CANADIAN TAX Highlights

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New Draft REOP Test

On October 31, 2003, Finance released draft proposals regarding the deductibility of interest and other expenses for income tax purposes, effective for taxation years beginning after 2004. New section 3.1 requires that a "reasonable expectation of cumulative profit" (REOP) from a business or property must underpin a deductible loss therefrom and clarifies that "profit" in this sense does not include capital gains. Finance is accepting comments on the proposals until December 31, 2003.

The Finance press release says that these measures reaffirm many current interest deductibility practices, including the deductibility of interest on money borrowed to purchase common shares, but the draft legislation does not appear to support this statement. Although we understand that both Finance and the CCRA do not intend to change the rules on the deductibility of interest expense on money borrowed to acquire common shares, it is expected that Finance will see many submissions asking that the proposals be clarified to better reflect this intention.

The proposals follow Finance's announcement in the February 2003 federal budget that recent court decisions (presumably the SCC decisions in *Stewart* and *Ludco*) created uncertainty about how taxpayers should treat expenses, especially interest, in computing income from a business or property. Finance was particularly concerned about situations in which a taxpayer derived a tax loss by deducting interest expense, even if there was no reasonable expectation that the taxpayer would earn any income (exclusive of capital gains). Finance was also concerned that under the gross income test the presence or prospect of revenue—not income net of expenses—was enough to conclude that an interest expenditure was incurred "for the purpose of earning income" as required under subparagraph 20(1)(c)(i).

However, this new rule applies broadly to all business expenses, not just interest. A taxpayer must re-evaluate its REOP in each year that it has losses: as long as a reasonable expectation remains that a business will eventually make a cumulative profit, deductions are generally allowed. In the case of income from property, a taxpayer must re-evaluate in every loss year its reasonable expectation of making a cumulative profit over the expected holding period of the property.

The breadth of the draft legislation's scope has raised concerns about the deductibility of business shutdown costs. Assume that an operating business (Opco) bought specialized manufacturing equipment. In years 1 to 5 of operation, Opco has startup losses, then a few breakeven years; Opco has no income for tax purposes or small business losses, and as a result it does not make any capital cost allowance (CCA) claims. Opco was clearly able to demonstrate a REOP during that period, but at the beginning of year 6 it decides that the business is not working out and sells its equipment at a significant loss, claiming a large terminal loss in that year. Opco effectively concluded as of year 6 that there was no longer a REOP. Proposed section 3.1 denies Opco a deduction for any expenses, including the terminal loss, if it creates an overall loss in year 6. The result seems harsh even if Opco can reduce the terminal loss by requesting revisions to prior years' CCA claims.

On the same day that the proposals were released, the CCRA issued the final version of IT-533, "Interest Deductibility and Related Issues," which does not take the proposals into account. The IT appears to be substantially the same as the previously circulated draft, with one apparent exception: the final version does not include former paragraph 22 and related old examples 8-10 on "Tracing/linking to an investment in shares, trust units or partnership interest followed by a return of capital thereon."

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REOP and Foreign Affiliates

The draft proposals regarding the deductibility of interest and other expenses released on October 31, 2003 do not amend the current rules: they layer a new reasonable expectation of profit (REOP) rule over all losses from business or property, whether generated partly from interest expense or wholly without any such expense. These proposals are very troubling for Canadian corporations (Cancos) that have borrowed or will borrow in Canada to acquire or establish foreign operations through a foreign affiliate (FA). If the proposals are enacted in substantially similar form, they will complicate FA structuring and could lead to increased taxation as a result of lost interest expense.

The new loss limitation rule is generally worded, no definitions are provided for new terms, and there are no specific rules of application. As a result, the rule creates a great deal of uncertainty about its interpretation in practice and its administration by the CCRA. In many situations, taxpayers do not repatriate dividend earnings to fully offset the amount of interest expense, and therefore the CCRA may require detailed support for the cumulative profit projections, an exercise presumably involving consolidated GAAP accounting projections and detailed business plans. Investing in foreign operations can be a risky business, and giving the CCRA the ability to second-guess management on business projections now compounds the risk of investing abroad: the taxpayer faces the potential risk of disagreement with the CCRA over business projections and the denial of interest expense in the event that the foreign operations do not pan out. On a literal interpretation, the threshold for meeting the REOP test is higher for foreign operations carried on through an FA because of the amount of underlying foreign tax paid on earnings paid for dividend distributions. It is not clear how foreign taxes will be treated in determining profit, but it appears that underlying foreign taxes reduce profits; arguably, so do foreign withholding taxes because they are a commercial expense, even though withholding taxes on dividends from FAs are neither tax-deductible nor creditable. Issues may thus arise if foreign tax rates go up. A taxpayer is also at risk of losing its interest expense due to currency fluctuations in the case of a non-Canadian-dollar borrowing or simply because the foreign earnings are denominated in foreign currency. A major foreign currency devaluation, such as that which occurred in Mexico, could quickly eliminate a Canadian-dollar interest expense deduction.

In computing a property loss in this context, it is assumed that FAPI net of a subsection 91(4) deduction and subsection 93(1) dividends will give rise to profit for this purpose if the borrower is the taxpayer that holds the FA shares and there is no intermediate Canadian holdco. It is assumed that hedging transactions such as a currency swap over a foreign currency borrowing would normally be taken into account in computing income or loss from this property source.

The new REOP rule could result in a loss of a FAPL at the FA level. Assume that a US corporate group carries on an investment business and has a loss and no REOP with respect to that business or property. Proposed paragraph 95(2)(f.1) may eliminate what would otherwise be a FAPL, another example of the proposal's far-reaching and unintended consequences. Concerns over this provision were raised by the Joint Committee on Taxation of the CBA and the CICA in their September 18, 2003 submission on the draft FA rules.

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GST Not Payable Twice

In *Airport Auto* (2003 GTC 899-105), the CCRA attempted to force a purchaser to pay GST again after the vendor did not remit the tax.

Airport Auto was a car dealer that purchased vehicles from two GST-registered suppliers; it paid GST on the purchase and claimed input tax credits (ITCs). There was no dispute that the GST had been paid to the suppliers, but when they did not file GST returns or remit the GST collected, the CCRA assessed the dealer for the tax. There was no suggestion of fraud or collusion between the dealer and its suppliers. Could the GST be collected directly from a person that had already paid the GST to a supplier? An Excise Tax Act (ETA) rule states that a person required to pay or remit an amount (under part IX) is not considered to have done so until the amount is received by the receiver general; the CCRA argued that even if a person who makes a taxable supply in Canada collects GST as the Crown's agent, the recipient of the supply is not considered to have paid the tax—and its liability therefor continues—if the tax is not remitted.

The TCC noted that although the CCRA is permitted to assess any "tax payable" by a person, the tax must in fact be payable. Airport Auto had already paid the tax to its suppliers at the time of purchase. In *Carlson* (5 GTC 1097), the TCC said that once GST is paid, the tax is no longer payable and a complete defence to any collection procedures is established. The TCC in *Airport Auto* said that a review of the ETA's collection and remittance provisions shows that a supplier acts as the receiver general's agent when collecting GST on taxable supplies. The court dismissed the CCRA's argument that that was not a "regular agency relationship" and held that, based on simple agency law, the payment of the tax to a vendor as the Crown's agent extinguishes the payer's liability to pay the tax in the absence of fraud or collusion or explicit statutory language to the contrary; any other outcome would be "ludicrous." The Crown thus bears the risk that its agent, the supplier, will not remit GST collected and cannot collect the GST from the original payer for a second time. To find otherwise would create a host of "ridiculous" complications and force recipients to make significant efforts to ensure that GST paid to a supplier was remitted to the receiver general: this was not the intent of the ETA, and common sense dictated that the legislation could not be interpreted to impose impossible requirements on every recipient who acquires a taxable supply. The appeal was allowed with costs.

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Prosperity Pays: GDPP and Tax

Every year, Statistics Canada's analyses of provincial economic accounts provide a measure of each province's tax burden. Every year, the high and low provinces are Quebec and Alberta. Newly released data for 2001 show the same picture, but the overall burdens are declining in relative importance.

Overall, taxes collected from all sources by all levels of government amounted to 34.8 percent of total gross domestic provincial product (GDPP) in 2001, a decline from 36.4 percent in 1997. Tax as a percentage of GDPP is just one of many measures of comparative tax burdens, and it has its limitations. Of more interest to individuals contemplating moves to warmer climates or areas of greater opportunity are the comparisons of specific taxes, such as personal income, sales, and property taxes. The ratios shown in the table do not distinguish between taxes on business and those that fall only on individuals and families; more importantly, the ratios do not reveal anything about the services received from government. Nevertheless, these ratios of tax to GDPP provide one quick method of comparing the impact of raising government revenue on provincial economies.

Tax Revenue by Province, 1997 and 2001, All Levels of Government

	2001	1997
Newfoundland	31.3	36.1
Prince Edward Island	37.4	37.3
Nova Scotia	34.1	35.7
New Brunswick	32.9	34.1
Quebec	39.3	40.0
Ontario	36.6	37.7
Manitoba	34.2	35.5
Saskatchewan	30.9	32.7
Alberta	25.4	29.0
British Columbia	33.8	35.2
Average, including territories and outside Canada	34.8	36.4

Traditionally, Alberta has recorded the lowest ratio of taxes to GDPP, and its 2001 ratio amounted to only 25.4 percent, down from 29.0 percent in 1997. In Quebec, taxes collected by all levels of government represented 39.3 percent of GDPP, the highest in the country, but down from 40.0 percent in 1997. The ratios are sensitive to changes in GDPP. Newfoundland's ratio dropped from 36.2 percent in 1997 to 31.3 percent in 2001, not as a result of major changes in the province's tax system, but because of a significant increase in economic activity and GDPP. The ratios for the three territories are all below 30 percent, making them attractive to those willing to brave the cold winters. Since spending is well above the national average of 40.0 percent, it is apparent that federal funds are responsible for keeping the tax burden down.

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New Canada-Ireland Treaty

The Irish Finance Act of 2000, enacted March 23, 2000, introduced important changes to Irish inheritance tax, the capital acquisitions tax (CAT). As a result of one major change, if a Canadian expatriate living in Ireland dies there, his or her world estate is subject to CAT, even if he or she was not domiciled there. Many Canadian expats typically became resident, but not domiciled, in Ireland to benefit from the Irish remittance-basis taxation rules: until the CAT was changed, such individuals counted on their non-domiciled status to insulate their non-Irish assets, typically located in a tax haven, from Irish inheritance tax. The inheritance tax change was only the first shoe to drop. On October 8, 2003, Canada and Ireland signed a new income tax treaty; once it is ratified, Canadian expats may find living in Ireland less attractive from an income tax perspective.

■ The new treaty is much more comprehensive than the existing 1966 treaty and has adopted many of the standard OECD articles and principles. For example, there is a tie-breaker rule for an individual resident in both states. Under the existing treaty, it is possible for an expat resident in Ireland to also be regarded as a Canadian resident if he or she retains some residential ties with Canada, resulting in double taxation of Irish- and UK-source income.

■ Under Irish tax rules, individuals resident but not domiciled in Ireland are taxed on investment income arising in Ireland and the United Kingdom; but on such income from another country, they are taxed only on a remittance basis. Thus, a Canadian expat living in Ireland may arrange to keep investment income outside the Irish tax net by establishing, for example, a trust in a tax haven where investment funds can accumulate tax-free: Irish tax applies only if and when such income is remitted to the individual in Ireland. Article 28(2) of the new treaty denies treaty benefits on Canadian-source income paid unless such income is remitted. A Canadian-expat Irish resident will suffer 25 percent Canadian withholding tax on any Canadian-source income that is not remitted but rather accumulates in a tax haven. It may be advisable to convert such income to non-Canadian-source; alternatively, if the income is remitted to the Irish resident and Irish tax is paid, the lower treaty rates of 10 percent for interest and 15 percent for dividends (other than those between affiliated companies) apply, with a foreign tax credit.

■ Article XI of the existing treaty exempts from tax pensions or annuities derived from sources within Canada, such as income from an RRSP, an RRIF, or a Canadian pension, by an Irish-resident individual. The new treaty allows tax on such income at a rate not to exceed 15 percent. War pension and allowances paid to war veterans as a consequence of damages suffered in a war, etc., continue to be tax-exempt.

■ Before Canada implemented departure tax rules for shares (other than taxable Canadian property), a Canadian expat could relinquish Canadian residency and dispose of shares while resident in Ireland, incurring tax of only 15 percent on the capital gain on the basis that article VI(1) of the existing treaty applied. Article XIII of the new treaty deals with the alienation of property, including share dispositions. Generally, gains therefrom are taxable only in the alienator's state of residence; however, a Canadian-expat Irish resident is still taxable in Canada on a share gain if the share owned at the departure date is disposed of within five years therefrom. Gains derived from immovable property are taxable in the state where the property is situated. If Canadian departure tax applies when an individual relinquishes residence, in certain circumstances an election may be filed for Irish tax purposes to treat such property as having been sold and repurchased for an amount equal to the lesser of its FMV when the individual becomes an Irish resident and the deemed proceeds for Canadian tax purposes.

Canadian expatriates living in Ireland will want to consider the new treaty's impact. Furthermore, tax-planning techniques implemented before a Canadian expat becomes an Irish resident may mitigate the Irish inheritance tax problem. Finance has indicated that a treaty ratification bill will be prepared next spring or fall, with expected application to individuals after 2004.

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Taxable Now, Exempt Later

Very little GST jurisprudence addresses the issue of input tax credit (ITC) entitlements and allocation requirements for businesses involved in making both taxable and exempt supplies. In *Travel Now Pay Later* (2003-1742 (GST)I), a business incurred expenses to make taxable supplies with the expectation and business objective that exempt supplies would follow at a later date.

Travel Now Pay Later administered a credit card program to facilitate the purchase of travel packages and travellers' cheques from travel agencies; a third-party financing company extended the credit. To join the credit card program, a travel agency paid a one-time set-up fee. The right to participate in the program was a GST-taxable supply. After the credit cards were used, Travel Now earned fees and commissions for GST-exempt financial services. Could Travel Now claim ITCs on expenses incurred in visiting travel agencies to sell the right to participate in the program? The CCRA denied the entire ITC claim: "substantially all" of Travel Now's revenues were GST-exempt, and thus "substantially all" of the goods and services it acquired were for use in exempt activities; the TCC agreed and applied a revenue-based allocation method to the goods and services acquired by Travel Now.

The TCC said that Travel Now's ITC entitlement is "governed by sections 169, 141 and 141.01" of the ETA and that ITCs are available "only to the extent that it has paid GST on property or services that it has acquired for the purpose of making taxable supplies for consideration." Apart from the lack of evidence offered by Travel Now to establish the purpose behind the various expenses, particularly whether they were used in commercial activities, the court appeared to shy away from a "first-order supply" analysis and focused on Travel Now's larger business objectives: the making of exempt supplies.

> [I]t is obvious that his own efforts, and the expenses for travel that they involved, do not go only to producing the set-up fees, as he would have us believe. Without his efforts in visiting the travel agencies and persuading them to become participants there would be no opportunity for the Appellant to earn either commissions on travellers' cheques sold through the agencies or profits from the credit card transactions. Clearly those expenditures make a very significant contribution to the generation of income from the financial services that the Appellant provides.

To the extent that the travel expenses were incurred to maintain Travel Now's relationships with program participants, the court's reference to future supplies and revenues resulting from these activities is appropriate; however, if travel expenses are incurred to obtain new program participants and make a taxable supply, the focus on a broader business purpose test appears to run contrary to the FCA's approach in both *London Life* and *398722 Alberta Ltd.* ([2000] GSTC 111 and [2000] GSTC 32). In *London Life*, the court ignored London Life's larger business purpose—the making of exempt supplies of financial services—and held that ITCs were available for leasehold improvements supplied by it to its landlord even though "the ultimate purpose . . . is to lease improved premises for its financial services business." Similarly, *398722 Alberta Ltd.* held that a hotel operator and developer was not entitled to ITCs on the construction of a residential apartment building even though it was built as a "condition precedent" to obtaining approval to build a hotel, which was the primary business focus and involved the making of taxable supplies. The February 1994 technical notes to section 141.01 also indicate that ITC eligibility is determined on the basis of the "first order supplies to which the particular properties or services relate" and not the subsequent supplies (second-order supplies) that may occur in the future.

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GST Constructive Importers

Following years of debate over the appropriate corrective measures, Finance has released legislative proposals to deal with goods supplied outside Canada to a Canadian customer through an importer of record who will not consume, use, or supply the goods in Canada.

The CCRA had argued, for example, that a GST-registered vendor acting as the importer of record for goods supplied with terms of delivery outside Canada should not be entitled to claim an input tax credit (ITC) for the GST paid on importation: the only person entitled to an ITC claim for the import GST is the purchaser in Canada to whom the goods were supplied, the true or de facto importer. Thus, notwithstanding that the vendor actually reported and accounted for the goods under the Customs Act and did so to further the legitimate business objectives of facilitating and completing the supply of goods to its customer, it could not claim an ITC for the GST paid by it on importation. The CCRA's concerns were apparently linked to potential leakage when a purchaser not involved exclusively in commercial activities acquired goods outside Canada and arranged for the non-resident GST-registered vendor to act as the importer of record. The vendor would recover the GST paid by it at the border and it need not charge GST on the sale because the goods were delivered outside Canada.

To effect the appropriate result, the proposed amendments introduce the term "constructive importer" (CI), the person in respect of which the goods are imported for consumption, use, or supply and that is the last person to whom a supply of the goods is made outside Canada before their release. Under these circumstances, any GST paid on the goods' importation is deemed to be paid by the CI, who alone can claim ITCs for the import GST. Alternatively, the new rules contemplate that the supplier, acting as the importer of record for a supply of goods made outside Canada, can claim ITCs on the importation if it also charges GST on the supply of the goods to the CI. The supplier and the CI must elect this treatment in prescribed form. The proposed rules can be complex and should be reviewed to ensure that their impact is not unintentionally broader than anticipated.

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Usufructs, Foundations: NRTs

On October 30, 2003, Finance released the fourth draft of non-resident trust (NRT) legislation, which draws usufructs and foundations within the rules' ambit.

The proposed NRT rules deem a trust with a Canadian-resident contributor or beneficiary to be itself a Canadian resident for a year. A resident beneficiary is defined as any Canadian-resident beneficiary with a "connected contributor," generally also a Canadian resident. Complex rules govern indirect contributions. The contributor and beneficiaries are jointly and severally liable for the trust's tax. For the purposes of computing the NRT's income, Canadian rules apply as if the trust were resident throughout the year. Special relieving rules apply if Canadian-source income is paid to non-resident beneficiaries. A trust includes a testamentary trust; a usufruct, right to use or habitation, or substitution is deemed to be a trust, thereby ensuring that these civil law entities are caught by the new rules. New paragraph 248(3)(b) extends to foundations the rules applicable to trusts. If at any time a foundation not otherwise treated as a trust or corporation holds property, it is deemed at that time to be a trust (created by a will, if the foundation was) and the property is deemed to be held by a trust throughout the holding period.

Foreign reporting rule amendments require the reporting of contributions to a non-resident entity that may not be a trust. The foreign investment entity rules also now apply to any non-corporate, non-trust entity formed, organized, continued, or existing under the laws of a foreign country. For example, Netherlands Antilles, Panama, and Liechtenstein apparently recognize an entity that is a foundation, formed by a founder's filing articles, without share capital, and managed by a board that also appoints the beneficiaries; such a foundation not otherwise treated as a trust or corporation is treated as a trust under the proposals.

Section 104 says that a reference to a trust is a reference to the trustee or the executor, administrator, heir, or other legal representative having ownership or control of the trust property, establishing a minimum requirement that the vehicle have a trustee or a legal representative with ownership or control of the trust property. Furthermore, subsection 248(3) deems to be a trust an arrangement that involves property governed by the laws of Quebec and that involves obligations similar to those under a trust; usufructs and substitutions are also deemed to be trusts.

At least in the domestic context, it appears that whether a trust has been validly created for tax purposes is determined in accordance with the traditional common law requirements. Sir Arthur Underhill's common law trust definition was approved in *Andrews Estate*:

> an equitable obligation, binding a person (who is called a trustee) to deal with property over which he has control (which is called the trust property), for the benefit of persons (who are called the beneficiaries or *cestuis que trust*), of whom he himself may himself be one, and any one of whom may enforce the obligation. ((1966) 42 Tax ABC 303 at 309.)

In *Kingsdale Securities*, the FCA recognized that trusts are not autonomous legal entities. In *Atinco Paper*, it set out three basic elements necessary to validly create a trust: (1) the words employed must be so couched that, taken as a whole, they ought to be construed as imperative; (2) the subject matter of the trust must be certain; and (3) the objects, or persons intended to be benefited, must also be certain ([1975] CTC 10 and 78 DTC 6387). In *Atinco*, the settlor defined the trust's objects and the trustees' powers in the most general way, and the trust was not validly created. In *Ablan Leon* (76 DTC 6280), the FCA concluded that lack of certainty of beneficiaries prevented a trust's being created. Constructive trusts and resulting trusts are also recognized for the Act's purposes.

IT-343R sets out the meaning of a "corporation" in the context of foreign affiliates:

> 2. A corporation is an entity created by law having a legal personality and existence separate and distinct from the personality and existence of those who caused its creation or those who own it. A corporation possesses its own capacity to acquire rights and to assume liabilities, and any rights acquired or liabilities assumed by it are not the rights or liabilities of those who control or own it. As long as an entity has such separate identity and existence, the Department will consider such entity to be a corporation even though under some circumstances or for some purposes the law may ignore some facet of its separate existence or identity.

The IT lists 23 such entities. On other occasions, whenever asked whether a particular foreign entity is a corporation, the CCRA has concluded in the affirmative: Liechtenstein Anstalt (document no. 9203695, April 13, 1992); Tennessee LLC (document no. 9642195, September 24, 1997); Chilean Limitada (document no. 9415705, January 25, 1995); Hungarian Korlatolt Feleossegu Tarsasag (document no. 9829875, February 10, 1999); Netherlands BV (document no. 9503045, August 30, 1995); Russian joint stock company (document no. 9625015, January 28, 1997); and Kazakhstan limited liability partnership (document no. 9624595, July 30, 1996). If a foundation is in fact a corporation, it must then be established whether any Canadian-resident person owns its shares. The CCRA's approach in several of the technical interpretations cited above and in IT-392 is to treat the entity as if it had 100 issued shares held proportionately by each beneficial interest holder.

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US Reduced Dividend Rate

The US Jobs and Growth Tax Relief Reconciliation Act of 2003 reduced the US federal income tax rate on qualified dividend income received by individuals to 15 percent, effective for tax years beginning after 2002 and ending for tax years beginning after 2008. (See "US Tax Bill: Dividends" and "US Dividend/Capital Gain Rates," *Canadian Tax Highlights*, June 2003 and November 2003.) Under the Act, qualified dividend income is derived only from a qualified foreign corporation, which includes a corporation (1) incorporated in a US possession, (2) eligible for the benefits of a comprehensive income tax treaty with the United States, or (3) whose stock is "readily tradable on an established securities market in the United States." A foreign personal holding company (FPHC), a foreign investment company (FIC), and a passive foreign investment company (PFIC) are expressly excluded. The IRS recently issued guidance on the definition of a qualified foreign corporation. IRS Notice 2003-69, issued September 30, 2003, identifies the treaties that qualify as comprehensive US income tax treaties for this purpose—all such treaties that include exchange-of-information programs (except the Barbados treaty, which may provide benefits that are intended to mitigate or eliminate double taxation in cases where there is no risk of double taxation). The US-USSR income tax treaty was excluded because it does not include an information-exchange program; treaties with Bermuda and the Netherlands Antilles are also excluded. The IRS also indicated that it would continue to study the operation of each US income tax treaty, including the implications of any changes in the domestic laws of the treaty partner, to ensure that the treaty accomplishes its intended objectives. The IRS further indicated that a foreign corporation must be considered a resident under the relevant treaty and must satisfy any other treaty requirements, such as those under a limitation-on-benefits provision. The notice stated that Treasury and the IRS continue to work on guidance as to whether foreign corporations are qualified foreign corporations under the comprehensive income tax treaty test.

IRS Notice 2003-71, issued October 3, 2003, offers guidance on the application of the reduced tax rate for dividends paid by a foreign corporation whose stock is readily tradable on an established US securities market. For tax years beginning after 2002, common or ordinary stock or an American depository receipt in respect thereof meets that "readily tradable" test if it is listed on NASDAQ or on a national securities exchange that is registered with the Securities and Exchange Commission (SEC), including, as of September 30, 2002, the New York Stock Exchange, the American Stock Exchange, the Boston Stock Exchange, the Cincinnati Stock Exchange, the Chicago Stock Exchange, the Philadelphia Stock Exchange, and the Pacific Exchange, Inc. The IRS will continue to consider the treatment of dividends with respect to stock listed otherwise, such as on the OTC bulletin board or on the electronic pink sheets, and specifically whether and to what extent a stock's meeting the "readily tradable" test should be predicated on the satisfaction of parameters regarding minimum trading volume, minimum number of market makers, maintenance and publication of historical trade or quotation data, issuer reporting requirements under SEC or exchange rules, and issuer disclosure or determinations regarding PFIC, FIC, or FPHC status.

The IRS also issued guidance on simplified 2003 reporting procedures for dividends paid by a qualified foreign corporation (Notice 2003-79). For the 2003 tax year, recipients of a form 1099-DIV indicating that a dividend is a qualifying dividend may treat it as such unless they know or have reason to know otherwise.

The new administrative guidance leaves many issues open. For instance, how should qualified foreign corporation status and the reduced rate for dividends affect the foreign tax credit (FTC) available to a dividend recipient? The non-US tax available for FTC purposes is reduced in a manner similar to the existing law's reduction applicable to a capital gain. Generally, a taxpayer must reduce the numerator in the FTC limitation by the "rate differential portion" of any foreign-source capital gain net income (section 904(b)(2)). A foreign-source capital gain in the hands of a US person includes a gain from the sale of non-US real property or from the sale of personal property in an office or fixed place of business in a foreign country; such items must be taken into account for purposes of computing the FTC limitation (section 904(b)(2)(A)). A taxpayer cannot cross-credit foreign tax on foreign-source capital gain against US tax on US-source ordinary income and reduce the effective rate of tax thereon (section 904(b)(2)(B)).

The new law's application to controlled foreign corporations (CFCs) raises some interesting issues. Unlike an FPHC, FIC, or PFIC, a CFC is not disqualified from qualified foreign corporation status, and thus its distributions can qualify for the 15 percent reduced rate if it meets one of the three tests above. However, it appears that a CFC's subpart F inclusions generally do not qualify for the reduced rate because technically they are not treated as actual dividends; in contrast, section 1248 inclusions represent non-subpart F earnings and profits and are treated as dividends.

On a related note, proposals before Congress repeal the FPHC rules, which may be welcome news to many US shareholders of Canadian corporations who are unfairly caught up in the FPHC regime by its broad attribution rules.

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LCT etc. Late-Filing Penalty

Large corporations should remember that late-filed tax returns attract a section 235 penalty even if no tax is unpaid.

Assume that a large corporate taxpayer (Opco) filed its 2001 tax return a year and a half late; it was unconcerned about penalties because instalments paid into its 2001 account were sufficient to ensure that all part I tax and large corporations tax (LCT) under part I.3 was paid before the 2002 filing deadline. When Opco eventually files its 2001 return, it is assessed a section 235 late-filing penalty. That penalty equals 0.0025 of the aggregate gross parts I.3 and VI taxes payable, multiplied by the number of complete months (to a maximum of 40) that each return (T2, part I.3 return, part VI return) is late. (Part VI tax is a capital tax on financial institutions. A similar penalty applies for provincial capital tax returns in some provinces.) Therefore, even if Opco paid its gross \$100,000 LCT liability by the balance due date for 2001, it still incurs a \$4,500 fine under section 235 for the late filing: [0.0025 × \$100,000 (i.e., \$250)] × 18 months = \$4,500.

Form T106: Second de minimis reporting threshold reinstated. A little-publicized CCRA notice issued in March 2003 indicated that the single-entity de minimis threshold of $25,000 had been reinstated for the filing of form T106, "Information Return of Non-Arm's Length Transactions with Non-Residents." This change provides welcome administrative relief for filers whose total transactions with particular non-residents fall below $25,000, effective for tax years that begin after 2002.

Before section 233.1 amendments in 1998, the CCRA says, it required taxpayers to report detailed information on a T106 return only when their transactions with particular non-residents amounted to $25,000 or more. A 1998 global de minimis rule eliminated reporting unless the total amount of the taxpayer's non-arm's-length transactions with all non-residents exceeded $1 million in a reporting period; many smaller taxpayers were thus exempted from the reporting requirement, and the CCRA felt that it was appropriate to remove the $25,000 single-entity de minimis threshold. However, although the new $1 million threshold eliminated reporting for many taxpayers, it created an administrative burden for others. Once a taxpayer exceeded the $1 million threshold, it was required to report all its non-arm's-length transactions with a non-resident, and some taxpayers faced time-consuming preparation of detailed information returns even though their total transactions with particular non-residents fell well below the previous $25,000 single-entity de minimis threshold. Under the new policy, a taxpayer must still file form T106 to report other information but need not report detailed information if its total transactions with a particular non-resident are below the $25,000 threshold. Taxpayers thus need no longer report these transactions in part III of the form.

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Valuing Gifts in Kind

Tax shelter season has arrived, and the CCRA has provided a list of caveats related to in-kind charitable donations: be wary of gifting arrangements for property such as art, books (even comics), and software valued at many times its cost; confirm directly with the recipient charity that it will exercise due diligence regarding the valuation; read the related tax opinions—in particular, the underlying assumptions—carefully; ensure that the valuator is a member of a professional appraisal society and is independent from the promoters; review the valuation report, but be aware that the CCRA is not required to accept any valuation opinion prepared by the promoter or an independent valuator; and remember that the registration of the arrangement and an identification number do not guarantee but are a prerequisite to a tax credit or deduction.

Finance has just released proposed subsection 248(35) containing an FMV grind to block buy-low, donate-high arrangements where the tax benefit is greater than the actual cost of the donated property. The FMV of a gift is deemed to be the lesser of its FMV otherwise determined and the donor's tax cost, if the property was donated within three years of acquisition or the property was acquired as part of a gifting arrangement. Gifts of publicly traded securities, certified cultural property, ecological gifts, inventory, and Canadian real property are excluded.

Although these caveats are aimed primarily at in-kind gifts in a tax shelter context, the CCRA will scrutinize most, if not all, charitable gifts in kind, including preferred or common shares of a private family business. Share valuations will be scrutinized for the applicability and quantum of minority discounts, key-person discounts, special-purchaser and strategic-buyer premiums, control premiums, portfolio discounts, discounts for trapped-in capital gains, and other adjustments.

Tax planners and tax preparers should be aware that third-party civil penalties can apply if the donated property's valuation is inflated to the point that it constitutes a false statement. (See IC 01-0.) The registered charity may also be subject to such penalties, and it may lose its registered status if it knowingly issues an inflated charitable receipt.

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Foreign Tax News

OECD

In November 2003, the OECD issued its twice-yearly report on its member states' economic outlook. The report recommends that member states revisit their long-term fiscal proposals under the "palpable" economic upswing ahead and take advantage of these prosperous times to revitalize public finances to better deal with aging populations. The report also recommends reduction of budget deficits.

The OECD Working Party No. 1 issued a discussion draft on tax issues arising from cross-border pensions. The draft upholds the position dictated by policy and administration that the resident state should tax such pensions; but because some states are reluctant to accept that that state should have the exclusive right to tax, the draft contains model treaty language permitting taxation by the source jurisdiction. The draft proposes changes to article 18 commentary of the treaty model, which addresses the allocation of pension-benefit taxing rights; exempt pensions; statutory social security programs;

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individual retirement plans; contributions to foreign pensions; and tax obstacles to the portability of pension rights. Comments should be submitted before January 15, 2004.

In light of recent scandals, the OECD is upgrading its principles for good corporate governance; it is anticipated that the proposals will be available by May 2004.

United States

The IRS announced a new reporting procedure for individuals with interests in Canadian RRSPs and RRIFs. Filing obligations under section 6048 have been replaced by a single form that can be attached to a taxpayer's 1040.

Italy

Italy's 2004 budget contains a number of tax reform proposals. A company carrying out international activities may enter into an agreement with tax authorities on transfer pricing, dividends, and royalties related to those activities. A reduced corporate tax rate (20 percent) applies to a company listed for the first time on a regulated EU stock exchange. The substitute tax on an investment fund specializing in small and medium-sized enterprises listed on a regulated exchange is reduced from 12.5 to 5 percent. A new tax rate of 12.5 percent applies on certain income from Italian real estate funds. The tax credit on profits distributed through year-end is reduced to fully match the current corporate rate of 34 percent.

Effective January 1, 2004, a new corporate income tax features a flat-rate tax of 33 percent; a check-the-box system allowing certain Italian entities to be treated as flowthrough entities; thin capitalization provisions; exemptions for capital gains and losses on a sale of shares; a new dividend-received deduction mechanism to avoid double taxation; options to file consolidated returns for all Italian entities within a group and worldwide consolidation to include foreign subs; a new foreign tax credit carryforward and carryback; and a definition of "permanent establishment."

France

The French Supreme Court held that under the treaty with Switzerland, a French sub may constitute a PE in France if the sub is acting as an agent of the Swiss parent and is legally or economically dependent on it, and the dependent agent habitually exercises the authority to bind the Swiss parent in commercial transactions.

In order to attract multinationals and promote France's business environment, five-year tax breaks may soon be offered to foreign corporate executives and expatriates. Approval for this incentive is expected before the year-end.

New Zealand

Inland Revenue issued final guidelines on payments to non-resident software suppliers, similar to US IRC regulation 1.861-18. The guidelines address two major tax issues: (1) whether payments are royalties, business income, rental income, or non-taxable receipts, and (2) their tax treatment. New Zealand says it is now in conformity with the OECD model treaty commentary to article 12 (Royalties). Full text is available at http://www.ird.govt.nz/promotion/ig-software.pdf.

Luxembourg

The 1929 holding company regime is included in the European Union's list of potentially harmful tax regimes; such companies are exempt from all taxes. A draft bill rescinds the tax-exempt status, and "comparable taxation" applies at the rate of at least 11 percent (about half of the Luxembourg corporate rate). The entity must apply each year for this benefit; receipt of dividends of at least 5 percent from a low-tax jurisdiction will nullify the benefit.

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