Canadian Tax Highlights

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Cap Tax: Inventory Financing 2

The 2004 Ontario budget delayed the demise of corporate capital tax and increased the capital tax liability for any corporation that finances inventory through debt from creditors other than its supplier.

In *QEW 427 Dodge Chrysler (1991)*, a car dealership that financed its new vehicle purchases through a line of credit arranged with the manufacturer's credit subsidiary entered into a conditional sales contract for each vehicle purchased from the manufacturer. (See "Cap Tax: Inventory Financing," *Canadian Tax Highlights*, August 29, 2000.) The Ontario Corporations Tax Act was amended in 1993 to exclude "current accounts payable" from paid-up capital; the Ontario Superior Court said that the term included amounts owing to any creditor, not just a supplier, including a financial institution, and that they may be part of a line of credit, may be secured, and may bear interest. On the facts, the indebtedness created to finance each vehicle was prepaid in less than a year and hence was current as defined. The terms "accounts payable" and "current accounts payable" thus encompassed the taxpayer's financing of new vehicle inventory, and its paid-up capital was reduced accordingly.

The new Ontario government's May 18, 2004 budget responded to the *QEW 427* decision directly and proposed an amendment to the "current accounts payable" definition to confirm that it applies only to a payable to a supplier for purchases of goods and services, effective for taxation years ending after budget day. The proposals also "clarify" that the definition of "current accounts payable" does not include liabilities incurred in connection with the purchase or trading of shares, bonds, or other securities, effective for taxation years ending after May 19, 1993.

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Multinational Task Force

Canada, the United States, the United Kingdom, and Australia have established a multinational task force to combat abusive tax transactions. The Joint International Tax Shelter Information Centre (JITSIC) will supplement ongoing work of those countries' tax administrations under a memorandum of understanding signed in April 2004. Although each tax administration operates primarily within its own borders, many transactions that are perceived as abusive by tax authorities cross international borders, and many promoters operate globally. The IRS list of abusive transactions includes, for example, "lease-in, lease-out" transactions.

The JITSIC is intended to enable the four countries to identify and understand abusive tax schemes and those who promote them; to share expertise, best practices, and experience in tax administration to combat abusive tax schemes; to exchange information about specific abusive tax transactions and their promoters and investors, consistent with the countries' existing bilateral tax treaties; and to carry out their separate abusive-tax-transaction enforcement activities more effectively and efficiently. The JITSIC aims to deter the promotion of and investment in abusive tax schemes through a focus on information sharing. Existing treaties provide for exchange of information: for example, under the Canada-US treaty, both competent authorities must exchange information necessary to carry out the provisions of the treaty or the

In This Issue

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Pages 1 – 9

domestic laws of either country concerning taxes covered by the treaty. The JITSIC intends to coordinate "real time" exchanges of tax information consistent with bilateral tax treaties and to develop new Internet search and "other" techniques for early identification of promoters and investors involved in abusive tax schemes. The JITSIC participants also intend to identify emerging trends and patterns to anticipate new schemes and to improve their knowledge of techniques used to promote cross-border schemes.

The new agreement complements two US domestic agreements. In 2003, the IRS and 45 states, the District of Columbia, and New York City agreed to coordinate their efforts and share data on illegal schemes that evade both federal and state taxes. Because some transactions are designed to avoid state taxation only, tax agencies in 34 states and New York City signed a joint agreement to share information between themselves on abusive tax shelters and illegal transactions. The information-sharing agreements provide formal structures for jurisdictions to notify one another when they uncover a scheme, to share insight on compliance initiatives, and to suggest potentially significant directions for audit exploration. US practitioners have already seen the effects of this process—for example, in the coordination between the IRS and the New York State Tax Shelter Unit. California enacted its own tax shelter disclosure and penalty legislation, and New York has proposed similar rules.

Taxpayers with multinational operations must be up to date on compliance requirements and the scope of "abusive transactions." Taxpayers should assume that their transactions are transparent to the taxing authorities and be prepared to defend them globally.

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Snow White Out

Snow White Productions successfully petitioned the Supreme Court of British Columbia (BCSC), seeking a rectification order to amend documentation papering a movie-of-the-week production agreement so that Snow White could claim federal and BC film tax credits. *Snow White* (2004 BCSC 604) is another in a long line of cases in which taxpayers have been able to mitigate adverse tax results flowing from documentation that did not reflect the true intention of the parties to the agreement.

The Sextant group was involved in the entertainment business, including the film and television industry, in Canada. In 1999, PMP, a Sextant group member, and Balbelsberg (a German limited partnership) agreed to produce a film in Canada either through PMP or an affiliate. It was standard practice at the time for a film production in Canada to be structured to qualify for tax credits; without the tax credits, the particular production would not have been filmed in Canada. In 2000, Snow White was incorporated as a Sextant group member to produce the film. As was customary, legal documentation followed once the deal was struck. Errors were picked up in an audit by the CRA when it reviewed the film tax credit application. The application was rejected because the documentation as it stood showed that Snow White did not hold the copyright, nor had it contracted directly with the copyright holder, Balbelsberg, as required under tax credit rules. The documentation described PMP, not Balbelsberg, as holding sole and exclusive title and ownership in and to the television motion picture, including the copyright. The rectification petition sought to correct this shortfall.

The BCSC reviewed the relevant jurisprudence and concluded that before rectification can be ordered, the applicant must establish (1) that the written document does not reflect the true intent of the parties and (2) that they shared a common continuing intention up to the time of signature that the provision in question was to stand as agreed rather than as reflected in the instrument. The standard of proof of these elements is stringent, although not as high as the criminal law standard of "beyond a reasonable doubt"; the court said that terms such as "certainty" and "convincing proof" are appropriate.

The court reviewed the Ontario Court of Appeal's upholding of a rectification order in *Juliar* (2000 DTC 6589) that retroactively converted some problematic debt into shares to avoid an "unfair" section 84.1 deemed dividend; the parties' intention to avoid tax was primary and was a continuing objective from the inception of the transaction. The court in *Juliar* referred to English texts and cases to the effect that "[w]hat is rectified is not a mistake in the transaction itself but . . . in the way in which the transaction has been expressed in writing. Courts of Equity do not rectify contracts; they may and do rectify instruments purporting to have been made in pursuance of the terms of the contract." Jurisprudence also supported the conclusion that the rectification remedy was available even if the sole purpose was to obtain a legitimate fiscal advantage. Leave to appeal to the SCC was denied. In *Bramco*, rectification was denied because the objective of mitigating land transfer tax was neither initial nor continuing until documentation; it arose only after an adverse assessment. In *Snow White*, an officer indicated in a sworn statement that Balbelsberg expected the film to be produced in a manner that would enable it to qualify for tax credits; otherwise, it would not have entered into the agreement. As soon as the documentation error became known, the parties executed and filed with the tax authorities an amending agreement to reflect the correct ownership.

Income Tax Technical News no. 22 (2002) stated that, generally speaking, the CRA accepts all rectification orders for assessment and reassessment purposes, especially if it has had an opportunity to contest the order, as in *Juliar*. However, the CRA has indicated that it is most likely to challenge applications to obtain rectification if it is not properly informed of the rectification application or if it thinks that the process has been abused, and it will consider taking the right case through the TCC process: the CRA feels strongly that a rectification order should not become a convenient method of "fixing" aggressive tax plans that are uncovered on audit. The CRA will not challenge the "corporate slip" type of mistake, as in the *Dale* case (2000 DTC 6579), nor will it challenge a case that fits squarely within the facts of *Juliar*. The CRA is now monitoring the number and types of rectification applications to determine whether a legislative amendment is desirable; thus, its position on rectification has yet to be finalized. As a matter of procedural law, the BCSC in *Snow White* said that it was appropriate for a petitioner to serve the CRA and the attorney general of Canada on its behalf with the petition for rectification and notice of the hearing. The attorney general appeared to ensure that all relevant information was before the court. Given its stated policy, the CRA will presumably have no problem accepting the outcome in *Snow White*.

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A Lot from a Few: PIT

Preliminary statistics of personal income tax collections for the 2002 tax year are now available on the CRA's Web site. Despite changes in the design of the federal rate structure and the conversion of provincial taxes from tax-on-tax to TONI (tax on net income), the very few rich continue to shoulder a hefty part of the total tax burden.

Table 1 shows that 44 percent of all taxable returns showed 2002 income of less than $30,000, roughly the first rate bracket in the federal system. These taxpayers provided only 7.5 percent of federal tax and 9.6 percent of provincial (and territorial) tax (except Quebec). Taxpayers with incomes over $100,000, roughly the top bracket, made up only 4.3 percent of all taxpayers but provided 31.6 percent of federal tax and 37.6 percent of all provincial tax. The fact that the provincial percentage distribution differs from the federal is in part a reflection of the different rate schedules used by the participating provinces. Although the $30,000 to $60,000 group carried a higher share of the federal than the provincial tax burden, the reverse is true for incomes over $100,000, reflecting the higher provincial rates and surtaxes at that level.

Table 1

	Percentage distribution		
2002 income	Taxpayers	Federal tax	Provincial tax
Under $30,000	44.0	7.5	9.6
$30,000 to $60,000	44.4	35.7	27.6
$60,000 to $100,000	7.2	25.2	25.2
Over $100,000	4.3	31.6	37.6

Table 2

	Percentage distribution		
1992 income	Taxpayers	Federal tax	Provincial tax
Under $30,000	56.6	19.4	17.7
$30,000 to $60,000	34.9	44.7	44.0
$60,000 to $100,000	6.6	18.8	19.2
Over $100,000	1.9	17.2	19.1

The 2002 figures contrast sharply with 1992 data. A comparison with table 2 shows, over the decade, that the number of taxpayers at the two lower income levels decreased from nearly 92 percent to 88 percent, and their share of the federal tax dropped from 64 percent to 43 percent. The increase in the number of taxpayers in the higher income brackets contributed to this change, but the reductions in tax rates for the lower income groups accentuated the shift in federal tax.

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New Cross-Border Income Trusts

In March 2004, two new income trust structures were set up to acquire all or part of US businesses.

Hardwoods Distribution Income Fund. Units are offered by an income fund, which owns units and subordinated notes of a holding trust. The Canadian business is owned by a Canadian limited partnership (Hardwood LP), 80 percent of which is owned by the holding trust (the remainder is owned by the selling group). Similarly, 80 percent of the general partner is owned by the holding trust (the balance is owned by the selling shareholder). The US business is operated by a US LP, which is 80 percent owned by a US LLC, which is owned by a Canco, which in turn is owned by the holding trust. US LLC owns all the US general partner's shares. For tax purposes, the US LP and the US LLC are flowthrough entities; Canco pays tax on its share of US LP's income and deducts the interest expense on the subordinated notes issued by it to the holding trust.

■ The US tax commentary indicates that if a business entity not automatically classified as a corporation has at least two members, it may elect to be treated as a partnership (or a corporation) for US tax purposes. It may escape being taxed as a corporation under Code section 7704 if at least 90 percent of its gross income for every taxable year is qualifying income, a test that the fund expects to meet—although no opinion is expressed on this—because its income will consist of dividends and interest on Canco's common shares and notes and dividends from Hardwood LP. Fund unitholders are treated as the beneficial owners of interest on the Canco notes if no holder owns through the fund 10 percent or more of the voting power of Canco and is not a bank; the portfolio interest withholding tax exemption should apply, but if the partnership is regarded as an entity for US tax purposes, 35 percent US withholding applies.

■ Because the business is carried on by a US LP, not a corporation, its income allocable to a foreign corporate partner (Canco) is subject to a 35 percent withholding. The withholding may be refunded if it exceeds Canco's US federal income tax liability, but it will be a drain on cash flow, particularly in the first year.

■ The earnings-stripping rules apply. Canco's ability to deduct interest expense on the subordinated notes owned by the holding trust is limited if its debt-to-equity ratio exceeds 1.5:1 and its net interest expense exceeds 50 percent of its adjusted taxable income (before interest, taxes, depreciation, and amortization). Depending on the facts each year, Canco's US federal income tax and branch profits tax liabilities may increase, reducing income available for distribution.

■ With respect to the recharacterization of debt as equity, the opinions do not seem to distinguish this deal; because the earnings-stripping rules may apply, the transaction may not have been perceived to be an IRS target, although a note to the pro forma financials indicates that there is at least a hypothetical possibility that the debt may be challenged.

Medical Facilities Corporation. Income participating securities (IPS) are a Canadian version of income deposit securities (IDS). A Canco issues an IPS, a unit of common shares, and subordinated notes. Canco owns all the membership interests in a US LLC, which owns a 51 percent interest in a US partnership (the balance is owned by the business's current owners). Like an IDS, an IPS can be separated into its component parts by the holder at any time after 90 days from the closing; it is automatically separated upon a repurchase, redemption, or maturity of the subordinated notes or upon a change of control of the issuer. Holders may combine component parts acquired separately. For Canadian tax purposes, the issuer is a Canco whose income is distributions from the US LLC, regarded as a controlled foreign affiliate. As a result, if the US LLC's income is from carrying on a US active business, Canco will not have FAPI and US LLC distributions are exempt surplus dividends.

■ For US tax purposes, US LLC is disregarded; Canco is taxable on income from the US partnership and deducts the interest on the subordinated notes. The 35 percent US withholding tax applies, and Canco may be entitled to a refund. The portfolio interest exemption applies to subordinated noteholders who own less than 10 percent of the voting shares of the issuer and are not a bank. Generally, no US withholding on dividends is paid on the shares of the issuer.

■ As with an IDS, the US tax opinion indicates that the debt should not be recharacterized as equity; the ability to separate the subordinated debt and the equity provides a greater degree of comfort, although the opinion on its face is no stronger than opinions on traditional structures. The US earnings-stripping rules may not apply. The issuer's shares and debt are not foreign property to Canadian pension funds and RRSPs. A dividend paid to a Canadian individual from Canco benefits from a 32 percent tax rate, compared with a rate of 46 percent on interest income.

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HIGH-TECH LEASES

The 2004 federal budget increased the CCA rate for computer equipment and data network infrastructure equipment to enhance productivity through increased investment. The measure provides a tax incentive for direct purchases and enhances the tax-effectiveness of leases.

Computer equipment (in the regs, general-purpose electronic data-processing equipment) is exempt from specified leasing property (SLP) rules, which limit a lessor's cumulative CCA claim to the lesser of the regular claim and the cumulative repayment of principal on a notional interest-bearing loan equal to the assets' FMV. Subject to other relevant limitations—in particular, regulation 1100(15)—a lessor's CCA claim is typically limited only by the regular 30 percent declining-balance rule applicable to class 10.

A principal business corporation (PBC) exempt from regulation 1100(15) may theoretically create a loss from computer leasing; a non-PBC lessor may claim sufficient CCA to shelter its rental income, not just the hypothetical return of principal computed under the SLP rules. In practice, the SLP exemption is often irrelevant because the 30 percent limitation applies. For example, laptop computers are generally on short-term leases and have low resale values; lessors typically charge rents that allow them to recover their investment at a rate that exceeds the regular CCA available, resulting in lessors' having higher accounting income than tax income. The low CCA rate makes the exemption from the SLP rules so irrelevant that some PBCs that lease information technology equipment elect under regulation 1100(1.14) to treat it as SLP and effectively compute CCA under the regular limitation without reference to the half-year rule.

The budget increases the CCA rate on computers from 30 to 45 percent and continues its exemption from the SLP rules if an item's capital cost does not exceed $1 million. Deductions using the new rate may exceed rents, creating a net deduction for tax purposes in the early years of leases by PBCs. The proposed elimination of the separate class election for such equipment is unfortunate, although the rate change may render a single pool of leased assets preferable. The separate class election allowed a terminal loss on disposition, but pooling avoids recapture. A lessor that sells an asset after a three-year lease and 45 percent CCA claims need only recover 23 percent of the original cost before the pooling becomes preferable (42 percent under the old rate). Moreover, in a pooled class the half-year rule applies to net current-year additions and disposals, whereas the half-year rule applies to each new separate class asset.

The CCA rate increase to 30 percent for network infrastructure equipment may not be as positive for lessors, because such property is likely SLP. However, a lessor's CCA claim for such equipment is often restricted by the regular limitation, not the SLP rules. The budget changes are not likely to cause such SLP equipment to be leased for its shelter value—there is very limited opportunity to create tax losses from an SLP lease—but the changes should reduce the instances in which income for tax purposes exceeds accounting income in the lease's early years.

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FAT Timing

If a taxpayer includes in his income for the year (or for any of the five previous years) an amount of FAPI in respect of a controlled foreign affiliate (CFA), he may deduct a grossed-up amount of foreign accrual tax (FAT) in computing his income (subsection 91(4)). FAPI is computed under the rules of the Income Tax Act, and foreign tax is computed under foreign law; thus, the application of subsection 91(4) to factual situations may raise interpretive issues. A recent CRA Access Letter (document no. 2002-0134201I7) addresses four issues.

■ The CRA says that the FAT deduction is not claimed in the year in which the FAPI is recognized or the foreign accrual tax paid, but rather in the year to which the foreign tax liability relates. Assume that the taxpayer and the CFA have calendar taxation years. In year 1, the CFA's only source of income is FAPI, but there is no related foreign tax liability because of a reserve under foreign tax law. The FAT deduction is available in year 2 if the reserve is then reversed and that related tax liability is eventually paid. Similarly, a US sub that is part of a consolidated group may take a FAT deduction for a compensatory tax payment for the year in which its tax would have been payable computed on a non-consolidated basis per regulation 5907(1.3)), not for the year in which the compensatory tax payment is made. The CRA also acknowledges that if the foreign tax is payable in a year before the year in which FAPI arises, the FAT deduction is available in the latter year.

■ When FAT "may reasonably be regarded as applicable" to FAPI is an objective test that is complicated by the fact that FAPI is computed under rules in the Act for computing income, but foreign tax is computed under foreign law. There is often no clear meshing of the two taxing systems on the application of losses, the use of reserves, or the mixing of FAPI and active business income or loss in an FA in a particular situation. The CRA reaffirmed its guidance in a prior TI (document no. 9719055) that foreign taxes payable in a subsequent year because they are mixed FAPI and active business losses can relate back to FAPI recognized in a prior year.

■ How proposed regulation 5907(1.4)—the restriction on the deduction for compensatory payments for losses that are not FAPLs—applies to such a payment is not addressed, but the CRA indicated that under the coming-into-force provision it is effective for such payments made in a taxation year beginning after 1999, not the year in which the FAPI was earned or the year to which the payment related.

■ Compensatory payments must be "paid" to satisfy regulation 5907(1.3). Although it is not required, most such payments are computed and paid pursuant to a tax-sharing agreement among the US corporate group. The amounts may be computed and not settled in cash but rather posted as a journal entry to an intercompany account that is not cleared out routinely. The CRA's comment is helpful: "Where the companies are going concerns and the entry is made to an intercompany account that has many offsetting entries, it may be reasonable to consider payment made at the time of [book] entry. Where the payable remains outstanding for a longer period of time, in our view it is not reasonable to consider the amount 'paid.' "

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Ontario Non-Income Taxes

Although the 2004 Ontario budget's non-income tax changes may not be significant overall, one is particularly unwelcome and one has been awaited for many years.

■ The employer health tax (EHT) rules are amended retroactively to address a recent Ontario Court decision (file no. 03-CV-2488030CM3), which held that Ontario-based professional sports teams did not have to pay EHT on salaries paid to players and others for games played outside Ontario, because such salaries were attributable to non-Ontario permanent establishments (PEs). (See "Locker Room PE," *Canadian Tax Highlights*, May 2004.) Legislation will "clarify" that such a result does not accord with the EHT Act and that all remuneration paid to a person who reports to work at an Ontario PE is taxable, retroactive to January 1, 1990. Not unexpectedly, Ontario indicates that it will appeal the *Blue Jays* decision, presumably on the basis of the new retroactive legislation.

■ A long-awaited change "modernizes" RST rules for exempt transfers of assets between related corporations and, mutatis mutandis, establishes rules for the transfer of assets between partnerships and their principals. Draft regs will be posted on the Ministry of Finance's Web site for industry comment and finalization in autumn 2004, effective as of the draft regs' release. A similar budget proposal was made several years ago, but the commitment to a fall 2004 finalization date is a step forward. The current rules, in place since 1961, sometimes seem anachronistic when applied to common contemporary income tax transactions.

■ A one-year retail sales tax (RST) exemption applies for "destination marketing" fees connected with the marketing of a particular place for tourism purposes; such fees were previously subject to a 5 percent accommodations tax. The tax holiday is reportedly in "support of the hotel industry's initiative in funding tourism marketing and . . . the recovery of Ontario's tourism industry," presumably from the 2003 SARS crisis, effective for fees billed from May 19, 2004 to May 18, 2005.

■ The RST rebate for solar energy systems broadens to include residential wind, micro-hydroelectric, and geothermal energy systems (for heating or cooling) to "enable homeowners to be more energy self-sufficient using clean, renewable energy." The rebate is available for purchases made from March 28, 2003 to November 25, 2007.

■ Ontario took a second step toward its commitment to bring tobacco tax rates up to the national average, raising immediately the Ontario rate to 11.1¢ per cigarette, tobacco stick, or gram of cut tobacco. Forthcoming legislation will give the minister regulatory power to prescribe different rates for certain tobacco products. Changes are afoot to improve the overall enforcement of the Tobacco Tax Act and crack down on "unregulated contraband tobacco and unauthorized distribution activities," including an increase in the minimum court-imposed fine from $500 to $1,000, depending on the offence, and increases in offences and penalties (such as for repeat offenders) for individuals distributing tobacco without authorization. However, the new minimum fine is of dubious benefit to the enforcement effort.

■ The "volume levy" increases across the board for spirits, wine, and beer and certain other beverages, effective June 21, 2004.

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Tax Shelter Rulings Moratorium

In a recent advance ruling (2004-0062961R3), the CRA said that it is studying the ruling process in a joint review with Justice and Finance. Until this process is complete, the CRA will issue no rulings involving the use of two-tiered limited partnerships to raise capital for existing businesses, with losses from such businesses being allocated to the investors or limited partners. The CRA promised to "make an announcement later this year when our study is completed."

The review seems primarily aimed at tax shelters and was triggered by recent settlements reached by the CRA with certain film tax shelters that had obtained advance tax rulings, as reported in the popular media. It is anticipated that the CRA may consider changing caveats and other wording to clarify that taxpayers' representations may be subject to audit, among other things.

Joint Committee submission on FIE and NRT rules. The CBA-CICA Joint Tax Committee submitted comments to Finance on April 27, 2004 on the October 30, 2003 proposed amendments relating to foreign investment entities (FIEs) and non-resident trusts (NRTs). The 18-page submission covers the following topics.

■ **FIEs.** Changes to rollovers (subsections 51(4), 73(1), 85(1.11), 85.1(4), 97(2), 98(7), and 107(4.01), and paragraph 107.4(1)(k)); non-resident entities held by partnerships; double tax relief (section 94.4); application of paragraph 94.1(2)(a) to the income accrual regime; order of dispositions of FIE interests that have been subject to the prescribed rate regime; definitions in subsection 94.1(1); application rules (subsection 94.1(2)); treatment of foreign insurance policies (subsection 94.2(11)); and foreign affiliates holding non-resident entities (paragraph 95(2)(g.3)).

■ **NRTs.** Definition of "closely held corporation"; foreign-source income distributed to non-resident beneficiaries;

non-resident investment trusts; retroactive application of rules on a contributor's return to Canada; trusts terminated in 2003; and technical drafting points.

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Sale-of-Business Planning

A recent technical interpretation (2003-0029955) is concerned with whether GAAR or specific anti-avoidance rules (subsection 84(2) and section 84.1) apply to a series of transactions involving shareholders who extract corporate surplus and claim the capital gains exemption (CGE) on the related sale of shares of an Opco.

The TI was issued in response to question 1 at the 2003 Association de planification fiscale et financière (APFF) round table. The question sought to clarify the CRA's position on tax planning that was similar to that in *Geransky* (2001 DTC 243). The TCC held that there was no subsection 84(2) deemed dividend, and GAAR did not apply to recharacterize the sale proceeds as a dividend rather than a capital gain. The CRA was asked to comment on a series of transactions contemplated by Opco's shareholders, who wished to sell the business Opco carried on. The assumptions were as follows: Opco transfers all its assets to Subco—goodwill on a taxable basis, other assets on a rollover basis; Subco and Opco merge, resulting in a tax year-end; the capital dividend account (CDA) is dividended to the vendors; the shares' sale price is adjusted to take into account the tax payable as a result of the asset sale and the CDA disbursement; Opco shares are sold; and the vendors claim the CGE on qualified small business corporation shares.

The CRA stated that subsection 84(2) does not apply if none of Opco's funds or property is distributed or otherwise appropriated in any manner for the benefit of Opco's shareholders (the vendors). No comment was made on the potential application of section 84.1 because relevant information—the consideration the vendors would receive and whether the vendors and the purchaser were dealing at arm's length—was not provided. The CRA affirmed that GAAR should not apply if there is an overriding business purpose for a series of transactions. In general, when the proposed transaction is supported by bona fide non-tax business purposes and the purchaser and Opco's shareholders are unrelated and have distinct and different interests, an agreement between the parties that the purchaser will acquire Opco's assets via the purchase of its shares does not by itself indicate that the purchaser and vendors are non-arm's-length.

The CRA pointed out that its opinion applies only to the shareholder-vendors' tax consequences arising from the disposition of their Opco shares, and not to other tax consequences that may arise in such situations—for example, from transactions carried out by Opco before the sale of its shares.

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New Basis of Assessment

In *Loewen*, the TCC (2003 TCC 101) had struck parts of the Crown's reply filed in defence of an income tax assessment to which the taxpayer had objected and filed a notice of appeal. The FCA (2004 FCA 146) reversed and affirmed that while the minister's reply cannot increase the tax payable, he can add a new argument or "basis of assessment" to support an existing reassessment even after the normal reassessment period has expired. Further, the validity of the transaction itself can be challenged by the use of language such as "purported" and "alleged" without making the pleading duplicitous or ambiguous. *Loewen* reviews the basic principles of pleadings in light of the SCC decision in *Continental Bank* ([1998] 2 SCR 358); subsection 152(9); the FCA decision in *Anchor Pointe* (2003 DTC 5512); and the rules of pleading. The Crown views *Loewen* as silencing challenges to the minister's ability to support his position on different grounds in the pleadings.

In 1993, Loewen acquired an undivided 6.25 percent co-ownership interest in software (for a total cost of $8 million) for $500,000 ($150,000 down plus a promissory note) and claimed CCA of $500,000. His 1993, 1994, and 1995 returns were audited and reassessed in 2001 on the basis that the software's total FMV was $1,600,000, and that the software was not available for use until 1994. The reassessment period for 1993 and 1994 expired two months later; Loewen objected and appealed to the TCC. The Crown's reply to the appeal presented three defences related to the cost and a fourth that could deny the entire CCA claim. Loewen moved, inter alia, that particular challenges in the reply (that the transaction was not arm's-length, that the liability was contingent, and that there was no income-earning purpose) be struck because the Crown's challenges constituted a new and different assessment from that under appeal. The TCC granted the taxpayer relief in part and ordered struck from the reply the no-income-earning-purpose challenge and particular words—"so-called," "called a," purported," and "alleged"—and ordered lump-sum costs of $2,000 to the taxpayer.

The FCA reiterated basic principles: (1) the pleadings define the issues; (2) the taxpayer commences an appeal by filing a notice of appeal containing the facts and arguments relied on to challenge the assessment; (3) the

Crown has no right to appeal an assessment; (4) the Crown's reply states its position on the facts and arguments in the notice of appeal and the facts and arguments on which it relies to defend its assessment; and (5) the taxpayer may file an answer, but rarely does so. The FCA said that the basis of assessment, which "is a matter of historical fact, and does not change," normally includes the facts that, in the minister's view, justified the increased taxable income in the reassessment; describes how they applied to the relevant law; and states any conclusions of law that guided the facts' application.

On basic principles regarding onus of proof, the FCA noted that unless a taxpayer disproves the facts or proves that the minister did not make the assumptions, those factual assumptions are taken as having been made. To succeed, the taxpayer must show that even if the assumed facts are true, they do not justify the assessment as a matter of law. The Crown's responsibility in pleading is to ensure that the assumptions paragraph is clear and accurate and that assumptions made after a notice of objection are not asserted as assumptions made when the assessment was carried out. Alternative pleas cannot be inserted as assumptions; they must be situated elsewhere in the reply, because the Crown bears the onus with respect to them. The Crown may plead that the minister, when confirming an assessment, made an assumption that he did not make at the time of the original assessment; the facts and arguments underlying that later assumption can be inconsistent with the initial basis of assessment. In *Schultz* (95 DTC 5657), for example, the Crown asserted a different legal result flowing from the same set of facts. However, in such a case the onus falls on the minister. Further, by virtue of subsection 152(9) of the Income Tax Act (enacted after the SCC decision in *Continental Bank*), the Crown may defend an assessment on any ground after the normal reassessment period has expired, so long as the taxpayer is not prejudiced by new factual allegations many years after the event. Subsection 152(4) also restricts the minister's ability to reassess outside the time limitations imposed by the Act or to collect tax exceeding the amount in the assessment appealed. The Crown may also present new legal arguments that arose from the evidence presented in the TCC proceedings if they were consequential on the facts alleged in the pleadings (including the facts alleged in the notice of appeal and the facts alleged and assumptions in the reply).

The FCA concluded that the Crown's arguments regarding "reasonableness," arm's length, and the promissory notes' validity were not objectionable because they only led to limiting the total CCA claim to the software's FMV at acquisition. Although success on the Crown's fourth defence—lack of the requisite income-earning purpose to claim any CCA—could theoretically increase, and thus be inconsistent with, the assessment, the Crown sought only to defend the reassessment and not to deny CCA. Although the Crown's new argument emerged at the end of the objection stage and not in the pleadings, the FCA said that *Anchor Pointe* was consistent with allowing the Crown to raise new arguments after the time for reassessment had expired, so long as it was not seeking to increase the tax. The FCA reversed the TCC's striking of "so-called," "called a," "purported," and "alleged" because the taxpayer had not asserted this line of attack and such language is appropriate to refer to allegations of fact not admitted. The FCA also said that a taxpayer does not acquire a defence against factual allegations and issues that the taxpayer believed had been laid to rest at the reassessment or objection stage, even though the taxpayer had already spent time and money in the administrative process and must duplicate his efforts at the TCC.

The courts in *Loewen* and *Anchor Pointe* accepted the minister's seemingly unfettered ability to defend the assessment on any argument, "basis," or ground at the appeal stage regardless of the grounds upon which the matter was based throughout the administrative process and before the limitation period expired. The only restriction is that the minister must not seek to increase the tax in issue or take into account different transactions than those that formed the basis of the reassessment within the normal reassessment period. The conclusion is legally sound and not entirely unfair given the complexity of the Act, the ever-evolving jurisprudence, and the CRA's obligation to uphold the statute and apply it equitably as between taxpayers. However, the conclusion is certainly onerous for the individual taxpayer who has spent considerable money assembling evidence and arguments to contradict the minister's challenges to his position throughout the course of a normally lengthy administrative review, only to find that he has an entirely new and unexpected array of arguments to contest when the door to the courtroom is in sight. The minister has many opportunities to test his theories of the case. In particular, avoidance cases typically involve thousands of outstanding objections related to shelters founded on similar principles and structures and marketed to taxpayers with legal assurance that the legal fundamentals of the deal will withstand scrutiny. Placing some restrictions on the minister's ability to challenge an issue in a particular case (or a set of cases as defined by counsel) would force the minister to make a more careful initial analysis and to be more selective in choosing to litigate or settle in order to acknowledge the burdens faced by an individual taxpayer (or by a group with similar issues). By the time the assessment is made or the objection received, the minister

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has had ample opportunity to solidify his position; in avoidance cases, CRA Headquarters and Justice counsel have normally reviewed the issues at their leisure. If not the law, then administrative fairness should require the minister to commit to a position before preparing pleadings.

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Foreign Tax News

Treaties

The new treaty with **Venezuela**, signed on July 10, 2001, entered into force on May 5, 2004, effective for withholding taxes on amounts paid or credited to non-residents after 2004 and in respect of all other taxes for taxation years beginning thereafter. The new treaty with the **United Arab Emirates**, signed on June 9, 2002, entered into force on May 25, 2004, effective with respect to withholding taxes on amounts paid or credited to non-residents after 2003 and in respect of all other taxes for taxation years beginning thereafter. Treaty negotiations with **Singapore** to update the existing tax treaty will commence on August 16, 2004. Finance is interested in learning of any particular issues and difficulties under Singapore's tax system that should be considered during these negotiations.

OECD

On June 4, 2004, the OECD concluded a global forum in Berlin on harmful tax competition. The OECD aims to establish standards of fairness, inclusiveness, and mutual benefits through bilateral implementation among OECD member countries, countries home to financial centres, and low-tax jurisdictions by 2006. The report is available on the OECD Web site (http://www.oecd.org) and through the Foundation's library.

Belgium

To encourage investment in the feature film and documentary industry by companies not directly related to the film sector, available tax shelters have been made more attractive by reducing the investor's risk. Up to 40 percent of an investment can be advanced as a loan repayable over time; the corporate income tax of 33.99 percent on the exempt profit provides a return of 51 percent. Proof that all conditions have been met must precede the distribution of tax-exempt profit.

Australia

To establish an internationally competitive framework for venture capital investments, new legislation retroactively expands tax breaks to July 1, 2002. Eligible investments in a holding company and its spinoffs qualify.

Serbia

To attract foreign investment, spur economic growth, and encourage domestic companies to accurately report profits, the tax rate will fall from 14 to 10 percent. New tax credits and incentives will be established for the agriculture, leather and textile production, automotive, metal-processing, and film-production sectors.

Finland

A new tax reform bill, effective January 1, 2005, abolishes the imputation credit system and reduces corporate and capital income tax rates by (1) continuing with the broad-based tax system and low rates and (2) reducing the current corporate rate from 29 percent to 26 percent and individuals' capital rate from 29 percent to 28 percent, both effective at the beginning of 2005. Other changes include certain exemptions for capital gains and changes to dividend taxes, with taxable income of a listed company taxed at 57 (formerly 70) percent (dividends in an unlisted company fall into many tax brackets). Wealth tax rates fall to 0.08 percent from 0.09 percent, and the base rises to €250,000 from €185,000.

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