Canadian Tax Highlights

Editor: Vivien Morgan, LL.B.

Volume 12, Number 4, April 2004

CRA Valuation Comfort

To accommodate valuation-related inquiries on proposed transactions, the CRA plans to provide a new valuation service and has issued an exposure draft. The CRA's Technical Application and Valuations Division invites comments on its "Future Directions" initiative in business equity valuations and real estate appraisals.

The service will provide some comfort to individuals and corporations on a proposed transaction's valuation methodology and to charities on the appropriate scope of review, methodology, elements to be considered, and procedures to be followed in determining donated property's FMV for the purpose of issuing a charitable receipt. FMV issues on a rulings request will also be addressed. Moreover, as a pilot project the CRA will provide at no cost a preliminary interpretation of contentious or complex issues before a business enters into a transaction or before it files an annual tax return. The CRA will provide answers to questions on specific valuation-related matters, but will not express a valuation opinion or a statement thereon.

It is expected that the service will not apply to tax shelter transactions, irregular tax-planning arrangements, and GAARable transactions. Requests must be made in writing and the standard of value must generally be FMV and not, for example, value to owner or fair value. The taxpayer need not be identified.

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Unreported Losses Deductible

In *Burleigh* (2004 TCC 197), the TCC said that an individual's loss not reported in his income tax return in the year incurred was deductible in a later year. Thus, an individual is entitled to a section 111 deduction for a previously unreported loss, subject to carryover time limitations.

Mr. Burleigh filed his 2002 income tax return in April 2003 and his 2001 return in November 2003. In the 2002 income tax return, he applied net capital losses incurred in 2001 against 2002 taxable capital gains. The CRA argued that a net capital loss carryforward under paragraph 111(1)(b) can be claimed only if the loss was reported in the income tax return for the year incurred and the return was processed and accepted by the CRA. If the loss calculation was not accepted, the taxpayer must appeal.

The TCC said that the CRA's argument was flawed in many ways. For example, section 111 imposes no requirement that a loss be reported in an income tax return for the year incurred: the losses have "an existence that is independent of their being reported in a return of income." Further, if an individual has a loss resulting in nil taxable income for the year, nothing in the Act requires the filing of a return for that year in order to carry the loss forward. A taxpayer can simply carry forward a loss to a year when there is income. If the CRA disagrees with the taxpayer's calculation and disallows part or all of the carryforward, the taxpayer can then object and appeal. Nothing in the Act supports the notion that a taxpayer can challenge the CRA's calculation only through a loss determination.

The TCC's findings may benefit individuals who have failed to report previous losses by allowing them to claim the losses against current or future income or gains. It appears that the administrative burden of filing an income tax return when not required or completing a T1 Adjustment Request to report a prior year's loss on a previously filed return is not necessary.

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In This Issue

Imperial Oil Reined In

Imperial Oil (TCC 2004 207) concluded that paragraph 20(1)(f) did not allow a deduction for a foreign exchange (FX) loss suffered by the taxpayer on a US$300 million debt issued at a discount of 1.199 percent. Many tax practitioners are wondering whether the decision, which the taxpayer has appealed, has launched a new era of proactive judicial reasoning.

Ten years after issue, debentures with a face value of about US$87.1 million were redeemed. In the interim, the US dollar had appreciated from Cdn$1.1766 to $1.48192, resulting in an FX loss of about Cdn$27.8 million, which amount the taxpayer claimed in its entirety under subparagraph 20(1)(f)(ii) in its 1999 return. The court held that some Cdn$1.5 million was deductible under subparagraph (i); nothing was deductible under subparagraph (ii).

Both the taxpayer and the CRA agreed that paragraph 20(1)(f) should be interpreted in totality, in context, and, as per the frequently quoted text of Professor Driedger, "harmoniously with the scheme and the object of the Act and the intention of Parliament." Both parties' positions were premised on the *Gaynor* principle, which requires a conversion of each element in the paragraph 20(1)(f) formula into Canadian dollars, and agreed that the threshold tests in subparagraph 20(1)(f)(i) had been met. The formula to compute a deduction under this subparagraph can be summarized mathematically as X=(the lesser of A and B) minus C: A is the principal amount of the obligation, B is all amounts paid in satisfaction of the principal amount, and C is the amount for which the obligation was issued. The parties agreed that B and C were computed, respectively, as Cdn$129 million [US$87.1 million × 1.48192 (the FX rate at redemption)] and Cdn$101.2 million [1.17660 (the FX rate at issuance) × US$86 million (US$87.1 million minus the US$1.1 million discount)]. The remaining issue was whether A, the principal amount of the obligation, was computed using the FX rate in 1989 (when the debt was issued) or in 1999 (at redemption), yielding Cdn$102 million or Cdn$129 million, respectively.

The taxpayer argued that the 1999 FX rate applied because the "principal amount" is defined as the "maximum amount payable in respect of the obligation": the 1989 FX rate would yield a lesser amount. The Crown argued that subsection 248(26) applied, but the TCC said that it led to an illogical result and that it was introduced to deal with the timing of the issuance of the obligation more for the purposes of section 80 than for the purposes of paragraph 20(1)(f). The taxpayer also cited *Waltz* (2001 DTC 462), in which the TCC said that in the absence of a statutory provision to the contrary, "principal amounts" are computed at the time of disposition—in this case, the debt's redemption. The taxpayer argued further that an FX loss otherwise on capital account was simply part of the cost of borrowing and was deductible under paragraph 20(1)(f) just as other such costs were, but the TCC disagreed: an FX loss is not derived from the "contract of origin," but rather arises from external currency fluctuations.

The court readily accepted that the order of calculation under the Act required that a deduction under paragraph 20(1)(f) preceded subsection 39(2)'s application. However, the *Gaynor* principle did not apply because the conversion of an FX amount differed, depending upon whether the purpose was to calculate a capital gain or an income amount—for example, under paragraph 20(1)(f). The taxpayer argued that the term "principal amount" is clearly defined and that clear and unambiguous words must be followed. However, the court said that the uncertainty over the application of the FX rate created an ambiguity and the results of the transaction could be used to ascertain Parliament's intent: it was "too much of a stretch to find Parliament intended to effectively bury such a significant deduction in paragraph 20(1)(f), with no commentary, no headings, no guidance. It is not plausible." Technical notes issued in 1988 "do not suggest any Government intention to capture [FX] losses under paragraph 20(1)(f)." The heading of the section "Discount on certain obligations" had no bearing on the decision. The parties had focused only on which FX rate applied to the phrase "principal amount" instead of on the ordinary meaning of the words; they had taken too narrow an approach, which led to a result contrary to the purpose of the provision as a whole. Neither party's position adequately dealt with the situation in which the Canadian dollar strengthened vis-à-vis the US dollar: any deduction for a deep discount under paragraph 20(1)(f) would be wiped out by the FX gain. The only approach "where economic and legal reality mesh" is to apply the formula in the currency of the obligation and then convert the result into current Canadian dollars, an approach that was in accordance with the scheme of the Act and the intention of Parliament and did not offend any well-established principle of statutory interpretation. Although the court found substantially in the Crown's favour, the Crown was not awarded costs because the decision was not based on reasoning that it had developed.

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Non-Tax Government Revenue

All levels of government in Canada receive about 79 percent of their total revenue from taxes of all types. This ratio has been stable since the late 1980s, and so has mirrored the change in the ratio of tax collections to gross domestic product (GDP), as shown in the table. The data come from Statistics Canada's national income and expenditure accounts.

Non-tax revenue consists of three major and several minor categories. Investment income (including interest), remittances from government business enterprises, and provincial royalties from the exploitation of natural resources peaked at the equivalent of 5.56 percent of GDP in 1980 and declined to a low of 3.20 percent in 2002, the latest year for which information is available. That category represented over 55 percent of all non-tax revenue in the early 1980s, but now constitutes only 35 percent. Revenue from sales of goods and services makes up about

Tax and Other Revenue as a Percentage of GDP, Selected Years 1975 to 2002

	Total revenue	Tax revenue	Investment income	Sales	Total other revenue
1975	39.35	30.61	4.18	2.15	8.74
1980	39.06	29.20	5.56	2.37	10.18
1985	40.50	31.09	5.23	2.74	9.60
1990	44.55	35.06	4.30	2.95	9.49
1991	45.50	35.81	4.12	3.13	9.69
1992	45.96	36.13	3.97	3.22	9.83
1993	45.33	35.54	3.86	3.21	9.79
1994	44.93	35.15	3.84	3.19	9.78
1995	45.00	35.13	3.86	3.22	9.87
1996	45.50	35.79	3.80	3.23	9.70
1997	46.31	36.39	3.61	3.23	9.91
1998	46.27	36.42	3.48	3.34	9.85
1999	45.62	36.23	3.36	3.29	9.38
2000	45.55	35.74	3.98	3.17	9.82
2001	44.46	34.85	3.70	3.08	9.61
2002	43.05	33.99	3.20	3.03	9.05

one-third of non-tax revenue, up from one-quarter 20 years ago. This revenue source represented as much as 3.34 percent of GDP in 1998, but it declined to only 3.03 percent in 2002.

The third major non-tax category, notional capital consumption allowances, presents a rough estimate of depreciation on all government capital assets. This item accounts for only 20 percent of non-tax revenue, down from about 25 percent at the beginning of the period under review; it fell from 2.21 percent of GDP in 1975 to an all-time low of 1.89 percent in 2002. Other revenue sources, which collectively account for less than 10 percent of non-tax revenue, include transfers from persons—motor vehicle licence fees, driver's licences fees, and provincial health-care premiums. At the beginning of the period shown in the table, these latter sources equalled 0.56 percent of GDP; they peaked at 0.78 percent in 1998 and have since subsided to 0.72 percent.

The total non-tax revenue does not differ greatly from tax revenue. As the table shows, the ratio of total revenue to GDP has performed very much like the tax-to-GDP ratio.

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Retroactive QEF Elections

Recent IRS rulings provide further guidance on retroactive qualified electing fund (QEF) elections for stock in passive foreign investment companies (PFICs).

Many US residents and citizens who hold shares in Canadian corporations are affected by the PFIC regime, which was designed to eliminate the benefit of deferred US tax on income earned through foreign corporations deemed to be engaged primarily in passive activities. A corporation is a PFIC if either (1) at least 75 percent of the corporation's gross income is passive income or (2) at least 50 percent of its assets (an FMV test in most cases) produce or are held for the production of passive income. Before the PFIC regime's enactment, a US shareholder could defer tax on undistributed profits of such a corporation that was not a CFC or an FPHC until he sold the shares; at that time, the gain on the sale was normally a capital gain, even though some or all of the shares' appreciation was attributable to the company's undistributed income.

In general, a PFIC's US shareholder is subject to a special tax on receipt of an "excess distribution," including a gain on a sale of the stock and the distributions from the PFIC to the extent that the total received in the year exceeds 125 percent of the actual average distributions to him in the preceding three years. The "excess distribution" is treated as if realized pro rata over the taxpayer's entire holding period and taxed as ordinary income (not capital gain) at the highest rate in effect for each year; an interest charge applies to the tax on the gain allocated to prior years in which the corporation was a PFIC. The tax liability generated is so harsh and punitive that the "excess distribution" stigma should be avoided if at all possible. The QEF election offers one solution.

An investor who makes a QEF election includes in gross income each year his pro rata share of the PFIC's ordinary income and net capital gain for the year. The election must be made by the due date for filing the investor's tax return for the first year that the corporation becomes a PFIC. A subsequent election cannot prevent the "excess distribution" regime's application; the stock bears "PFIC taint" and is subject to the excess distribution rules upon sale. However, a retroactive election may be available to an investor who learns that a company was a PFIC in a prior year if the failure to file a timely election arose because the investor reasonably believed that the company was not a PFIC. A retroactive election may be made under the protective regime or the consent regime.

Under the protective regime, the investor must have reasonably believed as of the election due date that the foreign corporation was not a PFIC, and he must file a protective statement that describes the basis for the belief and that extends the statute of limitations for the assessment of taxes under the PFIC rules. Certain qualified shareholders who own less than 2 percent of the votes and value of each class of the PFIC's shares need not satisfy the "reasonable belief" requirement or file a protective statement and may make a retroactive election for any open tax year in their holding period.

Under the consent regime, a US investor who was not aware of the PFIC rules and failed to file a protective statement may request the IRS commissioner's consent to make a retroactive election. Consent is granted if the investor reasonably relied on a qualified tax professional who failed to identify the corporation as a PFIC or failed to advise the shareholder of the consequences of making or not making a QEF election; consent is not granted if the shareholder knew or reasonably should have known that (1) the foreign corporation was a PFIC and that a QEF election could have been made, (2) the tax professional was not competent to render tax advice with respect to the ownership of shares of a foreign corporation, or (3) the tax professional did not have access to all the relevant facts. No reasonable reliance exists if the shareholder chose not to elect after the tax professional informed him that the foreign corporation was a PFIC and that a QEF election was available. Nor is consent granted if it would prejudice the interests of the US government; the IRS generally considers such prejudice to exist if the QEF election would result in an aggregate lower liability for tax and interest charges in the affected tax years.

In a series of recent private letter rulings, the IRS granted retroactive QEF elections in situations where the accountants or attorneys who rendered tax return advice to taxpayers failed to advise them of the possibility of making QEF elections. Another recent IRS ruling denied a partnership's request for permission to make a retroactive QEF election: the IRS said that the partnership did not reasonably rely on the accountant's advice because it knew or reasonably should have known that the accountant involved did not have access to all relevant facts and information.

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Price Not Affordable

Recently the Ontario Superior Court in *Ford Motor v. OMERS* held that from 1985 to 1995 the transfer-pricing system between Ford Canada and Ford US prejudiced the rights of the minority shareholders of Ford Canada under corporate law because it did not generate arm's-length prices. (See "The $3 Billion Question," *Canadian Tax Highlights*, March 2004.) On the facts, the CRA had not put the regime to the test of a full-scale audit, although it was satisfactory to the IRS. The court defined fair value as the "highest price available in an open and unrestricted market between informed and prudent parties acting at arm's length," a definition similar to FMV for income tax purposes.

The corporate entity Ford Canada has three functional divisions: manufacturing, assembly, and sales. Ford's transfer-pricing system imputes a profit via a markup to the costs incurred when products are transferred from the manufacturing and assembly divisions. Ford Canada's selling division (CVD) purchases vehicles from the assembly division of both Ford Canada and Ford US. Ford's transfer-pricing system follows a "price parity" principle whereby the same US-dollar price is paid by both Ford US and Ford Canada for any assembled vehicle and manufactured component, based on fully allocated costs. CVD is allocated a portion of design and engineering development expenses (TELO) performed by Ford US. CVD resells the vehicles to independent car dealers at prices that the Canadian market will bear, a price lower than its US counterpart (USVD) achieves in the US market. The court noted as an aside that this approach led to a "comparatively greater realized profit margin on vehicles assembled in Canada, given a lower labour cost, due to the exchange rate and due to much of the costs of health care in Canada being borne by governments." Furthermore, the price parity principle did not account for the impact of foreign exchange fluctuations, and during the period a lower Canadian dollar adversely affected Canadian profit levels. Nor did the price parity principle account for different market conditions in Canada—less disposable income, a preference for smaller cars, higher gasoline prices, a more prolonged recession, etc. CVD incurred a cumulative loss of Cdn$5.954 billion, and Ford Canada, as a whole, had a cumulative loss of Cdn$709 million between 1985 and 1995. Using the principle that two transacting parties would structure an arrangement to obtain a reasonable expectation of profit, the court rejected the transfer-pricing system.

The court's primary concern was not one of methodology, but whether the results effected under the Ford transfer-pricing system truly reflected arm's-length dealings. Alternative transfer-pricing methods were considered, however, and the court went so far as to say that the profit-split method would have been appropriate not only from the standpoint of better achieving arm's-length results but also because it accorded with the reality of Ford's operating in an integrated manner for the North American market. Interestingly, CRA auditors often perform a high-level profit-split analysis as a reasonableness test of a transfer-pricing system, irrespective of the actual method used.

The transfer-pricing system imposed by Ford US places entrepreneurial risk in CVD and USVD because of the ownership of intangibles, but the court concluded that this was simply an artificial construct or accounting approach. The court viewed Ford as an integrated manufacturer, assembler, and seller of vehicles in an integrated North American market—that is, a single North American entrepreneur. The transfer-pricing system did not reflect considerations incorporated into independent third-party arrangements between Ford US and Mazda, for example, which followed the principle that both parties should receive a reasonable profit and would renegotiate if that did not occur. The price-setting mechanism in that agreement was a discount to the wholesale dealer price in each jurisdiction. The court noted that a market is still profitable to a vendor, provided that it recoups only its incremental costs plus some contribution to fixed costs, not necessarily the fully allocated TELO as in the agreement with Ford Canada. "It is in the mutual self-interest of an arm's-length vendor and purchaser to negotiate such an agreement, because it constitutes a 'win-win' situation, that is, both will profit." The court concluded that Canada should have been seen as a profitable incremental market, as both GM and Chrysler had done in their pricing into the Canadian market.

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Single Price, Multiple Supplies

The TCC's recent informal procedure decision in *Hidden Bay Lodge* offers some hope that multiple supplies for GST purposes may exist even though a single charge was made for the two putative supplies (2004 TCC 48).

The appellant corporation operated a fishing lodge in northwestern Ontario. Hidden Bay Lodge offered its guests access to even more remote "fly-in" fishing camps in a single-cost all-in fishing package that included each day's food. Some of the goods were supplies kept in stock at the remote camps, such as dried and canned goods; fresh food was also flown into the remote camps as ordered by the guests; and prepared foods such as boxed lunches were available from the main lodge. Hidden Bay argued that the food portion of the fishing packages could be backed out and treated as zero-rated; only the balance of the price paid for the fishing packages was taxable for GST purposes. (The Excise Tax Act zero-rates "[s]upplies of food or beverages for human consumption.") Was the supply of the fishing packages that included food a single supply for GST purposes in which the food lost its identity and was taxable? Or was it severable into multiple supplies, so that Hidden Bay could charge tax on the net non-zero-rated portion? Somewhat surprisingly, the TCC found that multiple supplies existed and allowed Hidden Bay to conduct an accounting exercise to estimate the portion of the fixed price for the zero-rated food.

After reviewing the seminal case of *O.A. Brown* ([1995] GSTC 40), the TCC posed two possible tests to determine whether single or multiple supplies exist: (1) "Is there a composite whole being supplied of which a particular supply is a component?" (Under this test, the fishing package could be a single supply.) (2) Is there "an interdependency of component parts or a degree of interconnectedness such as to make each component a necessary and integral part of the whole?" (Under this test, the fresh food would be a separate supply.) Ultimately, the TCC preferred the second test. The dry and canned foods that were always kept at the camps as a necessity for survival were incidental to the main supply: "There is no interdependency of [the fresh food] component," and other fishing operations did not offer fresh foods on order.

The court was not deterred by the fact that the invoices failed to break out the amounts charged for the zero-rated food provided, and it accepted Hidden Bay's proration of the charges for the average food portion as $64 per person per day out of a total average charge of $176.50 per person per day. The fact that the fresh food was not itemized on the invoice "cannot be determinative."

Driving the court's conclusion was its view that the common taxpayer has difficulty applying concepts such as single versus multiple supplies: "The Minister has legislated the Appellant as an agent in the collection of tax. The Appellant has complied with its best understanding of its obligations. The CCRA has some responsibility to give its agents better guidelines than have been afforded here. Where that has not happened and the Minister presses for compliance relying on protection from estoppel, I think it is reasonable to apply the test that affords the Appellant some relief."

Hard cases make bad law. This decision may not withstand the test of time, or the Crown may seek to distinguish it on its facts. Perhaps the TCC was able to overlook the after-the-fact accounting because the Crown agreed to the allocations performed, but in future the Crown might be reluctant to agree to such a backdoor accounting exercise. For the time being, taxpayers may have some additional ammunition even if a single charge is made for multiple supplies. However, on the facts the fresh food had significant value; severable supplies of relatively low value might be deemed incidental and subsumed in the main supply under section 138.

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Dividends Exceeding CDA

Technical Interpretation no. 2003-0051211I7 (January 30, 2004) considers the consequences of a subsection 184(3) election related to an excess capital dividend when the payer corporation's relevant taxation years are statute-barred.

The CRA says that the recipient corporation can be assessed part IV tax in accordance with subparagraph 184(4)(b)(ii), but because "a reassessment of the payor corporation with regard to Part III tax could generally not be made," "a determination or redetermination of the dividend refund of the payor corporation" was forestalled. The CRA explains that the payer is subject to the subsection 152(4) limitations with regard to the normal reassessment period. It follows that the payer corporation is not entitled to a dividend refund on the excess capital dividend. Because the payer corporation's earnings have been distributed, the RDTOH could become "trapped" in the payer: it may not have other earnings to distribute to recover the refundable tax, effectively rendering it a permanent tax. A submission to Finance recommends that subsection 184(4) be amended to permit a reassessment of the payer corporation with respect to part III if its returns are statute-barred when a subsection 184(3) election is made; the payer could then be reassessed with regard to a dividend refund.

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FA Distributions

The February 27, 2004 technical amendments significantly modify the rules dealing with foreign affiliate (FA) distributions. The objective of the changes appears to be twofold: (1) to provide greater reorganizational flexibility given the income/gain suspension rules of paragraphs 95(2)(c.1)-(c.6) and (f.3)-(f.6) and the loss suspension rules of paragraphs 95(2)(h)-(h.5) for non-arm's-length transactions, and (2) to ensure that FAPI treatment is afforded on income and capital gains on internal dispositions of excluded property above tax cost.

■ Subsection 88(3) has been broadened to apply to most if not all distributions of property, including cash dividends, from an FA (currently only a controlled FA) to a taxpayer resident in Canada. (1) If the distributed property is another FA's stock that is excluded property, the taxpayer's proceeds of disposition and tax cost are its ACB; if the taxpayer elects another amount up to FMV, the gain becomes FAPI. For all other property, the proceeds and tax cost are FMV. (Currently, for FA shares that are not excluded property, proceeds equal tax cost.) (2) The tax amount of a dividend or other property distribution is the aggregate tax costs of the property distributed less the liabilities assumed. (3) The proceeds to the taxpayer of any stock of the disposing affiliate disposed of continue to be the aggregate tax costs of the property distributed less the liabilities assumed. (4) The amount of a distribution of property is an ACB reduction if the distribution is a return of share capital or contributed surplus previously contributed by a shareholder; to the extent that it is not so deducted, the amount is included in the taxpayer's income from property.

These amendments provide the taxpayer with greater flexibility to distribute excluded property FA shares without Canadian tax by selectively accessing high-basis shares for redemption or by executing a return of share capital. However, because the return of ACB in a distribution of property is limited to amounts contributed to the FA, the taxpayer gets no relief for purchased ACB that exceeds contributed amounts. Similarly, if an FA capitalizes retained earnings as share capital through, say, a stock dividend and then returns this new share capital, the result is an income inclusion, not a basis grind. (Under current law, the return of share capital gives a basis grind and a subsection 40(3) capital gain if it goes negative.) Because the income inclusion is not a disposition, the taxpayer cannot access any surplus under a subsection 93(1) election. It is understood that a grind or income inclusion for a return of FA share capital under point (3) or (4) above is not intended to be in addition to an ACB grind under subparagraph 53(2)(b)(ii), which may exclude a reduction or inclusion under paragraph 88(3)(e) or (f). Purchased ACB in excess of inside share capital may be accessed via a share redemption or repurchase, which is a disposition of the shares.

■ Broader companion provisions for distributions from one FA to another include a modified paragraph 95(2)(e) and new paragraphs 95(2)(e.2)-(e.6). Distributions from an FA now include a liquidation and dissolution other than one to which paragraph 95(2)(e.1) applies (paragraph 95(2)(e)); de facto liquidations and dissolutions in which at least 90 percent of the FA's assets are distributed on a redemption or in which the surplus entitlement percentage goes from more than 90 percent to nil and the FA has no issued shares (paragraph 95(2)(e.2)); a dividend or other distribution of property (paragraph 95(2)(e.3)); a "dividend-like redemption," generally a pro rata share redemption of an FA that is excluded property (paragraph 95(2)(e.4)); and any other distribution on an FA share redemption, acquisition, or cancellation (paragraph 95(2)(e.5)).

Unlike paragraph 95(2)(e.1), which generally provides a tax-deferred rollover of inside assets and outside stock basis, these new provisions provide that inside excluded property is disposed of at relevant cost base—the ACB or a greater elected amount (in the latter case, any elected gain is FAPI). A subsection 93(1) election is not permitted if these inside excluded property assets consist of FA shares. All other inside assets are deemed disposed of at FMV.

If the distributee FA's shares are being disposed of—whether actually or under a subsection 40(3) gain—the gain is a FAPI gain; the taxpayer must elect to escape FAPI treatment on FA shares that are excluded property. Any capital gain on this outside stock may be reduced by the mandatory subsection 93(1) election. The ability to elect out of FAPI may not cover all circumstances brought within the scope of these provisions, and it appears that a subsection 40(3) gain arising from a return of capital on excluded property FA shares is neither covered by these provisions nor included in FAPI.

Subsection 88(3) treats non-dividend property distributions as property income to the extent that there is no ACB grind. In contrast, paragraph 95(2)(e.3) appears to presume that all such distributions result in an ACB grind, whereas subparagraph 53(2)(b)(ii) provides a grind only if the distribution is also a PUC reduction. Taxpayers will generally prefer to avoid distributions that are legally neither dividends nor a return of PUC, such as a return of contributed surplus, because in this context they are arguably subsection 15(1) shareholder benefits.

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Control: All Rights Exercised?

A recent technical interpretation (2003-0048571C6) outlines the CRA's differing treatment of stock options and rights in determining control for the purposes of CCPC status or associated corporation status. The comments have implications for, inter alia, refundable R & D claims and the use of the small business deduction for CCPCs.

For the purposes of determining control of a corporation, paragraph 251(5)(b) (for the purposes of the definition of "related persons" in subsection 251(2) and of "CCPC" in subsection 125(7)) and paragraph 256(1.4)(a) (for the purposes of the association rules) both provide that a person is deemed to own all the shares that he has an option or a right to acquire. It is not clear whether control is tested for as if all rights outstanding have been exercised, or only the particular shareholder's rights.

For example, assume that a Canco has two shareholders: Mr. A, a Canadian resident, who owns 1,000 common shares and an option to acquire 400 more, and Publico, a public corporation, which owns 600 common shares and has an option to acquire another 500. There is only one class of shares, and each carries one vote. No agreements or other documents affect Canco's control, nor is there any de facto control.

If only Publico is deemed to exercise its options, it controls Canco with 52 percent ownership, and Canco is not a CCPC. But if Mr. A's options are also deemed exercised, Publico has only 44 percent ownership and does not control; thus, Canco is not a CCPC. The CRA says that for the purposes of the CCPC definition in paragraph 251(5)(b), only the particular taxpayer's rights are deemed exercised. In contrast, on the basis of the different wording in the association rules in paragraph 256(1.4)(a), the CRA says that a corporation's control is determined once, taking into account all shares that all persons with a right are deemed to own and that are deemed to be issued and outstanding. The surprising result is that Canco is not a CCPC because of the control implicit in the options held by Publico; yet Canco is not associated with Publico.

	Mr. A	*Publico*
Common shares owned	1,000	600
Additional common shares owned if options exercised	400	500
Ownership excluding options	62.5%	37.5%
Ownership if options exercised separately	70%	52%
Ownership if all options exercised simultaneously	56%	44%

Foreign affiliate (FA) receives active business income (ABI) for shrink-wrap software sales. Another recent technical interpretation (2003-0016791E5) confirms that shrink-wrap software is generally considered to be tangible goods for tax purposes. Thus, income of a Canadian company's FA from the sale of such software is considered ABI and not royalty income from an investment business (subsection 95(1)).

For example, assume that a taxable Canadian corporation (Canco) manufactures shrink-wrap software in Canada for sale to its controlled FA (CFA), which on-sells it to unrelated non-resident corporations. CFA does not have exclusive distribution rights, a licence, or any other right connected to the software other than the right to resell it in exactly the same form as it is purchased from Canco. CFA does not employ the equivalent of more than five full-time employees in the active conduct of its business. Is CFA's income from those sales a royalty or a similar return in the context of the definition of "investment business"?

The CRA says that the term "shrink-wrap software" generally describes computer software prepackaged with a plastic shrink-wrap cover that is commercially available through mail order or a retail store. The software package includes a general licence agreement that does not contain the name of the end user or the amount of the licence fee; the end user is normally not required to acknowledge that he has read or agreed to the terms of the software licence. On the basis of its understanding of software industry practice, the CRA's position is that such a licence of shrink-wrap software to an end user is a sale of tangible goods. Thus, the CFA derives its income from the sale of tangible goods and is not engaged in a business whose principal purpose is to derive income from property for the purposes of the "investment business" definition. The CRA notes in closing that Canco must sell the software to CFA for the same price as it would charge an arm's-length distributor; if it does not do so, the transfer-pricing rules in section 247 may apply.

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US RESIDENTIAL REAL ESTATE (2)

Many Canadians who hold US real estate, whether as a vacation property or otherwise, face potential exposure on death to US estate tax, with only limited treaty relief. Various structures have been devised to avoid or reduce the exposure—such as the single-purpose corporation (SPC), which pays 35 percent tax and is thus less attractive because of the reduced 15 percent US tax rate on capital gains for individuals. (See "US Residential Real Estate," *Canadian Tax Highlights*, March 2004.) Other alternatives are discussed below.

■ **Joint ownership.** If the US property's cost is not substantial, co-ownership may even eliminate US estate tax. If two parents and three adult children share a US residence that cost US$300,000, each person benefits from the minimum US unified credit, and estate tax is exigible at death on only one-fifth of the value. Each person should contribute funds toward the purchase. A parent's gift to a child to finance the acquisition does not attract Canadian tax, but a gift conditional on its use to finance the acquisition may attract US gift tax. A gift in the form of a cash transfer should be made outside the United States, and not through a deposit to the donee's US bank account. On the property's sale, each individual is eligible for the 15 percent personal US tax rate on the gain. That tax is creditable against Canadian tax of about 24 percent.

■ **Canadian discretionary trust.** If a Canadian discretionary trust owns a US residence for the benefit of several family members, there is no taxable benefit for the beneficiaries' use of the trust property. *Cooper* ([1989] 1 CTC 66 (FCTD)) held that the CRA could not impute interest on an interest-free loan to a beneficiary. To avoid a section 105 taxable benefit, the beneficiaries and not the trust should pay for the upkeep, maintenance, or taxes of or in respect of a property.

Internal Revenue Code section 2036 is a major concern: the trust assets are included in the estate of a transferor (settlor) who retains the use of property in a trust. Generally, the rule is not invoked by a beneficiary's life interest in the trust without a general power of appointment or analogous rights (as trustee, protector, etc.) or by a settlor who does not retain any prescribed powers over the trust.

■ **Non-recourse debt.** Estate tax is based on the taxpayer's equity in the US real estate. If a family member in Canada makes a non-recourse loan to assist in the property's acquisition, the debt reduces the holder's equity in the property and thus the estate tax exposure (reg. 20.2053-7). However, interest should be charged, which may increase the recipient's taxable income. A recourse mortgage does not reduce the equity.

■ **Partnership of family members.** A Canadian general or limited partnership of family members acquires the US residence, and each partner makes a pro rata capital contribution to the partnership that in total equals the price of the property. A parent may gift funds to other family members for this purpose. In contrast to the result under the Canadian corporate attribution rule, no taxable benefit in Canada arises if a partner has the use of partnership property. This alternative may compare favourably with the SPC. The property's use by a limited partner may be a benefit under the at-risk rules, but there should be no adverse results: no losses are contemplated, and the partnership interest's tax cost includes the purchase price and carrying costs. If the partnership checks the box to be treated as a foreign corporation for US tax purposes, the Canadian-resident partners are protected from US estate tax. The partnership is treated as such in Canada and thus no taxable benefit arises in Canada. However, the election renders inapplicable the lower US capital gains rate on the property's sale. If the partnership does not so elect, there is some authority to the effect that if the partnership is not engaged in a US trade or business, the interest in the foreign partnership held by a foreign person is not included in his or her US estate. Under existing US law, there is no clear authority on the situs of partnership interests and almost no authority for looking through the partnership to the situs of its assets; the partnership structure should thus isolate partners from estate tax. If the structure is used, the applicable partnership law must not cause the partnership's dissolution on a partner's death; otherwise, the individual is treated as owning the underlying partnership assets, which then automatically fall into the decedent's estate. A continuation clause protects against dissolution in Canada. A limited partnership may be preferable.

The primary advantage of this structure is that upon a partner's death, an election may be made to step up the partnership assets' basis to the then FMV, thereby eliminating any gain on the decedent's portion of the underlying property for US purposes upon the property's ultimate sale. Furthermore, non-recourse debt is easier to establish: essentially, the obligor is the partnership, and if the individual partners are limited partners, there is no recourse to them, making the debt non-recourse. The general partner, a Canadian company, should have unlimited liability and be entitled to a nominal participation in the partnership. The lower US capital gains rate may be available on the property's sale if no election is made to treat the partnerships as a corporation; Canadian partners pay Canadian tax on the gain, with a credit for US tax.

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CANADIAN TAX Highlights

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

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ISSN 1496-4422 (Online)

FOREIGN TAX NEWS

OECD

A discussion draft clarifies the taxation of income of a resident working in another contracting state under model treaty article 15(2). Special attention is given to the definitions of "employer," "employment," and "self-employment" and the treatment of a non-resident that provides services through an intermediary. Working Party no. 1, a subgroup of the Committee on Fiscal Affairs, has prepared 22 new paragraphs to replace paragraph 8 of the commentary. For a copy of the report visit the OECD site at http://www.oecd.org/dataoecd/52/61/31413358.pdf, or call the CTF library. Interested parties are asked to provide comments before June 30, 2004.

Australia

To attract multinational investment, a new bill introduces three main measures effective July 2004: (1) reduction of capital gains or losses by domestic companies and their CFCs on disposals of non-portfolio interests (of at least 10 percent of the voting rights); (2) extension of exemptions for foreign non-portfolio dividends after June 2004; and (3) a reduction of the scope of tainted services income under the CFC rules, excluding non-resident associates' services.

Belgium

A new law enhances incentives for film and documentary production, providing corporate income tax exemptions up to 150 percent of invested amounts. Profits must exceed €1,500,000 to maximize savings. The European Commission must consider these changes in the light of its state-aid rules.

Gibraltar

The European Union advised Gibraltar that the proposed corporate tax reforms are incompatible with the EU rules on state aid even though they do not constitute harmful tax practices. Incompatibility resulted because corporate tax rates were capped at 15 percent, which provided an unfair advantage in Gibraltar compared with the rest of the United Kingdom; moreover, tax was eliminated for an offshore company with no physical presence in Gibraltar because the new system taxes on the basis of payroll and occupation of business premises. Gibraltar and the United Kingdom intend to challenge the decision in the European Court of Justice.

Russia

To attract foreign investment, the government proposes the creation of new technological and manufacturing zones; residents will receive benefits related to corporate taxes, real property and land taxes, and other state guarantees.

Republic of Korea

To increase foreign investment, tax investigations of companies with foreign investment will cease and tax regulations that are not up to international standards will be eliminated. Foreign firms will be eligible for awards of preferential tax treatment, such as three-year audit exemptions. Late in 2003, several changes were also issued to encourage foreign investment: foreign employees can elect a flat rate of 18.5 percent applied to their income or the full marginal rate with a 30 percent overseas allowance; only services performed in Korea are taxed, and services used in Korea are no longer subject to withholding tax; and corporate taxes are reduced by 2 percentage points after 2004. Foreign investment zones, free economic zones, and free trade zones will provide a 100 percent exemption from taxes for seven years and a 50 percent exemption for the next three years; mutual investors in different companies may aggregate holdings to meet thresholds.

Denmark

Proposals will render transparent a Danish company or a foreign company with a permanent establishment in Denmark if (1) it is transparent for foreign tax purposes; (2) the Danish company's income is included in the foreign taxable income of one or more affiliated companies in the foreign country; (3) the affiliates hold more than 50 percent of the capital or voting power of the Danish company; and (4) the foreign jurisdiction is a member of the European Union or the European Economic Area or has concluded a tax treaty with Denmark. The transparent company is taxed as a permanent establishment.

Isle of Man

To improve economic development, specified businesses in the space and satellite industry will enjoy a zero rate of corporate tax. Non-resident trading companies' tax rate is reduced to 10 percent for trading income up to £100 million.

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