Canadian Tax Highlights

Editor: Vivien Morgan, LL.B.

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US Pressures on Canadian Customs Exemptions

A US Senate resolution of September 18, 2003 (S. Res. 119) calls on the US administration to discuss with its NAFTA partners, Canada and Mexico, ways to harmonize their personal exemption allowances for customs purposes at or above the current US level.

The personal exemption allowance is the value of goods that Canadians are permitted to import duty- (and GST-) free when returning from trips abroad. The current Canadian exemptions are (1) for a visit abroad of a minimum duration of 24 hours, $50; (2) for 48 hours, $200; and (3) for 7 days, $750. (Under the 24-hour rule, if more than $50 worth of goods is imported, the entire amount is subject to duties and taxes.) Tobacco is not included, but alcohol is. The US Senate resolution aims to pressure Canada and Mexico to raise their personal exemption allowances to US levels and ultimately to harmonize their systems. US personal exemptions are currently US$800 for a trip lasting over 48 hours and US$200 otherwise.

The issue is of particular importance for Canadian and American border-state businesses, but all Canadians have a vested interest in the outcome. An increase may be timely in Canada, where the last major change to exemptions occurred in 1995. But Mexico may set up roadblocks because it offers even smaller exemptions than Canada and imposes different rules for residents returning by car or airplane. The different exemptions and approaches undoubtedly do ultimately act as trade barriers and are therefore a legitimate target for NAFTA action.

Robert G. Kreklewetz
Millar Wyslobicky Kreklewetz LLP, Toronto

In This Issue

Bonus from Corporate Partner

In a recent technical interpretation, the CCRA said that it will generally not challenge the reasonableness of bonus payments to a shareholder by a CCPC that is a partner in a partnership if the shareholder is active in the partnership business (2003-0034035).

According to *Income Tax Technical News* no. 22 (and confirmed at the Foundation's 2003 conference), the CCRA will generally not challenge the reasonableness of salary or bonuses paid by a CCPC to a Canadian-resident shareholder-manager actively involved in the day-to-day operations of the corporation. In the example given in the TI, Mr. S, a Canadian resident, owns all the shares of Holdco, a CCPC, which owns all the shares of A Ltd., also a CCPC. A Ltd. is a general partner in and derives all its income from its interests in several Canadian partnerships as defined in subsection 102(1). Mr. S is actively involved in the management of A Ltd. and in the partnerships' income-earning activities. A Ltd. proposes to pay salary and bonuses to Mr. S equal to the income that A Ltd. receives from its partnership interests.

The CCRA said that its general view is that managing a CCPC's interest in one or more Canadian partnerships as a general partner and being involved in the partnerships' day-to-day operations satisfies the requirement that the shareholder be actively involved in the CCPC's day-to-day operations. If the CCPC is a limited partner in the Canadian partnership and not a general partner, the TI says that it is a question of fact whether the shareholder is actively involved in the CCPC's day-to-day operations. If all the income earned by the CCPC is partnership income attributable to the limited partnership interest and "the shareholder is actively involved in the CCPC's day-to-day operations," the CCRA said that its position in ITTN no. 22 applies; we believe that the CCRA probably meant to say that the shareholder must be active in the partnership business, rather than the CCPC's business.

Wayne Tunney
KPMG LLP, Toronto

Specified in a Waiver

In *Mah* (2003 TCC 720), the TCC said that a waiver specifically referencing tax provisions pertinent to a share exchange did not permit an increase in a deemed dividend on the shares' redemption. The decision reaffirms the importance of carefully constructing waivers and clarifies that a reassessment after a statutory limitation period has expired can be effective only if it is clearly and demonstrably justified by the language used in the waiver and the parties' intention.

Ms. Mah exchanged 250 shares in Wei's Holdings for 8,000 preferred shares. The directors determined that the common shares' FMV was $800,000; the preferred shares' redemption value was thus $100 per share. Five days later, 500 preferred shares were redeemed at that price; Ms. Mah's 1996 tax return showed a deemed taxable dividend based thereon. The CCRA obtained a waiver referring to subsections 86(1) and (2) with respect to the share exchange and reassessed to show a taxable capital gain on the exchange because the redemption value was too low. A second reassessment eliminated that gain (the redemption value was increased according to a price adjustment clause) but increased the deemed dividend on redemption by $25,000 to reflect the higher redemption value. The court concluded that the deemed dividend in the second reassessment could not "reasonably be regarded as relating to . . . a matter specified" in the waiver as required under subparagraph 152(4.01)(a)(ii) and that the second reassessment after the normal assessment period was invalid. The two substantive issues—the share exchange and the subsequent redemption—were discrete transactions. In contrast, in *Stone Container* a reassessment deleting an alleged shareholder benefit pursuant to a waiver "in respect of" such a benefit automatically and necessarily triggered the mechanical calculation of the federal abatement: that recalculation was connected with and necessarily flowed from the recalculation of income. Given the parties' intentions when the waiver was granted, the absence of prejudice (the waiver specifically referred to the agency's own proposal letter), and the lack of any evidence that Ms. Mah contemplated anything other than a possible reassessment for a capital gain when she filed the waiver, the matter was statute-barred.

The decision makes clear that the broad language "in respect of" or "with respect to" used in the standard waiver to describe its ambit does not extend its application to include a transaction that could not have occurred but for the transaction contemplated in the waiver. Substantive bases of assessment must be specifically and expressly identified in the waiver. Nor was Ms. Mah obliged to address the omission. Mechanical adjustments that necessarily flow from the Act's operation consequent upon the matter specifically referred to in the waiver need not be expressly addressed, presumably whether or not to either party's benefit.

Susan Van Der Hout
Osler Hoskin LLP, Toronto

A Light Trim

Top marginal rates in the personal income systems have declined over the past 30 years. (See "A Lot Off the Top," *Canadian Tax Highlights*, October 2003.) But these high-profile numbers reflect only a part of the change in the tax system over that period. Almost all taxpayers are enjoying lower total income tax burdens than they did in the dark days of 1993 and 1994, but a surprising number see little or no improvement relative to 1973. Taxpayers at very high income levels have seen the most improvement, simply because more of their income is subject to the now reduced top rates.

The table compares the income tax payable (as a percentage of income) by a single taxpayer who earns $110,000 in 2003, barely into the top bracket. The income amounts on which the earlier years' figures are based were adjusted by the consumer price index to remove the effects of inflation on the tax burden. In all provinces except Newfoundland and Quebec, the total income tax burden relative to income is lower than in 1973. The largest reduction, 17 percent, occurred in Alberta. The tax burden has fallen in all provinces from the peak in 1994, and over 20 percent in Ontario and British Columbia.

The pattern of change varies with income. Flattening the rate schedule provided smaller benefits for lower income levels. Single taxpayers who earned $50,000 in 2003 paid slightly more tax in 2003 than in 1973 in Prince Edward Island and Quebec; reductions in the other provinces ranged up to a high of nearly 12 percent in Ontario. The reduction for a single taxpayer who earned $50,000 was also smaller from 1994 to 2003; only in Ontario was the reduction larger for that taxpayer than for the higher-income taxpayer.The lower top marginal rates explored in last month's article provide more benefit to those with incomes well into the top bracket. Taxpayers with income of $500,000 in 2003 enjoy reductions in

Combined Federal and Provincial Income Taxes, Single Taxpayer, Income of $110,000 in 2003, As a Percentage of Income

	1973	1983	1993	1994	2003
Newfoundland	35.1	37.3	39.4	39.3	35.8
Prince Edward Island	35.1	35.6	37.2	37.2	34.4
Nova Scotia	35.7	36.5	26.6	38.0	34.3
New Brunswick	36.5	36.9	38.2	38.2	33.7
Quebec	35.4	42.7	41.7	41.7	36.1
Ontario	33.6	34.5	38.0	39.6	31.6
Manitoba	36.8	46.3	38.9	38.8	34.3
Saskatchewan	36.1	35.2	39.7	39.7	32.0
Alberta	35.1	32.3	35.1	35.0	29.1
British Columbia	33.6	33.6	37.1	37.9	30.2

their total tax bills relative to 1973, ranging up from 17 percent. The largest reduction, 33 percent, inured to Alberta residents.

David B. Perry
Canadian Tax Foundation, Toronto

Dividend Paid by Note

In *Banner Pharmacaps* (2003 FCA 367), the FCA upheld the TCC decision that the taxpayer was a non-resident-owned investment corporation (NRO) in 1996, and in particular that its principal business was not the making of loans. The FCA also held that a dividend declared by its sub was paid via the sub's issuance of a promissory note.

Banner (USco) and its wholly owned sub (Canco) were incorporated in the United States and Canada, respectively, and manufactured gelatin capsules for the pharmaceutical and nutritional industries. In 1996, an NRO (Holdco) was inserted between Canco and USco: USco sold all of Canco's issued shares to the NRO Holdco in exchange for its common shares. A day later, Canco reduced its stated capital by $900,000 and declared a $5.6 million dividend, issuing to Holdco two demand promissory notes with a total principal amount of $6.5 million.

Holdco filed its 1996 income tax return as an ordinary corporation, not as an NRO, out of concern that it might not meet the condition that its business was not the making of loans. Holdco included in income and then deducted under section 112 the $5.6 million dividend received from Canco. The CCRA reassessed Holdco for part I tax of about $1.4 million (25% × $5.6 million), saying that Holdco was an NRO in 1996 and not entitled to the intercorporate dividend deduction. The FCA agreed with the TCC that Holdco was an NRO in 1996 and that its principal business in the year was not the making of loans: Holdco made no loans to any person in 1996, and the debtor-creditor relationship between Holdco and Canco was not the result of lending or borrowing. There was no evidence that Holdco ever advanced money to another party on the condition that the money be repaid, and thus no evidence that it made any loans at all, much less that it carried on a money-lending business.

The TCC had said that the dividend was not paid via the demand promissory note but must be included in the NRO's 1996 income in accordance with the accrual method of reporting income for tax. The FCA agreed in the result, but said that it was clear under the combined operation of paragraph 12(1)(j) and clause 82(1)(a)(ii)(A) that such dividends are taxable only when received, not when they are merely receivable. The FCA disagreed with the conclusion that as a matter of law a dividend cannot be paid by delivery of a promissory note. The legal effect of delivery of a promissory note depends on all the relevant facts—most importantly, the maker's intention. A promissory note may be evidence of a debt to be paid currently or at some time in the future. On the facts, Canco's resolution authorizing the dividend stated in the clearest possible terms that a $5.6 million dividend was to be paid on the date of the resolution by means of delivery of a promissory note: the promissory note was delivered as the resolution required and it was thus impossible to conclude that the dividend was not so then paid. Holdco must therefore include the dividend in its 1996 taxation year's income.

Repayment of contributed surplus may result in shareholder benefit. In a recent technical interpretation (2003-0031585), the CCRA confirmed its view that contributed surplus paid directly to a shareholder without being converted into paid-up capital (PUC) is not a tax-free return of capital and must be included in income as a shareholder benefit (subsection 15(1)). Inter alia, the rule excludes a benefit that arises as a result of a reduction of PUC, which generally means the legal stated capital of a class of shares. A shareholder may transfer property to a corporation without increasing the corporation's legal stated capital. For example, the corporation may have only par value shares, which limit the amount that can be added to their legal capital. In general, the excess of the capital contribution over the increase in legal stated capital is contributed surplus. If a corporation distributes such surplus to a shareholder, the shareholder might expect that the amount is a tax-free return of capital if the original contribution did not flow from a tax-deferred rollover.

In the example given in the TI, Mr. A transferred cash to Opco for shares with low par value. The excess of the cash contribution over the shares' par value was recorded as contributed surplus under GAAP and subsequently distributed in cash by Opco to Mr. A as such. The repayment was not a dividend under corporate law. The taxpayer argued that Mr. A should not be taxed on the payment from contributed surplus because it was a repayment of tax-paid capital. The taxpayer referred to paragraph 84(1)(c.3), which provides that a corporation is not deemed to have paid a dividend under subsection 84(1) when it converts its contributed surplus into PUC if the surplus arose as a result of one of several specific circumstances, such as the issuance of shares to which various rollover provisions did not apply. However, because Opco did not first convert the "tax-paid" contributed surplus into PUC, the shareholder was deemed to have received a subsection 15(1) benefit.

Though the TI deals with a distribution from a Canadian corporation, the CCRA's views may also apply to taxpayers who receive distributions from foreign affiliates. For a variety of reasons, a Canadian corporation may choose to structure its investment in a foreign corporation so that the lion's share is attributed to a surplus account and only a nominal amount to the shares' PUC. If a foreign corporation makes a distribution, it is generally accepted that the foreign corporation law determines the payment's characterization for Canadian tax purposes. Problems may arise if a distribution is not clearly classified as a dividend or a return of legal stated capital under that local law.

Paul Hickey
KPMG LLP, Toronto

Franchisees Not Associated

In *Lenester Sales* (2003 TCC 531), the TCC concluded that the corporate taxpayers, Lenester and Sushi, were not associated for the purposes of subsection 256(1) with other franchisees of their mutual franchisor and each other. Thus they did not have to allocate a portion of their business limits for the small business deduction. The case offers reflections on the franchise exception in subsection 256(5.1) and on the concept of not acting at arm's length in fact. The minister has appealed to the FCA.

Giant Tiger Stores (GTS) offered a would-be franchisee 501 of 1,000 shares of an operating company such as Lenester and Sushi and retained the balance of the shares. A shareholders' agreement required the company to hire the individual as a full-time employee and also contained a typical shotgun clause. Two directors were elected, a nominee of GTS and a nominee of the individual. The parties also agreed to certain banking and financial arrangements that notionally pooled all franchisees' cash receipts (charging or paying interest on balances or overdrafts) and provided for the centralized ordering of inventory by GTS.

GTS did not have de jure control over the franchisees via a majority of shareholdings. Did the controls it exercised over the franchisees' operations amount to de facto control as contemplated by subsection 256(5.1)? The minister said that GTS had direct or indirect influence over Lenester and Sushi that, if exercised, would result in control in fact of each and argued that the ancillary financial and banking arrangements did not fall within the franchisee exception. The exception applies if the parties are at arm's length and the influence is derived from a franchise whose main purpose is to govern the relationship regarding the manner in which the company is to carry on the business. The court applied the test in *Silicon Graphics* to determine whether GTS had de facto control ([2002] 3 CTC 527 (FCA)). Although the franchise agreements imposed serious limitations on the way the businesses were to be conducted, the court accepted expert evidence that such restrictions are typical of all franchise agreements and that the existing arrangements were "perfectly ordinary franchise operation[s]." The court also found that the franchisees and GTS were dealing at arm's length: they had separate interests, there was no single or controlling mind, and they were not acting in concert in a way that deprived the relationship of its arm's-length nature. "To say that every time two independent business persons in pursuit of their own business interest work together to achieve a mutually beneficial commercial objective means that they are 'acting in concert' and are, therefore, not at arm's length would mean that no business relationships would ever be at arm's length."

The court held that the GTS arrangement was exactly the type of arrangement contemplated by subsection 256(5.1) and questioned why the CCRA was attempting to "whittle away" at an extremely beneficial exemption for so "important a part of the way business is done in Canada and that enable[s] small entrepreneurs to compete with big and aggressive multinationals." The court commented that "Parliament [had] obviously recognized that franchisors often exercise significant control over the way franchisees run their operations and to refuse to apply the exception in this case would be to write the exception substantially out of the Act."

Dawn McKevitt
Thorsteinssons, Toronto

Finance on FIE Legislation

At the Foundation's 2003 annual conference, Finance's Wallace Conway and Grant Nash commented on anticipated FIE amendments, which are expected to be released soon. As anticipated, the accrual method will be reintroduced as an elective regime; however, Finance said that few taxpayers will be able to avail themselves of the method because of requirements to file information and documents with the taxpayer's tax return for the year. Although the matter was not elaborated on, the redrafted tracked property rules may now allow taxpayers with a participating interest in a tracking entity to use the default imputation regime or to elect the mark-to-market method.

A welcome change to the current rules is the introduction of a stepdown mechanism for participating interests if their FMV has dropped below cost at the beginning of the first taxation year in which the rules apply. The current draft sets a participating interest's designated cost at the higher of cost and FMV as of the first taxation year beginning after 2002, a one-sided adjustment that could not be justified by policy or fairness if the FMV declined. However, many taxpayers may find it difficult, onerous, and expensive to obtain valuations.

Rules related to the use of consolidated and non-consolidated financial statements will be loosened. However, an expansion of the types of GAAP deemed substantially similar to Canadian GAAP does not seem to be contemplated, nor does it appear that the technical notes will offer any insight into that determination. Finance responded to questions on this matter by reiterating that taxpayers must use "good GAAP." It is hoped that CCRA guidance in an information bulletin or other release after the legislation is issued will alleviate uncertainty.

Additional relief is contemplated in respect of dividends paid out of exempt surplus to ensure that the foreign affiliate regime takes precedence over the FIE regime. Finance did not offer comfort with respect to the minister of national revenue's discretionary powers in cases where 60-day information requests cannot be met because information is not available; it said only that taxpayers that make a reasonable attempt to do so should be able to respond within the time limits. Furthermore, concerns about the new FIE rules' compliance burden and associated costs will not be allayed by a potential doubling of certain compliance requirements in the first year for the filing of tax returns for short taxation years already ended in 2003. Although final legislation has not yet been released, Finance expects taxpayers to reasonably comply with the FIE legislation by filing a return now under the current rules and by later filing an amended return, if necessary, once the final legislation is adopted.

Other expected changes include minor amendments to the "widely held and actively traded" test: the unavailability of the principal business exemption if no business is carried on; relief on the sale of an FIE interest at a loss; amendments to ensure that exempt status is not lost if an interest is held through a trust; and withholding relief for an FIE interest held by a Canadian trust. Finance did not indicate that the FIE rules will be limited to the 1999 budget's initial stated objective of countering the avoidance of Canadian tax by individuals investing in foreign-based investment funds. The FIE legislation will apparently merely undergo some minor changes that are for the most part welcome but that do not address concerns regarding the cost of compliance and the availability of information. Finance indicated that new FIE rules are likely to be released closer to the conference date (September 22, 2003) than the end of the year.

Albert Baker
Deloitte & Touche LLP, Montreal

[Editor's note: The FIE legislation was released on October 30, 2003.]

US Dividend/Capital Gain Rates

The US Jobs and Growth Tax Relief Reconciliation Act of 2003, signed into law on May 28, 2003, has significant implications for US individual and US mutual fund shareholders of corporations due to the temporary elimination of the dividend and capital gain rate differentials and the reduction of both rates. Perhaps most importantly, corporations with high earnings and profits may benefit their shareholders by distributing those earnings and profits under the new lower tax rates and relieve from double tax the future appreciation of those earnings.

To determine shareholder benefits from the new rules, corporations must have accurate earnings and profits determinations. In addition, Canadian corporations must know whether the dividends they pay qualify: dividends are defined in US federal tax law without reference to corporate law. Under the act, the current top US individual rate on adjusted net capital gain of 20 percent (10 percent for taxpayers in the 10 and 15 percent brackets) is reduced to 15 percent (5 percent for taxpayers in the lower brackets). These lower rates apply to both regular and alternative minimum tax, for assets held for more than one year. Further, dividends received by an individual US shareholder during the period January 1, 2003 to December 31, 2008 from domestic corporations and qualified foreign corporations are treated as net capital gains and thus taxed at a 15 percent rate (5 percent for taxpayers in the lower brackets) for both regular and alternative minimum tax. A foreign corporation is qualified if it is eligible for benefits of a "comprehensive" US income tax treaty that the Treasury secretary determines is satisfactory and that includes an information-exchange program. No definition of "comprehensive" has been provided, although the word is likely intended to exclude treaties that cover only limited sorts of income or activities, such as the US-Bermuda treaty, which covers only insurance income and activities. New Treasury guidance states that many comprehensive treaties with information-exchange programs, including Canada's, are deemed satisfactory. A very few, including the US-Barbados treaty, are not.

In addition, dividends paid on foreign corporation stock that is readily tradable on US securities markets are eligible for the lower rates; a share is so traded if an American depository receipt (ADR) backed by such a share is traded. Dividends paid by foreign personal holding companies (FPHCs), foreign investment companies (FICs), and passive foreign investment companies (PFICs) do not qualify for the reduced rates.

If a Canadian corporation is an SEC registrant, it may need to mention in certain SEC filings whether its dividends are qualifying. For example, securities-law counsel will likely insist on such compliance in any prospectus that offers shares for sale. Further, US mutual funds and US custodians of, for example, shares held in street name must have that information before January 31, 2004, if, as they often do, they file the income slip (form 1099) reporting on behalf of a Canadian public company for the 2003 year. For a Canco to remain competitive with US corporations in retaining and attracting US individual and mutual fund investors, the Canco must be a qualified foreign corporation that pays qualified dividend income. The US capital markets are already changing. Long-time pure capital gain plays such as Microsoft have overnight become periodic dividend payers.

Steve Jackson and George Guedikian
Ernst & Young LLP, Toronto

Single-Purpose Corp Lookthrough?

The use of a single-purpose corporation by Canadians to avoid US estate tax may be threatened by recent US court decisions.

Canadians who are not US citizens are subject to US estate tax only on US-situs assets, including US real property, tangible personal property located in the United States, stock in US corporations, and debts of US persons or entities (subject to various exclusions, perhaps most significantly deposit accounts held in US banks). Assets owned outright by the decedent at the time of death are included in the estate tax base, but the decedent's interest in a legal entity in many cases results in the inclusion of the entity's assets, such as a trust created by an individual over which he or she retains some economic interest or control. (See, for example, Code sections 2036, 2037, and 2038.) In order to avoid direct ownership, it is common practice for Canadians to invest in US-situs assets (particularly vacation homes and stocks) through a non-US holding company, such as a single-purpose Canadian corporation: at the time of death the individual simply owns stock in a foreign corporation, clearly not a US-situs asset.

Although the IRS has long maintained that it routinely and successfully ignores such foreign holding companies, particularly single-purpose corporations and other holding companies wholly owned by the decedent, in the author's experience the IRS's success is merely anecdotal. No cases or rulings support the IRS's position, even in analogous circumstances, except where the corporate formalities have not been followed or the corporation was purely a nominee title holder. However, recent US court decisions related to US domestic estate planning may provide the IRS international examination team with legal support for their lookthrough approach to foreign holding companies. Two cases in particular—*Kimbell* (244 F. Supp. 2d 700 (N.D. Tex. 2003)) and *Estate of Strangi* (293 F. 3d 279 (5th Cir. 2002))—represent a considerable breakthrough for the IRS. In both *Kimbell* and *Strangi*, the decedent and a corporation owned generally by him and his children formed a limited partnership about two months before his death. The corporation, the general partner, contributed 1 percent of the partnership's capital; the decedent, a limited partner, contributed the remaining 99 percent. The US court looked through each partnership and included the transferred property in the decedent's gross estate (section 2036(a)).

The general purpose of section 2036 is to prevent individuals from avoiding estate tax on transfers that are essentially testamentary because the transferor retains during his lifetime a significant interest in or control over the property: "the possession or enjoyment of, or the right to the income from, the property or the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom." The rule does not apply to a bona fide sale for adequate and full consideration in money or money's worth. In *Kimbell* and *Strangi*, the court said that documents governing the limited partnership effectively gave the decedent the right to cause him and/or others to benefit from the income of the partnership. Each estate argued (unsuccessfully) that the US Supreme Court decision in *Byrum* (408 US 125 (1972)) applied: even if the decedent had such a right, several circumstances constrained its actual exercise and thus the court should have respected the form of the transactions and not included the transferred property in the decedent's gross estate.

The decedent in *Byrum* funded a trust with shares of three closely held corporations, each of which had an active business and a substantial number of minority shareholders unrelated to him. Byrum retained the right to vote the shares and veto their sale or transfer. The independent trustee, named by Byrum, had sole discretion to make distributions to the beneficiaries. The commissioner argued unsuccessfully that Byrum could select the corporate directors and thus control corporate dividend policy via his voting rights. The USSC held that Byrum did not have the right to designate himself or anyone else to enjoy the income from the trust property as set out in section 2036, because three primary economic and legal constraints impeded Byrum's power to elect the majority of the directors and thus control corporate dividend policy: (1) The independent trustee had sole discretion to distribute trust income; although Byrum had the power to elect a majority of the directors, he had no enforceable legal right to command them to pay or not to pay dividends. (2) Byrum, as majority shareholder, had the fiduciary duty to not abuse his power for personal gain at the corporations'expense, and the directors had the fiduciary duty to promote the corporate interests: if Byrum had influenced the directors to pay a dividend to the detriment of the corporation, a substantial number of minority shareholders unrelated to Byrum would have had a cause of action against Byrum and the corporate directors. (3) Each corporation faced the typical economic and business challenges of a small business, such as bad years, product obsolescence, new competition, and industry regulation; the corporation needed to retain resources to maintain financial viability, such as adequate working capital, debt retirement, replacement and modernization of plant and equipment, and growth and expansion. Thus, even if Byrum had a right to designate persons to enjoy the trust income, there was no guarantee of either a flow of net corporate earnings or its availability for the payment of dividends.

None of these constraints applied in *Kimbell* and *Strangi*: (1) the decedent had a legally enforceable right under the partnership agreement to determine the distribution policy of the partnership; (2) the decedent's fiduciary duty to the partnership was overshadowed by the fact that the minority interest represented only 1 percent of the partnership and was held by persons related to the decedent; and (3) the partnership did not operate a small business subject to economic and business challenges. As a result, the courts looked through the partnership and included the transferred property in the decedent's gross estate.

The same analysis might apply to a single-purpose corporation formed by a Canadian to avoid US estate tax in the absence of the economic and legal constraints present in *Byrum*. It is apparently common for a Canadian to form such a single-purpose corporation to be owned almost entirely by the would-be transferor, who elects perhaps one or two family members as directors; some family members may own an insignificant minority interest. Under this arrangement, none of the *Byrum* constraints applies: (1) the Canadian can elect all the directors and determine the corporate dividend policy; (2) because one shareholder owns most of the shares, his or her fiduciary duty is overshadowed, and in any case no unrelated shareholders exist to file a derivative suit; (3) the corporation does not operate a business, and thus there are no economic and legal business constraints on the corporation's cash flow.

Edward Northwood and Gayle Sered
Hodgson Russ LLP, Buffalo

Cross-Border Income Trusts

The last few years have witnessed tremendous growth in the number and diversity of businesses, including US businesses acquired by Canadian publicly traded income trusts. The recent resignation of Specialty Foods Group Income Fund's (SFGIF's) auditor, a major accounting firm, has cast considerable uncertainty over the future of cross-border income trusts. If the IRS and Treasury are harbouring concerns, it is hoped that they will be made public and quickly dealt with to restore certainty in the marketplace.

According to an SFGIF news release of September 15, 2003, the auditor provided no reason for its decision, a fact confirmed by SFGIF's notice of change of auditor and by the auditor in a letter to the Canadian securities commissions. At the time of writing, no new auditor had been appointed. SFGIF said that it has reason to believe that the former auditor was uncertain about accounting for the deductibility of interest paid on its subordinated notes.

In a press release dated October 16, 2003, Heating Oil Partners Income Fund (HOPIF) announced that that same auditor had reviewed its tax structure and would audit its 2003 fiscal year. On the advice of tax counsel, HOPIF will continue to deduct interest on its subordinated notes, although it also has sufficient US tax loss carryforwards to offset its US tax liability through its 2008 fiscal year. HOPIF will take a conservative financial reporting position and exclude such interest from its tax provision calculations.

In an income trust such as SFGIF, which is structured to acquire a US C corp's business, a Canadian mutual fund trust (MFT) is formed and its units listed on a Canadian stock exchange. The MFT forms a Canco and invests about 25 percent of its raised funds in Canco common shares; Canco invests in the common shares of a C corp (Acquireco), which forms and invests in common shares of a Nova Scotia unlimited liability company (NSULC). (The NSULC is a corporation for Canadian tax purposes and is ignored for US tax purposes.) The NSULC borrows the funds left in the MFT, generally at 12 to 14 percent interest. The MFT annually distributes all its income to unitholders and takes an offsetting deduction: the unitholders pay Canadian tax on the income. The NSULC invests in Acquireco preferred shares that yield dividends that are ignored for US tax purposes and that fund the NSULC's interest obligations. If the arrangement is properly structured, the MFT loan to the NSULC, and thus the income trust units, is not foreign property for Canadian pension funds and certain other non-taxable investors, and the NSULC is not taxable in Canada on the preferred share dividends. Acquireco purchases all or part of the US target company and merges with it or simply consolidates for US tax-filing purposes. Acquireco deducts the interest paid to the MFT by the NSULC in computing its US consolidated income.

Alternatively, if a US partnership or LLC (such as HOPIF) is being acquired, the structure is simpler. The MFT raises the funds in Canada and invests in a Canco: 25 percent in shares and the balance in debt. The Canco purchases the partnership interest or membership interest in the LLC and files both Canadian and US tax returns, deducting the interest paid to the MFT. If a partnership or an LLC with more than one member is acquired, 35 percent US withholding tax applies and is refunded if the interest expense is sufficient to eliminate Canco's income for US tax purposes.

US withholding tax on interest may be eliminated in either structure if the portfolio interest exemption applies. The interest is treated as payable by Acquireco to the unitholders, because the income trust and the NSULC are ignored. The portfolio interest exemption generally applies if the unitholder, which is not a CFC related to the US payer, or a bank, owns, directly or indirectly or constructively, less than 10 percent of all classes of the income trust's outstanding equity and if certain documentation requirements are met.

One US tax risk is the potential recharacterization of the debt as equity, making interest paid to the MFT not deductible. The US earnings-stripping rules may also defer the deductibility of interest paid to related foreign persons if a debt-to-equity ratio exceeds 1.5 to 1 and net interest expense exceeds 50 percent of adjusted taxable income. The earnings-stripping rules will not apply if the MFT is a grantor trust that is not owned more than 50 percent by a foreign person. Pending legislative proposals may impose additional limitations on interest deductibility.

The SFGIF prospectus indicates that SFG US intends to deduct from its consolidated taxable income the interest paid on its notes, but says that their characterization is a factual inquiry based on jurisprudence and is without clear statutory or regulatory guidance. The tax opinion, issued by three well-regarded US firms, says that an important factor supporting the debt characterization is the unconditional obligation to pay a sum certain. In addition, the debt-to-equity ratios are favourable; interest is currently being paid at a fixed rate of 14 percent; the notes are not convertible into equity and have no voting rights; the principal is repayable unconditionally; normal creditor remedies apply on default; and an investment bank determined that the notes were reasonable and substantially similar to arm's-length terms, that the principal amount relative to capital is commercially reasonable, and that the parties are likely to be able to repay the notes as required. Although the unitholders and the existing shareholders own all SFG US common shares and all notes, the opinion concludes that the notes "should be" treated as debt and related interest "should be" deductible. (Commentators suggest that "should" means 70 to 80 percent certainty, a stronger opinion than the "on-balance" opinion (more than 50 percent) in several other cross-border deals.)

Unfortunately, the uncertainty associated with the withdrawal of SFGIF's auditor may have permanently damaged the use of Canadian income trusts as an appropriate vehicle to hold US businesses. Several months ago, the IRS and Treasury initiated a meeting with certain tax professionals involved in cross-border income trust structures. A tax commentary in a prospectus dated April 29, 2003 declared itself unchanged as a consequence of that meeting: "[Neither] Treasury [nor] the IRS indicated that they have completed their consideration of these transactions, that they have taken a position with respect to the US federal income tax consequences applicable . . . or that they intend to issue any rulings or regulations or seek any [relevant Code] amendment." No other accounting firm has taken the extraordinary step of resigning as auditor of an income trust; others have been reported in the media as standing behind their clients' income trust structures and saying that they will continue to audit their clients' financial statements.

Jack Bernstein and Barbara Worndl
Aird & Berlis LLP, Toronto

FOREIGN TAX NEWS

OECD

Jacques Sasseville, head of the OECD tax treaty unit, advises that a discussion draft on attribution of profits to a permanent establishment (PE) will be released in November 2003 and, it is intended, finalized by mid-2004. The two main topics to be clarified are (1) determining whether existing PE definitions are appropriate for the digital economy and (2) establishing the appropriate nexus for taxing business profits.

Following a 2002 Italian Supreme Court decision in *Philip Morris GmbH*, the Tax Executives Institute provided comments on the PE definition, rejecting the multiple-entity PE concept and elements such as supervision and control of contracts and participation in contracts as sufficient to establish a PE.

A discussion draft on cross-border issues regarding pensions is expected the week of November 10, 2003.

The 1965-2002 Revenue Statistics issued on October 22, 2003 indicate that tax revenue in OECD countries has declined for the second year. The report is available on the OECD Web site, http://www.oecd.org, or from the Foundation's library.

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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
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Netherlands

Draft thin capitalization rules, effective after 2002, comply with a recent European Court of Justice ruling in *Bosal*, which concluded that the denial of expenses related to a foreign sub under the Dutch participation exemption regime violates EC law. The new rules abolish that denial and introduce thin capitalization rules. Currency gains and losses on acquisition debt are taxable or deductible, respectively. Loss carryovers are restricted for pure holding companies.

United Kingdom

Non-resident insurance companies regulations came into force on November 13, 2003, effective for accounting periods after 2003, for the calculation of taxable profits of non-resident insurance companies.

A plan to double air passenger taxes is under review.

Hong Kong

Airport departure taxes increase by 50 percent, effective January 9, 2004.

New Zealand

The tax treaty ratification process has been revised: it now requires compliance with New Zealand's international treaty examination process, which requires prior examination by the Foreign Affairs, Defence and Trade Select Committee. Ratification now includes preparation by the revenue department of a national interest analysis for approval by Cabinet; consideration of the treaty text and the analysis by the committee, which reports back to Parliament; and notification of the other party to the treaty, which must then notify New Zealand that the treaty is in agreement with domestic laws. This process will undoubtedly extend the time required for ratification.

Brazil

Rules for foreign capital investment are relaxed and allow funds to flow into Brazil while a foreign entity's corporate taxpayer registration is in process. Foreign investors must still appoint a resident Brazilian to obtain the registration, and it must be completed within 180 days.

Ecuador

New anti-tax-haven rules are proposed. Expenses relating to transactions and/or residents of or in a tax haven are disallowed unless they are properly documented and appropriate taxes are withheld. Jurisdictions considered havens will be identified. Investments made by Ecuadorian residents in a haven will be treated as subject to Ecuador tax. New transfer-pricing rules invoke the arm's-length principle. Methods to be used in determining prices and values are (1) uncontrolled comparable price; (2) resale price; (3) additional cost (cost-plus); (4) residual profit splitting (profit-split); and (5) transactional net margin.

Russia, Belarus, Kazakhstan, Ukraine

These countries will form a "single economic space"—customs territories of the member states where uniform principles set the foundation for economic regulation based on the free movement of goods, services, capital, and workers. Uniform policy is set for taxes, finance, and foreign trade. A commission representing each state in proportion to its economic potential will govern the area, subject to the authority of the Council of the Heads of State, in which each member state has a vote; council decisions must be unanimous.

Carol Mohammed
Canadian Tax Foundation, Toronto