfy Canadian tax rules with part of the Canco note and shares, which then may be separately disposed of.) Several months ago, the IRS and Treasury initiated a meeting with tax professionals involved in these cross-border structures. Treasury and the IRS apparently have not completed their review of these transactions or defined the US tax consequences; at this time, there is no indication that they intend to issue any rulings or regulations or seek a legislative fix.

Further limitations arise because income trust units are not offered for sale in the United States. Canadian law also requires that Canadians hold a majority of the units. If US residents do hold units, creative structures may avoid the 15 percent Canadian withholding tax to a US investor on income distributions.

IDSs. A new structure in two recent public offerings for Canadian and US investors by Volume Services America Holdings Inc. and American Seafoods Inc. mirrors the economics of Canadian income trusts and may reduce the risk of debt recharacterization. Debt yielding a high rate of interest is moved to the corporate level to reduce or eliminate taxable income. An IDS—a common share and a portion of a subordinated note of a US Acquisitionco—is offered by a new US Acquisitionco listed on the TSE. The IDSs, but not the notes, are listed on a US and possibly a Canadian exchange. An IDS may be separately traded as shares and notes, which may be recombined to form IDSs; separation occurs automatically when the notes are repurchased or mature. The notes have a fixed term with possible renewals; interest accrues at a fixed rate, and is payable monthly or may be initially deferred up to 24 months. The IDS subscription price is allocated between shares and notes.

The US tax issues are simplified because investors hold the IDS directly. There is no fixed investment trust. US tax practitioners say that the separability of debt and equity lowers the debt recharacterization risk. A Canadian investor that owns less than 10 percent of the IDS's benefits from the portfolio interest exemption on the note and is not subject to US tax on a trading gain; dividends suffer a treaty-reduced 15 percent US withholding tax that is creditable against Canadian tax. In Canada, the interest received or receivable (including penalty or bonus on early debt repayment) is fully taxable, and one-half of any capital gain arising on the IDS's actual disposition or payment at maturity of the note is taxable. An IDS cannot reduce a unitholder's tax by structuring a portion of distributions as a return of capital, nor is it as attractive as a Canadian income trust to Canadian pensions, because it is foreign property.

All the structures require a substantial and regular payment of interest by the US business, thus sapping funds available for expansion. A Canadian income trust or a US company will sell additional trust or IDS units, respectively, to the public to finance an acquisition. In the latter case, for US securities purposes, each noteholder (in or outside an IDS) is deemed to have exchanged a portion of existing notes for new notes so that subordinated notes of each separate issuance are held in the same proportion by each holder. The deemed exchange is a disposition for Canadian holders and may result in a capital gain (loss) for Canadian tax purposes, based on a valuation of the new note relative to the tax cost of the original note or based on a foreign currency gain (loss). US holders do not generally recognize the exchange for US tax, unless the new notes feature an original issue discount; a gain (loss) is realized on a sale, exchange, or retirement of a note and if a note is held for more than one year, an individual is taxed at the reduced capital gain rate.

An IDS investment does not trigger Canadian FIE reporting by a Canadian holder; a foreign reporting information return may be required if the investment exceeds Cdn $100,000. A Canadian individual shareholder (and, if the portfolio interest exemption is denied, a Canadian individual noteholder) may be exposed to US estate tax.

Jack Bernstein and Barbara Worndl
Aird & Berlis LLP, Toronto

Authorized Foreign Banks

A 2001 technical bill introduced a regime of authorized foreign (schedule III) banks that may establish branches in Canada and carry on business here. The amendments were in part intended to relieve borrowers from part XIII withholding and remittance obligations related to interest on loans not originating in a foreign bank's Canadian branch. Draft regs of February 13, 2003 raise practical issues for authorized foreign banks.

Under the 2001 technical bill, effective June 28, 1999, an authorized foreign bank was deemed resident in Canada for part XIII purposes in respect of an amount paid or credited to or by it in respect of its Canadian banking business—that is, its business carried on through a Canadian branch, other than a business conducted through a representative office registered or required to be registered under section 509 of the Bank Act. (June 28, 1999 was the date on which foreign banks were first permitted to establish Canadian branches under the Bank Act.) The change did not amend the application of part XIII to interest paid on loans made directly by an authorized foreign bank and not through a Canadian branch.

Under current rules, the borrower must thus satisfy itself—generally by relying on the bank's representation—that the loan is in fact made through a Canadian branch. The draft amendments recognize the difficulty of requiring borrowers to determine that the loan is made through a Canadian branch, and they relieve Canadian-resident borrowers from the obligation to withhold and remit part XIII tax on interest paid or credited on loans made directly by the bank and not through a Canadian branch. 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

Canadian Tax Foundation
595 Bay Street, Suite 1200
Toronto, Canada M5G 2N5
Telephone: 416-599-0283
Facsimile: 416-599-9283
Internet: http://www.ctf.ca
E-mail: vmorgan@interlog.com
ISSN 1496-4422 (Online)

compliance obligations are thus shifted from the borrower to the authorized foreign bank, which must file an annual return in prescribed form disclosing its part XIII tax payable and pay that tax by the filing due date. The draft regs apply retroactively to taxation years of authorized foreign banks and Canadian-resident borrowers ending after June 27, 1999; a bank's prior years' returns are due six months after the draft regs come into force. Such banks are retroactively liable for any part XIII tax not withheld and remitted by a Canadian borrower in taxation years ending after the effective date, and they may be assessed for related interest and penalties; the borrower is relieved of such liability.

Many cross-border loans are not economic unless a part XIII tax exemption is available. However, the draft regs have practical implications for existing loan agreements where part XIII applies, and they may affect the drafting of future agreements in such cases. Many such loan agreements are drafted on the assumption that the borrower must withhold and remit part XIII tax: in order to indemnify the lender against any such tax, and to the extent that the borrower is obliged to withhold, the payment obligation is grossed up to eliminate the part XIII tax cost to the lender. Under the draft regs, the withholding obligation of the borrower ceases. Thus, the gross-up and indemnity clauses in existing loan agreements not made through a bank's Canadian branch may not be effective in protecting the bank against part XIII tax if the borrower's obligation to gross up the payment to the lender is predicated on its obligation to withhold and remit part XIII tax. When future agreements are drafted, the obligation to gross up and indemnify should, where necessary and possible, require the borrower to make additional payments so that the bank receives the same after-tax amount it would have received ex-part XIII tax, even though the borrower is not required to withhold and remit. The bank is thus left with adequate funds to pay its part XIII tax liability. It is understood from discussions with Finance that some banks have expressed concern over the retroactive nature of the draft amendments, which may be revised after the public consultation process.

Barry N. Segal
Ogilvy Renault, Toronto

FOREIGN TAX NEWS

OECD

A July 1, 2003 report of the Consumption Tax Technical Advisory Group, "Implementation Issues for Taxation of Electronic Commerce," suggests that tax collection problems be solved using technology. Cross-border delivery of services and intangibles to remote locations requires a new definition of place of consumption: the EU approach uses the place where the supplier is located, but the new VAT directive focuses on the customer's location for digitally delivered services. Compliance with audit requirements and retention of data are also problem areas. The report is available in the Foundation's library and on the OECD Web site.

Argentina

Proposed new legislation affects the uncontrolled import and export of tangible goods, provides a new transfer-pricing method and new thin capitalization rules, and extends tax haven rules. Imports and exports of tangible goods are priced according to public international prices from transparent markets to calculate Argentine-source income. Foreign exporters' income is foreign-source income and is not subject to withholding. In the absence of widely known international prices, parties must provide documentation that prices are set on a reasonable market basis; the new transfer-pricing methods apply when transactions do not meet an arm's-length standard or involve a foreign entity in a low-tax jurisdiction. Enforcement of new standards and methods is at the discretion of the Argentine Revenue Service.

Korea

The Ministry of Finance is proposing 10 years of tax advantages to foreign firms that invest in high-tech cultural industries such as digital media, online gaming, motion pictures, virtual reality, and graphic design, effective later this year. The first seven years are completely free from local and national taxes; the remaining three years are 50 percent exempt. There are no restrictions on company size or location.

Carol Mohammed
Canadian Tax Foundation, Toronto