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Volume 12, Number 2, February 2004

## IRS: TREATY FILINGS, ITINS

IRS Notice 2004-1 recently announced that eligibility for individual taxpayer identification numbers (ITINs) has been tightened to help eliminate their non-tax use. Effective immediately, a taxpayer who is ineligible to obtain a social security number can no longer obtain an ITIN without simultaneously submitting the original completed income, estate, or other return for which the ITIN is needed along with (revised) form W-7 (Application for IRS Taxpayer Identification Number). To avoid confusion with a social security card, the ITIN certificate's format is now a letter, not a card.

Generally, an individual must use his or her US social security number as a taxpayer identification number, except for children in the process of being adopted and non-US persons who must obtain ITINs in lieu of social security numbers. A large percentage of ITINs are issued to non-US workers who are ineligible for social security numbers. The IRS discovered that individuals apply for ITINs without any intention of filing tax returns; they use the ITINs as proof of identity for non-tax purposes in lieu of social security numbers—for example, when applying for drivers' licences and to establish identity for health and welfare benefits and for employment purposes.

A form W-7 now must be accompanied by an original, completed return; the form is not accepted in advance of the return. The return and the form W-7 should be sent to the IRS office specified in the form's instructions, not to the mailing address designated in the return's instructions. The return is processed in the same manner as if it were filed at the service centre specified in the return's instructions. However, revised form W-7 details circumstances in which a completed return need not be filed

with the form. For example, a holder of financial accounts generating income subject to information reporting or withholding requirements who is applying for an ITIN must provide the IRS with evidence that he or she opened the account with the financial institution and has an ownership interest in the account.

The IRS has reduced the number of documents it will accept as proof of identity before it issues an ITIN from 40 to 13, including an original passport (or a notarized or certified copy), national identification card, birth certificate, and military identification card. If an individual does not have a passport, the IRS requires two or more types of secondary identification.

It has come to our attention that since the IRS issued the notice, it no longer processes applications for tax identification numbers for US business entities (employer identification numbers, or EINs) if the entity has only non-US officers unless one of the officers first applies for and obtains an ITIN, a process that currently takes four to six weeks. In the past, a photocopy of the non-US officer's passport or driver's licence was submitted with the EIN application, and the officer was not required to obtain an ITIN even though the instructions to the EIN application indicated otherwise; the EIN process usually took only one to two days.

### IRS to examine foreign corporations' tax forms.

A senior IRS official recently indicated that the IRS will examine certain filings by non-US corporations to determine whether further enforcement measures are necessary. Forms 1120F (US Income Tax Return of a Foreign Corporation) and 8833 (Treaty-Based Return Position Disclosure) filed by foreign corporations will be examined by the IRS with a view to determining, in particular, any permanent establishment (PE) and withholding tax issues and problems associated with foreign companies taking treaty-based tax positions, said Elvin D. Hedgpeth, acting director (international) of the IRS Large and Midsize Business Division. At a meeting of the District of Columbia Bar Association Tax Section, Mr. Hedgpeth indicated that the results of the examination may lead to further enforcement or compliance measures.

Foreign corporations usually are not required to pay federal income tax on their business operations if they are not engaged in a US trade or business or if they are resident in a US treaty-partner country (such as Canada) and do not have a US PE. Under Code section 882, a foreign corporation must file a true and accurate return (form 1120F) in order to benefit from allowable deductions

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or credits, unless it neither has a US PE nor is engaged in a US business; but some foreign corporations file (so-called protective tax returns) to ensure that they are not denied such benefits should the IRS subsequently find them to have such a business or PE. Moreover, a foreign corporation that is engaged in a US trade or business without a US PE may be treaty-protected from US net federal income tax; the foreign corporation must file form 8833 to preserve such treaty protection against US taxation.

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## ASSETS FOR NEWLY ISSUED SHARES

A recently issued technical interpretation (2003-0048585) states that the tax cost of property acquired in a non-section 85 transfer by a corporation from an arm's-length vendor in exchange for shares issued from treasury is generally not the shares' stated capital; rather, the price stated in the purchase and sale agreement or conveyance document prevails. This position is counter to longstanding case law principles established prior to *Teleglobe Canada* and may apply in arm's-length transactions where high-stated-value shares cannot be issued (2003 FCA 408).

The TI request notes that the decision in *Tuxedo Holding* ([1959] CTC 172) suggests that the cost of property acquired in exchange for a corporation's own shares is equal to the amount added to the stated capital, a proposition cast in doubt by the recent FCA decision in *Teleglobe*. The latter said that "the agreement of the parties determines the cost to the corporation of issuing shares in exchange for property. . . . [W]hile one can say that the capital accounts are an indication of the agreement between the parties, it is the agreement of the parties, not the capital accounts, which is determinative of the cost."

The CCRA says that if the price of an asset is stated in the conveyance agreement, the asset's cost generally equals the price agreed to by the parties, subject to section 85. The CCRA adds that, under most corporate statutes in Canada, the amount in the agreement will be the amount to be added to the stated capital account for the class or series of shares issued. But, for example, if the governing legislation permits the issue of par value shares, a cost based only on the stated capital addition does not truly reflect the value of the consideration given to acquire the asset. However, the stated capital account addition may become relevant in determining the cost if the purchase and sale agreement does not specify a price.

**Updated IT: Subsection 85(1) rollovers of capital property.** IT-291R3, "Transfers of Property to a Corpora-

tion Under Subsection 85(1)," was issued on January 9, 2004 to reflect, among other things, legislative changes since the September 1994 version. Highlights of selected changes follow.

- An administrative position to facilitate the tax-deferred transfer of depreciable property or eligible capital property in certain divisive reorganizations is explained (paragraph 16).

- The expression "wholly owned corporations" in subsection 85(1.3) is said to include second- and lower-tier wholly owned subs for the purposes of the conferral-of-benefits rule (paragraph 18).

- If paragraph 13(7)(e) has restricted the transferor's capital cost of a depreciable property acquired in a non-arm's-length transaction, that cost is relevant in the application of subsection 85(5) to a subsequent transferee corporation (paragraph 30).

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## NON-RESIDENT DIRECTORS' FEES

The CCRA recently changed its administrative policy on withholding income tax from fees paid to non-resident directors of Canadian corporations. The recently released *2003 Employer's Guide to Payroll Deductions* says that corporations must withhold from non-resident directors' fees the same regulation 102 graduated rates applicable to Canadian-resident directors' fees, effective January 1, 2004. Previously, the CCRA administratively accepted a 15 percent withholding tax rate for directors' fees paid to non-residents. As usual, employers may be subject to penalties and interest if they do not withhold tax at the correct rates.

Technically speaking, even though the withholding rate has changed, the non-resident directors' overall Canadian tax cost should not change: a non-resident director's fees for services rendered in Canada have always been subject to Canadian income tax. Generally, a non-resident is subject to Canadian tax on employment services, including directors' services, rendered in Canada (subsections 2(3) and 115(1)). However, many non-resident directors likely regarded the 15 percent withholding tax as their complete Canadian tax obligation and did not file Canadian returns.

A non-resident director rendering services in Canada may be exempt from Canadian tax under a tax treaty between Canada and his or her country of residence. For example, under article XV(2) of the Canada-US treaty, a withholding tax exemption may be available if the amount paid to the non-resident does not exceed Cdn \$10,000 for the year or the non-resident is in Canada for no more than 183 days in the year and the remuneration is not borne

by an employer who is resident in Canada or by a Canadian permanent establishment of the employer. Alternatively, planning may reduce or eliminate the Canadian tax liability: for example, the director could participate in board meetings by conference call from outside Canada so that his or her services are not rendered in Canada.

As in prior years, employers must withhold CPP contributions on non-resident directors' fees if the services are performed in Canada, but not if they are performed wholly or in part outside Canada. For US tax purposes, directors' fees are considered self-employment income, and a US citizen or resident is therefore subject to US self-employment tax (social security) on such fees. Presumably, a US-resident director can obtain a certificate of US social security coverage to avoid the CPP withholding. EI premiums need not be deducted.

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## CIT RATE CUTS SLOW, BUT CONTINUE

Ontario has ended, at least temporarily, its march to lower corporate income tax rates. However, the tables show that the federal government and other provinces will continue to lower rates over the next two years.

Based on information available prior to 2004 federal or provincial budgets, table 1 shows scheduled changes in the rate for large corporations not engaged in manufacturing and processing (M & P) activities (exclusive of reductions in federal and some provincial capital taxes).

**Table 1 Income Tax Rates on General Profits by Calendar Year**

	2001	2003	2004	2005	2006
Newfoundland .....	14.00	14.00	14.00	14.00	14.00
Prince Edward Island .....	16.00	16.00	16.00	16.00	16.00
Nova Scotia .....	16.00	16.00	16.00	16.00	16.00
New Brunswick .....	16.00	13.00	13.00	13.00	13.00
Quebec .....	9.04	8.90	8.90	8.90	8.90
Ontario .....	13.62	12.50	14.00	14.00	14.00
Manitoba .....	17.00	16.00	15.50	15.00	15.00
Saskatchewan .....	17.00	17.00	17.00	17.00	17.00
Alberta .....	13.99	12.63	12.25	11.50	11.50
British Columbia .....	16.50	13.50	13.50	13.50	13.50
Yukon .....	15.00	15.00	15.00	15.00	15.00
Northwest Territories .....	14.00	12.00	12.00	12.00	12.00
Nunavut .....	14.00	12.00	12.00	12.00	12.00
Federal .....	28.12	24.10	22.10	22.12	22.10

**Table 2 Income Tax Rates on Small Business Profits by Calendar Year**

	2001	2003	2004	2005	2006
Newfoundland .....	5.00	5.00	5.00	5.00	5.00
Prince Edward Island .....	7.50	7.50	7.50	7.50	7.50
Nova Scotia .....	5.00	5.00	5.00	5.00	5.00
New Brunswick .....	4.00	3.00	3.00	3.00	3.00
Quebec .....	9.04	8.90	8.90	8.90	8.90
Ontario .....	6.37	5.50	5.50	5.50	5.50
Manitoba .....	6.00	5.00	5.00	5.00	5.00
Saskatchewan .....	7.00	6.00	5.50	5.00	5.00
Alberta .....	5.25	4.13	3.25	3.00	3.00
British Columbia .....	4.50	4.50	4.50	4.50	4.50
Yukon .....	6.00	6.00	6.00	6.00	6.00
Northwest Territories .....	5.00	4.00	4.00	4.00	4.00
Nunavut .....	5.00	4.00	4.00	4.00	4.00
Federal .....	13.12	13.12	13.12	13.12	13.12

Alberta plans to drop its general rate to 8 percent as finances permit; no specific date has been announced. The federal rates will not change, but some provinces plan further rate reductions.

Table 2 shows anticipated rates for corporations eligible for the small business deduction, but not the complementary scheduled increases in the threshold at which the preferential rate ceases.

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## HARSH RESULT ON OBJECTION

Taxing statutes such as the Income Tax Act (ITA), the Excise Tax Act (ETA), and the Ontario Retail Sales Tax Act (RSTA) often contain special procedures for challenging an assessment through an objection. Generally, the taxpayer must accurately describe each issue and the relief sought for each issue, including the amounts involved, and provide supporting facts and reasons. (For example, ITA subsection 165(1.11) applies to large corporations; ETA subsection 301(1.2) applies to specified persons; and RSTA section 24(1.2) applies to every person who challenges an assessment.) On appeal, the issues to be addressed and the taxpayer's arguments are generally limited to those raised in the objection. The FCA's recent decision in *Potash* serves as a useful lesson on what the substantive objection requirements entail ([2003] FCJ no. 1827).

In *Potash*, the taxpayer sought to amend notices of appeal filed with the TCC to include 5 specific amounts in its resource profits calculation for the purposes of the

resource allowance. The objection and notices of appeal based thereon referred to 31 specific amounts and the categories of income believed to be included in the resource profits calculation, but 5 amounts were not included. Unless the notices of appeal were amended, the minister could not be compelled to take these amounts into account in determining the resource allowance.

The TCC said that subsection 165(1.11) only precludes expansion in the appeal notice of “the general issues to be decided and the relief sought,” but allows for changes to be made to the relief’s quantum. On appeal, the FCA noted that the purpose of that rule was to “discourage large corporations from engaging in a full reconstruction of their income tax returns for a particular year, after the objection or appeal process had started, based on developing interpretations and the outcome of court decisions in litigation involving other taxpayers,” and that the rule was intended to enable the CRA to “assess at the earliest convenient possible date both the nature and quantum of pending tax litigation and its potential fiscal impact.” Given the precise manner in which the minister assessed the taxpayer, the FCA concluded that the taxpayer had not reasonably described each issue in the objection and could not raise the issue of the five amounts on appeal. In particular, the reassessment set out the precise items of income that were disallowed, and thus the taxpayer was also required to describe the issues in the same fashion in the objection and specify which particular elements of the resource allowance calculation it was disputing. Accordingly, the five amounts not specified in the objection could not be addressed on appeal. (Surprisingly, the FCA decided not to make a determination as to whether the taxpayer complied with the requirement in paragraph 165(1.11)(b)—the requirement to specify “the relief sought, expressed as the amount of a change in balance . . . or a balance of undeducted outlays, expenses or other amounts” for each issue, concluding in obiter that “there may be situations where an amendment to a notice of appeal could be permitted if the amendment goes only to quantum and does not entail the raising of a new issue.”) Taxpayers challenging an assessment should therefore ensure that their objection describes the issues in dispute with the same degree of specificity that the minister uses in assessing the taxpayer. Failure to do so may lead to the “harsh result” that Parliament intended.

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## IRS: BAD DEBTS AND STOCK

The actual windup and complete liquidation of a Canadian subsidiary by a US parent is a clear event that allows

the parent to ascertain whether it has a gain or a terminal loss from the investment. For US tax purposes, a US parent may trigger terminal losses—often ordinary in character—on a sub’s liquidation due to partial worthlessness on intercompany debt owed to the parent and a loss due to worthless stock. Revenue ruling 2003-125 says that a deemed liquidation resulting from a check-the-box (CTB) election constitutes an identifiable event for such purposes. A deemed liquidation solely for US taxation purposes of a Canadian sub may arise, for example, when an Ontario corporation converts itself into a Nova Scotia unlimited liability company.

The ruling points out that the US taxpayer must still establish that the stock was worthless at the time of the deemed liquidation by, for example, establishing that the shareholder received no payment for its stock in the liquidation. The ruling specifies that a shareholder receives no payment for its stock in a liquidation if, at the time of the liquidation, the FMV of the corporation’s assets, including intangible assets, is less than the corporation’s liabilities. The ruling involves a situation in which a foreign sub of a US parent continues its manufacturing operations after the CTB election and evaluates the relative values of the sub’s assets and liabilities. It thus appears that, although the taxpayer must still establish that the stock is worthless, the continuance of the business is not solely determinative. The IRS also clarifies that, when determining whether the sub’s stock and intercompany debt are worthless, intangible assets, such as goodwill and going-concern value, must be included in the sub’s assets. In addition, the ruling takes the position that if a company continues operations after a worthless stock writeoff and can pay its debts without a significant capital infusion, then the FMV of the company’s assets (including goodwill and going-concern value) exceeds the amount of all debt.

Worthless stock and bad debt deductions that arise in connection with subs’ liquidations, particularly liquidations structured as CTB elections, may be subject to substantial scrutiny upon audit. By issuing this ruling, the IRS makes it clear that US corporations that wish to take such deductions must present, in addition to a CTB election, substantial evidence of worthlessness, which will entail building a strong case regarding valuations.

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## PARTNERSHIPS AND GST

From a structural perspective, the GST legislation is strikingly different from the Income Tax Act in its treatment of partnerships. For GST purposes, partnerships are defined as separate “persons” in subsection 123(1) of the Excise

Tax Act (ETA), which can create some difficulties in even the most common of income tax transactions. ETA section 272.1 is meant to provide a statutory codification of the way in which partners are seen to interact with their partnership entities for GST purposes. Subsection (1) provides a broad deeming rule: “anything done by a person as a member of a partnership is deemed to have been done by the partnership in the course of the partnership’s activities and not to have been done by the person.” To date, the CCRA has not finalized its only piece of substantive policy on this important deeming rule: its Draft Policy Statement on the Application of Subsection 272.1(1) of the Excise Tax Act was released for comments in April 2002.

The subsection 272.1(1) deeming rule has broad application and is significant when partners provide goods, services, or employment labour to their partnerships. In the absence of some certainty as to how transactions between partners and their partnership entities are treated, the “first principles” conclusion is that the GST applies. For example, if a partner is reimbursed for the purchase of a new computer for her law firm, is the partner required to register and charge and collect GST on the reimbursement? Subsection 272.1(1) is not likely to apply in this case, but may apply in many similar examples in most corporate commercial transactions involving partnerships. If a limited partnership is created, and one partner provides some goods and management services while another contributes the labour of its employees, it is not clear whether the partners must charge GST to the partnership. Furthermore, it is not clear who is entitled to claim the ITCs that may have been paid by the partners on the initial acquisition of the goods or services. This is a significant question, particularly if the partnership entity is engaged in exempt activities and unable to recover any GST charged. In one recent situation, \$11 million a year was in issue, and any GST payable by the partnership was not recoverable because it was engaged in an exempt business.

The CCRA draft policy establishes three separate criteria for determining whether a “partner” is doing something “as a member of a partnership” and is thus sheltered by the deeming rule in section 272.1: (1) the “terms of the partnership agreement” (for example, is the partner clearly responsible for taking the action under the terms of the agreement? Is the partner’s conduct consistent therewith?); (2) the “nature of the action undertaken by the partner” (for example, does the action taken by the partner relate to the purpose of the partnership’s business? Who is liable for the partner’s action?); and (3) the “partner’s ordinary course of conduct” (for example, is the partner doing the activity only for the partnership, or is the partner engaged in a separate business involving that same activity for other persons?). The draft policy

also sets out three examples. Example 2 confirms that when a partner provides labour to the partnership, in certain circumstances she need not charge GST on the amount reimbursed by the partnership.

Unfortunately, senior Finance officials indicate that the draft policy will change, because its wording may surpass the original intention; this is not particularly good news for practitioners who are attempting to plan for the GST’s application. The policy’s final version should receive close attention.

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## PRIVATE CORP SHARE GIFTING

Effective at 6 p.m. EST on December 5, 2003, draft legislation limits the tax benefits of charitable donations under tax shelter and other arrangements. Although it is intended to thwart “buy-low, donate-high” arrangements, the legislation may result in punitive tax consequences on the gifting of a private corporation’s shares.

Various promoters have been marketing to the public certain charitable gifting arrangements that involve a taxpayer’s acquisition of property and its subsequent donation to a charity at a value represented as FMV and exceeding its cost. Typically, the property—such as art, computers, and prescription drugs—is acquired at a reduced price through a promoter, who then arranges for its appraisal and donation to a registered charity. The charity issues a tax receipt based on the appraised value, which is high enough to produce a tax credit that exceeds the property’s cost plus any capital gains tax resulting from the arrangement. The draft legislation’s response is to limit the value of a charitable donation to the donor’s cost if the property is donated within three years of acquisition or was acquired through a gifting arrangement or in contemplation of donation. Only donations of publicly traded securities, certified cultural property, real property situated in Canada, inventory, and ecological gifts are exempt, as are gifts made on death. Non-exempt property that has appreciated since acquisition is not affected if it was held at least three years and was not acquired under a prearranged gifting arrangement. The rule thus appears to apply if a private corporation’s shares were held for less than three years or were created specifically with gifting in mind, although the policy underlying this result is not clear.

Assume that a taxpayer holds all of a private corporation’s common shares and wishes to carry out an estate freeze to transfer future growth to his children and to enable him to make some charitable gifts to arm’s-length regis-

tered Canadian charities. The commons are exchanged for redeemable retractable preferred shares with an adjusted cost base (ACB) of \$100 and a redemption amount of \$100,000, which are gifted to a public foundation or an arm's-length charitable organization. The corporation will redeem the charity's preferred shares for cash. Under existing legislation, the taxpayer is deemed to dispose of the gifted shares for their FMV (the redemption amount), resulting in a capital gain; the taxpayer receives a charitable donation receipt in the same amount. Under the draft, the deemed proceeds and the amount of the donation receipt both equal the taxpayer's ACB. The table compares the results of such a donation with an investment in and gift of marketable securities that generates an equivalent capital gain.

The preferential capital gains inclusion rate for marketable securities was intended to encourage increased donations to charities, but it is not clear why this treatment does not extend to donations of private corporation shares, even if steps are taken to provide the charity with additional liquidity through a redemption feature. Now the draft rules are even more punitive to such gifts.

The new rules do not apply if the taxpayer held the gifted property three or more years and did not expect to make the gift at the time of acquisition, or if the gift was made as a consequence of the taxpayer's death. But restricting the donation of inter vivos gifts undermines

the goal of many charities to encourage planned giving, which is often favourably received by donors willing to consider sizable donations during their lifetimes. A submission made to Finance suggests that one solution may be to deem new shares issued under any rollover provision in exchange for previously owned shares to be the same shares for the purposes of the holding period test and for determining the reason for acquisition. Alternatively, the exemption could extend to gifts of private corporation shares, a course that is probably more appropriate, given that the provisions dealing with non-qualifying securities already contain restrictions on gifting private corporation shares.

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## NRTs AND INVESTMENT FUNDS

On October 30, 2003, Finance released the fourth draft of the proposed non-resident trust (NRT) and foreign investment entity (FIE) rules, which are generally intended to tax currently income earned by an NRT that has a Canadian-resident settlor or beneficiary and a Canadian resident's share of income from investments in foreign investment funds, respectively.

The fourth draft expands the investment fund trust category in one of the draft's classes of "exempt foreign trust" that is not subject to the proposed NRT rules, in order to avoid overlap between the two regimes. An exempt foreign trust generally fits one of two exemptions. The first exemption applies if at least 150 investors each hold at least a \$500 interest in the fund; if a beneficiary and non-arm's-length persons hold in excess of 10 percent of the FMV of the interests in a class of the fund, the beneficiary must also be a specified contributor; and the beneficiary's interest must also be a specified fixed interest. A second exemption may apply if a prescribed form and a copy of the trust document is filed with the CCRA; the interest must be a specified fixed interest; and each beneficiary, regardless of the value of his holding, is a specified contributor.

The fourth draft essentially preserves the first exemption and expands the second. In practice, the new first exemption requirements dealing with the 10 percent interest holder and the transfer of restricted property narrow the exemption, but they should not affect most ordinary investors. However, the exemptions may still be somewhat restrictive. For example, the 150-investor/\$500 threshold is a bright-line test that is easy to apply, but the 150-investor threshold (generally applicable to Canadian mutual funds) may not suit a fund that is likely be formed in, organized in, and tailored to meet the tax

**Gift of Preferred Shares Versus Gift of Marketable Securities**

	Preferred shares		Marketable securities
	Existing rules	Draft rules	Existing and draft rules
Deemed proceeds . . . . .	\$100,000	\$100	\$100,000
Adjusted cost base . . . . .	100	100	100
Capital gain . . . . .	<u>\$99,900</u>	<u>\$0</u>	<u>\$99,900</u>
Taxable capital gain . . . . .	<u>\$49,950</u>	<u>\$0</u>	<u>\$24,975*</u>
Donation receipt . . . . .	<u>\$100,000</u>	<u>\$100</u>	<u>\$100,000</u>
Tax on taxable capital gain at 46.41% (top combined federal/Ontario marginal rate) . . . . .	\$23,182	\$0	\$11,591
Tax credit (federal/provincial) at 46.41% . . . . .	<u>46,410</u>	<u>46</u>	<u>46,410</u>
Net tax savings . . . . .	<u>(\$23,228)</u>	<u>(\$46)</u>	<u>(\$34,819)</u>
Net cost of donation (value of gift less net tax savings) . . . . .	<u>\$76,772</u>	<u>\$99,954</u>	<u>\$65,181</u>

\* The taxable capital gain is 1/4 of the capital gain on the donation of the listed shares.

and securities law of a foreign jurisdiction. The corresponding US test requires only 100 investors; given the extent to which Canadians invest in US funds or funds that are designed to be marketed there, the first exemption's requirements may have benefited from more scrutiny of US or other foreign tax or securities laws.

The first exemption may also be problematic for tiered fund structures if a Canadian resident invests in a partnership that owns NRT units: the Canadian partner is likely both a contributor to the NRT via the back-to-back transfer and a beneficiary via an extended definition of "beneficially interested" in subsection 248(25). However, the extended definition does not apply for the 150-investor requirement, so that the Canadian partner is a trust beneficiary but not an investor per the first exemption. The policy rationale behind this schism is less than clear. The second exemption filings may also be problematic. The fund may be reluctant to file the prescribed form if it requires disclosure of information on all investors, including non-residents, especially if there is an onus on the fund to obtain and verify the information. The NRT rules impose a tax liability on the trust's undistributed income, but the trust's willingness to file may depend on the quantum of its Canadian assets and the percentage of its investors that are Canadians. Because a Canadian investor may be jointly and severally liable for the trust's Canadian tax liability up to distributions received, he or she must be diligent in ensuring that the appropriate filings are made.

The second exemption's additional requirements on investment fund trusts (relative to other investment funds structured as corporations or partnerships that are subject to the FIE rules) may make such structures less attractive to Canadian investors and may make Canada a less attractive market for investment fund trusts that cannot rely on the first exemption. Perhaps the first exemption should be further expanded given that, from a policy perspective, these types of funds should (and would otherwise be) taxed under the FIE regime. For instance, if the 150-investor threshold were reduced to 100 or even 75 or replaced with a test based on units of the trust being qualified for public distribution in Canada or a province, combined with the percentage ownership and restricted property limitation currently in the first exemption, the rules might be made more manageable without significantly increasing the risk of tax leakage.

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## IMPERIAL OIL REIGNS

The FCA has upheld the TCC's conclusion in *Imperial Oil* that GAAR did not apply because there was no abuse of the

relevant provisions and no abuse of the Act read as a whole (2004 FCA 36). The court thus did not consider the taxpayer's arguments that the TCC erred in finding that the loans constituted avoidance transactions from which Imperial obtained a tax benefit.

*Imperial* dealt with the calculation of investment allowance for large corporations tax (LCT). Imperial made three loans just before its year-end to corporations that were not financial institutions (FIs)—a finding that would have precluded Imperial from obtaining an investment allowance. The corporations were wholly owned subs of two Canadian banks, which guaranteed the loans. Such a loan transaction was a common LCT reduction technique, effectively converting a taxpayer's cash on hand prior to its year-end—which does not earn an investment allowance—into a qualifying short-term liquid asset with minimal investment risk; conversion was made so that at year-end the company had made a loan to a non-FI. Shortly after the year-end, the loan was repaid. The usual reps and warranties were given that the borrower was not an FI. The minister argued GAAR: the loans were structured to obtain the commercial benefits of short-term lending, the security of lending to a bank, and the tax benefits not available for short-term loans to banks; thus Imperial attempted to achieve indirectly what it could not achieve directly.

The TCC set out three questions established by the FCA in *Water's Edge* to determine whether section 245 applies: (1) Is there a resultant tax benefit to the taxpayer? (2) Were the transactions undertaken primarily for a purpose other than to obtain a tax benefit? (3) If not, was there a resultant misuse of the provisions of the Act or an abuse of the Act read as a whole? The TCC said that there was a tax benefit and avoidance transactions, but no abuse or misuse as required. The fact that two major law firms gave opinions as to whether the subs were FIs probably indicated that the loans were structured for capital-tax-avoidance purposes. But there was no misuse because the object and spirit of part 1.3 was to allow a deduction from capital for loans to another corporation that would include such amount in its taxable capital; there was no abuse because the deduction was necessary to avoid double taxation. (However, there was no evidence to support whether the borrowers were taxable. The court merely said that resort to GAAR would not have been necessary if they were exempt.) The taxpayer did not create a new sub or enter into a partnership to achieve the deduction. There was no "abuse" of the Act as a whole when the deduction sought was necessary to avoid double taxation of capital. An expert witness testified that the transactions would not have occurred but for the LCT reduction. However, Imperial achieved net income on the transaction before capital taxes, and the transaction

satisfied the criteria of its treasury group that the principal be secure and the term no longer than 35 days.

The FCA concluded that there was no misuse as required. Imperial took advantage of a “loophole” in the LCT statutory scheme, which failed to deal with the consequences of different corporate year-ends. In contrast, Parliament pre-empted another equally foreseeable planning device by requiring proration of the \$10 million LCT deduction between related corporations. The loans did not violate the purpose for which Parliament provided that a short-term loan to an FI does not qualify for investment allowance; the loans were not made to FIs, and thus did not enable Imperial to do indirectly what it could not do directly; and the loans were ordinary commercial transactions, with no artificial elements, undertaken for both tax and non-tax purposes. The court also rejected the minister’s abuse argument that in the context of the Act it was clear that the year-end capital must be representative of the entire year’s balance. Having earlier referred to *OSFC*’s test of a “clear and unambiguous” policy in the misuse-and-abuse analysis, the court said that there was no clear policy, and that it would have been simple to structure alternatives to the year-end valuation date, although this would have placed a very onerous administrative burden on the taxpayer. Notwithstanding this decision, it is doubtful that this particular planning vehicle will return to vogue; other more sophisticated structures have evolved.

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## CFA DEBT FORGIVENESS

A recent technical interpretation (doc. no. 2003-0165195) provides surprising comments on the application of the debt-forgiveness rules to a CFA of a Canadian corporation.

The TI involved a Canco that owned a US sub (US Holdco) that in turn owned other US corporations (US Subs) that only carried on active businesses in the United States. Canco made non-interest-bearing US-dollar-denominated loans to US Holdco, which used the funds exclusively (1) to acquire shares of US Subs; (2) to lend at interest to US Subs (all the income was active business income [ABI] per subparagraph 95(2)(a)(ii)); (3) and for expenses related to the foregoing. The Canco loans were assumed to be on capital account to both parties.

**Relevant in computing FAPI.** FAPI includes debt-forgiveness income under subsection 80(13) only if interest paid or hypothetically paid is deductible in computing the debtor’s FAPI (paragraph 95(2)(g.1)). Debt-forgiveness income on the TI’s facts does not enter into the FAPI

computation because the borrowed funds were used to secure non-FAPI (CFA dividends and deemed ABI). The TI says that if some of a Canco loan was used to earn FAPI, the entire loan’s debt-forgiveness income enters into the FAPI calculation, because any amount of interest sourced to a FAPI use taints the entire loan under the modified definition of a commercial debt obligation. This rather surprising analysis does not seem to take into account the qualifying language in part A.1 of the FAPI formula and subsection 80(13), both of which link the debt forgiveness to the source of income. Because interest expense can be sourced on the basis of actual use under the interest deductibility rules, FAPI should capture only debt-forgiveness income commensurate with the funding of a property or non-active business use.

The Canco loan funding of share investments in US Subs (and related expenses) is sourced to an investment business even though the gross income, CFA dividends, is not included in FAPI (carved out in part A(b) of the formula). Under paragraph 95(2)(g.1), amounts are included in FAPI only if, under the modified definition of a commercial debt obligation, the interest expense was or would be deductible in computing the debtor’s FAPI. Although interest on the Canco loans that related to US Subs’ shares is in part D of the formula as a deduction in computing FAPI, one suspects—although it is not clear—that US Holdco need not ever have FAPI for it to be said that the interest was deductible in computing FAPI: debt-forgiveness income related to that portion of the Canco loans used to acquire the shares of US Subs should be included in computing US Holdco’s FAPI. (Unfortunately, the TI does not address whether debt-forgiveness income that falls into the FAPI computation is reduced by paragraph 80(2)(g.1) if the FMV of the US Holdco stock is increased via the debt settlement.)

**Surplus adjustments.** The TI also discusses whether the debt-forgiveness income increases US Holdco’s surplus accounts vis-à-vis Canco. Because US Holdco does not carry on an active business, a surplus increase for the non-FAPI portion of the debt-forgiveness income (not in part A.1) is under part (b) of the “earnings” definition or elsewhere, such as in “exempt earnings”; there is no pickup in “exempt earnings” or elsewhere if the commercial debt obligation’s forgiveness did not relate to FAPI. Any debt-forgiveness income related to the deemed ABI is only included in (b) of the “earnings” definition under proposed paragraph 95(2)(f.1), which assumes that a US Holdco is a Canadian resident in the computation of the property income, an assumption that falls short of the commercial debt obligation requirement that the taxpayer have (taxable) income earned in Canada. If the debt-forgiveness income falls into FAPI under formula

part A.1, a surplus adjustment arises from the increase in the amount of FAPI only when the suspended debt-forgiveness income comes into play based on the interplay of parts A.1, A.2, and G.

**Contribution to capital.** On a welcome note, the TI recognizes that an absolute forgiveness of the debt by Canco gives rise to a contribution of capital that bumps Canco's US Holdco shares basis under paragraph 53(1)(c).

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## FOREIGN TAX NEWS

### United Kingdom

The UK pre-budget report outlines significant changes planned for transfer-pricing rules expanding to domestic transactions the arm's-length principle on cross-border activities that confer a tax advantage. The draft legislation provides for an exemption for small or medium-sized businesses if the related parties are in the United Kingdom or in a country whose treaty with the United Kingdom includes a non-discrimination article; compensating adjustments in domestic transactions via a tax-free cash payment to the party whose tax is increased by the party benefiting from a tax-reducing adjustment; and replacement of thin cap non-deductibility of interest with transfer-pricing rules for non-arm's-length intercompany loans. A two-year grace period applies in which penalties will not be imposed for failure to comply with the documentation rules.

### Ireland

The 2004 budget includes encouragement to multinationals to locate in Ireland their regional headquarters and holding companies and the development and exploitation of intellectual property. Capital gains tax exemption applies for Irish companies that dispose of substantial shareholding in certain trading subs. Legislation is promised to provide double taxation relief on dividends paid to parent companies.

### Ukraine

New law establishes an investment activity program in the priority development territories of the Chernigov region and the city of Shostka in the Sumoskoy region. Investment projects must meet certain estimated cost levels. Benefits include customs duties and VAT exemptions on equipment imported for the projects; exemption from corporate profit taxes for three years and 50 percent tax for the subsequent three years; and a five-year land tax exemption. Proceeds such as funds,

material values, and intangible assets gained from investment projects are excluded from the tax base.

### Kazakhstan

A new law is intended to expand the telecommunications market by limiting foreign ownership to 49 percent and levying a tax on certain international long-distance services. Changes will take effect after April 2004, when deregulation occurs and Kazakhstan's own long-distance operation is privatized.

### Uruguay

A new trust act will regulate new legal instruments and is expected to increase savings and create credit. The new law is designed to create a neutral system for trusts that prevents trusts from being used as tax-avoidance tools. Foreign and domestic trusts are subject to the same rules.

### Estonia

A new law levies an 18 percent turnover tax on the sale of previously exempt vessels and planes. The tax also applies to new houses and apartments, tickets to cultural events, and thermal and alternative energy supplies (the last were formerly taxed at 5 percent).

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