CANADIAN TAX *Highlights*

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FINANCE ON FA PROPOSALS

At the Foundation's 2003 annual conference, Finance's Wallace Conway and Brian Mustard discussed selected modifications being considered to the December 20, 2002 foreign affiliate (FA) proposals.

■ **Internal dispositions of excluded-property FA shares.** (Subsections 93(1.4)-(1.6) and regs 5902(7) and 5907(5.1)-(5.3).) Finance is concerned that existing law allows internal transfers of FAs to be effected (usually in combination with a third-party sale) to increase surplus amounts and ACBs—for example, a doubling up—in cases contrary to tax policy. The subsection 93(1.4) proposal denies excluded-property status for FAs disposed of in internal transfers by converting such gains into FAPI gains. To prevent the use of pre-acquisition surplus distributions to circumvent the proposal, it will be expanded to include negative ACB gains under subsection 40(3). Mandatory FAPI treatment for gains flowing from the loss of excluded-property status is acknowledged to be unreasonably harsh, and Finance is considering allowing the transfer to occur on a rollover basis: the transferor's proceeds equal the ACB unless it elects out and treats the gain as FAPI (one cannot elect into a loss). Such a rollover is available even if the disposing FA receives all cash. This is a welcome modification, but it increases the rules' complexity and creates double taxation pitfalls due to the surplus and carryover basis implications. Consistent with concerns over duplicating surplus, the disposing FA does not increase any surplus on a disposition treated as a rollover. Distribution complications may arise when no surplus bump supports the underlying FMV proceeds received: absent a 50 percent ES increase, a dividend distribution by the disposing FA may be out of TS or pre-acquisition surplus. If the disposing FA pays a cash dividend, the recipient FA shareholder's ACB may fall below zero to trigger a subsection 40(3) gain that could in turn trigger subsection 93(1.4) again. If the disposing FA's stock ceases to be excluded property as a result of the FA sale, the FA shareholder's gain is FAPI: amended subsection 93(1.4) only saves gains from FA stock that is otherwise excluded property. There was some confusion about the surplus treatment if the subsection 93(1.4) gain is FAPI: in many cases, the proposed surplus rollover regs (5907(5.1)-(5.3)) could apply to yield both FAPI and no corresponding surplus increase, an oversight that will be amended. An elected FAPI gain under subsection 93(1.4) will result in appropriate ES and TS increases.

Because surplus increases in the disposing FA are to be suspended until such time as the transferred FA is disposed of in an arm's-length transaction, surplus implications may be realized if the internal transfer is part of a two-step arm's-length disposition. Some issues remain unresolved: for example, whether the purchasing FA gets carryover ACB and how to deal with subsequent changes in value of the transferred FAs.

■ **Potential modifications to subsection 93(1) elections.** If an FA that is disposed of has subs that are also FAs to the taxpayer's FAs, the maximum net surplus available for the election will be computed by aggregating all surpluses and deficits on a "consolidated" basis, including lower-tier deficits. Any surplus recognized by the disposing FA under subsection 93(1) will be relieved from the surplus accounts of the FAs being disposed of; it is hoped that a taxpayer electing less than the maximum will have discretion in allocating the adjustments. Where surplus has been relieved in one of the disposing FAs, the shareholder FA's ACB is bumped on a decrease and ground if a deficit is reduced. In tandem with these proposed changes, Finance may abandon proposed reg 5902(7), which limited access to lower-tier surplus in a subsection 93(1) election covered by subsection 93(1.4).

All the internal transfer changes above apply to transactions after the announcement date for the proposals' next release, anticipated before year-end. Taxpayers may elect to retroactively apply the to-be-released proposals as of December 20, 2002, and still use the current subsection 93(1) rules for external dispositions from that time until the new announcement date.

■ **Reg 5907(5.1) now applies to excluded property other than FA stock.** The "subject-to-tax" requirement in reg 5907(5.3) will be eliminated: the surplus rollover rule applies even if the transferor FA is subject to tax, but not to dispositions at arm's length or in the ordinary course of the FA's business, regardless of the purchaser's relationship to the vendor. Thus, internal dispositions remain subject

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to this surplus rollover rule whether or not the disposing FA pays tax on the transfer.

■ **Interaffiliate lending (clause 95(2)(a)(ii)(D)).** The rule applies if a borrowing FA uses loan proceeds to acquire the stock of another FA situated in the same country. The proposals substantially revised this rule, and because of concerns over the amending language, Finance indicates that it may drop the test that ensures that the interest expense is relevant in computing the income tax liability of the consolidated group in that country. Taxpayers say that the test (subclause VI) is unnecessary and introduces practical concerns if, for example, the group has in a year a small amount of FAPI and a nominal amount of income from an active business. However, because of Finance's concerns with exempt deficits, the second FA (the borrower) may need to push down the exempt deficit caused by the interest expense to the third FA, the targetco.

■ **Other changes under consideration.** Finance speculated on changes to (1) the "more than five full-time employees" test in the investment business definition, (2) the regulation of banking activity under the investment business definition, and (3) the fresh-start rules, as well as on splitting off certain proposals from the global section 95 as separate elections (clause 95(2)(a)(ii)(D)).

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US Foreign Partner Withholding

New proposed regs revise withholding tax rules for a partnership with non-US partners that are engaged in US trade or business. The regs supplement earlier guidance requiring a partnership to withhold and remit tax on net income connected to a US enterprise and allocable to foreign partners (Rev. proc. 89-31, amended 92-66). The withholding rate is still the highest marginal rate, currently 35 percent for foreign corporations and 38.6 percent for individuals. The proposed regs apply to partnership taxable years beginning after the date the regs are published as final.

The regs attempt to reduce paperwork burdens by having taxpayers follow Code section 1441 to determine the status of partners as foreign or domestic. A partnership must obtain one of the following forms from each partner: form W-8BEN, Certificate of Foreign Status of Beneficial Owner for US Tax Withholding; form W-8IMY, Certificate of Foreign Intermediary, Flow-Through Entity, or Certain US Branches for United States Tax Withholding; or form W-9, Request for Taxpayer Identification Number and Certification, a form used for partners that are US persons, including US-resident aliens. Failure to obtain one of these forms gives rise to a rebuttable presumption of foreign status, and withholding is necessary; the partnership may then show evidence, if any, that it has correctly characterized the partner as non-foreign.

The regs also contain rules for computing effectively connected taxable income (ECTI) allocated to foreign partners under an aggregate approach. A partnership first determines the ECTI—effectively connected partnership items—allocable to each foreign partner, and then aggregates all ECTI allocable to all foreign partners. The amount to be withheld is based on the aggregate ECTI.

Consistent with Rev. proc. 89-31, the regs follow the withholding and reporting regime set forth in section 6655 regarding estimated tax payments for corporations: a partnership must annualize ECTI or apply a safe harbour and make the payments in quarterly instalments. The method now addresses seasonal income of a partnership electing to annualize. A partnership that uses the safe habour approach need not file form 1065, US Return of Partnership Income, or form 8804, Annual Return for Partnership Withholding Tax, at the time an instalment is made, if these forms are later timely filed.

Since the enactment of section 1446 (which requires the withholding of tax on foreign partners), practitioners and taxpayers have commented on the potential for overwithholding relative to a foreign partner's actual tax liability for a taxable year. For example, the rule does not take into account a partner's losses from outside the partnership during the year or loss carryovers, and withholding is fixed at the maximum statutory rates generally applicable to a foreign partner with effectively connected income. The proposed regs mitigate overwithholding in the case of tiered partnerships. Thus, if a foreign partnership (upper-tier partnership) is a partner in a second partnership (lower-tier partnership) subject to withholding, in some circumstances where documentation requirements are met, the lower-tier partnership may look through the upper tier and determine its withholding tax obligation based on the status of its indirect partners, which may be US persons not subject to withholding. This rule is meant to ensure that the withholding tax paid by the partnership more closely approximates the actual tax liability of the ECTI's beneficial owners. In other circumstances, however, foreign partners must still file a US tax return to obtain a refund of overpayments.

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Non-Compete Payments: GST

In analyzing the GST status of a supply, one must examine issues such as whether the supply is made in the course of a commercial activity, the place of supply (Canada or a harmonized province), and the nature of the supply (property or a service). The FCA recently dealt with the proper characterization of a non-competition payment (NCP) for income tax purposes in *Manrell*, and concluded that the appellant "did not have an exclusive right to do something that no one else had, his right was a general right to carry on business, which is the right of anyone and therefore not the property of anyone." What remains unclear is the impact on the CCRA's GST analysis of NCPs: their categorization or GST status.

Pre-*Manrell*, the CCRA commented on the GST status of NCPs in two non-confidential rulings dealing with individual shareholders who sold their interests in a company and also received money for agreeing not to compete with the company for a period. Both rulings concluded that although a non-competition agreement is considered to be a supply, it was not taxable for GST/HST purposes because it was not made by the individual in the course of a commercial activity. A commercial activity is broadly defined as a business carried on by a person or an adventure or concern in the nature of trade. On the facts, the individual shareholder had no other sources of commercial activity either before or after the sale. The CCRA did say, however, that a non-competition agreement may be a taxable supply if, for example, the NCP was made to a corporation or a sole proprietor already involved in a commercial activity. Unfortunately, neither ruling dealt with the issue of classifying taxable NCPs, an exercise necessary to determine both the place of supply and the ultimate application of tax in the context of a sale of business assets.

At a recent CCRA round table discussion, CCRA representatives said that notwithstanding *Manrell*, a conclusion had not yet been reached as to whether the supply of an NCP is one of property or a service for GST/HST purposes. They did, however, confirm orally that classification as property or service is moot if an NCP is made to an individual shareholder not otherwise involved in commercial activity, because such a payment continues to be viewed as non-taxable.

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[Editor's note: An October 7, 2003 Finance release indicates that NCPs received or receivable after that date will be taxable for income tax purposes except for NCPs received before 2005 pursuant to a written agreement made on or before that date between arm's-length parties.]

A Lot Off the Top

When complaints about high tax rates were at their zenith in the early 1990s, the top marginal rates were substantially lower than they had been 30 years earlier. Tax cutting from 1995 to 2000 brought in Canada's lowest marginal personal income tax rates since the Second World War, but the change did little to lower the overall burden of personal income tax in relation to gross domestic product.

Combined Federal and Provincial Top Marginal Rates

	Personal income tax, selected years				
	2003	1994	1993	1983	1973
	percent				
Newfoundland	48.64	51.30	51.30	54.40	63.92
Prince Edward Island	47.37	50.30	50.30	51.85	63.92
Nova Scotia	47.34	53.80	50.30	53.21	65.10
New Brunswick	46.84	51.40	50.70	53.72	66.51
Quebec	48.22	52.90	50.50	60.40	63.72
Ontario	46.41	53.20	50.70	50.73	61.34
Manitoba	46.40	50.40	50.40	56.03	66.98
Saskaskatchewan	44.00	51.90	51.90	53.42	65.80
Alberta	39.00	46.10	46.10	47.09	63.92
British Columbia	43.70	54.20	54.20	50.46	61.34
Yukon	42.40	46.50	46.50	49.98	61.10
Northwest Territories	42.05	44.40	44.40	49.98	61.10
Nunavut	40.50				
Federal	29.00	31.30	31.30	34.00	47.00

Just after the massive tax reform exercise of 1971-72, the top marginal rate in most provinces came between 61 and 64 percent, as shown in the table, and began at $60,000 of income. There was not a wide range of rates across the country: Manitoba had the highest rate at nearly 67 percent, while Ontario, British Columbia, and the territories had the lowest at 61 percent. By 1983, the top rates had dropped, and the threshold also dropped to slightly over $56,000. The highest rate was in Quebec (60.4 percent), and the lowest in Alberta (47.1 percent).

A number of increases occurred between 1993 and 1994, the recent high point. In 1994, British Columbia had the highest top marginal rate, 54.2 percent, and the Northwest Territories the lowest, 44.4 percent. The top federal rates took effect at incomes of about $59,000, but provincial surtaxes took effect at income levels from $30,000 to nearly $100,000. The changes over the last eight years have been dramatic. This year, no top marginal rate is above 50 percent. The highest, in Quebec, is 48.2 percent on taxable income over $54,000; the lowest, in Alberta, is 39.0 percent on income over $103,000.

Thirty years ago, high marginal tax rates were generally accepted, albeit at income brackets that, when adjusted for inflation, were substantially higher than today's. As the tax system changed, the rate schedules flattened and the range of provincial rates broadened. In 1973, combined federal and provincial top rates ranged up to 10 percent higher, but never lower, than the rate charged by the federal government on non-residents. In 2003, combined rates range from 13 percent above to 9 percent below that benchmark used by the federal government.

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Normal Course Dividends

Recently in *CanUtilities* (2001-4026, 2001-4030 (IT)G), the TCC held that subsection 55(2) did not recast deemed dividends as proceeds of disposition to yield capital gains treatment because they were subject to part IV tax. The part IV exception prevailed because the normal course dividends, which triggered a part IV tax refund, were not part of the same series of transactions and events that resulted in the deemed dividends.

The transactions facilitated the taxpayers' disposition of a publicly listed Canadian company: the taxpayers, CU and CU Holdings (two Cancos), paid refundable part IV tax on subsection 84(3) deemed dividends instead of substantial part I tax on unrealized gains on the shares. Regular or normal course dividends paid in that same year triggered full recovery of the part IV tax. The part IV exception to subsection 55(2) requires that the deemed dividend be subject to part IV tax, unless it is refunded because the deemed dividend's recipient pays a dividend to a corporation (the corporation dividends requirement) and that dividend payment is part of the same series of transactions and events that resulted in the deemed dividend receipts (the series requirement).

The TCC clarified that the series requirement refers to the series at the beginning of subsection 55(2)—that is, the series of transactions or events as part of which a corporation has received a taxable dividend, deductible under subsection 112(1). That base series of transactions to carry out the disposition did not include the normal course dividends. To so attach the normal course dividends to the base series, under subsection 248(10), there must be a series of transactions within the common law meaning and a transaction related thereto must be completed in contemplation of that series (*OSFC*, 2001 FCA 260). The latter test was not met by the normal course dividends: their payment demonstrated no intent to link them with the base series to achieve a particular result.

The TCC turned to the English House of Lords decision in *Furniss v. Dawson* ([1984] AC 474, as approved in *OSFC*) to determine whether a transaction is a part of a series under the common law and decided that the normal course dividends clearly did not form part of the base series. However, a reliance on the normal course dividends' certainty called for further examination. The TCC was satisfied that a paid-up capital allocation as a distinct event in the base series took into account the normal course dividends, and its primary purpose was to avoid a capital gain and thus eliminate taxes on the sale of the target's shares. But the TCC ultimately said that the reliance on the normal course dividends did not attach them to the base series at common law. Regarding the PUC allocation, the TCC said:

> The paid-up capital of a corporation's shares can be reallocated on amalgamation. I attribute no pejorative connotation to transactions that shift paid-up capital amongst different classes of shares. Shareholders come and go. New shares can be issued and/or cancelled at various times at varying prices. The Act makes no attempt to trace capital accounts to particular shareholders. Shifting paid-up capital accounts is a tax planning tool and there is no reason in a case like this that paid-up capital allocations would not be factored into fine-tuning the amalgamation agreement as a tax planning consideration or if it otherwise helped ensure that the sale to Forest would be approved.

The TCC said in obiter that the corporate dividends requirement was not met because the normal course dividends were paid to both corporations and individuals. The taxpayers prevailed in their argument that the dividends paid to individuals accounted for the full part IV refunds, although the CCRA argued that the dividends paid to corporations accounted for the full refund or at least part of it.

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CCRA Round Table, Part 1

The CCRA round table session at the Foundation's 2003 annual conference covered several topical issues affecting corporations and other businesses, generally reaffirming already well-known positions. The panel comprised two tax practitioners and two CCRA officials, Paul Lynch and Daryl Boychuk. The highlights that follow are based on notes taken at the oral presentations; official papers and documents will be released by the government in due course.

In-house loss utilization. The CCRA confirmed its longstanding acceptance of transactions designed to achieve tax loss consolidation within an affiliated corporate group, provided that they are legally effective, comply with the provisions of the Act, and do not offend stop-loss rules such as subsections 69(11) and 111(4) to (5.2). GAAR will not apply.

An advance income tax ruling request for such transactions must include a summary of losses and income for all affiliated corporations, a summary of planned loss applications to specified years, and assurances that tax losses will not be refreshed beyond the normal carryforward period.

Daylight loans to finance intercompany loans between a lossco and profitco must be commercially reasonable (see ATR no. 44): the size and the time frame of the loans cannot be "blatantly artificial," a charge most quickly dispelled by the taxpayer's obtaining a commitment letter from a financial institution confirming how much, and the terms on which, the corporation could borrow.

The CCRA confirmed that it has provided rulings in "upstream shareholding" situations such as *CRB Logging* if the acquiror has sufficient assets other than target shares to generate income to pay dividends on the upstream preferred shares.

Partnerships' allocation of income. The CCRA reaffirmed that remuneration paid to a partner is not deductible in computing partnership income: a partner is a participant in the business, not an employee, because legally a person cannot contract with himself or herself. Similarly, the CCRA says that legally a partner cannot lend to the partnership. The CCRA will thus not follow the TCC's informal procedure decision in *Archbold*, which allowed a deduction for a partner's draw of salary, to which section 24 of the Ontario Partnership Act offered no legal impediment. The CCRA said that the permissive stance of the applicable provincial partnership act did not establish tax deductibility. Asked if there were any exceptions, the CCRA said that a deduction is generally available, for example, for remuneration related to services performed by a partner but not qua partner and other than in the course of the partnership's business or activities: the partner must "step out of his shoes of being a partner" and carry on a new business. For example, a 1997 ruling said that a qualified limited partnership could deduct under section 9 a management fee paid to a general partner for managing a partnership. The fee was not considered an allocation of partnership income (doc. no. 9711923).

In regard to partnership "preference units" (the holder is entitled to a preferential share of partnership profits or losses), if there are no legal impediments to the issuance of the units, the CCRA may apply the anti-avoidance rule in section 103 to upset the income allocation if the partnership interests carry different entitlements.

Withholding tax: new loan. In *General Electric Capital*, the FCA held that changes to three of four fundamental terms of promissory notes—principal amount, interest rate, and maturity date—represented substantial modifications and created new debt obligations. Thus, the five-year principal repayment exception in subparagraph 212(1)(b)(vii) was no longer met, triggering withholding on the interest paid to non-residents.

As outlined in *Income Tax Technical News* no. 14 (December 1998), if the terms of a renegotiated debt obligation are changed from the original, whether the change is a substitution of one debt for another is determined by the relevant provincial law. Most issued rulings on these modifications—such as those made to defer interest and amend security—conclude that no new debt obligation is created. When asked how the postamble to paragraph 212(1)(b) applies to debts that contain provisions for interest rate adjustments based on financial statement earnings before interest, taxes, depreciation, and amortization (EBITDA), the CCRA replied that the postamble is very broad and could catch such adjustments, but it could give no specific responses due to the absence of ruling requests on this issue and rate adjustments based on credit risk.

Prepaid income. Prepaid income falls into income under paragraph 12(1)(a) or subsection 9(1). Generally, the former requires the inclusion of a receipt that relates to services not rendered or goods not delivered before year-end, although a paragraph 20(1)(m) reserve may be claimed. Subsection 9(1) generally provides that a taxpayer's income for a business or property for a taxation year is the profit therefrom, without any related reserve. If both provisions apply, the CCRA allows a taxpayer to use the former and claim a reserve except if a taxpayer's actions have been substantially performed at the time of the receipt of the prepayment or shortly thereafter; if there are no restrictions to retaining the prepayment even if the services or goods are not provided; or if subsection 9(1) provides a truer picture of income.

Tax-avoidance update. The CCRA confirmed that it is currently examining several areas of tax-avoidance concern, including treaty shopping; surplus stripping and dividend stripping; foreign property in deferred income plans; indirect loans; offshore spousal trusts; and tower financing structures. In another panel discussion, Ian MacGregor, Assistant Deputy Attorney General, Department of Justice, indicated that the following GAAR issues are in the courts: avoiding section 80; part I.3 tax reduction; surplus and dividend stripping; misuse of exempt surplus rules; disallowance of interest expense; improper access to CCA; purchase of partnership losses; part XIII tax avoidance; and treaty shopping. The CCRA is particularly concerned about treaty shopping—any transaction establishing residence in a country to take advantage of its tax treaties—and will seek to deny treaty benefits based on article 1 of the OECD model treaty commentary and/or on GAAR.

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CCRA Round Table, Part 2

The CCRA round table session at the Foundation's 2003 annual conference covered several topical issues affecting individuals: in some cases, the CCRA reaffirmed its already well-known positions but it also announced some new administrative positions. The highlights that follow are based on notes taken at the oral presentations; any uncertainty should be resolved by reference to official papers and documents that the government will release in due course.

Shareholder-manager remuneration. The CCRA confirmed that generally it will not challenge the reasonableness of salary or bonus paid to a CCPC's Canadian-resident shareholder-manager who is active in its operating business, a policy intended to provide shareholder-managers with flexibility in tax planning, certainty of tax consequences, and the ability to take advantage of integration. (See the round table discussions at the 2001 and 1984 conferences, page 39:12 and question 81 at page 839, respectively, and "Integration Update," *Canadian Tax Highlights*, August 2003.) The CCRA does not consider certain types of income to fall within its general policy, such as extraordinary income realized from the sale of the company's assets; investment income earned by an investment holding company; funds derived from management fees or dividends flowed through a complex corporate structure; and funds derived from pre-CCPC-status business operations by a company that recently achieved CCPC status. Situations not within the policy will be considered on their own merits. The particular facts and circumstances will determine whether the salary or bonus's reasonableness will be challenged under section 67.

Social security taxes and foreign tax credits. Effective for 2004 and subsequent years, the CCRA will no longer allow a foreign tax credit (FTC) for social security taxes paid to foreign countries, but the applicable treaty may specifically allow a credit. In accordance with the TCC's informal procedure decision in *Yates* (2001 DTC 761), a tax is defined as a levy applied for a public purpose; social security taxes, which ultimately give rise to an economic benefit, cannot be said to be so levied. IT-122R2 is slated for cancellation, and a technical newsletter outlining this policy change will follow.

Although social security taxes are generally not classified as an income or profits tax, the CCRA had allowed US, German, and French social security taxes to be so treated for the purposes of subsection 126(1) FTC calculations: a Canadian taxpayer with foreign-source income may claim such credits against Canadian tax paid thereon. US social security tax (FICA) is creditable pursuant to article XXIV(2) of the Canada-US treaty, and consequently its creditability is not changed. FTCs for French and German social security taxes as non-business income tax have been allowed administratively as a result of several technical interpretations, at least one of which reasons that French social security contributions are creditable because they are similar to US and German contributions and are mandatory.

Pre-judgment interest. The CCRA reversed its longstanding and well-documented administrative position and said that pre-judgment interest related to an award for wrongful dismissal is taxable in the same manner as the damages—that is, as employment income or a retiring allowance. Pre-judgment interest is classified as such by the courts or under the terms of a settlement agreement, payable for the time between the emergence of the cause of action and receipt of the damages. Post-judgment interest, payable from the date of the award to the actual payment, has always been taxable as interest income. This new policy will apply in 2004, giving taxpayers three months to adjust. Pre-judgment interest relating to awards for personal injury or death and retroactive workers' compensation payments continue to be non-taxable because the underlying awards are not taxable.

Restricted farm losses. In the recent decisions in *Kroeker* and *Taylor* (2002 DTC 7436 and 7596, respectively), the taxpayers had full-time jobs, but the FCA found that the time, labour, and capital devoted to farming were sufficient to render the farm losses fully deductible. The CCRA said that its approach is consistent with the FCA's: the taxpayer's farm income is compared with other sources to determine whether it is the taxpayer's chief source of income either alone or in combination with employment income. The CCRA considers three factors: time spent, capital invested, and potential profitability of farm operations; as in *Kroeker* and *Taylor,* time spent and capital invested tend to have more significance if the taxpayers have a farming history.

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LEVERAGE LEASE UPDATE

■ **Railcars.** Over the years, some tax practitioners have expressed concern whether a bonus 6 percent CCA was available to a Canadian lessor on a cross-border leveraged railcar lease of railcar assets that originated outside Canada and then were leased to a foreign lessee. The issue was whether the railcars were "leased in Canada" as required under reg 1101(5)(d). A technical interpretation recently confirmed that the lessee need not use the railway cars in Canada or be a Canadian resident; however, the lessor must be a Canadian-resident taxpayer and report all income derived from the leasing in Canada, and the railway cars must be leased under an agreement negotiated, executed, and administered in Canada under the laws of a province in Canada.

Cross-border railcar leases are attractive to Canadian lessors: railcars are exempt property under reg 1100(1.13), and thus are not subject to the specified leasing property (SLP) rules. The SLP rules restrict CCA to the lessor, who must split the lease payment received into separate interest and principal elements, and CCA is limited to the lesser of the principal received and the CCA available if the leased property was not SLP. Whether or not the SLP rules apply, CCA and other deductions may be limited by the net income rule, unless the Canadian lessor is a principal business leasing corporation (reg 1100(16)). Railcars are included in class 35 and are depreciable at a rate of 7 percent; each such property rented, leased, or used by the taxpayer in Canada in the taxation year falls into a separate class, and an additional 6 percent CCA applies (regs 1100(1)(z.1a) and 1101(5d)(f)).

On the facts, a Canadian lessor (Canco) purchased railcars from an arm's-length US vendor (USco) and leased them on a head lease to a UK-resident special purpose company (UKco), which subleased the railcars back to USco, which dealt at arm's length with UKco. The sublease was negotiated, executed, and administered in Canada under the laws of Ontario. USco sub-subleased the railcars to the Canadian branch of another US corporation, which further subleased the railcars to various Canadian end users for use in Canada and the United States.

■ **Software.** *CIT Financial* involved a cross-border leveraged lease structured in the usual fashion. At issue were a CCA claim on software acquired in 1993, the application of GAAR, the software's FMV, and the reasonableness of the CCA claim under section 67. The taxpayer was Commcorp Financial Services, one of a number of predecessors amalgamated to form CIT (formerly Newcourt Financial). The software was first sold by a steel company resident in New Zealand to an arm's-length NZ company (MLL), which sold it to a numbered company (Numco) that was formed for the purposes of granting security and that was not at arm's length with CIT. The software was sold by Numco to CIT, which subleased and licensed it to the original vendor through a series of transactions. Various defeasance transactions were also executed. The software was a unique and specialized package developed by the vendor to run its New Zealand steel mill.

The TCC reduced CIT's class 12 CCA claim to $13.1 million from about $34.1 million (including transaction fees). The parties were directed to prepare a draft judgment incorporating the court's conclusions. Of particular interest is the TCC's analysis of evidence of various valuation methodologies used to value the software: unfortunately for the taxpayer, a letter sent by a lawyer on the vendor's behalf to New Zealand tax authorities "stuck out like a sore thumb": it fixed the software development costs at $7.4 million only a month before the sale. After considering other evidence from valuators, the court added a 70 percent "slippage factor" to arrive at a value of about $13.1 million. Tax practitioners might consider expanding their list of vendor reps and warranties to ensure that such compromising information does not exist when they negotiate a purchase of high-value assets.

The court also said that section 67 does not add further tests, given that section 69 applies to the non-arm's-length purchase. It was conceded that the transaction was an avoidance transaction, but GAAR is a weapon of last resort to be used when the (series of) transactions results in a misuse of the Act's provisions or an abuse of the Act read as a whole. GAAR does not "subsume or encompass the other sections of the Act, nor is it a substitute for them": the abuse was readily counteracted by section 69, and "therefore section 245 need not be resorted to nor does it have application."

The definition of FMV traditionally accepted in Canadian courts has been the highest price available in an open and unrestricted market between informed and prudent parties acting at arm's length and under no compulsion to act, expressed in terms of cash. The definition generally adopted by the US courts is the cash, or cash equivalent, price at which property would change hands between a willing buyer and a willing seller, both being adequately informed of the relevant facts and neither being compelled to buy or sell. Although CIT conceded that it acquired the software from Numco, a non-arm's-length person, that company was formed not for tax purposes but only to grant security in the leased assets. CIT contended that the FMV was about $33 million at the acquisition date: the initial purchase and sale involved two arm's-length parties—the original vendor and another party, MLL—and there was hard bargaining on the price. Only a scintilla of time elapsed between the initial sale and when the taxpayer acquired the software from Numco. The apparently damning letter to the New Zealand tax authorities spoke to the software's development costs, which did not necessarily reflect or limit its FMV. These facts do not seem to have influenced the court's decision. It is not yet known whether the case will be appealed.

■ **Trailers.** The CCRA has decided to appeal *Canada Trustco* (2002-1155(IT)(G)). (See "Cross-Border Sale Leasebacks," *Canadian Tax Highlights*, June 2003.)

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Agent, Principal, or Broker?

The TCC informal procedure decision in *Dick Irwin* illustrates the GST's complex handling of agents and the potential traps. Generally, a person acting on his or her own account—as principal—is obliged to charge, collect, and remit the GST; an agent may be obliged to collect the tax, but the actual GST accounting is left to the principal. But there are some important exceptions.

Richard Irwin was the vice president of the Dick Irwin Group (DIG), a yacht broker involved in the resale of preowned yachts. Through DIG, Mr. Irwin agreed to sell vendors' boats; DIG was authorized to contract and sell for a specified price, and to use due diligence to find purchasers for the vessels, boarding and showing the vessels to prospective purchasers. At the bottom of the purchase and sale agreement form, in the area signed by the vendor, DIG's commission was referred to as "paid to the Broker as my/our agent."

The CCRA assumed that DIG was selling the vessels as an agent on behalf of the owners, who were not required to collect GST on the sales, probably because they were not used in commercial activities, or were otherwise small suppliers. Excise Tax Act section 177 deems, in these circumstances, a taxable supply to exist between the agent and the ultimate purchaser: the agent must charge tax to the purchaser on the full sales price even though the principal acting directly would not. The CCRA assessed DIG for underreported GST of $106,622.29, plus penalty and interest. Was DIG the vendors' agent? The TCC concluded, on the first principles of agency law, that DIG was not the sort of agent contemplated by section 177, but was a broker, a more restricted form of agency. Citing Fridman's *Law of Agency*, the TCC noted that brokers are agents that are not given possession of goods or documents of title, and though they may negotiate sales, they are not generally expected to sell in their own name. Section 177 "describes a person who 'is making the supply on behalf of the principal,' . . . not . . . a broker." A section 177 agent's collecting of tax is "perfectly logical respecting an agent who has possession of the goods and receives the payment of consideration for the sale of goods. It is not logical respecting a broker such as [DIG] who is not 'intrusted' to fix terms, to have possession, to receive payment for, and to execute a transfer of the goods. . . . In other words, a broker is not an agent within the meaning of [section] 177 . . . because he does not make a supply."

The decision may be logically sound, but it adds yet another layer of complexity to the treatment of an agent for GST purposes. The tax policy underlying section 177 is not clear. Under the old rules, if a registered but undisclosed agent sold goods on behalf of an unregistered principal, the purchaser may have viewed the undisclosed agent as a registered vendor that failed to charge and collect tax. Section 177 may have been intended to remove this confusion and require all agents to collect tax. *Dick Irwin* does not disturb that putative tax policy, because the broker is always disclosed, but it makes broker situations a bit more complex for taxpayers and practitioners. It is also worth noting that section 177 is aimed only at agents selling tangible personal property, and does not apply to sales of real property or services; other special rules also exist for auctioneers.

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US Tax Opinions

Although Canada and the United States share a common language, Canadian tax practitioners involved in US cross-border transactions quickly learn that US tax opinion letters differ from their Canadian counterparts in terminology and expectations. Canadian tax practitioners often need to interpret the strength of a US opinion and may receive more or less pressure to adopt similar terminology in drafting the related Canadian opinion. The sometimes subtle differences between "will," "strong should," "should," "more likely than not," and "arguably" opinions must be appreciated.

A paper on the range of legal opinions, given at an American Bar Association meeting last year, queried whether a lawyer acts as haruspex or a bookie in offering a legal opinion, the essence of which is a prediction of the likely outcome of litigation. Tax opinions are sought in both public and private transactions. Public offerings and reorganizations and financings often are supported by legal opinions. A tax opinion is based typically on a set of facts and assumptions and an analysis of legislation, proposed amendments, jurisprudence, and known administrative practice. Often the level of opinion is a matter of negotiation between the adviser who writes the opinion and the person who requests it.

"Arguably" indicates the weakest level of opinion and is given when the client asks counsel to find an argument for an aggressive position: for example, a client may attempt to justify a deduction or a transaction implemented before he sought advice, or he may take a position contrary to known administrative practice. The argument must have some legal basis. The term may suggest a likelihood of success between 5 and 10 percent, or less than 20 percent. A "more likely than not" opinion means a more than 50 percent chance of success based on substantial authority that may include jurisprudence and administrative positions; the case law may be conflicting, and there is significant doubt. (In Canada, clients are accustomed to receiving "will" or "should" opinions, albeit subject to caveats; the "more likely than not" opinion has not received acceptance.) "Not entirely free from doubt" may be a slightly higher level of opinion than "more likely than not." The "should" opinion, often used in tax shelter investments, suggests a 70 to 80 percent chance of success and rests on a reasonable argument for a probable outcome; a degree of certainty is implied, but some uncertainty prevents the delivery of a "will" opinion. For non-tax opinions, a "would" opinion has the same meaning as "should." A "strong should" opinion may represent an 81 to 89 percent chance of success. A "will" opinion is the strongest level of certainty: the legislation is clear, or there is high court authority that is undisputed and based on materially the

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same facts as those underlying the opinion. A "will" opinion is clean and unqualified and implies a 90 to 100 percent chance of success.

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Foreign Tax News

Treaties

The treaty with **Kuwait** entered into force on August 26, 2003, effective after 2002 for withholding taxes on amounts paid or credited to non-residents and, for other taxes, for taxable periods beginning on or after 2002. A treaty with **Senegal** entered into force on October 7, 2003, effective for withholding taxes after 2003 and for other taxes for taxable periods beginning after 2002.

On October 8, 2003, a new treaty was signed with **Ireland** that will fully replace the existing treaty. Withholding tax is 5 percent for dividends between affiliated companies, 15 percent for all others, and 10 percent on dividends. Exemptions exist for certain royalties on copyright, patents, and computer software and for information concerning industrial, commercial, or scientific experience. The treaty is effective in Canada for withholding tax on or after the first day of January in the calendar year next following the year of entry into force, and for other taxes, for taxation years beginning on or after that January 1. In Ireland the treaty has effect for income tax and capital gains tax for any year of assessment beginning on or after that January 1 and for corporation tax for any financial year beginning on or after that day. The treaty enters into force when the countries notify each other that ratification has taken place.

United States

In the absence of a published methodology for the foreign currency exchange advance pricing agreement (APA) taxpayer self-testing and reporting, the IRS had done the testing. At a recent TEI conference, the IRS explained a method for testing and reporting that is now the taxpayer's burden and must be reported in its annual report. The testing is done by comparing the related-party interbranch allocation to uncontrolled transactions closest in time. The APA defines which currencies are covered. The differences between controlled and uncontrolled are based on a standard deviation. The IRS will randomly select 35 days in the year to test these transactions.

OECD

By year-end or early 2004, working party no. 6 of the Committee on Fiscal Affairs will release new transfer-pricing guidelines regarding stock options, focusing on employee stock options from a parent to a foreign affiliate. The working party is also dealing with a review of the profit method and practical difficulties of application; attribution of profits to a permanent establishment (PE); application of the 1995 transfer-pricing guidelines to electronic commerce business models; cross-border financial transactions; thin capitalization; intragroup loans; and a project to improve dispute resolution.

The OECD Council did not agree on draft recommendations for improving access to bank information for tax purposes because there was no consensus thereon in the 2003 progress report of the Committee on Fiscal Affairs. Twenty-eight member countries agreed to a definition of tax fraud, and 26 agreed to take appropriate measures to achieve "access to bank information in order to verify tax liabilities" by December 31, 2005.

North Korea

A new industrial complex will be completed in 2007. The complex will provide investment opportunities with corporate tax advantages. Foreign firms investing in the area are subject to a 14 percent tax rate (10 percent for investment in social overhead capital, light industry, and high technology) and no taxes on insurance payments and capital gains from bank deposits in the industrial zone. A 15-year commitment to the area generates a 5-year tax exemption from the first profitable year and a 50 percent tax cut for 3 more years. Incentives are conditional on the foreign company's deducting 15 percent from Korean employees' wages for social security. Foreign firms will be liable for standard property, financial transaction, inheritance, and sales taxes.

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