# Canadian Tax Highlights

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## Series of Transactions

The FCA recently overturned the TCC decision in *Canutilities Holdings* (2004 FCA 234), although the result was substantially the same. The FCA adopted a different view of what constitutes a series of transactions and concluded that so-called normal-course dividends were part of a preordained series.

Subsection 55(2), a capital gains stripping anti-avoidance rule, converts an otherwise tax-free intercorporate deemed dividend arising on a share redemption into proceeds of disposition if the deemed dividend is part of a series of transactions that results in a significant reduction in capital gains that would otherwise have been realized on the shares' disposition. However, an exception arises if the deemed dividend's recipient is subject to part IV tax thereon that is not refunded by the on-payment of dividends to other corporations as part of a series of transactions that includes the initial deemed dividend.

On the facts, transactions were arranged to facilitate the disposition of a publicly listed Canadian company by two Cancos (CU and CUH) via a redemption of shares; refundable part IV tax was triggered on the resulting deemed dividends in lieu of part I tax on unrealized gains on the shares. CU and CUH had a history of paying dividends, and paid so-called normal-course dividends that generated offsetting part IV tax refunds. (CUH's part IV tax was offset over two years.) Were the normal-course dividends part of a "series of transactions" that reduced capital gains as contemplated by subsection 55(2)? If such a nexus existed, the court must determine whether the part IV tax exception was inapplicable because the normal-course dividends to corporations triggered a part IV tax refund.

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The TCC cited four criteria from the House of Lords decision in *Furniss v. Dawson* ([1984] STC 153) (followed in *Craven v. White*, [1988] STC 476) to determine whether a transaction is part of a series at common law:

1) The series was, when the intermediate transaction was entered into, preordained to produce a given result.
2) The transaction's only purpose was tax mitigation.
3) There was at the time no practical likelihood that the preplanned events would not occur in the order ordained, so that the intermediate transaction was not even contemplated practically as having an independent life.
4) The preordained events did take place.

The TCC concluded that the normal-course dividends were not part of the base series because they had an independent life. The FCA said that the House of Lords' approach was distinguishable because the four-pronged test was used to develop a judicial anti-avoidance measure; clearly, the tax purpose test and the independent life test (criteria 2 and 3) were predicated on that anti-avoidance purpose and were not necessary for developing a common law definition of "series." Those tests were directed to establishing whether the legal effect of an intermediate transaction with no non-tax purpose and no independent life could be ignored. Canada, in contrast, has a statutory anti-avoidance test, and thus those two criteria should not be imported wholesale in defining a series for Canadian tax purposes: whether a series of transactions exists at common law depends only on whether the base series and the normal-course dividends were preordained (as defined in *OSFC Holdings*, 2001 DTC 5471 (FCA)) to produce a final result and whether they actually took place. The taxpayers intended to use both the base series and the normal-course dividends to achieve their tax-avoidance objective; they were able to ensure that all the transactions would occur, and they did in fact occur. Thus, all the transactions were part of a common law series for the purpose of subsection 55(2.)

Although the normal-course dividends were part of a series, the part IV tax exception could apply to the extent that the refund thereof was triggered by the payment of dividends to non-corporations. The FCA said that nothing in subsection 129(1) suggests that dividend refunds must be allocated pro rata between individual and corporate recipients. Thus, the taxpayers could allocate or apportion the refund on a basis most beneficial to them, which on



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the facts meant that most of the refund could be allocated to dividends paid to non-corporations.

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## Data Sharing: IRS and CIS

On July 21, 2004, the US Government Accounting Office (GAO) released testimony before the Senate Finance Committee regarding the practice of data sharing between the US Citizenship and Immigration Services (CIS) and the IRS, with a view to enhancing US tax compliance and improving immigration eligibility decisions. Specifically, the GAO determined the extent to which the IRS and the CIS (within the Department of Homeland Security) share and verify data and the benefits and challenges, if any, of increased sharing.

Currently, the two agencies do not share data to ensure that taxpayers meet their tax obligations or to determine immigration eligibility. Some IRS officials believe that the information on taxpayers' income that is currently used is more accurate and useful for enforcing tax laws than CIS data. However, the GAO says that the IRS might benefit from the use of CIS immigration information to identify non-compliant taxpayers. In addition, the testimony indicated that the IRS may use CIS data to identify taxpayers who fail to file tax returns or who underreport income. For instance, in a nationwide selection of 413,723 businesses and organizations that applied to sponsor immigrant workers from 1997 to 2004, the GAO found that 5 percent were unknown to the IRS: such information can be used to select taxpayers for audit and to enhance enforcement efforts. One such business reported $162,000 in taxable income for 2001 to the CIS and none to the IRS. Nearly 20,000 businesses had cumulative unpaid tax of $5.6 billion at December 2003.

The testimony also indicated that CIS information may enable the IRS to identify less visible taxpayers, such as small businesses and self-employed individuals, and the CIS may benefit from access to IRS information when making immigration eligibility decisions (for example, whether to allow a business to sponsor an immigrant). Nearly 68,000 of the businesses in the GAO study failed to file an income tax return, which could affect a sponsorship decision by the CIS; the GAO suggested that sponsorship applicants be required to prove that they have met their US tax obligations.

The CIS (and to a lesser extent the IRS) face significant challenges to data sharing. Code section 6103 generally guarantees that the IRS will maintain the confidentiality of taxpayer information in order to buttress voluntary compliance; thus, a strong business case must support information sharing. Technological problems could stymie data sharing: the CIS does not automate financial data (such as the applicant's income), and both agencies use different tracking numbers (the CIS uses alien registration numbers, and the IRS uses social security numbers [SSNs] or employer identification numbers [EINs].)

The GAO also studied the IRS offshore voluntary compliance initiative (OVCI) to learn more about taxpayers who came forward and how they became non-compliant. The OVCI, introduced in January 2003, attempted to bring back into compliance taxpayers who illegally held funds offshore and to gather more information about them and about promoters of offshore structures. (It is not illegal to hold money offshore, but a taxpayer must disclose substantial holdings.) Under the OVCI, 861 taxpayers came forward, netting over $200 million in unpaid taxes, penalties, and interest. OVCI applicants displayed diversity in income, geographic location, and occupation. Non-compliance was sometimes apparently intentional and sometimes inadvertent. More than half the applicants in each year had reported their offshore income and paid taxes but had failed to file a Report of Foreign Bank and Financial Accounts, which must be filed by any US person with a financial interest in or authority over any foreign financial account valued at more than $10,000 in the calendar year. The form must be filed annually with the Treasury by June 30. The study suggests that multiple compliance strategies may be needed to ensure compliance regarding offshore accounts.

The proposed expatriation legislation also contemplates greater information sharing between the US tax and immigration authorities to identify non-compliant taxpayers. An individual who renounces US citizenship and is determined by the US attorney general (AG) to have expatriated with a tax-avoidance purpose is an inadmissible alien and may be denied entry into the United States. One of the current proposals denies a former citizen re-entry if he is not in compliance with his tax obligations under the expatriation tax rules, regardless of the motive for expatriation; on the AG's request, the IRS may disclose information such as any items of non-compliance.

In summary, the GAO testimony recommended that the IRS and the CIS assess the benefits and costs of information sharing to enhance tax compliance and to improve immigration eligibility decisions; such sharing may significantly affect US citizens who live in Canada, green-card holders who spend substantial time in Canada, and Canadians who frequently travel to the United States on business. Failure to file US tax returns could affect an individual's immigration status. Individuals could also be asked about their US tax returns when crossing the US-Canada border. Data sharing may thus lead to more audits and enforcement actions against Canadians who must file US tax returns.

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## Bonus Can Create Loss

A recent advance ruling (2004-0072741R3) says that a shareholder-manager bonus may be reasonable even though it creates a non-capital loss. Such a loss may be carried back and reduce income in the three preceding years to the small business deduction limit.

The CRA confirmed at the Foundation's 2003 annual conference that it will generally not challenge the reasonableness of a salary or bonus paid to a CCPC's Canadian-resident shareholder-manager who is active in the company's operating business; the remuneration must be paid from income derived from those normal business activities. A company can deduct such a bonus in computing business income for the taxation year only if the bonus is reasonable under section 67.

The ruling says that a CCPC had adopted a policy of declaring bonuses to its principal shareholder-manager, a Canadian resident, to remunerate him for the company's profits that were attributable to his special knowhow, connections, and entrepreneurial skill. In year X, the company declared a bonus payable to the individual, to be paid from cash reserves generated in prior years by its normal ongoing business operations. The company proposed to deduct the bonus on its year X tax return, thereby creating a non-capital loss that it would carry back to reduce taxable income earned in prior years. The ruling says that the proposed transactions were intended to remunerate the shareholder-manager for his contribution to the successful management of the company and to create a non-capital loss to carry back to earlier taxation years to reduce Canadian-source active business income in those years to (approximately) the small business deduction limit. The CRA says that section 67 does not prevent the deduction of the bonus in computing business income for year X, and the company may carry back and deduct the non-capital loss so created.

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## Racing Down: SBD Rates

This year's budget round had good news for small incorporated businesses. Federal and provincial governments continued to drop the income rate for small businesses and raised the point at which they begin to pay full rates. This trend started as a move to lower rates for all corporations, but it survived the fiscal restraint that produced a pause in the benefits flowing to larger companies. The rates for 2004 are firm. The next round of provincial budgets may well see further changes that lower the rates for small businesses and raise the amount of income eligible for those preferential rates in 2005 and beyond.

**Provincial Corporate Income Rates on Small Business, Calendar Year 2004***

| Provinces | Rate | Limit for low rate |
|---|---|---|
| | *percent* | *$000* |
| Newfoundland and Labrador | 5.0 | 250 |
| Prince Edward Island | 7.5 | 250 |
| Nova Scotia | 5.0 | 250 |
| New Brunswick | 2.8 | 425 |
| Quebec | 8.9 | 250 |
| Ontario | 5.5 | 400 |
| Manitoba | 5.0 | 360 |
| Saskatchewan | 5.5 | 300 |
| Alberta | 3.3 | 400 |
| British Columbia | 4.5 | 300 |
| Northwest Territories | 4.0 | 250 |
| Nunavut | 4.0 | 250 |
| Yukon | 6.0 | 250 |
| Federal | 13.1 | 250 |

* Some figures are rounded.

The table shows that small business rates for calendar 2004 range from a low of 2.75 percent in New Brunswick to a high of 8.9 percent in Quebec. New Brunswick's rate dropped to 2.5 percent on July 1, 2004; a table for 2005 would show a lower annualized rate. For 2005, Saskatchewan drops its small business rate to 5 percent; the Yukon rate drops to 4 percent.

The federal government applies a rate of 13.12 percent on the first $250,000 of income. Seven provinces and territories use the same level to end their preferential rates; six have implemented higher thresholds. Next year, Manitoba will raise the level to $400,000, and Yukon will introduce the same threshold in 2007. Newfoundland, Prince Edward Island, Nova Scotia, Northwest Territories, Nunavut, and Yukon will raise their thresholds to $300,000 next year.

Two provinces limit the benefit of their small business rates: the tax saved is clawed back as taxable income rises above the threshold. For the 2004 calendar year, New Brunswick effectively taxes small corporations at a rate of 7.7 percent when income exceeds the threshold. Ontario adds an additional tax of 3.57 percent on income above the threshold for manufacturing profits and 4.67 percent for other corporations. For manufacturing and processing profits, the clawback applies until income exceeds $1.1 million.

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## CRA Creditor Super-Priority

In *National Bank* (2004 FCA 92), the FCA held that a bank must pay a customer's unremitted source deductions to the CRA from the proceeds of property that it had seized when the customer defaulted on its loan. The FCA held that the property was subject to the deemed trust rules in section 227 of the Income Tax Act: because the bank was a secured creditor on the property seized, it became directly liable for its customer's unpaid tax debts.

Subsection 227(4) (and section 86(2) of the Employment Insurance Act) stipulates that every person who deducts or withholds an amount thereunder is deemed to hold it in trust for the Crown; if the amount is not remitted, the trust extends to the person's property, even if it is held by a secured creditor. The property is deemed beneficially owned by the Crown, despite any security interest, and the CRA must be paid out of the proceeds in priority to all secured interests. These deemed trust rules grant the Crown absolute priority for any amount that is (deemed) deducted from employees' wages or collected as GST/HST.

In *National Bank*, four separate bank customers were indebted to the CRA for source deductions withheld but not remitted. Loans made by the bank were guaranteed by rights to the customers' property; on default the bank seized and sold the property, receiving the proceeds on account of its claims. The bank ignored the CRA's formal notification that it must pay an amount equal to each customer's unremitted source deductions out of the proceeds. The CRA commenced legal action to recover the amounts. The FCTD held that the bank was a bona fide purchaser and thus excluded from the purview of the deemed trust rules; provincial law applied to the mode of recovery of the tax debts. The FCA disagreed: the Crown has an absolute priority over the proceeds from the property subject to the deemed trust, and they must be paid to the CRA to the extent of unremitted deductions. If this obligation is breached, section 222 provides that any amounts payable thereunder are recoverable in the Federal Court or any other court of competent jurisdiction, or in any other manner provided by the Act: "[T]he positive obligation imposed on the secured creditor to pay the Receiver General the proceeds from the property subject to the trust could not be clearer." In addition, the FCA said that the legislative intention is not difficult to decipher. Parliament wished to confer on the Crown an ongoing interest in the property that is deemed held in trust for as long as the tax debtor's default persists and to subject the secured creditor to the obligation to remit to the CRA the proceeds in absolute priority to the extent of the unpaid debt. The FCA also said that a secured creditor that does not comply with its statutory obligation to pay the CRA the proceeds is personally liable for the unpaid amount.

■ **Limiting beneficiaries' liability.** Alberta's Bill 34, which specifies that investors in publicly traded trusts are not liable for the trust's activities, received royal assent on May 19, 2004 and was proclaimed in force July 1, 2004. Alberta announced the change in its 2004 budget. Ontario's 2004 budget also proposed similar clarifying legislation. Bill 106, introduced on June 21, 2004, includes the Trust Beneficiaries' Liability Act, 2004, which governs the liability of trust beneficiaries if the trust is a reporting issuer under the Securities Act and is governed by the laws of Ontario. Beneficiaries of such a trust are not as such liable for any act, default, obligation, or liability of the trust or its trustees. The new law applies after royal assent; the bill has not yet proceeded beyond first reading.

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## US-Barbados Treaty Protocol

In a continuing effort to ensure that all its tax treaties contain its model limitation-on-benefits (LOB) article, the United States signed a second protocol to its treaty with Barbados on July 14, 2004. A more restrictive LOB article in that treaty is of particular importance because of Barbados' reported popularity as a site for former US public companies that have "inverted" (placed a foreign parent company at the top of the worldwide group). This protocol could significantly affect Canadian taxpayers' foreign affiliates with US-source income, including the loss of permanent establishment protection on US-source business profits and the loss of favourable withholding rates on US-source dividends, interest, and royalties. (The US non-treaty rate is 30 percent.) The in-force date is not subject to a 12-month-greater-relief provision: the withholding provisions enter into force on the first day of the second month after the protocol enters into force.

The current LOB article generally denies treaty benefits on US-source income of Canadian-controlled Barbados companies (such companies whose shares are traded on an exchange are beyond the scope of this discussion) unless the income is derived in connection with, or is incidental to, the active conduct of a trade or business in Barbados (except the making or managing of investments). The new LOB article's active business exception is more restrictive. The Barbados business activity must be substantial relative to the US business activity, and the meaning of "active business" is clarified. A Barbados trade or business is deemed substantial if, for the preceding year or for the average of the three preceding years, each of its related asset value, gross income, and payroll expense equals at least 7.5 percent of such US-business-

related items, and the average of the three ratios exceeds 10 percent. Currently, Canadian-controlled Barbados banks and insurance companies are generally not entitled to the active business exception (except for their non-banking business) if they enjoy a favourable taxing regime in Barbados. They may so qualify under the new protocol; but in the case of a business of making or managing investments, a bank must be licensed to take deposits from Barbados residents and make loans to customers (and must regularly do so), and insurers must be licensed to underwrite risks of Barbadian residents (and must regularly do so).

However, even if the active business exception is met, treaty benefits are denied under the dividend, interest, and royalties articles if the Barbados-resident corporation is entitled to the benefits of a special low-tax regime—for example, under the Exempt Insurance Act, the International Financial Services Act, the Societies with Restricted Liability Act, and the Insurance (Miscellaneous Provisions) Act.

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## Patronage Dividends

A recent ruling confirms that a Canadian sub (Subco) can claim a subsection 135(1) deduction for patronage dividends paid to its sole shareholder-customer, a taxable Canadian corporation (Canco). The ruling should also be of interest to those involved in cross-border patronage dividend structures that were implemented in the last few years in order to limit to withholding tax the size of Canada's tax bite on profits of the Canadian entity that paid such a dividend.

Canco was established by a group of investors, none of which controlled Canco. Canco borrowed from a bank and used the funds along with its investors' equity to acquire the shares of Subco. Subco provided certain services to Canco, its sole customer, and billed Canco at FMV. Canco paid for the services in a timely manner. Subco advertised in prescribed form the prospect that allocations would be made in proportion to patronage to its customers for its taxation year and that it had no plans to make patronage payments to non-shareholder customers. Subsection 135(5) provides that a taxpayer can hold out the prospect of the patronage allocation in various ways by including an appropriate provision in its charter, articles, or bylaws, or in its contract with the relevant customers. A "throughout the year" requirement appears to mean that steps must be taken before the commencement of the year in respect of which the patronage payment allocation is proposed. The deduction of a patronage dividend (section 135 and paragraph 20(1)(u)) is an independent deduction in computing income and assumes a prior (correct) computation of income. The CRA ruled that if Subco held out the prospect that amounts would be credited to its customers in accordance with subsection 135(5), it was entitled to a deduction (subject to the subsection 135(5) limitation) in computing its income for payments made to Canco within the year or within 12 months thereafter pursuant to allocations in proportion to patronage. Canco must include the dividends received in income.

For the purposes of subsection 135(2) and the definition of "income of the taxpayer attributable to business done with members" in subsection 135(4), the CRA ruled that the income of Subco included income from all sources determined in accordance with section 3 before a deduction for the patronage dividend. The CRA also ruled that section 67 and GAAR did not apply.

The ruling has limited future application: the March 23, 2004 federal budget proposed to amend section 135 to prevent persons, other than cooperatives and credit unions, from deducting patronage dividends paid on or after the budget date. However, the ruling supports the view of most practitioners that existing law does not deny the deduction merely because the dividend's recipient is related to the payer. Further, the ruling puts to rest the concern of some practitioners that the plural references to "members" in section 135 somehow could preclude a deduction in a "sole member" context. The FCA applied section 135 to a sole member in *Consumers' Co-Operative Refineries* (87 DTC 5409), but it did not specifically address the question. (But see section 33(2) of the federal Interpretation Act to the effect that the singular includes the plural, and vice versa, unless a contrary intention appears.)

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## Sales of Tobacco to Indians

In 1993, the CRA released its seminal policy on the collection of GST from natives (B-039R). Hot on the heels of *Airport Auto* (2003 TCC 683), which held that the CRA cannot treat its vendor collection agents with impunity, tobacco sales have given rise to another vendor collection issue related to sales to natives.

In a typical case, a GST registrant supplier purchases tobacco products, pays the GST (and pays other provincial and excise taxes or relies on G permits or other resale exemptions), and on-sells to natives (on- or off-reserve), but delivers the goods on-reserve. The Indian Act relieves the sales from GST, and the supplier takes full input tax credits for GST paid on its purchases—in effect, creating a zero-rated sale for GST purposes. *Technical Interpreta-*

*tion Bulletin* B-039R confirms this treatment and sets out the CRA's wish list for documentary evidence of deliveries on-reserve and other matters. Recently, an alarming number of sales have followed this scenario; some suppliers reached over $100 million in annual on-reserve sales. The facts underlying *Yang* (38 OR (3d) 417) may have also raised the CRA's concerns about possible revenue losses if native purchasers on-sell tobacco free of GST to non-GST-registered black market wholesalers, who in turn supply convenience store owners in a nearby city such as Toronto. The result is net tax loss to the government.

The CRA's first line of offence has been against the suppliers to the natives: it has said that their input tax credits are at risk or that they should have collected GST, despite the Indian Act and B-039R. This approach may be politically palatable, but it is technically difficult: the suppliers need only charge GST on taxable sales, and sales to natives are relieved under the Indian Act. The logic seems to be that the suppliers knew or ought to have known that the sales were not for the natives' personal consumption but rather for resale. The natives receive free cigarettes from the federal government, and if a reserve's population is 10,000, annual purchases of $100 million in cigarettes must have been for resale. However, whether sales are for personal or commercial use may be irrelevant under the Excise Tax Act and the Indian Act. Given cases like *Airport Auto*, it is also unlikely that the supplier, as the Crown's collection agent, must inquire into the purchaser's intended use of the goods. The technical core of the problem is that the natives are not charging, collecting, and remitting GST on their resales and are refusing to register to do so. Ultimately, the CRA must tackle that issue.

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## Holdco Still Costs More

The efforts of all levels of government to balance budgets have slowed tax decreases. Top personal marginal rates for 2004 are unchanged from 2003, except for increases in Nova Scotia and Northwest Territories (the latter will also increase its top rate in 2005). General corporate income tax rates for 2004 decreased in Alberta, Manitoba, and Quebec and increased in Northwest Territories and Ontario. The federal rate applicable to a CCPC's investment income is unchanged. Recent decreases in top personal marginal rates outweigh decreases in corporate rates on investment income, diminishing the appeal of earning Canadian investment income through a holdco.

As in the past three years, earning Canadian interest income and capital gains through a holdco attracts a tax prepayment in every province and territory. And because

**Income Tax Payable on $10,000 of Canadian Investment Income Earned Through a Corporation and Directly, Year Ending December 31, 2004**

| | British Columbia | Alberta | Quebec |
|---|---|---|---|
| | | *dollars* | |
| **Portfolio dividends** | | | |
| Corporate tax | 3,333 | 3,333 | 3,333 |
| Refundable tax | (3,333) | (3,333) | (3,333) |
| Individual tax on dividend | 3,158 | 2,408 | 3,281 |
| Combined tax | 3,158 | 2,408 | 3,281 |
| Individual tax if earned directly | 3,158 | 2,408 | 3,281 |
| Tax cost with Holdco | nil | nil | nil |
| Tax prepayment with Holdco | 175 | 925 | 52 |
| **Capital gains** | | | |
| Corporate tax | 2,464 | 2,377 | 2,602 |
| Refundable tax | (1,333) | (1,333) | (1,333) |
| Individual tax on dividend | 1,263 | 963 | 1,312 |
| Combined tax | 2,394 | 2,007 | 2,581 |
| Individual tax if earned directly | 2,185 | 1,950 | 2,411 |
| Tax cost with Holdco | 209 | 57 | 170 |
| Tax prepayment with Holdco | 279 | 427 | 191 |
| **Interest income** | | | |
| Corporate tax | 4,929 | 4,754 | 5,204 |
| Refundable tax | (2,667) | (2,667) | (2,667) |
| Individual tax on dividend | 2,527 | 1,927 | 2,625 |
| Combined tax | 4,789 | 4,014 | 5,162 |
| Individual tax if earned directly | 4,370 | 3,900 | 4,822 |
| Tax cost with Holdco | 419 | 114 | 340 |
| Tax prepayment with Holdco | 559 | 854 | 382 |

Note: The figures assume top marginal rates, no capital gains deduction for qualifying small business corporation shares or qualified farm property, a taxable dividend paid sufficient to fully recoup refundable tax, no net alternative minimum tax liability, and no provincial health care levies. For Ontario figures, see "Ontario Higher Tax Recipe," *Canadian Tax Highlights*, January 2004.

the top personal tax rates on Canadian dividend income are lower than the federal part IV tax rate—except in Manitoba, New Brunswick, and Newfoundland and Labrador—the tax prepayment with a holdco ranges from 0.27 percent in Nova Scotia to 9.25 percent in Alberta.

There is also a tax cost associated with earning Canadian investment income in a holdco: from more than 1.1 percent to more than 4.1 percent on interest income for Alberta-resident and British Columbia-resident individuals and holding companies, respectively; and one-half those amounts for capital gains. There is thus a continued preference to earn Canadian investment income at a personal level and not through a holdco. Numerous other

factors should be considered, including the use of a holdco to control the amount and timing of an individual's income received and thus minimize various personal federal, provincial, and territorial clawbacks. A holdco also allows for estate planning, probate fee minimization, income splitting, financing, creditor proofing, and restructuring opportunities, but it results in incorporation costs and the payment of accounting and legal fees, federal and provincial capital taxes, and corporate minimum taxes; and a holdco cannot offset its capital gains against personal losses (or vice versa in certain circumstances).

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## MALETTE: CULTURAL PROPERTY FMV

In *Malette* (2004 FCA 187), the FCA reversed the TCC and allowed a block discount in determining the FMV of cultural property donations under section 118.1 of the Income Tax Act in the context of a "buy-low, donate-high" purchase and donation of multiple works of art. Although the decision focuses on a narrow point, it delivers another blow to already beleaguered tax-driven charitable donations. (In response to concerns that promoters are marketing buy-low, donate-high gifting schemes to the public, on December 5, 2003 Finance released much-commented-on draft amendments limiting the tax benefits of charitable donations under tax shelter and other arrangements. The amendments could grind the FMV of gifted property other than inventory, publicly traded securities, certified cultural property, ecological gifts, and Canadian real estate.)

A donor who makes a gift of cultural property to a designated institution may request a determination by the Canadian Cultural Property Review Board of the property's FMV for tax purposes. In *Malette*, the taxpayer and his family donated 981 works of art by the Canadian artist Harold Feist and requested that the board determine their FMV. The purchase price was set at 25 percent of the board-certified value. The appraiser identified the FMV of each work and applied a volume or market absorption discount ranging from 30 to 90 percent to arrive at a final discounted FMV for all the works. The discount was based on the volume of works involved and the artist's sales history. The parties agreed that the sole issue was whether the work's FMV should be determined for each object or whether it should be subject to a blockage effect when the paintings were donated together. The TCC focused on the reference in the Income Tax Act and the Cultural Property Export and Import Act to an "object" in the singular, and concluded that each work must be valued as an individual object. The TCC also relied on its decision in *Whent* (96 DTC 1594), which rejected a block discount for 215 donated Norval Morrisseau paintings because their sale on the relevant market over the two years when the donations were made would not have negatively affected individual prices. The FCA disagreed, noting that the singular "object" was not determinative: the federal Interpretation Act dictates that the singular includes the plural and vice versa. *Whent* was distinguished on the facts.

The FCA made some interesting comments on determining the FMV of donations under the Act. Since blockage discounts are an accepted principle of valuation methodology, the need to value each object individually should not preclude the application of a discount, as circumstances dictate. If Parliament had contemplated a deviation from accepted valuation principles, it would have made that intention clear. There was no evidence that Parliament intended to enhance existing donation tax incentives by eliminating the depressive effect of volume discounts.

*Malette* may make it harder to support a higher valuation that is based on the retail values, trading prices, or other benchmarks of value of one item gifted as part of a bulk donation. However, the FCA did not deny that in some cases such as *Whent* a block discount is inappropriate. Furthermore, the FCA did not consider the SCC's comments in *Untermeyer* ([1929] DLR 315) regarding the difference between FMV and market value (or market price) and the role of the block discount in determining FMV of a large block of listed shares for succession duty purposes. (See also, for example, *Dobieco*, 63 DTC 1063 (Ex. Ct.).) A sale of the whole block would break the market and depress the price: the SCC accepted that a reasonable executor would sell over time and attract the quoted trading price, which was thus the FMV. *Untermeyer* also makes it clear that market value is not the same as FMV. Market price is the rebuttable best evidence or starting point of FMV. If the market price is consistent and not affected by a "transient boom or a sudden panic on the market," then it can be determinative of FMV; but if the sale of a block could at a single stroke reduce the market price, that reduced price is not the proper measure of value. Arguably, no prudent person would attempt a mass sale of the 981 works of art by the same artist in *Malette* and hope to attain the highest possible price; the "dumping" value is not the measure of what the paintings could command in an appropriate market setting. The tax-shelter-market concept embraced by the courts in cases where works of art were purchased for donation may have overshadowed some of the fundamental valuation issues raised in *Untermeyer*. Perhaps the FCA will illuminate these issues further when it hears the appeal in *Klotz*.

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## Domicile: US Estate Tax

The US income tax test of residence is based on the number of days the taxpayer is present there, but for estate tax the test is one of domicile, a broader concept. A non-citizen US domiciliary is subject to estate tax on all his assets, whatever their situs. A person may become a US resident for income tax purposes but not for estate tax purposes; conversely, a short US stay that does not trigger income-tax residence can trigger domicile status.

According to the regs, "A person acquires domicile by living there, for even a brief period of time, with no definite present intention of moving therefrom. Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile affect such a change unless accompanied by actual removal." The courts weigh several factors to determine whether the intent to remain indefinitely exists: the length of the individual's stay in, and the frequency of travel away from, the United States; the value, nature, and permanency of the individual's housing abroad and in the United States (houses in resort areas have less weight); the location of any expensive personal possessions (particularly those of sentimental value); business interests; family and close friends; insurance policies on life and property; memberships; declarations of intent in wills, trusts, visa applications, re-entry permits, and driver registrations; why the individual left the country; citizenship; and the country where the person votes and files income tax returns.

The determination is fact-dependent and is often far from clear. For example, *Paquette* (TC Memo 1983-571) held that the deceased was not a US domiciliary although he had wintered at his Florida home for 25 years; in Canada, he voted, filed all income tax returns, and maintained a valid driver's licence and passport and the bulk of his assets. His accountant and investment manager were Canadian residents. However, the holding of a green card requires that the holder intend to reside permanently in the United States; even a temporary visa holder may be US-domiciled if he has the intent to remain indefinitely. In *Est. of Jack v. US* (Fed. Cl., 2002-2 USTC 60,452), the court concluded that the TC and TN non-immigrant temporary professional visas under which the deceased was admitted to the United States did not preclude a determination of US domicile. Given the deceased's continued Canadian connections and his stay of only four years in the United States, it is of concern that the IRS pursued the case. In contrast to residence, a person can have only one domicile at a time. The relevant intention is "not a fleeting or casual or sporadic intention which controls, but a serious conception of home" (*Rodiek*, 33 BTA 1020 (1936)). Abandonment of domicile must also be clearly established: in *Fokker* (10 TC 1225 (1948)), the deceased's US domicile was not abandoned even though a statement in his will contradicted statements to immigration officers of his intent to return to the United States. In *Forni* (22 TC 975 (1954)), statements filed with the US government were inadequate to establish US domicile. In *Fifth Avenue Bank* (36 BTA 534 (1937)), the court said that "a domicile of origin [birth] is presumed to continue until it is shown to have been changed. A prolonged absence from a domicile does not change [it] without intent to acquire a new domicile and where residence away from the original domicile is for purposes of travel and health such a presence does not usually change domicile."

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## Ontario PST: Related Parties

Several years ago, Ontario proposed to review its PST relief provisions for related-party transfers and to codify its administrative policy for asset transfers within a partnership group. A new consultation draft introduces those measures and replaces regulation 1013's section 13, which exempts certain transfers of assets between wholly owned (and other) parties. The new rules attempt to close perceived loopholes that left the old rules open to abuse. Ontario requests that comments on the draft regs be submitted by September 3, 2004.

Under the new rules, persons are related if one of them holds directly or indirectly the beneficial share ownership of at least 95 percent of the stated capital of all classes and series of the other person; the reference to indirect ownership broadens the rules to encompass certain multi-tier scenarios. The new rules also remove the one-time limitation on benefiting from related-party relief, thus bringing the rules in line with those in other provinces. Eligible property is property on which PST was previously paid by the transferor or by certain related individuals or corporations; property is excluded if no tax was payable based on the purchase or use of the goods or because they were purchased for resale.

Transfers between related corporations require that the relationship continue for at least 180 consecutive days thereafter. A retention period previously applied only to assets transferred in exchange for shares of the purchaser. The new requirement precludes exemption in the typical scenario of a transfer of assets from a parent to a sub and then an immediate sale of the sub's shares to an unrelated party. Amalgamations and windups within the 180 days do not infringe the holding period if the beneficial interest in the related party's shares is retained by the amalco, or by the parent following a windup.

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The changes also incorporate rules that apply to transfers between unrelated parties and to transfers between partners and their partnerships; the latter were previously covered *RST Guide* 210. The ministry's stated intention in codifying the partnership transfer rules is to bring them in line with the related-party relief rules and thereby achieve a degree of consistency.

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# Foreign Tax News

## Status of Canada's Tax Treaties

**In force (83)**
Algeria
Argentina
Australia
Austria
Bangladesh
Barbados
Belgium
Brazil
Bulgaria
Cameroon
Chile
China (PRC)[1]
Croatia
Cyprus
Czech Republic
Denmark
Dominican Republic
Ecuador
Egypt
Estonia
Finland
France
Germany
Guyana
Hungary
Iceland
India
Indonesia
Ireland
Israel
Italy
Ivory Coast
Jamaica
Japan
Jordan
Kazakhstan
Kenya
Korea, Republic of
Kuwait
Kyrgyzstan
Latvia
Lithuania
Luxembourg
Malaysia
Malta
Mexico
Moldova
Mongolia
Morocco
Netherlands
New Zealand
Nigeria
Norway
Pakistan
Papua New Guinea
Peru
Philippines
Poland
Portugal
Romania
Russia
Senegal
Singapore
Slovak Republic
Slovenia
South Africa
Spain
Sri Lanka
Sweden
Switzerland
Tanzania
Thailand
Trinidad & Tobago
Tunisia
Ukraine
United Arab Emirates
United Kingdom
United States
Uzbekistan
Venezuela
Vietnam
Zambia
Zimbabwe

**Signed but not yet in force (8)**
Armenia
Belgium[2]
Gabon
Ireland[2]
Italy[2]
Lebanon
Oman
Romania

**Under negotiation/renegotiation (17)**
Azerbaijan
Barbados
Bolivia
China (PRC)
Colombia
Costa Rica
Cuba
Egypt[2]
Greece
Korea, Republic of[2]
Mauritius
Mexico[2]
Saint Lucia
Serbia and Montenegro
Singapore
Turkey
United States[3]

[1] This convention does not apply to Hong Kong.
[2] This will completely replace the existing treaty.
[3] Protocol.

### OECD

On June 1, 2004, the Committee on Fiscal Affairs approved changes to model treaty article 26 (exchange of information). The revised article is available at the Foundation's library and at http://www.oecd.org.

### Treaties

A new treaty with **Armenia** was signed on June 29, 2004, limiting withholding tax to 5 percent for dividends between affiliated companies (15 percent otherwise) and 10 percent for interest and royalties. A new treaty with **Oman**, signed June 30, 2004, limits withholding to 5 percent between affiliated companies (15 percent otherwise), 10 percent for interest, and 10 percent for royalties, except for certain copyright royalties and certain payments for the use of any patent or computer software, or for information concerning industrial, commercial, or scientific experience. Both treaties enter into force when given the force of law in each country, effective for tax withheld at source on amounts paid or credited to non-residents from the start of the first calendar year after the treaty enters into force, and, for other taxes, for taxation years following the in-force calendar year. The treaties are available in the Foundation's library and on the Finance Web site.

### Dubai

To attract new information technology companies, on June 14, 2004, Dubai opened a tax-free outsourcing zone that allows participating companies to retain and repatriate 100 percent of their capital.

### Saudi Arabia

On August 1, 2004, the multiple-rate tax for foreign persons (from outside the six-member Gulf Co-operation Council) is replaced by a flat 20 percent rate for all non-hydrocarbon businesses. Natural gas income is taxed at 30 percent, oil projects at 85 percent.

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