Canadian Tax Highlights

Editor: Vivien Morgan, LL.B.

Volume 12, Number 3, March 2004

Withholding on US Partners

The CRA recently issued a technical interpretation concerning the applicability of the reduced withholding tax rate under the Canada-US treaty on interest payments made to a Canadian partnership of two US corporations (2003-0039051E5).

According to the TI, the partnership elected to be treated as a foreign corporation for US tax purposes, ensuring that the interest income it receives is not taxed in the United States until it is actually distributed to the partners. Neither partner has a permanent establishment (PE) in Canada for treaty purposes. For Canadian tax purposes, the partnership is viewed as a non-resident partnership.

The partnership made an interest-bearing loan to a Canadian corporation (Canco) that is related to the US-resident corporate partners. The TI confirms the CRA's position that interest paid by Canco to the partnership qualifies for the 10 percent reduced withholding tax under the treaty (article XI(2)), but also says that this position is "currently under review" because it conflicts with proposed changes to the OECD model convention commentary relating to partnerships. In 2000, the OECD Committee on Fiscal Affairs published a report on the proposed changes entitled "The Application of the OECD Model Tax Convention to Partnerships." The report suggests that the state of source is required to examine how the state of residence taxes the income to determine whether treaty benefits should be granted: if the domestic legislation of each state differs on the taxation of the partnership income, then the right to claim treaty benefits must be reviewed.

The CRA has been aware of the OECD report since its 2000 release and has continued to issue favourable rulings and TIs. It is therefore unsettling to hear that this position is "under review": if the CRA applies the report's conclusions to the facts set out in the TI, the interest payments might not be eligible for the 10 percent treaty rate. Instead, the general part XIII withholding tax rate of 25 percent could apply. The TI indicates that the results of its review will be announced in a future issue of *Income Tax Technical News*. Until such time, we understand that the CRA intends to maintain its longstanding position that allows the reduced withholding rate in the circumstances described in the TI.

Paul Hickey
KPMG LLP, Toronto

In This Issue

US Tax Opinions and Practices

The US Treasury recently proposed changes to Circular 230, which incorporates regulations that govern practice before the IRS. These changes prescribe best practices for all tax advisers, combine and modify standards for marketed and "more likely than not" tax shelter opinions, revise procedures for ensuring compliance with standards of practice, and provide for advisory committees to the Office of Professional Responsibility. The proposals hope to restore, promote, and maintain the public's confidence in the honesty and integrity of professionals who provide tax advice.

■ Best practices must be observed by all tax advisers for oral and written advice: (1) communicate clearly with the client regarding the terms of the engagement and the form and scope of the advice or assistance to be rendered; (2) establish the relevant facts and evaluate the reasonableness of any assumptions or representations; (3) relate the applicable law, including potentially applicable judicial doctrines, to the relevant facts; (4) arrive at a conclusion supported by the law and the facts; (5) advise the client regarding the significance of the conclusions reached; (6) act fairly and with integrity in practice before the IRS. All tax advisers must follow best practices and comply with certain tax shelter opinion requirements; managing

Editor's note: On December 12, 2003, the CCRA became the Canada Revenue Agency (CRA), but until the name is legislatively modified, "CRA" will not appear on legal or contractual documents. The customs program is now part of the new Canada Border Services Agency (CBSA).

tax partners must also ensure that procedures are in place to enable advisers to do so. Devising adequate procedures to comply with the regs will require creativity to balance the clients' needs for timely responses.

■ Key definitions are modified for tax shelter opinions. A "tax shelter" includes any partnership or other entity or any investment plan, other plan, or arrangement with a significant purpose of avoidance or evasion of any tax imposed by the Code. Tax avoidance generally refers to a strategy to minimize tax and includes an essentially unlimited range of personal, financial, and business transactions. A "tax shelter opinion" is written advice by a practitioner concerning federal tax aspects of any federal tax issue related to a tax shelter item or items (for example, income, gain, loss, deduction, or credit; the existence or absence of a taxable transfer of property; and the value of property), including a financial forecast or projection, predicated on assumptions regarding federal tax aspects of the investment or tax risks portion of offering materials.

Current exclusions for municipal bonds, annuities, family trusts, individual retirement accounts, stock option plans, and certain other specific transactions are eliminated. Written advice may range from a short e-mail response to a client inquiry to an extensive formal opinion letter, challenging managing tax partners to develop practical compliance procedures. A practitioner must determine whether an opinion is a tax shelter opinion, for which there are additional compliance requirements.

A "more likely than not" tax shelter opinion reaches a conclusion at a confidence level greater than 50 percent that one or more federal tax issues will be resolved in the taxpayer's favour. A "marketed tax shelter opinion" exists if a practitioner knows or has reason to know that it will be used by others in promoting or recommending the tax shelter to one or more taxpayers. If either type of opinion exists, the adviser must, inter alia, identify and consider all relevant facts and must not rely on any unreasonable factual assumptions or representations; relate the applicable law to the relevant facts and not rely on any unreasonable legal assumptions, representations, or conclusions; reach a conclusion, supported by the facts and the law, with respect to each material federal tax issue; and provide an overall conclusion about the federal tax treatment of the tax shelter item or items and the reasons therefor. If a practitioner cannot reach a conclusion or an overall conclusion, the opinion must state the issues and reasons for failure to reach a conclusion and make certain disclosures; limited-scope opinions are allowed only for non-marketed opinions.

■ A practitioner must disclose any compensation arrangement or any referral agreement with any person (other than the client) with respect to promoting, marketing, or recommending a tax shelter. A marketed opinion must disclose that it may not be sufficient for a taxpayer to use for the purpose of avoiding penalties and that the taxpayer should seek advice from his or her own tax adviser. A limited-scope opinion must state that additional issues may exist that may affect the federal tax treatment of the tax shelter under discussion. If an opinion fails to reach the confidence level of at least "more likely than not" with respect to one or more material federal tax issues, it must disclose that fact and that it was not written, and cannot be used by the recipient, for the purpose of avoiding penalties with respect to such issues. One objective of the proposed regulations is to ensure that a client is informed explicitly about what protection an opinion provides to him or her.

Alice Joseffer
Hodgson Russ LLP, Buffalo

Treaty Article XV Purpose

Employment income is generally taxable in the country where the services are rendered. Most of Canada's treaties provide tax relief in the host country if a non-resident individual is not present there for more than 183 days (or other specified period) in the taxation year, the employer-payer is not a resident there, and the remuneration is not borne by the employer's permanent establishment (PE) or fixed base there. The OECD model treaty commentary states that the objective is "to avoid source taxation of short-term employments to the extent that the employment income is not allowed as a deductible expense in the State of source because the employer is not taxable in that State as he neither is a resident nor has a [PE] therein." Once the 183-day criterion is established, the main issue is the identification of the employer.

Tax avoidance by means of this treaty exemption has escalated to the point of abuse in a practice known as international hiring out of labour. A local employer who wishes to employ foreign labour for one or more periods of less than 183 days recruits through an intermediary established abroad, which purports to be the employer and hires the worker out to the local employer. The worker thus appears to qualify for exemption despite a fee charged back to the local employer for salary costs. To curb such abuse, the OECD has adopted an "economic employer" or substance-over-form definition: "[I]t is understood that the employer is the person having rights on the work produced and bearing the relative responsibility and risks."

In the absence of a treaty definition of the term "employer," the country in which the employment is exercised applies its domestic law. In Canada (and most other countries) the term is not defined legislatively. Tax authorities must turn to jurisprudence, which examines the particular facts and circumstances and the terms and conditions of employment in the light of four factors: (1) degree of control by the company, (2) ownership of tools used to render services, (3) chance of profit and risk of loss, and (4) integration of the individual into the company's business. The CRA takes the position that if a foreign-resident individual comes to Canada and exercises duties for a Canco that is related to a foreign company and the costs relating to the individual's services are borne by the Canco directly or indirectly, there is a general presumption that the individual is its employee.

To reduce the abuse of article XV, a number of countries have recently adopted an "economic employer" concept. For instance, the Australian Taxation Office issued a public ruling on non-resident assignees that provide services of limited duration in Australia; the ruling focuses on the "economic employer," a substance-over-form approach, in analyzing the relevant employment relationships; factors that are assessed include which entity bears responsibility and risks for the work produced, has authority to instruct and provide direction, and provides the tools and materials required to perform the work, and at whose premises the work is performed. Effective January 2004, Germany has also adopted the "economic employer" test.

The revised public discussion draft on cross-border issues related to stock options, released by the OECD Committee on Fiscal Affairs in July 2003, further supports the objective of article XV(2). The current commentary indicates that the phrase "remuneration is not borne by a [PE]" means remuneration that is not deductible in computing the PE's profits. The proposed commentary clarifies that the phrase does not suggest that stock option remuneration cannot be viewed as borne by a PE merely because the state where it is located does not allow a deduction therefor. The absence of a deduction results from the nature of the payment, not from the fact that the payment is not incurred in relation to the PE, and the proper test is whether any deduction otherwise available in respect of that remuneration would be allocated to the PE.

Albert Baker and Terri Spadorcia
Deloitte & Touche LLP, Montreal

Tax Burdens Internationally

The Organisation for Economic Co-operation and Development provides an annual review of tax statistics in member countries. The most recent edition shows that the tax burden in Canada is declining faster than in our major trading partners in the OECD.

Total Tax Revenue as a Percentage of Gross Domestic Product, 2000 to 2002

	2000	2001	Provisional 2002
Sweden	54.0	51.4	50.6
France	45.2	45.0	44.2
Italy	41.9	42.0	41.1
United Kingdom	37.2	37.3	35.9
Germany	37.8	36.8	36.2
Canada	35.6	35.1	33.5
United States	29.7	28.9	na
Japan	27.5	27.3	na
G7 average (estimated)	36.4	36.1	35.2
OECD average	37.1	36.9	na
OECD Europe	39.6	39.4	39.0

na Not available.

The table shows that our total tax collections, as broadly defined for national accounts purposes, dropped from 35.6 percent of gross domestic product in 2000 to 33.5 percent in 2002. The simple arithmetic average of the ratios in the G7 countries, assuming that the 2002 ratios in Japan and the United States—not shown in the OECD publication—performed as they had in the previous years, fell from 36.4 percent to 35.2 percent. Our ratio was lower than those in all the other G7 countries except the United States and Japan.

Canada remained below the average ratio for all OECD members and well below the average for the European members, ranking 19th out of the 30 member countries covered in the study, and showed more improvement than the average for the OECD as a whole. Sweden remained the highest-tax jurisdiction, with tax collections equal to 50.6 percent of GDP in 2002, but still significantly better than the 2000 ratio of 54.0 percent.

The numbers show that Canada's tax burden is far from the highest in the industrialized world, but is significantly higher than that of the United States, our closest and best-known trading partner. Our tax burden is well below the levels of our European trading partners, but, as with the US comparisons, care must be used to determine what it is that taxes are expected to finance in each country. Canada's level of public spending is above that in the United States and below that in most European countries. Furthermore, these broad comparisons of tax collections mask the fact that Canada's personal income taxes are well above the levels in many OECD member countries.

David B. Perry
Canadian Tax Foundation, Toronto

Access to Information

When an adviser represents taxpayers before the CRA Appeals Division or in TCC informal procedures, the ability to discover the minister's case and information against the taxpayer is limited. Disclosure practices among district offices upon receiving a notice of objection or a specific request for documents are widely divergent. Requests under the Access to Information Act (AIA) have become extremely useful in an increasing array of situations.

AIA section 2 states that the act's purpose is to extend the laws of Canada to provide a right of access to information in records under a government institution's control, in accordance with the principles that such information should be available to the public; that necessary exceptions to the right of access should be limited and specific; and that disclosure decisions should be subject to independent review. Section 6 provides that a request for access to a record must be made in writing to the government institution that controls the record and must contain sufficient detail to enable an experienced employee thereof to identify the record with a reasonable effort.

Separate forms are prescribed for filing requests for access to information in respect of individuals (personal information request) and in respect of other entities or other general information (access to information request). No filing fee applies to the former, although in either case the institution may request reimbursement for employee time and photocopying when a large number of relevant documents are identified in a request. Although the CRA provides a directory of codes for all the databases in which it collects information and the types of information contained therein, experience indicates that the types of information are constantly changing and that the same or more information is provided if the request is not limited to certain database codes. The auditor's report and working notes do not generally include information such as actual referrals and communications between the Verification and Enforcement Division of the CRA and other divisions (including Business Valuations and Special Investigations). Such information is obviously crucial in making submissions or developing settlement strategies for reassessments based on unreported revenue, net worth assessments, and reassessments with important cross-border or valuation issues. For example, in one objection dealing with regulation 105 withholding on live performances by non-resident entertainers, an access-to-information request triggered the release of copies of e-mails between the auditor in Vancouver and the International Tax Services Office in Ottawa that made it clear that the auditor had misunderstood not only the relevant facts but also the law's application. An access-to-information request may also uncover such interesting items as requests for information made to the tax authorities of other countries, whether or not made pursuant to a tax treaty.

The AIA thus permits a taxpayer to gain access to information that will assist in disputing assessments and reassessments of tax, but there are prescribed exceptions to the right of access—for example, if the record contains trade secrets of a third party; if confidential financial, commercial, scientific, or technical information was supplied to a government institution by a third party; if disclosure could result in financial loss or gain; or if disclosure could reasonably be expected to interfere with contractual or other negotiations of a third party. Not infrequently, large portions of disclosed documents are either blacked out or severed and stamped to indicate the specific AIA provision under which disclosure is denied. Complaints regarding denied disclosure may be filed with the information commissioner. A third party to whom the head of a government institution is required to give a notice of a decision to disclose a record may apply for review by the Federal Court. For example, in *Canadian Tobacco Manufacturers' Council* (2003 FC 1037), the Federal Court recently decided not to grant an order requiring the information commissioner to disclose certain reports to the Canadian Cancer Society (CCS) that had been commissioned by the Canadian Tobacco Manufacturers' Council (CTMC) and delivered to the CRA in confidence. The reports related to the CTMC's desire to make representations to the CRA in regard to tobacco smuggling and contraband activities. The CCS had asked for disclosure of all records sent to and received from the tobacco industry or its representatives, including the CTMC, "with respect to marking/stamping on packages of tobacco products." The court found that an initial decision to deny access to the requested records by a CRA official was improper; that an unduly narrow interpretation of the access request had been taken; that none of the records at issue in the case should have been withheld on the basis that they were not relevant to the request; and that the exception relied upon by the CRA and raised by the CTMC did not apply to justify secrecy in that case. The court explained that while a government institution is not obliged to retrieve and disclose documents that are not relevant to an access request, a third party cannot invoke "relevance" as an exception. The court made it clear that all exceptions to access must be limited and specific, and it applied the exceptions very strictly.

Sergio Rodriguez
Thorsteinssons, Vancouver

The $3 Billion Question

The reasons for judgment of Strayer J of the FCTD (as he then was) in the constitutional case of *Smith, Kline* pinpointed a transfer-pricing problem.

> [I]f this company . . . had been paying the international market price for supplies of this drug rather than a higher price to a related corporation [at a non-negotiated price], its operating profits then would have been almost three times as much. . . . [O]ne could readily speculate that the company would still have been in a profitable position had it decided not to purchase the more expensive drug from its sister subsidiary. [(1985), 24 DLR (4th) 321, at 370-71.]

Eight years later, Revenue Canada reassessed SmithKline's Canadian sub under the now repealed subsection 69(2) and disallowed about $67 million deducted in its 1981-1986 taxation years for the purchase of cimetidine, the active ingredient used by it in the manufacture of the drug Tagamet. An appeal to the TCC filed in 1995 triggered eight years of litigation, featuring numerous interlocutory motions and appellate decisions concerning many of the steps in a tax appeal, including amendments to pleadings and the effect of (then) newly enacted subsection 152(9); the production of documents before discovery (including an expert's report from the constitutional case); the scope of examination for discovery; and even contempt-of-court proceedings brought against the attorney general and Crown counsel, which the Federal Court eventually permitted SmithKline to discontinue upon the payment of solicitor and client costs to the Crown. In late 2003, SmithKline finally settled its TCC appeals: of the $67 million in disputed deductions for cimetidine, $51.5 million was disallowed under subsection 69(2), and SmithKline agreed to pay the Crown $3.2 million in costs for expert witnesses and electronic document management.

Now a $3 billion question has been raised by the release of the reasons for judgment of Cumming J of the Ontario Superior Court of Justice in *Ford Motor of Canada Ltd. v. Ontario (Municipal Employees Retirement Board)*, [2004] OJ no. 191. The decision followed a 49-day trial concerning a "going-private" or "squeeze-out" transaction in which Ford US moved in 1995 to acquire the approximately 6 percent of Ford Canada shares that it did not own. Minority shareholders, including the Ontario Municipal Employees' Retirement System (OMERS) and others, dissented over the $185 per share price, alleging that they had been unlawfully oppressed through the intercorporate transfer-price regime between Ford US and Ford Canada from 1965 to 1995. The evidence at trial disclosed that the Canadian Vehicle Division (CVD) of Ford Canada, which sold assembled vehicles to independent Ford dealers in Canada, had a loss in each year from 1977 to 1995, totalling about $7.5 billion. The evidence also showed that Ford Canada's CVD was bound to accept prices set by Ford US and that prices and markups were not negotiated with Ford Canada. Ford Canada's CVD was charged TELO (tooling, engineering, launch, and obsolescence expenses) by Ford US totalling $3.586 billion for 1985-1995, a period during which Ford Canada's sales into the Canadian market registered a cumulative loss of $2.16 billion. Cumming J said:

> No reasonable arm's length entrepreneur would make that investm ent in intangible assets given the negative return and little prospect of any significant change for the future. . . . Why would the management of any truly independent entity in Ford Canada's position continue to tolerate an inter-corporate pricing arrangement that leaves it with a staggering aggregation of losses carried forward and with the only reasonable expectation for the future being that of continuing mammoth losses? . . . [A]n independent, arm's length party in the position of Ford Canada would have demanded reformulation of the inter-corporate arrangements. . . . [A]t arm's length, Ford Canada would have insisted on negotiating fundamental changes to the inter-corporate pricing system by 1984. . . . [I]t should have been clear by 1984 that there was a serious problem in the transfer pricing system in terms of fairness to Ford Canada and, in particular, to its minority shareholders.

The evidence also disclosed that Ford US had a net benefit from Ford Canada through the Canadian market for 1985-1995 of about $6.115 billion, at a time when Ford Canada had an aggregate reported loss from North American operations of $709 million.

Each of OMERS' three transfer-pricing experts used a different transfer-pricing method (profit-split, comparables, and return on investment) to determine Ford Canada's profit shortfall, which they independently concluded was in the $2.6 to $3 billion range. Cumming J stated that the profit-split method, which would result in an inclusion in Ford Canada's income of $3.036 billion during 1985-1995, not only better achieves arm's-length results but also accords with the substantive reality of the Ford enterprise.

Cumming J noted that the CRA had not done a full-scale audit or comprehensive evaluation of Ford's transfer-pricing system, but rather had looked at it only in a very "broad brush manner" and did not attack its fundamentals. However, Cumming J noted that it is not sufficient for a taxpayer to simply have a transfer-pricing system to which the tax authorities do not object; rather, the system must not result in unfairness to minority shareholders that constitutes oppression within the meaning of the Canada Business Corporations Act. Arguments that the OMERS transfer-pricing experts in effect restructured the intercorporate transactions between Ford Canada and Ford US were rejected; the court held that each of the experts' approaches constituted a proper transfer-pricing analysis.

The *Ford* decision represents the most extensive judicial consideration in Canada to date of the methodologies used in arriving at arm's-length prices, and it sets the stage for reassessment action by the CRA, assuming that Ford Canada's 1985-1995 taxation years are not already statute-barred. Given the confidentiality provisions in section 241 of the Income Tax Act and the availability of competent authority proceedings under the Canada-US tax treaty, the income tax implications, if any, of the decision by Cumming J (which is now under appeal) may never become public, unless they are eventually disclosed in financial statements. The decision nevertheless represents a "must read" for those interested in the transfer-pricing area.

Bob McMechan
Lawyer, Ottawa

Multi-SBD Ruling

The CRA recently issued a favourable ruling on the incorporation of a professional partnership of medical doctors with tax-planning flexibility included in the arrangement (2003-0049893).

The partners provided their services to hospitals as independent contractors, used the hospitals' infrastructure, and were paid by the province's medical insurance organization. The proposed transactions were designed, inter alia, to eliminate joint and several liability inherent in providing professional services through a partnership.

The proposed transaction contemplates the creation of a new corporation (Newco), which obtains a permit to practise medicine in the relevant jurisdiction. Newco's shares are owned by the former partners. Each former partner incorporates and controls a contracting professional corporation (CPC); non-voting shares may be owned by family members or other dependants, either directly through an irrevocable discretionary trust for their benefit or through a holding company owned by them. Each former partner may provide medical services directly to Newco as an independent contractor or to Newco through his or her CPC. In the latter case, Newco pays fees to the CPC for services performed. The CRA ruled that as long as the partner who provides medical services to Newco through a CPC would not, but for the existence of the CPC, be an officer or employee of Newco in respect of the professional services, then each such CPC is not considered to be carrying on a "personal services business" as defined by subsection 125(7). As a result, each CPC is eligible to claim the small business deduction on fee income received from Newco. The ruling also says that, subject to sections 18 and 6, fees payable by Newco to a CPC for professional services are deductible in computing profit and loss from Newco's business under section 9.

The CRA ruled that GAAR does not apply as a result of the proposed transactions to redetermine the tax consequences. However, the CRA was unable to rule that the anti-avoidance provision in subsection 256(2.1) could never apply to Newco and each CPC; that provision deems two or more corporations to be associated if it may reasonably be considered that one of the main reasons for their separate existence is to reduce tax otherwise payable. Corporations that are associated (or deemed so) must share the small business deduction. The CRA said that when a business that was previously carried on in a partnership is subsequently carried on by the former partners but not qua partners, for non-income-tax reasons, subsection 256(2.1) generally does not apply; on the ruling's facts, the partners' incorporation of the partnership business activities would not cause that provision to apply.

Wayne Tunney
KPMG LLP, Toronto

Corporations Not Associated

The recent TCC decision in *LJP Sales* reminds taxpayers that the anti-avoidance rule in subsection 256(2.1), which can result in the denial of separate small business deductions (SBDs), should be considered when closely held corporations are restructured and taxes are reduced or refundable ITCs are thereby increased (2004 DTC 2007). The court held that the rule did not deem two corporations to be associated, because it could be reasonably considered that tax reduction was not one of the main purposes for their separate existence; the only main reason was to resolve a family concern.

Mrs. Passarello operated a business through a corporation, Jo-Van, owned 91 percent by her and 9 percent by her spouse, who worked in the business part-time. Mrs. Passarello's will passed her assets to their children, who were disinherited by her husband. Mr. Passarello was concerned that a disproportionate amount of profits was accruing in Jo-Van, and he wished to equalize its future profits so that his children would not inherit his share. Following his accountant's recommendation, Mr. Passarello accomplished this objective by incorporating LJP Sales, which entered into a sales agency agreement with Jo-Van to receive 5 percent of Jo-Van's net revenues generated by LJP. Neither spouse was aware of the resultant tax savings from the transfer of profits to LJP and the creation of a second SBD.

The minister deemed LJP to be associated with Jo-Van via subsection 256(2.1), because tax reduction was one of the main reasons for the separate existence of the corporations. The court disagreed: the only main reason for the corporations' separate existence was to effect Mr. Passarello's wishes to disinherit his children and thus resolve a family issue that was "tearing them apart"; tax reduction was not a main reason. The court reviewed several factors, including whether the separate corporations changed the business or the spouses' roles in the business; how close Jo-Van was to the maximum small business limit before LJP was incorporated; what other tax planning the parties engaged in; whether Mr. Passarello could have achieved his objectives in another manner; and whether the plan would have been adopted if there had been no tax advantage. The court concluded that the taxpayer's accountant "would not have been doing his job for the Passarellos if he did not consider tax," but the reduction of tax was not a main reason for his recommendations.

Louis J. Provenzano and Christine Damianidis
PricewaterhouseCoopers LLP, Toronto

US Treaties: Partners' Income

IRS Rev. rul. 2004-3, released January 29, 2004, says that a non-resident partner in a service partnership is subject to US income tax on his or her allocable share of partnership income to the extent that such income is attributable to a US fixed base under article 14 (Independent Personal Services) of the US-Germany treaty, regardless of whether the non-resident performs services in the United States.

The ruling is a marked departure from the 1996 US model treaty's technical explanation, which concludes that a non-resident individual partner of a service partnership with a US fixed base is not taxed there on his distributive share of partnership income attributable to the fixed base, if other partners performed the services. However, technical explanations to a number of US treaties that subsequently entered into force state that such income may be taxed in the state where the services are performed through a fixed base, by the partner himself, by other partners, or by employees assisting them. (See, for example, recent US treaties with the United Kingdom, Switzerland, Ireland, Thailand, South Africa, and Japan.)

On the ruling's facts, P, a service partnership organized in Germany, has a German and a US office: the US office constitutes a "fixed base." P's two partners, A and B, agree to divide the partnership profits equally. A is a non-resident alien, resident in Germany under the US-Germany treaty; B is a US resident. A performs services solely at P's German office, and B performs services solely at the US office. The IRS concluded that A is subject to US income tax on his allocable share of partnership income attributable to the fixed base under article 14 of the US-Germany treaty, notwithstanding that he does not perform services in the United States. The ruling cites Code section 875(1), which provides that a non-resident alien partner is considered to be engaged in a US trade or business if the partnership is so engaged; under section 871(b), such a partner is taxed on his taxable income effectively connected to the US trade or business. The ruling also notes that section 894(a)(1) provides that the Code must be applied to a taxpayer with due regard to any applicable US treaty obligation vis-à-vis that taxpayer. The ruling cites *Donroy* (301 F. 2d 200 (9th Cir. 1962)), which concluded that the US permanent establishment was attributed to the individual Canadian partners. *Unger* (936 F. 2d 1316 (DC Cir. 1991)) is cited as support for the principle that a partnership's PE is deemed to be that of its Canadian limited and general partners. Based on these authorities, the ruling concludes that a partnership's fixed base is attributed to each of its partners for the purposes of applying the US-Germany treaty. That conclusion is also based on the unstated premise that the authorities regarding PEs apply equally to fixed bases.

Thus, on its facts, the ruling concludes that the German-resident partner is treated as having a fixed base regularly available to him in the United States. Moreover, if A's allocable share of partnership income is at least partially attributable to the partnership's US fixed base, he is subject to US income tax on such income regardless of whether he actually performs services in the United States. Significantly, the IRS also goes on to say that this holding applies to other US income tax treaties with provisions that are the "same [as] or similar to" article 14 of the US-Germany treaty. The language in the Canada-US treaty is similar in that respect.

Steve Jackson
Ernst & Young LLP, Toronto

Art Flip Flops

The TCC in *Klotz* (2004 TCC 147) denied donation credits for a 1995 "art flip" of limited edition prints (2003-308(IT)G). Mr. Klotz was one of 660 individuals who acquired listed personal property (LPP) that was then donated to prescribed colleges and universities. Mr. Klotz donated his 250 prints (which cost him about $300 each) and received a donation slip for about $250,000 (an average value of $1,000 per print) supported by a valuation appraisal prepared by an art dealer and appraiser. The appraiser's independence was somewhat compromised by her minor participation in the program. Mr. Klotz never saw the prints he donated, never had possession of them, and had no role in choosing them. Participants in similar programs who have filed objections regarding tax credits denied at the values claimed should consider whether they can differentiate themselves from *Klotz* on the facts.

Subsection 46(1) as it read in 1995 deemed a $1,000 minimum cost and proceeds for each personal-use property (PUP) (which includes LPP) for the purpose of calculating any capital gain. But the rules had no bearing on the value of a gift for donation credit purposes. (The 2000 federal budget introduced subsection 46(5) to exclude art flips from the $1,000 rule for property acquired after February 27, 2000.) Of the Klotz prints, 201 were valued at exactly $1,000, 13 at $1,100, 16 at $1,200, 11 at $1,400, 5 at $1,500, and 3 at $1,800. The court said, "[T]he conclusion that over 80 per cent of the prints . . . were valued at precisely CDN $1,000 (which by extraordinary coincidence is the amount mentioned in subsection 46(1)) is suspect, to say the least. I find it hard to believe there is no difference between the multiplicity of prints valued." The court did not reject the valuation out of hand because of the valuator's program participation, but questioned her choice of the "retail" rather than "wholesale" method to value the prints. The valuator said that the wholesale market exists only, for example, on a sale involving multiple prints at prices not available to members of the general public seeking a single print. The court remarked that "even if we accept that the proper market . . . is the retail market [on] the evidence . . . there were no actual sales of identical or similar prints in this market." The court did not apply a "block discount" to retail value as in *Putsina* (96 DTC 1594), but held that the best evidence of the prints' value was what Mr. Klotz paid for them almost contemporaneously with the donation. The court distinguished between valuing a masterpiece picked up at a garage sale for a nominal price and the purchase of thousands of prints in bulk for donation purposes.

In similar donation arrangements, in order to meet the PUP definition, participants are encouraged to take delivery of the prints when purchased, retain a few for personal use, and then ship the remaining prints to be donated to the charity. Mr. Klotz did not follow this prescription, but the court held that the prints were PUP: "one way of using an object is to give it away, whether the motive be altruistic, charitable or fiscal."

There was good news for taxpayers in similar deals under scrutiny. The court did not apply penalties under subsection 163(2) and counselled extreme caution in their imposition. Although the taxpayer did not seek independent valuation advice and did not pay sufficient attention to the tax opinions rendered, the taxpayer relied on his financial adviser, obtained what on its face was an appraisal by a qualified appraiser, and obtained two legal opinions which, however qualified they might be, would be taken by the layman as implicitly putting the imprimatur of two major law firms on the program. Although there may have been a lack of due diligence, it did not cross the threshold of reprehensible behaviour implicit in the penalty's gross negligence test.

John Jakolev
Goodman & Carr LLP, Toronto

US Residential Real Estate

Many Canadians are attracted to the ownership of US residential real estate, but not to the potential US estate tax. The US$13,000 unified credit is extended to Canadians under the treaty, but the benefit is prorated on the ratio of the individual's US-to-world asset values, which is usually less than 100 percent. Various tax-planning strategies have been developed, including a Canadian single purpose corporation (SPC); joint ownership by family members; a Canadian discretionary trust; non-recourse debt on the US residence to reduce the equity that is subject to estate tax; and a Canadian partnership that may or may not elect foreign corporation status for US tax purposes. The recent US tax reduction on individuals' capital gains may affect the choice of structure. This article will discuss SPCs; other structures will be covered next month.

An SPC will avoid a shareholder benefit for Canadian tax purposes if the following conditions are met:

1) The corporation is a Canadian corporation (per subsection 89(1)).

2) Canco's only objective is the holding of one US residential real property for personal use or enjoyment of the shareholder. (The rent-free use by other family members may indicate other purposes.)

3) Canco's shares are held by an individual alone or with related non-corporate persons.

4) Canco's only transactions relate only to its sole objective; occasional use as a rental property is not allowed.

5) The shareholder pays all the property's operating expenses and no rent; Canco shows no profit or loss from the property for tax purposes.

6) Canco acquires the property with funds provided solely by the shareholder and not by virtue of his or a related person's corporate holdings. Intercompany loans cannot be used. If there is more than one shareholder, each contributes equity or a loan pro rata. Attribution may apply if an individual uses funds from a non-arm's-length person; subsection 74.4(2) may impute taxable interest income to one spouse who contributes the funds to an SPC owned equally by both spouses.

7) Canco must acquire the property in a fully taxable transaction, not a rollover.

The CRA says that the amount of any shareholder benefit is the property's FMV rental less consideration

Readers are invited to submit ideas or written material to *Canadian Tax Highlights*. Please write to Vivien Morgan in care of the Canadian Tax Foundation.
Published monthly

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
ISSN 1496-4422 (Online)

paid. However, it may be appropriate to apply a normal rate of return based on prescribed rates on the greater of the FMV and cost plus operating costs, less consideration paid. (See *Youngman* [1990] 2 CTC 10; the benefit may be reduced by interest imputed on a related interest-free shareholder loan.) In *Fingold* (97 DTC 5449), the taxpayer and his brother had access to a US condo that was owned by a family Canadian holdco, not an SPC. The property cost about $4 million; it was used by the family for about 151 days per year and for business for 26 to 45 days per year. The taxpayer reported an FMV rental of $60,000 per year; the FCA valued the benefit by imputing interest on the cost, plus holdco's operating costs, totalling $274,000 in 1988 and $445,675 in 1989. However, US practitioners caution that strict compliance with the SPC guidelines may allow the IRS to ignore the corporation as an agent of the shareholder. The risks of collateral US income tax consequences generally are considered manageable. Although some US cases say that the FMV rental triggers deemed dividends, such dividends from a Canco are not subject to US tax. The IRS's attempts to impute rental income to the corporation have not been successful (see *Spark's Farm*, 56 TCM 464 (1988)).

If an SPC disposes of its residential real property, a shareholder benefit becomes moot. Canco is taxable on any gain in Canada and the United States; a Canadian foreign tax credit may offset US tax. The US corporate tax rate on the gain (35 percent plus state tax) is higher than the tax rate an individual bears (15 percent); a partnership of individuals may access the lower rate and will enjoy a basis step-up in the underlying property (rather than shares) on the shareholder's death. (It is highly unlikely that the underlying property will be subsequently sold through a stock sale.) Most states impose a franchise tax on Canco that may prove costly for more expensive residences. The CRA says that the transfer on death (but not inter vivos) of the SPC's shares and debt to a Canadian-resident spouse does not result in a loss of SPC status; there is no step-up in the underlying assets' basis.

It has been suggested that the shareholder can retain the beneficial interest and pass only legal title to Canco. The CRA assumes that an SPC has both titles: the purpose of an SPC is otherwise defeated, because, for example, the IRS will likely look through it. In any event, for a Canco to hold the property in trust as the shareholder's agent, there must be an agreement or declaration of trust, entered into before or at the time the property was acquired, that clearly sets out the parties' intention and the degree of the shareholder's participation in the property.

Jack Bernstein
Aird & Berlis LLP, Toronto

Foreign Tax News

Treaties

Negotiations will commence on April 19, 2004 to revise the treaty with the **Republic of Korea**. Finance welcomes comments, concerns, and suggestions from the public: contact Parry Athenaios in the Tax Legislation Division at (613) 992-5864.

Singapore

Singapore's 2004 budget gives priority to stimulating the economy over balancing the budget: it proposes corporate tax reduction from 22 to 20 percent (for oil producers from 10 to 5 percent) and tax exemptions for foreign-source income and earnings from financial instruments.

OECD

A spokesman for the OECD Business and Industry Advisory Committee says that there is a reasonable possibility that the model treaty's mutual agreement procedure will be replaced with mandatory arbitration to eliminate double taxation. Treaties may need to be renegotiated to provide for mandatory arbitration, but the OECD may request member countries to open up access to mandatory arbitration and thus eliminate renegotiation. The OECD hopes to post on its Web site by mid-March contact information for all the OECD member country competent authorities, and details of the competent authority processes of member countries.

People's Republic of China

To improve tax administration and collection in the special economic development zones, the State Administration of Taxation will ensure that subject enterprises are registered and operating within the zone, that new enterprises are properly reviewed before preferential treatment is granted, and that benefits follow federal government guidelines.

Carol Mohammed
Canadian Tax Foundation, Toronto