CANADIAN TAX Highlights

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GAAR COMMITTEE REFERRALS

At a recent meeting with tax professionals, the CRA presented updated national statistics on referrals to its GAAR Committee up to September 30, 2003.

The tables show that the committee has recommended that GAAR apply in nearly two-thirds of the cases referred to it. Four issues—surplus stripping, loss utilization, large corporations tax, and section 80 avoidance—appear to account for more than half of the cases referred. A previous CRA report on referrals in October 2002 included information current to March 2002. Since then, and until September 2003, the committee has made decisions in 70 more cases. Table 1 summarizes the GAAR Committee's decisions as of those dates; table 2 breaks down the issues involved in the cases that the CRA considered GAARable and referred to the committee.

2004 auditor general's report. The auditor general of Canada (AG) issued a report on March 30, 2004 stating that the CRA does not have a consistent and integrated approach to identifying threats to the tax base and thus ensuring that its resources are allocated most effectively. In chapter 5, "Canada Revenue Agency—Audits of Small and Medium Enterprises," the AG reports on her review of the CRA's strategy for auditing small and medium-sized enterprises and says that the CRA does not have the information that it needs to measure compliance.

The CRA defines small and medium-sized enterprises as all self-employed individuals, small and medium-sized businesses, and partnerships and trusts, altogether totalling some 4.5 million taxpayers. The AG says that this sector is most at risk of participating in underground economy activities and thus tax evasion, and she suggests several ways that the CRA could gather more information on non-compliance and strengthen its audit strategy:

■ Improve the CRA's computerized audit selection system by linking returns of taxpayer groups that do not operate at arm's length. Add information to enable the calculation of income tax at risk for trusts and large partnerships.

■ Apply penalties more often and capture information on the impact of penalties on taxpayer behaviour.

Table 1 GAAR Committee Decisions

	Cumulative number of cases		
	September 2003	March 2002	Increase over 18-month period
GAAR recommended	369	335	34
GAAR not recommended	196	168	28
Decision deferred	8	0	8
Total referrals to GAAR Committee	573	503	70
Percentage of cases in which GAAR was recommended	64.4%	66.6%	

Table 2 GAAR Issues Referred

	Number of cases	Percentage of total cases
Loss issues	95	17
Surplus stripping	107	19
Section 80 avoidance	36	6
Part I.3 LCT avoidance	52	9
Foreign financing structures	26	5
Kiwi loans	14	2
Capital gain	12	2
Debt parking	24	4
Interest deductibility	21	4
Other (fewer than 10 taxpayers per issue)	186	32
Total referrals to GAAR Committee	573	100

In This Issue

RULINGS REVIEW

The CRA is reviewing the overall rulings process. In the interim, it will not rule on an issue that involves two-tiered limited partnerships used to raise capital for existing businesses, with losses from such businesses being allocated to the limited partners (document no. 2004-0062961R3).

■ Develop a compliance strategy to minimize overpayments of GST/HST claims. Seek legislative authority to deny GST/HST refunds to registrants who late-file returns.

■ Strengthen the CRA's program of random audits. Develop a multi-year plan to cover specific segments of the population and analyze the results.

■ Develop a rational process to allocate the CRA's compliance resources to areas of highest overall risk; for example, assign complexity ratings to small and medium-sized enterprise files and allocate resources to tax services offices to reflect the profiles of their files.

■ Make better use of indirect methods of verification.

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More Retroactive Tax Law

The March 23, 2004 federal budget included a surprise proposal to retroactively amend the GAAR by extending it to transactions that result in a "misuse or abuse" of the regulations, the Income Tax Application Rules (ITARs), and Canada's international tax treaties. A concomitant proposal regarding the Income Tax Conventions Interpretation Act purports to clarify that the GAAR can apply to deny treaty benefits.

The proposals are said to be "for greater certainty," which suggests that they reflect the legislators' original intent and that retroactivity to the GAAR's inception is thus justified. However, in *Rousseau-Houle* (2001 DTC 250), the TCC concluded that the reference in subsection 245(4) to "the provisions of this Act" clearly and unambiguously did not apply to the regulations. And a number of cases before the TCC question the GAAR's application to treaties; the amendments most unfairly but effectively change the rules midstream for these taxpayers.

Tax legislation that is retroactive to the date of its initial announcement is commonplace, as is tax legislation that is retrospective—that is, it affects the future tax consequences of past transactions. However, tax legislation that changes the pre-announcement tax consequences of past transactions is exceptional, and has always been controversial because it undermines the effectiveness of the court system when it is used to retain tax revenue threatened by an unfavourable court decision. In response to an unfavourable FCA decision, *Commission Scolaire des Chênes* (2002 GTC 1053), last year's budget also proposed retroactive changes to certain GST rules. The CBA, the Joint Committee on Taxation of the CBA and the CICA, and the Toronto Board of Trade made submissions to both Finance and Justice. The Joint Committee said that retroactive tax law detrimental to taxpayers is inappropriate for two main reasons: it undermines the rule of law and the confidence that taxpayers have in our self-assessment tax system, and it is perceived as being reflective of a tax system that is neither stable nor predictable and is thus an impediment to foreign and domestic investment in Canada.

The president of the CBA reiterated that substantive adherence to the rule of law is fundamental to the very fabric of our country, particularly in tax matters because of the inherent tension between a government and its taxpayers, from which it wishes to capture optimal revenue. Our self-assessment tax system enhances the importance of adherence to the rule of law: taxpayers must be able to apprehend the law with some degree of certainty so as to determine which transactions to report and how those transactions are taxed. Respect for the law is seriously affected if the tax authorities can rely on ex post facto adjustments to make the law retroactively read favourably to the fisc.

The Toronto Board of Trade noted that fairness to the taxpayer dictates that tax legislation must not be retroactive. Stable and predictable laws maintain taxpayer confidence in the system and promote taxpayer compliance; retroactive changes may "erode [taxpayers'] willingness to support and comply with the tax system." If the government can easily neutralize poor legislative drafting or unforeseen tax consequences through the use of retroactive amendments, taxpayers cannot rely on the longstanding principle of tax certainty; a taxpayer cannot then alter the course of past events and is thus left surprised and defenceless against the force of retroactive changes.

The seventh report of the Standing Committee on Public Accounts of the House of Commons, issued in February 1995, recommended that the government develop criteria to determine when retroactive changes to tax legislation are appropriate. In its September 1995 response, Finance said that such clarifying amendments "undermine the certainty that taxpayers should be able to expect from the tax system," and should be made only in exceptional situations, if the amendments (1) reflect a longstanding and well-known interpretation of the law by the CRA; (2) reflect a policy that is clear from the relevant provisions and that is well known and understood by taxpayers; (3) are intended to prevent a windfall benefit to certain taxpayers; (4) are necessary to preserve the stability of the government's revenue base; or (5) correct ambiguous or deficient provisions that were not in accordance with the objects of the Act.

While the first criterion (a longstanding and well-known CRA interpretation) may justify a change that benefits taxpayers who have relied on the policy, its use to support retroactive amendments to taxpayers' detriment is tantamount to empowering the CRA to make law. Taxpayers would have to read CRA missives such as interpretation bulletins and technical interpretations as if they possessed the inchoate authority of retroactive legislation that could be triggered by a court's decision that the law reads otherwise. The second criterion (a clear and well-known policy) cannot justify the proposed retroactive GAAR amendments: its application to treaty benefits has never been clear, and many practitioners and academics have concluded that the law as written does not so apply. Nor did information in the budget papers suggest that the next two criteria (preventing windfall benefits and preserving the stability of the government's revenue base) motivated the proposal; if the object is to deny windfall benefits to specific taxpayers, the proposed retroactivity is more inappropriate. The fifth criterion (an ambiguous or deficient provision not in accordance with the Act's objects) is vague and could justify any change if a law does not effect what Finance thinks it should. A narrower reading parallels the second criterion, which does not apply to the GAAR proposal. The tax community has been concerned since at least 1983 about the increased use of retroactive tax legislation and taxpayers' apathy over the practice. The lack of alignment between the current GAAR proposal and Finance's retroactive legislation guidelines makes this an opportune time to revisit the issues.

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Locker Room PE

The Ontario Superior Court of Justice, in the *Toronto Blue Jays* case (April 27, 2004), found that locker rooms and coaches' rooms in stadiums outside Ontario where Ontario sports teams played "away" games constitute a fixed place of business and are thus permanent establishments (PEs) under the Employer Health Tax (EHT) Act. The EHT Act PE definition closely resembles that in the federal Income Tax Act.

Ontario does not impose EHT on an employer's total remuneration paid to employees who report to work at a non-Ontario PE of the employer. The applicants—the Toronto Blue Jays, the Toronto Maple Leafs, and the Toronto Raptors—argued that the deemed PE related to substantial machinery and equipment applied. The court felt bound by the SCC decision in *Sunbeam* ([1963] SCR 45) to the effect that the word "substantial" meant "substantial in size [and] was only intended to apply to machinery and equipment such as is used by contractors or builders." The court found it difficult to see why the number of baseballs, bats, etc. should affect the exemption's availability.

However, the court said that the basic definition of a PE—a fixed place of business—covered the situation in which a team plays at a non-Ontario "away" stadium and typically occupies a specially assigned place as a locker room. Team members, including players, coaches, and others, must report to that place. A visiting team has exclusive occupation of the place and assumes the right to arrange for its security supervision to block unauthorized access. The team members train and receive medical attention there and prepare for practice relating to the games they play. Coaches operate on a similar basis. The same location is used every time that team (or any other visiting team) plays at the venue. The court was persuaded that it is correct "to view each team as carrying on business together with and in conjunction with other teams in . . . the league. . . . Each team depends on every other team to provide competition and whatever else is necessary to earn [revenue]." Even if a visiting team does not share in the home team's gate receipts, it is still carrying on business. Thus, the basic PE definition for EHT purposes applies if an Ontario team plays in an away venue: it has a fixed place of business outside Ontario. By extension from the decision, it appears that non-Ontario teams that visit and play at sports stadiums in Ontario may be subject to EHT. It is not yet known whether the minister will appeal the decision, although there has been some mention that EHT amendments may be proposed to override it.

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GST Statistics

The first edition of the *Compendium of GST/HST Statistics* was recently released on the CRA Web site (http://www.ccra-adrc.gc.ca/E/pub/gp/rc4376/README.html). The compendium provides new information on the number and types of businesses registered to collect the federal GST and the HST in the Atlantic provinces. The 37 tables in the compendium show, for example, registrants by province, by tax services offices within each province, and by size and type of business, as well as detail on collections and input tax credits. Most of the tables cover all the years since the GST was introduced.

When the GST was first introduced, 1.7 million businesses registered; by 2000-1, that number had risen to 2.5 million. Of those registered in 2000-1, only 88,040, or 3.5 percent of the total, used the simplified accounting method available to small businesses. As shown in the table, 866,680 registrants, or 34.4 percent, reported total sales of less than $30,000 in the fiscal year. A further 726,500, or 28.9 percent, had annual sales ranging from $30,000 to $200,000. Thus, over 60 percent of all registrants could be considered small businesses, but less than 6 percent used the simpler accounting system for reporting collections, tax collected, and input credits.

The compendium does not identify separately the collections made by Quebec, but the size of the numbers for that province indicates that its collections are included. The collection numbers in the report do not agree with the figures reported in the Public Accounts, which indicate

Selected GST/HST Statistics, 2000-1

	Number of registrants	Percentage with annual sales Less than $30,000	$30,000 to $200,000
Newfoundland	28,870	43.6	23.3
Prince Edward Island	11,860	38.6	27.6
Nova Scotia	53,960	37.3	29.2
New Brunswick	42,000	34.3	32.8
Quebec	511,610	34.5	31.4
Ontario	915,410	31.6	27.9
Manitoba	89,520	37.4	30.2
Saskatchewan	129,870	42.3	31.2
Alberta	347,410	36.1	28.2
British Columbia	368,520	35.1	28.0
Territories	2,600	28.9	21.9
Outside Canada	16,650	34.8	12.1
Total	2,518,620	34.4	28.9

$25.1 billion net collections for 2000-1, far short of the compendium's reported $123.1 billion. The compendium also shows input tax credits, but reports them as $116.5 billion. The discrepancy is not explained.

The compendium is a welcome addition to official reports on the operation of all aspects of our tax system. The numbers provide a picture of how well the small business sector has adapted to what was at first considered an impenetrable paperwork maze.

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Stop-Loss Stopgap

The February 27, 2004 draft technical amendments augment the December 20, 2002 draft and propose a degree of integration between subsection 39(2) and the stop-loss rules in subsection 93(2). Currently, the stop-loss rules reduce the loss on a disposition of a foreign affiliate's shares by the amount of cumulative exempt dividends received from the FA even if the loss arises solely due to foreign exchange (FX) fluctuations. The situation is further aggravated if Canco has borrowed funds required for its investment in the FA in the same foreign currency and a capital gain is triggered in respect of the same FX fluctuations: the capital loss on the disposition denied under subsection 93(2) is coupled with a taxable capital gain on the borrowing under subsection 39(2).

A 2001 Finance comfort letter addressed this unfair result: "[S]ubsection 93(2) should not apply to deny a loss on the disposition of shares of a foreign affiliate where the loss results from the fluctuation in the value of a foreign currency, particularly where subsection 39(2) also applies to require the recognition of a corresponding gain." Finance indicated that it wished to consider further how best to identify the gains and losses related to such shares; it would recommend amendments effective for taxation years commencing after the announcement, unless taxpayers elected to apply them for 1994 and subsequent taxation years. The latest technical amendments preserve the loss incurred on the FA shares' disposition, but only to the extent of certain related capital gains computed under paragraph 39(2)(a). Regrettably, the proposed changes do not deal with instances in which a loss on the disposition results from currency fluctuations alone and there is no related capital gain on a foreign currency borrowing or similar transaction.

Finance did not address the September 18, 2003 report of the Joint Committee on Taxation of the CBA and the CICA, which suggested that the stop-loss rules be repealed or severely restricted because, in the FA context, the manufacture of a loss by paying a dividend out of pre-acquisition surplus is effectively blocked by the ACB adjustment in paragraph 92(2)(c). The report contrasted the superficial similarity of the stop-loss rules in subsection 93(2) and their domestic counterparts in subsection 112(3) with their quite different effect. The domestic rule prevents a corporation from artificially creating a loss by paying a dividend in excess of its retained earnings and thus out of contributed capital; a capital loss arises on the shares' disposition because the dividend did not correspondingly reduce the shareholder's ACB in the shares. In contrast, a dividend from an FA in excess of exempt and taxable surplus is deemed paid out of pre-acquisition surplus; the taxpayer's ACB in the FA shares is reduced accordingly, and so is any capital loss on the shares' sale. Thus, subsection 93(2) is based on the erroneous premise that a dividend payment in the FA context can artificially create a capital loss as it can in the domestic context. In addition, the relief provided in the technical bill is more restrictive than anticipated because the gain (other than a gain in respect of a related hedging agreement) under subsection 39(2) must occur in the same year as the loss. Furthermore, if the gain and the loss arise in different but related entities (as is the case with so-called tower financing structures), no relief is available under the current proposals.

The proposals are effective for taxation years of FAs beginning after February 27, 2004 unless a taxpayer elects, in its return for the taxation year in which the proposed amendments receive royal assent, to have the amendments apply to all the taxpayer's FAs for all taxation years that begin after 1994. Finance may consider it appropriate to broaden the instances in which the proposals relieve taxpayers from the stop-loss rules' application.

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FAILURE TO CLAIM TREATY RATE

In an informal procedure decision, the TCC recently held in *Meyer* (2004 TCC 199) that failure to assert treaty protection precludes a Canadian resident from claiming a foreign tax credit (FTC) for amounts not paid under compulsion. Such payments represent a gift to the foreign government rather than a tax.

Mr. Meyer, who held both US and Canadian citizenship, received US pension and US employment income, but was a Canadian resident for tax purposes. In his 2001 Canadian tax return, he claimed an FTC under section 126 for US tax paid on the US pension income. The CRA denied a portion of the credit on the grounds that US tax paid on the pension income exceeded the ceiling imposed by the Canada-US tax treaty: article XXVIII limits to 15 percent the US tax that can be levied on a pension paid to a Canadian resident. Mr. Meyer's 2001 US income tax return did not indicate that he was a Canadian resident (except for his Canadian address) and did not include any non-resident treaty claims. As a result, his pension income was taxed at the higher, regular US income tax rate, not at the 15 percent treaty rate. The CRA allocated the US tax paid between the gross pension and employment incomes and determined that the effective rate on the pension income was 21 percent.

The CRA argued that the withholding tax mechanism only secures payment of US tax, but does not create a liability. The treaty capped the liability at 15 percent; anything in excess of that rate was paid by mistake. Lacking the necessary element of compulsion, a mistaken payment does not qualify as "non-business income tax" for the purposes of paragraph 126(7)(i). The taxpayer alone bears responsibility for seeking a refund from the IRS. Expiry of the US limitation period does not transform the mistaken payment into a tax creditable under section 126. The TCC accepted the CRA's argument. By not claiming treaty protection, "the [taxpayer] has gifted to the United States Treasury a fiscal advantage" that the United States signed away in the treaty. "In a self-assessing system, it is incumbent on taxpayers to file on the basis prescribed by their circumstances. That requires the taxpayer in this case to establish that he filed in the US as required to ensure the benefit of rate limitation under the treaty." Having failed to carry this burden, the taxpayer lost his case. Failure to include information in his return that might have resulted in a refund of the excess withholding did not mean that the tax withheld and assessed as owing amounted to "a liability for the amount paid as a tax payable."

Meyer established that the CRA will not allow an FTC to compensate a taxpayer who fails to assert his or her treaty rights. The onus is thus placed on a taxpayer to guard his or her own interest rather than rely on the CRA or the courts to solve problems arising from failure to do so. However, the TCC rejected the notion that failure to claim discretionary deductions entitles the CRA to deny an FTC.

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US TRANSFER PRICING ON ROLLOVER

An international legal memorandum from IRS chief counsel advises that Code section 482 transfer-pricing rules can apply to non-recognition (rollover) transactions (ILM 200408030, October 29, 2003). A domestic corporation received from a related corporation appreciated shares that it contributed to a related overseas entity. The stock retransfer triggered recognition of built-in gain under section 367(a) that offset the transferee's soon-to-expire net operating loss (NOL) carryover. Thus, if common ownership or common control is present and the IRS finds tax-avoidance motives or a failure to clearly reflect income in a non-recognition transaction, it may attempt to apply US transfer-pricing rules to reallocate income or deductions.

In an earlier field service advice (FSA), the IRS refuted the taxpayers' arguments regarding the applicability of section 482:

- State law requiring a board of directors to represent the interests of minority shareholders does not prevent section 482 common control. The transfer-pricing rules apply to two or more entities "owned or controlled directly or indirectly by the same interests," a disjunctive requirement satisfied by the presence of either ownership or control by the same interests. (See, for example, *Collins Elec.*, 67 TC 911, at 918 (1977).)
- Compliance with state law fiduciary duties does not in itself satisfy the arm's-length standard.
- The taxpayers asserted that reg. section 1.482-1(f)(1)(iii), which permits the application of section 482 to transactions covered by non-recognition provisions, does not apply because the transactions did not entail an impermissible tax-avoidance purpose or a mismatching of income and deductions. The relevant non-recognition provision, section 351, permits built-in gains and losses to carry over to a controlled corporation. However, the FSA points out that in *G.D. Searle* (88 TC 252, at 371-76 (1987)), the Tax Court expressly rejected this position and applied section 482 to correct a distortion of income resulting from a non-recognition transaction.

> The present case is similar to the situation in *National Securities*... [in which] a parent corporation transferred to its subsidiary stock with a built-in loss for which the subsidiary subsequently claimed a deduction when it sold the stock. ... [T]he transferor and transferee improved

their aggregate tax position by advantageously shifting a potential loss. In the present case, the transferor and transferee improved their aggregate tax position by advantageously shifting a potential gain. The relevant issue is the shifting of income and resulting distortion of true taxable income, not the nature of the event that triggers recognition of the shifted item.

■ The taxpayer argued that the presence of an acknowledged business purpose precludes the presence of a tax-avoidance motive and therefore prevents the application of section 482 to rollovers. The taxpayer's argument implied that a business purpose that is sufficient for a transaction to qualify under section 351 necessarily precludes the application of section 482. The FSA points out that the section 482 transfer-pricing rules have no such prerequisite and may apply absent a tax-avoidance purpose under the "clear reflection of income" standard. Moreover, qualification of a transaction under a nonrecognition provision such as section 351 does not preclude section 482's application. The IRS cites the possibility of a more direct transaction by the taxpayer in addition to other factors such as timing, control, and tax-avoidance motives (for example, the expiration date of the NOL carryover) as relevant to its concern about the lack of business purpose in this case.

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SBD Rates and Limits

The federal government and the provinces and territories (except Nunavut and Ontario) have released their 2004 budgets; some of them announced changes to the CCPC small business tax rates or business limits.

The federal budget did not change the small business rate, but it proposed to accelerate the increase in the business limit to $300,000 by one year to 2005 (previously, $275,000 for 2005 and $300,000 thereafter). Manitoba intends to reduce the small business rate to 4.5 percent after 2005, but the effective date is uncertain. New Brunswick, which already has one of the lowest small business rates in Canada at 3 percent, proposes a further reduction to 2.5 percent and a business limit increase from $400,000 to $425,000, both effective July 1, 2004. Yukon proposes to decrease the small business rate from 6 to 4 percent after 2004 and to increase the business limit from $300,000 to $400,000 after 2006. Alberta and Saskatchewan confirmed previously announced rate reductions. British Columbia and Quebec announced no changes. Although Newfoundland and Labrador, Northwest Territories, Nova Scotia, Nunavut, Prince Edward Island, and Yukon introduced

Table 1 Small Business Tax Rates

	2003	2004	2005	2006
		percent		
Federal	12.00[a]	12.00[a]	12.00[a]	12.00[a]
Alberta	4.12	3.26	3.00	3.00
British Columbia	4.50	4.50	4.50	4.50
Manitoba	5.00	5.00	5.00	4.50[b, c]
New Brunswick	3.00	2.75[c]	2.50[c]	2.50[c]
Newfoundland and Labrador	5.00	5.00	5.00	5.00
Northwest Territories	4.00	4.00	4.00	4.00
Nova Scotia	5.00	5.00	5.00	5.00
Nunavut[d]	4.00	4.00	4.00	4.00
Ontario[d]	5.50	5.50	5.50	5.50
Prince Edward Island	7.50	7.50	7.50	7.50
Quebec	8.93	8.90	8.90	8.90
Saskatchewan	6.00	5.50	5.00	5.00
Yukon	6.00	6.00	4.00[c]	4.00[c]

Note: Rates apply for the calendar year indicated.
[a] Not including 1.12% surtax. [b] The effective date is uncertain. [c] 2004 budget change. [d] Nunavut and Ontario 2004 budgets have not yet been released.

Table 2 Small Business Income Limits

	Effective date	Limit
Federal	January 1, 2003	$225,000
	January 1, 2004	$250,000
	January 1, 2005[a]	$300,000[a]
Alberta	April 1, 2002	$350,000
	April 1, 2003	$400,000
British Columbia	April 1, 2002	$300,000
Manitoba	January 1, 2003	$320,000
	January 1, 2004	$360,000
	January 1, 2005	$400,000
New Brunswick	January 1, 2003	$400,000
	July 1, 2004[a]	$425,000[a]
Newfoundland and Labrador	Same as federal[a]	Same as federal[a]
Northwest Territories	Same as federal[a]	Same as federal[a]
Nova Scotia	Same as federal[a]	Same as federal[a]
Nunavut[b]	Same as federal[a]	Same as federal[a]
Ontario[b, c]	January 1, 2003	$320,000 (lower limit)
	January 1, 2003	$800,000 (upper limit)
	January 1, 2004	$400,000 (lower limit)
	January 1, 2004	$1,128,519 (upper limit)
Prince Edward Island	Same as federal[a]	Same as federal[a]
Quebec	Not applicable[d]	Not applicable[d]
Saskatchewan	January 1, 2002	$300,000
Yukon	Same as federal[a]	Same as federal[a]
	January 1, 2007[a]	$400,000[a]

[a] 2004 budget change. [b] Nunavut and Ontario 2004 budgets have not yet been released. [c] Ontario claws back the benefit if taxable income falls within a specified range. [d] Quebec's corporate income tax rate is 8.9% on all active business income (plus 1.6% surtax until March 15, 2003).

no rate changes, the accelerated increase in the federal business limit applies in these provinces and territories. The tables summarize the changes.

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INTERNATIONAL JOINT VENTURES

It is becoming increasingly popular for two or more multinationals to combine some aspects of their businesses without merging the companies or selling divisions. A strategic alliance is formed with a complementary business in other jurisdictions to more expeditiously achieve the parties' mutual business goals through synergies based on the ability to pool resources and access different markets, to cross-sell products to customers in the same industry, to develop new products jointly, and to access manufacturing and distribution facilities. The alliance aims to make each party more competitive internationally and to develop a greater presence in the global market.

An alliance may aim to jointly develop and exploit new products using one party's intellectual property and the other's marketing, production, and distribution skills. Alternatively, each party may be able to better satisfy the increasing customer demands for product availability, new technology, pricing, and service. The global alliance/cooperation agreement may enable the parties to pool their resources to participate in joint research, development, supply, sales, and services related to specific products of each party. The global agreement sets out each party's rights and responsibilities; provides for the alliance's governance; regulates the parties' joint international activities; and sets out the legal framework of the alliance, which is not intended to be a partnership or a separate legal entity. The members of a global board or regional boards, who are representatives of each party, are authorized to deal with all matters pertaining to the alliance. Meetings are scheduled to occur regularly. The agreement may encompass rights to existing or new intellectual property or technology; the sharing of information about customers; the markets to be covered; the sharing of costs and research for new products; the sales and marketing of products governed; production; royalties and licence agreements; the formation of joint entities, if applicable, in various jurisdictions; the contribution by each party of cash, inventory, equipment, existing contracts, and personnel; funding requirements; the sharing of profits and losses from joint aspects of the alliance business; transfer pricing; and support services. Such an agreement is for a fixed term; it may restrict competition during that term, provide for what occurs on its termination, and contain arbitration clauses. The choice of governing law should be set out.

Regional arrangements must complement and be in accordance with the responsibilities set out in the global contracts. Licence agreements with entities owned by one of the parties in each territory may be sufficient to carry out the global agreement's mandate, or a greater regional collaboration of the parties via separate jointly held entities formed in each country may be required. If there is a global agreement and a licensing arrangement in each country, the global parties may wish to ensure that they are not seen as jointly carrying on business in each country if the global agreement is construed as creating a partnership that overrides the licensing arrangements. In that case, a country may regard the royalties as profits from a partnership carried on by the global parties in that country, and it may subject the parties to corporate tax and any branch tax and expose them to questions surrounding the appropriate branch accounting for expenses.

If a new entity is formed in each territory, a local partnership of each party's existing or new entities may be formed in each country, or a joint corporation may be preferable. The transfer of assets to the new entity may trigger income tax and sales tax, or a tax-deferred transfer may be available. In Canada, a rollover is available to a Canadian corporation or to a partnership of which all partners are Canadian residents. The sharing of profits and losses of each entity must mirror the profit sharing in the global agreement. Separate agreements may govern the transfer of assets, products, and personnel; the joint entity's operations; and the licensing of intellectual property to the joint entity. Transfer-pricing issues may arise if products are sold, employees loaned, or intellectual property licensed to the new entity. A reasonable markup may be required. If non-resident employees are provided, a treaty's dependent personal service provisions may apply. The impact on customs duties should be considered. Investment Canada may require notification of a Canadian arrangement. The tax consequences of the arrangement's termination may involve multiple jurisdictions and may be costly.

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NO RECOVERY OF REFUND

In *Bulk Transfer*, a CCPC successfully challenged a reassessment of its 1991 taxation year that was based on adjustments consequential on a consent judgment related to its 1987 year: the minister was not empowered by subsection 152(4.3) to adjust the 1991 pre-settlement refund that arose because a capital gain originally assessed in 1987 had increased the RDTOH balance. The taxpayer thus benefited from the settlement, which vacated the 1987 capital gain, and retained the tax refund for its 1991 taxation year.

The taxpayer's 1987 reassessment treated the disposition of a business property as giving rise to a taxable capital gain; the RDTOH account was increased by $65,000 to reflect the non-taxable portion. The taxpayer objected. In the 1991 taxation year, the taxpayer paid a taxable dividend, and in its 1991 tax return it applied the 1987 reassessment's $65,000 RDTOH adjustment to offset its 1991 tax otherwise payable of $21,008. The minister's assessment denied the offset; after a number of reassessments, the taxpayer appealed.

The parties agreed by way of consent to judgment that there was no capital gain in 1987 because a replacement property had been acquired. Pursuant to the court order effecting that settlement, 1987 was reassessed to delete the taxable capital gain, and the RDTOH account was reduced from $65,000 to $8,420.68. When in 1997 the 1991 reassessment denied the RDTOH offset, the taxpayer's accountant requested a detailed explanation of the balance owing and an explanation of what was actually reassessed because the information provided did not permit an analysis to determine the reassessment's accuracy. No explanation was provided, and the taxpayer objected. More than three years later, the minister confirmed the 1991 reassessment on the basis of subsection 152(4.3). The accountant assumed that in effect the minister had reassessed the RDTOH and clawed back the refund.

The taxpayer argued that subsection 152(4.3) empowers the minister only to assess and thereby increase or decrease the amount of "tax, interest or penalties" payable by a taxpayer or to "redetermine an amount deemed to have been paid or to have been an overpayment." Absent express statutory authority in subsection 152(4.3), the minister cannot reassess to recover a refund previously assessed. If Parliament had intended to grant the minister the statutory authority to reduce and/or eliminate and recover a refund of tax, it would have enacted clear statutory language. The minister argued that subsection 152(4.3) allowed the downward adjustment of RDTOH because the 1987 reassessment reduced the capital gain, and thus the dividend refund for the 1991 taxation year was consequentially and properly reduced pursuant to subsection 152(4.3).

The TCC noted that on the basis of the FCA decision in *Sherway*, subsection 152(4.3) must be narrowly construed. Given the direction regarding statutory interpretation and the definition of "balance" in subsection 152(4.4), the TCC held that the term "balance" in subsection 152(4.3) is "limited to the 1987 taxation year, for which there has been a judicial determination and the balance is not a reference to what the Minister is empowered to reassess in respect of the 1991 taxation year." Clear statutory language was required to empower the minister under subsection 152(4.3) to reduce the amount of a refund or to newly assess tax, interest, or penalties in a later taxation year as a result of a change in a balance in a prior year.

The minister routinely adjusts balances in a taxpayer's various accounts in subsequent taxation years as a result of prior years' reassessments and typically reassesses at a taxpayer's request under subsection 152(3.3) to permit the taxpayer to claim the benefit of those adjustments in an otherwise statute-barred year. The narrow reading of the term "balance" reaped an unexpected tax saving in *Bulk Transfer*, but the decision may also preclude routine taxpayer-requested adjustments. That would be an unfortunate and unintended outcome.

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Life Insurance in Freezeco

A corporate-owned life insurance policy may reduce a shareholder's capital gains exposure at death by reducing the company's retained earnings.

Assume a typical term-to-100 type of life policy with no cash surrender value (CSV) during the insured's life and a premium of $100,000 a year for a fixed insurance death benefit. The insured's wholly owned company acquires the policy. If death occurs after payment 10, retained earnings of $1 million will have been diverted into the policy. Without CSVs, there is no value related to the policy to be added to the FMV of the deceased's shares at death, and his capital gains exposure will have been reduced by $1 million.

If the value of the parents' shares has been frozen in favour of their children, the reduced capital gains exposure from the life insurance premiums is enjoyed by the children's common shares—because the parents' preferred shares are fixed in value—unless the parents establish a single-purpose company to own the term-to-100 policy. Assume that a parent, a male aged 70, intends to carry out an estate freeze for shares of Investco (with an accrued $5 million gain) and to acquire a $2.5 million term-to-1ife policy with an annual premium of $100,000. Parent creates Newco to own the policy and rolls in $1 million of Investco shares. The intercorporate shareholding is redeemed; Investco owes Newco $1 million. Parent's $5 million accrued gain is now $4 million in Investco preferred shares and $1 million in Newco commons. Investco pays down its debt to Newco to fund the premiums. Each payment of $100,000 reduces Parent's capital gain exposure; after one payment, that exposure is $4.9 million—$4 million of Investco preferreds and $900,000 Newco commons. Newco is frozen at the corporate asset level rather than at the shareholder level, and reductions to Newco's assets still reduce Parent's equity interest therein.

A universal life policy, commonly used in estate planning, is generally based on a term-to-life structure but allows additional deposits above the cost of insurance. Those deposits can be directed into various fixed-income and equity-linked investments that generate tax-sheltered income; the income plus deposits increase death benefits and CSVs. If a Freezeco owns such a policy, consider a split-dollar arrangement in which the policy's ownership, responsibilities, and benefits are divided. For example, Newco bears the term-to-100 costs and is designated the non-cash-value life insurance beneficiary; Investco makes optional deposits and owns the policy's cash value death benefit. Newco's insurance costs reduce the parent's equity interest in Newco, and cash value growth does not increase Parent's equity interest in Investco, which carried out a freeze.

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In Defence of Foods

The new Ontario government's floating of trial balloons about taxing prepared meals costing under $4 and the continual reshaping of the CRA's approach to zero-rated goods raise sensitivity to tax measures aimed at foodstuffs. One recent GST case and Ontario's now recalled proposals merit comment.

The TCC in *Aliments Koyo* said that de minimis strawberry flavouring turned otherwise exempt soy milk into a GST-taxable item: the zero-rating provision requires that any beverage containing any fruit juice, or fruit flavouring, must contain at least 25 percent fruit juice. An "exception to the exception" for certain "milk-based" products did not apply because the soy base was not "milk" in the ordinary sense of the word. Both conclusions are probably technically correct, but the fruit juice exception, almost identical to the original FST provision, is dated and harks back to a time when Parliament was trying to address the advent of Tang and ensure that FST applied to fruit-flavoured products that were not nutritionally equivalent to natural products. It was unlikely that the exception was intended to capture fruit-flavoured soy-based milk. The TCC was "not convinced that Parliament was referring only to fruit-flavoured beverages of the Kool-Aid type," but it does not appear to have referred to *Hansard*, which named Tang as the mischief at which the original provision was aimed. The decision also comes on the heels of CRA policy developments that attempt to redefine "beverages" and generally treat so-called dietary supplement or health-type beverages as taxable. (See *GST/HST Policy Statement* P-240, "Application of GST/HST to Products Commonly Described as 'Dietary Supplements.' ")

From an overall tax policy perspective, the case and the CRA's administrative interpretations are very unfortunate, particularly because no really compelling argument for the taxation of basic foodstuffs has yet been made. The same sort of tax policy problem exists in Ontario's rumblings about taxing prepared meals under $4. Some news reports even cited government officials as describing the current exemption as a "tax loophole" in spite of the fact that that result is clearly intended legislatively: a specific rule in section 7 of the Ontario Retail Sales Tax Act exempts all "food products for human consumption," except for certain "prepared food products . . . the price of which exceeds four dollars." The province quickly withdrew its suggestion after public outcry. Although "prepared meals" (that is, food items that have undergone some sort of preparation by the seller) are subject to GST, that approach is itself apparently dated for tax policy purposes. The distinction between prepared meals and other foods was developed when it was not generally considered necessary or desirable for both spouses to be employed outside the home in order to support the family unit: going out to a restaurant was a luxury that could properly be viewed as taxable. Times have changed, and when a parent stops after work at the local supermarket to pick up a roasted chicken and coleslaw for dinner, these items should be RST-exempt and zero-rated for GST.

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Foreign Tax News

Treaties

The protocol signed on May 7, 2003 to the **United Kingdom** treaty entered into force on May 4, 2004. In Canada, the protocol is effective in respect of withholding tax on amounts paid or credited to non-residents after 2004, and in respect of other taxes for taxation years beginning thereafter. In the United Kingdom, the protocol is effective in respect of income tax and capital gains tax for years of assessment beginning on or after April 6, 2005, and in respect of corporation tax for financial years beginning on or after April 1, 2005.

A new treaty with **Romania** signed on April 8, 2004 supersedes the existing treaty of November 20, 1978 when ratified. Withholding is 10 percent for interest and dividends between affiliated companies; 15 percent on other dividends; and 5 percent on royalties on certain copyrights, patents, and computer software, and 10 percent otherwise. The treaty enters into force 30 days after each

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country notifies the other that ratification is complete. The treaty is effective in Canada on tax withheld on amounts paid or credited to non-residents after the calendar year of entry into force, and on other Canadian taxes for tax years beginning thereafter. In Romania, the treaty is effective on all taxes withheld at source, and on other taxes, in the calendar year thereafter.

Israel

The 2003 tax reform added a new section that establishes the arm's-length standard for transfer pricing in international transactions. New regs set the standard as being within the price range established by the taxpayer's transactions with unrelated parties or similar transactions between unrelated parties. Reporting requirements are set out for intragroup pricing. Pricing approval is available from tax authorities. Documentation on controlled international transactions must be provided on request.

Italy

The new corporate income tax of 2003 defines "permanent establishment" (PE), generally following the OECD model—"a fixed place of business through which the business of a foreign person is wholly or partly carried on"—and now exempts combinations of preparatory or auxiliary activities. A PE includes a place of management, branch, office, factory, workshop, mine, oil or gas well, quarry, and any other place of natural resource extraction, including those outside territorial waters over which Italy exercises exploitation rights.

Singapore

To enhance growth in the commodities derivatives market and improve Singapore's trading hub, a concessionary tax rate of 5 percent applies to approved commodity derivative traders, retroactive from February 27, 2004. Successful applicants are awarded the low rate for five years.

Russia

The government issued a letter clarifying VAT treatment for foreign entities that have a Russian office that carries out purely representational activities. VAT must be withheld on payment for services provided directly to Russian customers by the foreign entity if the Russian office is not involved in providing the service. Effective after 2003, a foreign organization that has a PE or that owns immovable property in Russia must now file an assets tax declaration: other foreign entities are exempt, although the absence of an official statement may augur administrative confusion about the change.

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