CANADIAN TAX Highlights

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INTEREST DEDUCTIBILITY: CCRA

On August 14, 2003, the CCRA released for consultation a draft interpretation bulletin on interest deductibility and related issues. The draft IT, not yet an official document, contains the CCRA's interpretations and positions based on current law and cases. The February 2003 federal budget announced that Finance will amend the Act to make certain changes in this area, but because these changes have not yet been released, the draft does not reflect specific changes that Finance is likely to be considering. In general, the IT confirms the positions announced by the CCRA at the Foundation's 2002 annual conference and in subsequent technical releases and clarifications.

The 43-paragraph IT contains 13 examples and refers to 18 precedent-setting court cases in support of the CCRA's draft admin policies. The IT covers topics such as tracing, linking, and cash damming; borrowing to invest (relating to the SCC decision in *Ludco*); borrowing to acquire common shares; borrowing to redeem shares, return capital, or pay dividends; leveraged buyouts; loss utilization; debts issued at a premium; honouring guarantees; and comments on the following items.

■ **Discounts on commercial paper.** Paragraph 33, dealing with discounts arising on the issue of debt obligations, says that if money is borrowed with a stated interest rate and in consideration of a promise to pay a larger amount—that is, issued at a discount—the discount is not considered interest expense, the larger amount is the amount borrowed (subsection 20(2)), and full or partial deduction of the discount is allowed at repayment, depending on the extent of the discount (paragraph 20(1)(f)). If no interest rate is stated in the contract, the CCRA says that subsection 16(1) may apply, rendering an amount deemed interest on the obligation vis-à-vis both investor and issuer.

■ **Restructuring borrowings.** In accordance with the SCC decision in *Singleton*, the IT includes an example of how a taxpayer may restructure borrowings to make previously non-deductible interest deductible. Taxpayers can restructure borrowings and the ownership of assets to meet the direct use test for interest deductibility (paragraph 15).

■ **ITs replaced.** The finalized IT will replace five previous ITs: IT-80, "Interest on Money Borrowed To Redeem Shares"; IT-315, "Interest Expense Incurred for the Purposes of Winding-Up or Amalgamation"; IT-445, "Deduction of Interest on Funds Borrowed To Be Loaned at Less than a Reasonable Rate of Interest"; IT-498, "Deductibility of Interest on Money Borrowed To Reloan to Employees or Shareholders"; and IT-203, "Interest on Death Duties."

The CCRA advises that the draft IT's consultation period may be short. Professionals who are interested in reviewing the draft or providing comments should contact Paul Lynch, Director, Financial Industries Division, CCRA Income Tax Rulings Directorate, 16th floor, 320 Queen Street, Ottawa, Ontario K1A 0L5, or e-mail paul.lynch@ccra-adrc.gc.ca.

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US RRSP REPORTING REPRIEVE

The IRS recently reconsidered changes announced in April 2003 to its reporting requirements for US citizens and residents with Canadian RRSPs or RRIFs. These changes proposed increased reporting requirements and imposed heavy penalties for failure to comply. (See "US RRSP Reporting," *Canadian Tax Highlights*, May 2003.) Notice 2003-57 says that the IRS is working to implement a simplified reporting regime for future taxation years.

In Notice 2003-25, released on April 11, 2003, the IRS said that it would no longer waive the requirement for American RRSP holders to file forms 3520 (a report on transactions with a foreign trust) and 3520-A (an information return for US owners of a foreign trust) for 2002 and subsequent years. The deadline for filing these forms for 2002 was extended to August 15, 2003. Completion of these forms would require that some taxpayers complete significantly more paperwork for their US returns or face heavy penalties and US taxes for a failure to comply.

New notice 2003-57 acknowledges that RRSP holders should be given relief from reporting requirements for forms 3520 and 3520-A. These taxpayers are not required

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to file the forms for the 2002 tax year if they make or have made an appropriate election under the Canada-US treaty to defer the income in the plan and received no distribution from the plan during 2002. The new notice provides that if an RRSP or RRIF holder has filed form 3520 or 3520-A but has failed to provide all the appropriate information, the IRS may request this information. However, until the IRS makes such a request and the taxpayer then continues to fail to provide the information, no taxpayer who has filed the forms is subject to penalties. The notice also provides that if an individual filed his or her 2002 return on time but did not elect to defer tax on an RRSP or RRIF under the Canada-US treaty, he or she may so elect for the 2002 tax year by filing an amended 2002 return in the appropriate format until October 15, 2003.

The IRS appears to recognize that US citizens and residents with RRSPs and RRIFs may not have all the information required to complete their information returns. As a result, the new notice appears to protect taxpayers from severe penalties if they make reasonable efforts to complete the returns. If taxpayers are unable to obtain certain information, such as statements from the trustees of their plans, no penalties will be assessed unless such information is not provided following a specific request by the IRS. However, the notice seems to imply that taxpayers continue to face significant penalties if they do not attempt to comply with the filing obligations.

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Transfer Pricing: Admin

So far in 2003, the CCRA has issued several significant directives and policy documents, including one aimed at compliance with the contemporaneous documentation requirement and related penalties and others covering internal procedures for downward transfer-pricing adjustments, repatriation, and the Transfer Pricing Review Committee.

■ The subsection 247(4) directive to tax services offices (TSOs) is similar to an initiative launched by the IRS: it requires auditors to issue a formal contemporaneous documentation request at the initial stage of each audit. The request must be hand-delivered or sent by registered mail in the form of a letter or a query sheet. It requires taxpayers to provide transfer-pricing documentation within a three-month period with no extensions allowed (paragraph 247(4)(c)). A taxpayer who fails to provide the documentation within that period is deemed not to have made reasonable efforts to determine and use arm's-length transfer prices and is thus exposed to penalties and to a more stringent audit process. If the audit results in an adjustment in excess of domestic penalty thresholds, a transfer-pricing penalty is assessed. The shift in the CCRA's strategy represented by this directive may have been influenced by the US initiative as well as by criticism in the auditor general's report that transfer-pricing reviews and document requests arising late in the audit process cause delays in concluding audits. The CCRA's formerly collaborative approach seems to be growing more assertive. Previously, paragraph 247(4)(c) was assumed to be a tool that enabled the CCRA to deal with taxpayers that failed to voluntarily comply with requests for transfer-pricing documentation. This shift in strategy is likely to render the audit process more adversarial, but it is also probably meant to pressure taxpayers to prepare contemporaneous documentation before an audit begins.

■ A CCRA policy document issued on March 18, 2003 outlines internal procedures to deal with downward transfer-pricing adjustments that result in a reduction of income or an increase in expenses of a Canadian taxpayer. Subsection 247(10) precludes the assessment of a downward adjustment unless the minister considers it appropriate, an authority that has been delegated to the local TSO or the International Tax Directorate (ITD). The new policy document requires that downward adjustments below $500,000 be referred to the TSO; other adjustments must be referred to the ITD director general. The $500,000 threshold may be increased in order to shift additional responsibility to local TSOs.

When the CCRA submits such a referral, information must also be provided with respect to the amount of the adjustment, the relevant tax years, the relationship between the parties, a description of the facts, any taxpayer representations, and the method of repatriation. On a taxpayer-initiated request, the local TSO will assess the reasonability of the request and will indicate to the TSO director or the ITD director general whether the request should be approved. Taxpayers must indicate the method of repatriation chosen to provide the related party with the funds resulting from any change. The ITD director general will notify the foreign jurisdiction's tax authorities of any adjustment to ensure that a corresponding adjustment is made to increase the foreign taxpayer's income. The policy document does not deal with downward adjustments initiated by parties other than the taxpayer or the CCRA, such as those resulting from an audit initiative of a foreign tax authority.

Taxpayers are well advised to take note of these documentation requirements and their stringent application and the new instructions related to downward adjustments. In particular, a taxpayer who waits for an auditor's formal request before beginning the process of obtaining transfer-pricing studies or updating information for taxation years that are open is unlikely to obtain complete documentation by the end of the three-month deadline. Although the transfer-pricing legislation has not been amended, its administration by the CCRA (including the activities of the Transfer Pricing Review Committee, which now has cases before it for penalty consideration) may continue to undergo modification and may thus warrant monitoring.

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WINNERS AND LOSERS

The economics of federalism does not permit the determination of a single bottom-line figure for the benefits of belonging to a federation. The gain or loss from operations of the federal government is most often used (and sometimes abused) as a proxy for the effect of membership in a federal country. In Canada, Statistics Canada's *Provincial Economic Accounts* provides the basis for calculating that net cost or benefit from our federal system.

The federal surplus or deficit indicates how much more the central government puts into (through spending) or takes out of (in revenues) each province. However, to assume that that federal surplus or deficit represents the net benefit of confederation ignores the importance of maintaining the country as an entity that allows, for example, the pooling of expenses, a larger market, and specialization by region. Non-economic aspects of federalism, such as protection of minority groups, are equally important but even more difficult to quantify. The table shows the federal surplus or deficit by province for the calendar year 2000, the latest year for which data are available. Federal income tax revenues are distributed by province according to the conventions used in the Income Tax Act, GST revenues according to personal spending by province, and customs and excise revenue according to the province where the CCRA collected the levies. Such allocations may not reflect reality: the customs and excise formula, for example, ignores the fact that goods may be imported through Vancouver (and customs duties paid there) for distribution across the country. On the spending side, there are other compromises. Federal government services, such as national defence, may be valuable to all citizens, but spending may be concentrated in one or two provinces, as measured by federal wages and salaries paid or goods and services purchased by province.

Nevertheless, this rough-and-ready indicator shows that for 2000 federal revenues exceeded federal spending in only three provinces: Ontario, Alberta, and British Columbia.

Federal Surplus or Deficit, by Province, 2000

	$ million	As a % of GDPP
Newfoundland	–2,569	–18.7
Prince Edward Island	–702	–20.7
Nova Scotia	–3,798	–15.7
New Brunswick	–2,627	–13.1
Quebec	–2,292	–1.0
Ontario	27,995	6.5
Manitoba	–2,548	–7.6
Saskatchewan	–1,788	–5.3
Alberta	7,499	5.2
British Columbia	3,128	2.4
Total surplus/average	17,750	1.7

The surplus built up in those provinces was sufficient to cover the federal deficits in the other seven provinces and provide for an overall surplus of nearly $18 billion. The relative importance of the federal balance in each provincial economy is indicated in the second column of the table, which measures the federal surplus or deficit, as a rough measure of the cost or benefit of confederation, as a percentage of gross domestic provincial product.

The federal surplus lowers the net benefit or raises the net cost of confederation. If that surplus were removed, the deficits (net benefits) in the seven provinces would be larger, and the surplus (net cost) in the other three would be smaller. As the federal government increased its surplus in the years from 2000 to 2003, the effect would have been pronounced. For a province such as Quebec, where the balance is small relative to its size, the larger federal surplus could easily switch the balance from benefit to cost.

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TINs FOR FIRPTA FILINGS

Final and temporary regs issued on August 4, 2003 by the IRS require foreign transferors of US real property interests (USRPIs) to provide taxpayer identification numbers (TINs) on withholding tax returns, applications for withholding certificates, and other Code section 897 and 1445 notices and elections. The regs are effective for dispositions occurring after November 3, 2003.

Under section 897, the so-called FIRPTA rules, a foreign transferor of a USRPI is generally taxed on the gain from the disposition as if the taxpayer was engaged in a US trade or business and the gain was effectively connected with the trade or business. USRPIs include interests in real property located in the United States and any interest (other than an interest solely as a creditor) in any US corporation that was a US real property holding corporation at any time during the five years ending on the disposition date. A gain from a USRPI's disposition is subject to tax at normal US individual and corporate tax rates.

To ensure collection of the tax, the transferee generally must withhold 10 percent of the amount realized on the disposition and report and remit the tax withheld along with form 8288 (US Withholding Tax Return for Dispositions by Foreign Persons of the USRPIs) by the 20th day after the USRPI's disposition (section 1445). The foreign transferor must also report the gain by filing a US income tax return for the year of transfer; the transferor receives credit against his US tax liability for any amounts withheld at the time of the transfer and a refund for any excess. Section 1445 withholding can be reduced or eliminated by virtue of various non-recognition provisions, an applicable US income tax treaty, or the tax-exempt status of the foreign transferor, or by obtaining a withholding certificate in cases where the transferor's actual tax liability on the disposition would be less than the withholding tax.

Under the prior section 6109 regs, a foreign person was not required to include a TIN on a return, statement, or other document unless the person (1) had income effectively connected with the conduct of a US trade or business at any time during the tax year, (2) had a US office, place of business, or fiscal or paying agent during the tax year, (3) had filed a tax return, an amended return, or a refund claim, excluding information returns, statements, or other documents, (4) is treated as a resident under section 6013(g) or (h) or makes an election under regulation 301.7701-3(c), or (5) furnishes a withholding certificate pursuant to the section 1441 regs (W-8BEN). The new regs require TINs on returns, statements, and other documents under sections 897 and 1445. Under the new regs, the application for a withholding certificate, notice, or election is considered incomplete and generally will not be processed by the IRS until the transferor's TIN is provided. Even if a TIN is not provided, amounts withheld under section 1445 must still be reported and paid to the IRS on form 8288 and form 8288-A, but a stamped receipt will no longer be issued and mailed to the transferor.

The IRS says that the change requiring a TIN from a foreign transferor will facilitate the identification of foreign taxpayers and more easily match applications, withholding tax returns, notices, and elections with the transferor's income tax return. In many cases, the foreign taxpayer already has a TIN; if not, the IRS emphasizes that the new regs merely accelerate the time for obtaining a TIN, because a TIN is required to file an income tax return reporting the gain for the year of the USRPI's disposition. Commentators have expressed concern about the time required for a non-resident alien to obtain a TIN and the impact on the timing of transactions. The IRS is exploring approaches to address that concern, such as implementing a program to process applications for a TIN and withholding certificates simultaneously. The need to obtain a TIN generally should not delay the time to obtain a withholding certificate.

The final and temporary regs also allow the foreign transferor to provide the transferee with notice of non-recognition that can be relied upon to forgo withholding on the simultaneous exchange of like-kind USRPIs if there is no boot, because that exchange is completed on the day of the exchange. This rule does not apply to a deferred like-kind exchange because the transferee cannot be assured that section 1031 non-recognition treatment applies: the exchange is not complete because the taxpayer has 45 days after the transfer to identify replacement property. However, the transferee may withhold a reduced amount based on a claim of non-recognition upon receipt of a withholding certificate. The IRS continues to believe that notices of non-recognition are not appropriate in such deferred exchanges, and the regs thus do not permit notices of non-recognition on such exchanges. Commentators have proposed that such notices should be permitted if a "claim of intent" to engage in a section 1031 qualifying non-recognition exchange is provided.

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Rent from Movables: The Norway Treaty

The fact that Canadian withholding tax often applies if rent is paid by the Canadian lessee to a non-resident for an asset used in Canada is a major impediment to cross-border leasing. If withholding tax applies to the gross rent, a lease is not economic for the parties involved. The CCRA recently confirmed that rental payments made by a resident of Canada to a resident of Norway for the use of movable property in offshore activities in Canada (including bareboat rental arrangements) are exempt from Canadian tax under the "new" Canada-Norway treaty, provided that the Norwegian lessor does not carry on the leasing activities through a permanent establishment (PE) in Canada.

Certain rents paid to non-residents—such as rents for aircraft and certain railway rolling stock—are withholding-tax-exempt under Canadian domestic rules, but treaty-based relief from Canadian withholding tax on lease payments continues to be very limited. Most tax treaties define royalties to include rental payments, but the royalty definition under the old Canada-Norway treaty did not include rent payments, and no other article in that treaty specifically referred to rental payments on movable property. Norway was one of the few "zero-rate" withholding tax solutions for a foreign lessor because the CCRA's assessing policy was not to require withholding on the rent payments, which were considered to fall into business profits if the amounts were received by the Norwegian lessor as part of its Norwegian business activities.

Under Canadian domestic law, rental payments for the use in Canada of any property made by a Canadian resident to the Norwegian resident can be taxed under part I (pursuant to subsections 2(3) and 115(1) of the Income Tax Act) if the Norwegian resident carries on a business in Canada. If the Norwegian resident does not carry on a business through a PE in Canada, rental payments made by a Canadian resident are subject to a 25 percent withholding tax under part XIII unless the tax is either reduced or eliminated under the treaty. Generally, rental payments received by a corporation resident in Norway from a Canadian resident for the use of movable property fall under treaty article 7 (business profits) unless such payments are covered by another article—in particular, article 12 (royalties) or article 21 (offshore activities). If article 7 does apply, such payments are exempt from tax in Canada unless the Norwegian resident carries on business in Canada through a PE. The definition of "royalties" in article 12 does not include rents paid for the use of movable property, and consequently that article does not apply to the payments.

Pursuant to article 21, a Norwegian resident who carries on activities in Canada in connection with the exploration or exploitation of the seabed and subsoil and their natural resources is deemed to be carrying on a business in Canada through a PE or a fixed base situated therein. This provision only requires that the Norwegian resident carry on activities in connection with the exploration and exploitation of the natural resources of Canada, which appears to set a lower threshold than carrying on a business. However, those activities must be in connection with the exploration or exploitation of the seabed and subsoil and their natural resources. The CCRA was of the view that the Norwegian resident is not considered to carry on activities in Canada in connection with the exploration or exploitation of the seabed and subsoil and their natural resources if the Norwegian resident's only activity is the rental of movable property used in offshore activities in Canada. In such a case, the Norwegian resident is not deemed to carry on a business in Canada through a PE under article 21 in relation to his rental activities.

Norway continues to be a viable zero-withholding leasing solution for foreign lessors that do not have US-based operations where US tax capacity is to be used. A US lessor with US tax capacity that wants to lease into Canada typically forms a Nova Scotia unlimited liability company (NSULC), which becomes the tax owner of equipment to be leased to the Canadian lessee. The Canadian withholding tax issue is solved because, from a Canadian perspective, the lease payment flows from the Canadian lessee to another Canadian taxpayer; because the NSULC is disregarded for US tax purposes, depreciation benefits flow through to the US owner.

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What Is Information?

The FCA's decision in *Kitsch* reverses the FCTD, finding that the minister may demand answers to questions posed in a requirement letter issued under subsection 231.2(1). The FCA also confirmed that a tax accountant-client privilege should not be recognized (2003 DTC 5540 and 2002 DTC 7315, respectively).

Subsection 231.2(1) authorizes the minister to deliver a notice (a requirement letter) requiring the recipient to provide any information, including returns, and any document. The letter may be issued for any purpose related to the administration or enforcement of the Act, including collection. A requirement letter that is part of a "genuine and serious" inquiry into the tax liability of any specific person is valid, at least in the context of the civil administration and enforcement of the Act. The letter may demand information pertaining to the tax liability of the recipient or another taxpayer, and must stipulate a reasonable time for compliance (30 days is standard). A requirement letter is a serious matter: failure to comply is a summary conviction offence, punishable by fine, imprisonment, or both. A requirement letter is thus an extremely powerful audit tool that enables the minister to compel the production of information and documents under the threat of prosecution.

In *Kitsch*, BDO Dunwoody prepared an emigration tax plan for Mr. Tower and others that involved reducing income from deemed emigration gains by substantial deductible interest expense incurred in the emigration year. The deductions prompted an audit. During the course of the audit, requirement letters were issued to Dunwoody demanding a broad range of documents, including all of its planning files relating to the clients and answers to questions related to the reasons for the pre-emigration borrowing.

Dunwoody sought an order excusing it from compliance with the requirement letter on the basis that the information sought was protected by a tax accountant-client privilege; alternatively, Dunwoody argued, the letter was invalid to the extent of the demand for answers to questions as opposed to documents. The FCTD rejected the claim for privilege but held that subsection 231.2(1) only authorized a demand for documents: use of the requirement letter as a "written interrogatory" was not permitted.

The FCA held that the rule permitted the minister to demand responses to questions: paragraph (a) entitled the minister to require information in addition to the documents under paragraph (b). Unless "information" was interpreted as having a meaning distinct from "document," the word would be redundant or rendered meaningless. The FCA accepted a dictionary definition of "information" as "facts or knowledge provided or learned as a result of research or study." Under the Act, "document" was defined to include "money, security or record," and "record" was defined as, generally, any tangible thing that conveys information. The FCA concluded that a requirement letter could be used to compel the production of knowledge or facts in response to questions posed by the minister. The FCA maintained its recent position in *Baron* that a tax accountant-client privilege should not be recognized to prevent disclosure of the information sought in the requirement letter (91 DTC 5055).

Although the *Kitsch* requirement letter was probably not the first ministerial demand for responses to questions, the decision may embolden the minister to increase the frequency and number of "written interrogatories." Unless the information demanded is protected by a recognized privilege, professional advisers who receive a requirement letter must comply, whether or not they will be paid for preparing the response and even if they no longer act for the client. Considering and responding to questions may involve a substantial amount of work. At least some comfort can be taken from the minister's concession in *Kitsch* that if the recipient did not possess the information demanded, an answer to that effect amounted to compliance with the requirement letter, apparently obviating the need to conduct investigations or research in order to acquire the information demanded.

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NY Anti-PIC Rules

The New York state budget for fiscal year 2003-4, which passed on May 15, 2003 notwithstanding an override by Governor Pataki, included legislation adopting anti-PIC (passive investment company) provisions that require taxpayers to add back certain interest and royalties paid to related parties. The amendment to NY Tax Law section 208 potentially affects some financing structures employed by Canadian companies with US business activities.

Effective for tax years beginning in 2003, the new law disallows a deduction for royalties and interest paid by a New York taxpayer to certain related parties (at least 30 percent common ownership) unless a taxpayer can prove a predominantly non-tax-avoidance business purpose—defined as a meaningful change in the taxpayer's economic position—and arm's-length pricing. To sustain the deductibility of related-party interest associated with many intercompany financing structures, the related member must fund the intercompany lending through unrelated third-party borrowings or prove that the debt is part of a regular and systematic funds management or portfolio investment activity.

The new law supplements an arsenal of weapons to challenge perceived tax abuses. New York already has broad authority to force combined filings with taxpayers and non-taxpayers, although US and Canadian corporations cannot be combined. In addition, several prominent examples in recent New York tax jurisprudence disallow related-party expense predicated on a lack of arm's-length pricing. Related-party structures that were already vulnerable to challenge by the New York tax authorities are probably more exposed now. Traditional royalty company structures and internal leveraging structures not involving third-party debt are likely not to satisfy the business purpose requirement and thus not to be deductible. Tax practitioners generally view the new law as poorly drafted; additional legislation expected this fall may provide some relief by narrowing the addback of interest, but it may further restrict the application of some of the new exemptions.

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NCA Valuation

Valuators are often confronted with the need to allocate the value of a business enterprise to individual assets. One of the more common and difficult intangibles to value is a non-compete agreement (NCA) executed in connection with a business's sale.

The shift from a manufacturing to a service economy heightens the importance of the relationship between service providers and the customer to the business's success. Owners with trade secrets essential to a better manufacturing process or specialized market and product development knowledge are critical to a business's ongoing value. A purchaser will want to ensure a smooth transition of relationships to the new owner and maintain trade secrets. An NCA requires that the seller not compete in the same industry, in a specific territory, and for a specified period after the sale in exchange for appropriate compensation. The FCA decision in *Manrell*, which broadens the *Fortino*-based tax-free status of certain non-compete payments, renders an NCA's structure and quantum extremely important to the seller. It is not yet known whether Finance intends to seek a legislative fix to rectify its loss in *Manrell*.

An NCA's value is an allocated portion of the overall purchase price of the shares or business assets. The value of the covenant is not in addition to the value of the business, but rather is part of it; without an NCA, the value of the business to a buyer may be greatly diminished. The NCA's value reflects the confidential information or client contacts that, without protection, would place business goodwill in jeopardy; the covenant is in part the measure of the value of key management (workforce in place) included in the valuation. Thus, a reasonable portion of the purchase price must be allocated to the NCA. In the absence of such reasonable allocation, the CCRA will apply section 68 to make such an allocation (doc. no. 9800145).

When an NCA is valued, the overall FMV of the company or business is determined on the assumption that the seller will willingly sign an NCA. Pre-tax earnings over the economic life of the agreement are established on the assumption that there is no discount for a restrictive agreement. After the seller's ability to re-enter the market and effectively compete with the company is evaluated, an estimate is made of pre-tax earnings that would be lost over the NCA's term if such an eventuality occurred. This process quantifies the profits attributable solely to the seller or the profits that would be lost if the seller did compete in each year of the NCA. The probability of competition in each year of the agreement is estimated and applied to the lost profits attributable to the seller. Those probable lost profits for each year of the NCA are present-valued using a discount factor such as the company's weighted average cost of capital.

To determine the probability of the seller's presenting a real and likely threat of competition without an NCA, one must evaluate his health and physical condition; his financial resources and technical knowledge; his ability to hire away key employees or contractors; his reputation in the business; his referral network or other ability to obtain business from past and existing customers or new business with the resulting impediments to future growth; his intention to retire, move, or otherwise leave the market; and his propensity to work for a competitor. The existence of other limitations on the seller's ability to compete, such as a franchise agreement or a patent, should be evaluated. A consulting or employment contract may nullify any reasonable ability to compete. A legal opinion as to whether the NCA is validly constituted and binding in scope, time, and geographical extent may be warranted.

The NCA should specifically and clearly separate amounts and conditions relating to it as distinct from the general agreement of purchase and sale. The value attributed to the NCA should be reasonable and substantiated by proper documentation. Care should be taken to avoid negating the effect of the NCA with conflicting consulting or employment contracts.

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Non-Residents in Real Estate: Part 2

Last month's issue reviewed corporate vehicles for investment in Canadian real estate; trust and partnership alternatives are discussed below.

Trust. A trust is a personal trust if the beneficiaries do not pay for their interest; otherwise, it is a commercial trust. For example, a non-resident may gift cash to a trust formed for the benefit of non-resident beneficiaries (such as children) and use the settled funds to acquire property. A non-Canadian trust is not a unit trust for Canadian tax purposes.

Trust income is calculated as if the trust is an individual; the trust is taxed at about 43 percent. A deduction is available for income paid or payable to a beneficiary, unless a trust is not resident in Canada throughout the year. Generally, a trust is resident where a majority of its trustees reside, or where a person other than a trustee exercises a substantial portion of management and control (IT-447). The CCRA also accepts the possibility of a trust's dual residence, a concept rejected in *Thibodeau Family Trust* (78 DTC 6376).

A resident trust is subject to a 36 percent part XII.2 tax on designated trust income payable to any beneficiary, deductible from part I taxable income, unless the trustee certifies that there were no designated beneficiaries in that year. A designated beneficiary is a non-resident, including a tax-exempt entity. Designated income is income from a business carried on in Canada or income from Canadian real property, including gains from dispositions thereof. Income distributions to US residents are subject to 15 percent withholding tax.

Effective January 1, 2003, a non-resident trust may be deemed to be a Canadian resident if the trust has either a resident contributor (generally, a person resident in

Canada who directly or indirectly makes a gift, loan, or transfer of property to a non-resident trust) or a resident beneficiary (a Canadian-resident beneficiary unless the trust qualified as an immigration trust).

A trust is often attractive because it is not subject to provincial capital tax, LCT, thin capitalization rules, or branch tax. A trust that earns income from property is arguably not subject to provincial tax but does not qualify for federal abatement.

A transfer of property from a commercial trust to a beneficiary is deemed to occur at FMV, and the beneficiary suffers a deemed disposition of his or her trust interest at that FMV. A personal trust is subject to a deemed disposition on its 21st anniversary.

If a non-resident pays or credits an amount to another non-resident, the payer is deemed resident for withholding-tax purposes for the amount deductible in computing its taxable income earned in Canada. Similarly, a deductible amount paid by a non-resident as interest on a mortgage secured by Canadian real property is subject to Canadian withholding tax.

If a non-resident trust earns income from property only, interest on beneficiaries' loans that are not secured by Canadian property is deductible under a section 216 net election and not subject to withholding. Withholding tax must be paid on interest related to a rental property in the year of sale.

Treaty relief may apply if a non-resident trust is not carrying on business in Canada and an unrelated pension fund beneficiary receives interest from the trust. A non-resident pension may also apply for the domestic exemption from withholding.

It may be advantageous for US beneficiaries of a US trust to check the box so that the trust income is taxable in their hands and not the trust's. Whether a trust beneficiary is liable for the trust's liabilities if its units are not publicly traded is unresolved in Canada. The risk may be partially overcome by obtaining appropriate liability insurance and by stipulating in all contracts that recourse lies only to trust property, or by making a non-Canadian limited partnership the non-resident trust's beneficiary. A Delaware business trust benefits from limited liability.

Non-Canadian partnership. If a non-resident partnership that holds Canadian real estate carries on a business, its US corporate partners bear part I tax, Canadian branch tax, LCT, and provincial capital tax. Whether a business is carried on is generally dependent on the number of services that are provided: minimal services normally required by a tenant may indicate income from property. There is some concern that a partnership presumes the carrying on of a business, but the CCRA appears to concede that a partnership may earn income from property.

An individual partner is taxed at progressive rates up to a maximum of approximately 43 percent. A non-resident partnership that pays deductible interest to a non-resident is deemed to be a resident and must remit withholding tax on the payment. Ten percent withholding applies on interest payable to a US recipient, which should be entitled to a foreign tax credit if taxable.

A US pension fund is treaty-exempt from Canadian tax on dividends or interest from an unrelated Canadian entity, but no special treatment applies for recapture or capital gains realized on the sale of a Canadian property. The CCRA will look through a partnership and allow the treaty exemption for the proportion of the partnership income allocable to a tax-exempt partner.

Rental losses under the section 216 net election cannot be carried forward, but a non-resident partnership carrying on business in Canada may carry forward losses. Debt financing should be structured so that an annual rental loss is not triggered. A non-resident partnership that earns property income but that does not file the net election suffers withholding tax on any payment to it by a Canadian resident; if the partnership carries on business in Canada, withholding may not apply if the appropriate CCRA waiver is obtained.

The thin capitalization rules do not apply. Whether interest payments to the non-resident partners by the partnership are payments of interest rather than a distribution of partnership income may be an issue, because only the former are deductible to the partnership.

A resident partner suffers a capital gain if the property is refinanced and surplus funds are distributed to the partners, because a Canadian-resident partner cannot have a negative adjusted cost base in its partnership interest. This is often a problem if a partnership has both US and Canadian partners.

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Foreign Tax News

United States

Final transfer-pricing regs, effective August 26, 2003, provide guidance on the treatment of stock-based compensation in connection with qualified cost-sharing arrangements (QCSAs); such compensation and stock options are included in a QCSA participant's contribution.

United Kingdom

A second consultation paper outlines revised corporate tax reform proposals; comments are invited by November 2003. Domestic proposals include the following: (1) a

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company's accounts will serve as the starting point for computing capital and profits; (2) in lieu of taxing source income, all income or trading and real estate income will be pooled; (3) options for pooling income and capital profits and losses will be considered; (4) the distinction between trading and investment companies will be removed; (5) commercial depreciation rates will replace capital allowances; (6) accelerated depreciation will serve as an incentive in cases of market failure; and (7) rollover relief may extend to investment property. Changes to international transactions include the following: (1) transfer-pricing rules will extend to domestic transactions; (2) thin capitalization rules will change from a group to a company-by-company basis, and excessive interest payments may not be recharacterized as dividends; and (3) CFC capital gains may be taxed.

Denmark

In response to an EU directive, draft legislation proposes changes to the thin capitalization rules, the withholding tax on interest, and the exit tax. On an intercompany loan between two domestic companies, the interest is not recognized as income or expense; a Danish creditor is tax-exempt on such interest if the non-Danish debtor is denied a deduction in its home state in accordance with the relevant treaty. A Danish debtor of a foreign creditor may deduct interest if it has a minimum 4:1 debt:equity ratio, and if the non-Danish creditor is subject to withholding tax on interest and is taxable thereon without relief in an EU-member state (a rule that cannot be circumvented by refinancing with a non-Danish group). A 30 percent withholding tax may be relieved under a Danish tax treaty or the EU interest and royalty directive. Effective January 1, 2004, changes to the exit tax eliminate the provision of security and the payment of interest if tax is deferred on a move to another EU-member or Nordic state.

France

On September 1, 2003, proposed income tax cuts to create jobs and encourage economic development were reaffirmed. Tax rates will decrease by one percentage point this year and next.

Republic of Korea

Business-friendly tax reform includes lowering the corporate tax rate for small- and medium-sized business to 10 percent from 12 percent and removing tax exemptions; removing excise taxes on luxury goods; and lowering the minimum investment for tax breaks for foreign investors from US $50 million to between US $10 million and US $30 million and reducing the exemption's duration from 10 years to between 5 and 7 years.

To increase foreign investment and the importation of technology, entities eligible for the foreign investment tax exemption are expanded by 29 types of high-tech businesses and 46 types of manufacturing businesses. Foreign investment in such businesses is corporate-income-tax-exempt for the first seven years and half-taxable for the next three years.

Russia

New procedures apply for the registration of foreign legal entities: all identification numbers and codes of foreign legal entities (CFLEs) must be reissued. From October 1, 2003, tax authorities will maintain a new CFLE database: by the end of December 2004, all foreign entities must apply for a new certificate of registration to obtain a new CFLE and TIN. Selective tax audits will be made during the reregistration period.

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