CANADIAN TAX Highlights

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Volume 12, Number 9, September 2004

Joint Committee on Taxation: Retroactive GAAR Change

A July 29, 2004 submission to Finance from the CBA-CICA Joint Committee on Taxation expresses concern about the retroactive nature of the GAAR amendment proposed in the 2004 federal budget. The submission urges Finance to eliminate such retroactivity because it is inappropriate: it circumvents the judicial system and effectively revokes the taxpayer's right to appeal tax disputes; it abandons the most basic principles of fairness in Canadian tax law; and it invites reproach from the international community. (The submission addresses only the retroactive nature of the proposal to GAAR, not the merits of implementing it prospectively.)

The 2004 federal budget "clarifies" that GAAR applies not only to a misuse or abuse of the Income Tax Act but also to a misuse or abuse of the Income Tax Regulations, the Income Tax Application Rules, and Canada's income tax treaties. This "clarification" is retroactive to GAAR's introduction in 1988. A notice of ways and means motion in the budget amends the Income Tax Conventions Interpretation Act to "clarify" that GAAR applies to treaty benefits. The joint committee's submission says that, under the guise of clarifying the law, the proposal in fact materially changes the law by broadening GAAR's scope: the TCC in *Rousseau-Houle* (2001 DTC 250) and *Fredette* (2001 DTC 621) held that GAAR does not apply to the regulations. The joint committee says that retroactivity violates the central principles underlying the Canadian tax system and could affect it adversely. More specifically, retroactivity is inappropriate for the following reasons.

- A retroactive change to the law undermines the role of the judicial system, which is fundamental to our society.
- The government is unilaterally decreeing the courts' application of GAAR to past transactions, effectively depriving affected taxpayers (those now in the appeals system and those facing reassessment because of the change) of their day in court.
- Reaching back 16 years to 1988 to retroactively impose tax on transactions that were acceptable then is a fundamental violation of the government's duty to act fairly.
- Finance had previously set out circumstances in which retroactive amendments to impose tax were appropriate; the proposal does not satisfy those guidelines.
- Retroactive GAAR amendments are particularly disconcerting: the rule is a powerful provision with significant breadth, and its application involves considerable subjectivity.
- For many years Finance was aware of the particular issues addressed in the proposal, but allowed taxpayers to rely on GAAR's original language; it is unfair to introduce a retroactive amendment now.
- The proposal affects the Act's treatment of foreign enterprises and Canada's international obligations under its bilateral tax treaties. Retroactivity will undermine international faith in the integrity of Canada's fiscal laws.

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In This Issue

GST and PEs, Revisited

A revised GST/HST *Policy Statement* P-208R on permanent establishments (PEs) was recently released for discussion purposes. The revised statement provides additional analysis of key concepts and includes new sections on the fixed place of business of an agent and electronic commerce. The e-commerce issues in the PE context mirror the position outlined in existing GST *Technical Information Bulletin* 090. Comments and suggestions should be forwarded to the CRA by October 29, 2004.

The statement also adds nine new examples, four of which focus on e-commerce. The e-commerce examples look to whether a computer server qualifies as a PE: a number of factors are involved, including whether the server is placed at the disposal of the non-resident by being leased or owned, and operated by, the non-resident, and whether the functions carried out through the server are a significant and essential part of the non-resident's business. The use of a server owned and operated by a non-resident only for auxiliary functions such as records storage does not trigger PE status for the server. However, if a Canadian-based server is exclusively at the non-resident's disposal and is used solely by it for the purposes of supplying a data storage facility to customers in Canada, the functions carried out through the operation of the server are likely to be viewed as essential to the non-resident's business activities. As well, enabling a server to automatically authorize, accept, and process customer orders and payments—activities essential to the making of a supply—may also indicate PE status.

The statement also provides examples of cases where the location at which an agent operates can be viewed as the principal's PE. The examples highlight several factors that determine whether an agent represents a PE of its principal, including the exclusivity of the arrangement between the non-resident principal and its agent; whether the agent acts on behalf of any other parties; and the degree of control exercised by the principal over the agent.

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Safe Income Not Prorated

In *729658 Alberta Ltd.* (2004 TCC 474), the TCC determined how safe income should be calculated if a corporation receives dividends on shares acquired on a partial subsection 85(1) rollover and later sold to an arm's-length party. The TCC disagreed with the CRA's argument that safe income should be apportioned pro rata between "income earned or realized" and the "unrealized appreciation in the value of underlying assets"; thus, subsection 55(2) did not apply.

Subsection 55(2) is a capital-gains-stripping anti-avoidance rule that converts an otherwise tax-free intercorporate dividend to proceeds of disposition if the dividend is part of a series of transactions or events that results in a significant reduction of capital gains realized on the shares' disposition. The rule is intended to ensure that the realization of an inherent capital gain on the shares that is not "reasonably attributable" to safe income is not avoided through the use of intercorporate dividends deductible under subsection 112(1). Generally, safe income is a measure of corporate income that can be extracted as tax-free intercorporate dividends without characterization as capital gains.

In *729658 Alberta*, N and L, two unrelated individuals, each owned 50 percent of the shares of Targetco, a Canadian-controlled corporation. Each of N's and L's shareholdings had an inherent capital gain of $12.4 million (approximately the shares' FMV); attributable safe income of about $1.9 million; and a related capital dividend account balance of $102,900. In the week before the sale of Targetco's shares to an arm's-length buyer, Purchaseco, N and L each sold their shares to a wholly owned Alberta corporation (N Co and L Co, respectively) in exchange for a $10.4 million promissory note and two million common shares, and elected $10.4 million as the agreed amount under subsection 85(1). The individuals reported taxable dividends of $10.4 million under subsection 84.1(1); the Targetco shares' ACB to N Co and L Co was $10.4 million; and N's and L's ACB of the two million common shares in N Co and L Co was nil.

Targetco then paid $2 million in dividends (taxable dividends of $1.9 million and non-taxable capital dividends of $102,900) to each of N Co and L Co, which reported the taxable dividends as tax-free intercorporate dividends (subsection 112(1)). (The dividends were stock dividends and the shares were redeemed for cash shortly thereafter.) The dividends paid reduced dollar for dollar the value of the Targetco shares held by N Co and L Co, which then sold the shares to Purchaseco for $10.4 million cash (the shares' ACB) and thus triggered no capital gain. The sale price equalled the shares' original FMV less the dividends paid before the sale; the CRA reassessed N Co and L Co under subsection 55(2) in respect of dividends received as a part of a series of transactions designed to extract safe income before the shares were sold.

Because most of the shares' accrued gain was realized by N and L on the transfer to N Co and L Co, the CRA argued that the safe income of $1.9 million should be apportioned on the same basis: the $1.9 million accrued gain transferred by N and L to N Co and L Co represented about one-sixth of the total $12.4 million gain, so that N Co and L Co should inherit only one-sixth of the safe income. The remaining five-sixths ($1.6 million) of the taxable dividends paid by Targetco to N Co and L Co should be recharacterized as proceeds of disposition under subsection 55(2). N Co and L Co argued that because the transactions were intended to defer tax on income that had been subject to tax (in Targetco), there was no reasonable basis to deny a result that was in accordance with the scheme of the Act: no tax was avoided, and dividends did not exceed safe income. The TCC said that the answer turned on the meaning of the phrase "reasonably attributable": how should an accrued gain be apportioned between "income earned or realized" and "unrealized appreciation in the value of underlying assets"? The suggestion that an accrued gain should generally be apportioned pro rata between the two categories had no support: the accepted approach, a purposive interpretation of the legislation, requires allocation of a gain to "income earned or realized," and only if dividends exceed this amount is a gain allocated to "unrealized appreciation in the value of underlying assets."

The TCC cited CRA's Robertson rules, which said that subsection 55(2) is intended to be limited to cases of genuine tax avoidance and that common sense should prevail. The TCC said that no tax was avoided—N and L paid tax on the untaxed appreciation in Targetco's assets when they reported the $10.4 million taxable dividends—and the dividends received by N Co and L Co did not exceed safe income. There was no "tax leakage" by virtue of the individuals rather than their Holdcos paying tax, or because the gain was realized in the form of dividends rather than capital gains. "The amount of tax that was paid, then, appears to be what Parliament intended," and subsection 55(2) did not apply.

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NON-TAXABLE INDIVIDUALS AGAIN

Non-Taxable Returns as a Percentage of All Returns in Income Class

	Total income					
	Under $15,000	$15,000 to $25,000	$25,000 to $50,000	$50,000 to $100,000	$100,000 and over	All returns
Number	77.4	14.1	1.8	0.4	0.5	31.1
Employment income	2.5	0.4	0.1	..	..	3.1
Retirement income	11.3	4.3	0.8	0.1	..	16.6
Exempt income	62.1	12.6	4.8	0.7	0.3	80.5

.. Less than 0.1 percent.

The CRA's annual release of personal income tax statistics was so quiet this year that there were none of the usual press stories about high-income individuals with no tax payable. However, 3,300 individuals with incomes over $100,000 paid no tax in 2002, an increase from 2,760 in 2001.

The 3,300 high-income returns showing no tax payable represented only 0.015 percent of all returns and only 0.5 percent of all returns from individuals with incomes over $100,000. Overall, the 6.8 million non-taxable returns represented 31.1 percent of the 21.9 million returns filed in 2002. Most of the non-taxable returns showed incomes of less than $15,000; 98.3 percent of all non-taxable returns had incomes of less than $25,000. Obviously, the majority of these non-taxpayers filed either to claim the child tax benefit and related provincial programs or the GST refundable credit, or to obtain a refund of tax withheld from part-time or part-year employment.

The table shows that 2.9 percent of all employment income was reported on non-taxable returns with total incomes of less than $25,000; such returns also included 15.6 percent of retirement income—Old Age Security, Canada Pension Plan benefits, pensions, and RRSP benefits—and 92.9 percent of exempt income from workers' compensation boards, social assistance, and federal supplements. Furthermore, such returns reported 6.8 percent of all income in 2002.

The income tax system is now an integral part of the social assistance system: it is used to deliver child tax benefits and various federal and provincial credits to offset the effect of general sales and property taxes, but it is also used to measure the need for more specific provincial and local assistance programs. Not surprisingly, non-taxable returns represent a large proportion of the annual flood of personal income tax returns. However, because the income tax system is being used as a vehicle to deliver social assistance, 3,300 individuals who had comfortable incomes but also had large deductions for prior years' losses, carrying charges, and other allowable offsets also qualified for federal and provincial support programs in 2002.

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PST: PRODUCTION MACHINERY

On July 31, 2001, British Columbia introduced a provincial sales tax (PST) exemption for purchases of machinery and equipment. (Ontario and Prince Edward Island already had similar exemptions.) Unlike the federal GST, PST paid by businesses on their purchases is generally unrecoverable; businesses embraced this relief from the 7 (now 7.5) percent tax on large capital purchases. However, the province now seems to be limiting the exemption by narrowly interpreting its key aspects. It is hoped that the Ministry of Provincial Revenue (MPR) will reconsider its views, given the significance of the exemption for many BC businesses.

Section 76(1)(k) of the Social Service Tax Act (SSTA) exempts prescribed machinery or equipment purchased or leased by a prescribed manufacturer or other prescribed person for a prescribed use. Details are set out in division 13 of the regs. Regulation 13.2(1) provides that the exemption is available to a manufacturer that leases or purchases machinery or equipment used primarily and directly in the manufacture of qualifying tangible personal property. "Manufacturer" is defined in regulation 13.1(1) to mean a person that fabricates, manufactures, processes, or produces a particular class of tangible personal property—a definition that includes activities beyond those in the classical definition. However, the actual exemption in regulation 13.2(1) requires that the manufacturer use the equipment in the "manufacture" of goods.

"Manufacture" is not specifically defined, an absence that has opened the door for the MPR to argue that the exemption is restricted to persons who manufacture, rather than to persons who engage in the broader range of activities enumerated in the extended definition of "manufacturer" in the regs. Thus, the MPR appears to say that the exemption is not generally available to processors, fabricators, and producers, even though they are specifically included in the definition of "manufacturer," a conclusion that surprised many practitioners.

The MPR takes the position that processing alone does not qualify for the exemption: a substantially different product must be created. A recent ruling in the Tax Interpretation Manual (ruling 8, regulation 13.1) concerning lumber-mill processors said that a mill must transform the lumber into a substantially different product to qualify for the exemption; limited activities (such as only one or two of kiln drying, planing, or cutting) do not qualify a person as a manufacturer. The limited activities referred to nevertheless constitute processing as defined by the FCA in *Tenneco* (91 DTC 5207): a change in form, appearance, or other characteristics of the goods that result in a more marketable product.

The term "manufacturing" is not defined in the Act, but it is defined administratively in *Consumer Taxation Branch Bulletin* FST 054 (February 2003) to mean subjecting raw materials to various processes to produce a finished product that is substantially different from the raw material inputs. In the leading case of *York Marble* ([1968] SCR 140), the SCC accepted that "manufacture" meant the production of articles for use from raw or prepared materials, giving them "new forms, qualities and properties or combinations whether by hand or machinery." Subjecting slabs of raw marble to book matching, grouting, rodding, gluing, grinding, rough polishing, fine polishing, cutting, and edge finishing resulted in "goods produced or manufactured in Canada" under the Excise Tax Act. The SCC's definition is not as demanding as the MPR's: it does not require that the finished product be "substantially different" from the raw or prepared materials.

It is difficult to reconcile the narrow administrative definition of "manufacturing" that the MPR uses to interpret the term "manufacture" in the context of regulation 13.2(1) with the broader list of activities that constitute a person a manufacturer. A narrow interpretation seems to render meaningless the extended definition of "manufacturer"; it appears that the inclusion of the enumerated activities in the definition of "manufacturer" was intended to influence the interpretation of the word "manufacture" in regulation 13.2(1).

Regulations 13.2(3) and (4) support the position that the exemption was intended to extend to producers and processors. These subsections provide that the exemption for mineral producers and processors of petroleum or natural gas is restricted to machinery or equipment for use at a mine site and at the well head or a processing plant or refinery, respectively. Because those producers and processors are not manufacturers under either the SCC's or the MPR's definition, the presence of these provisions suggests that the exemption was intended to apply to processors and producers. The MPR appears to take the view that these subsections prescribe the only processors and producers that qualify for the exemption.

British Columbia is also narrowing the exemption with a restrictive interpretation of the meaning of "part." Regulation 13.10.2 exempts parts purchased or leased for use on exempt machinery or equipment; the MPR says that materials used to make parts are taxable. A ruling in the Tax Interpretation Manual (ruling 4, regulation 13.1, issued May 2002) addresses conveyors manufactured by a business for use at its own plant site: machinery and equipment used to construct the conveyors is exempt under regulation 13.2(1), but materials that are purchased in bulk and that require fitting and cutting to install the conveyor belt are not parts and are thus taxable. However, the MPR says that only such materials purchased ready for use (without fitting or cutting) qualify as exempt parts. Characterizing the tax status of an item on the basis of whether it is ready for use or purchased in bulk and subject to processing seems counterintuitive, and perhaps counterproductive in policy terms.

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Subpart F: Discretionary Allocations

Recently issued proposed IRS regs tie the allocation of a CFC's earnings among multiple classes of stock for tax purposes to FMV differences between the classes if the actual allocation depends on an exercise of discretion by the board of directors (Code section 951(a)(1)). Such amounts include subpart F income and deemed dividends under section 956, which are currently taxable to certain US shareholders without credit for foreign taxes paid by the CFC (except for shareholders that make a certain election or that are C corps holding at least 10 percent of the CFC). If the proposed effective date—a CFC's taxable year beginning after 2004—materializes, taxpayers may have only four months to review and modify their structures if necessary.

The new regs may affect Canadian and other non-US corporations owned by US citizens and residents, including a Canco that was involved in an estate freeze and has fixed-value preferred shares with discretionary dividend rights to the former common shareholders. Last modified in 1965, the regs attempt to reflect intervening business developments and to address some structures that the IRS believes produce inappropriate results. For example, in the "Apache" transaction, Enron formed a CFC that lent money back to it (generating interest deductions). Enron held the common shares and a foreign lender held the preferreds, but under a shareholder agreement no earnings were distributable to Enron while the preferreds were outstanding. Arguably, Enron's common shares produced no subpart F inclusions because they were not subject to a hypothetical year-end distribution; and because distributions were not discretionary, they were arguably outside regulation 1.951-1(e)(3). The new regs provide that restrictions or limitations on the earnings distributions to US shareholders structured by the corporation or its shareholders are generally ignored in determining their pro rata share of subpart F amounts, even if such terms result from an arrangement that is between unrelated parties or that has a non-tax business purpose.

The general rule still applies: allocation to a particular class of stock bears the same ratio to the total section 951(a)(1) amount as the earnings distributable thereto if all earnings were distributed on the last day of the CFC's year (the hypothetical distribution date). But if the allocation between classes depends on board discretion, allocations are based on the relative value of the classes on the hypothetical distribution date, an approach analogous to that used for allocation adjustments under the consolidated-return regs. The right to redeem stock is not a discretionary distribution right under the new rules, a matter that is relevant to a typical Canco CFC freezeco whose preferred shares are redeemable and retractable.

The regs do not specifically address whether they also apply for FPHC purposes. This is potentially important for certain Cancos with US-citizen or US-resident shareholders: many such Cancos are FPHCs, but not CFCs because of the broader FPHC attribution rules, including those rules that may attribute to US shareholders stock held by siblings and by non-US shareholders. (Legislation introduced in the House [HR 4520] on June 4, 2004 proposes to repeal the FPHC rules.)

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EHT Update

The 2004 Ontario budget proposed several refinements to the employer health tax (EHT) rules—simplifying the process for making instalments, increasing the penalties applicable to late-filed returns, clarifying that taxable benefits are subject to EHT, and clarifying the imposition of EHT with respect to employees who report to work at an Ontario PE. (A future article considers the last two changes.)

The budget simplifies the EHT instalment process and eliminates over- and underpayments for many employers. If an employer's annual Ontario remuneration exceeds $600,000, instalments are currently due on the 15th of each month, based on the previous month's payroll. After 2004, each month's instalment is based on that month's payroll and is due on the 15th of the following month. No instalment is due on January 15, 2005; the first instalment for 2005 is due on February 15, 2005, based on January's actual payroll.

Generally, if in a calendar year an employer (and any associated corporations) pays Ontario remuneration exceeding the $400,000 exemption, it must file an annual EHT return on or before March of the next year. Other due dates apply if an employer dies or ceases to have an Ontario PE (for example, on moving, termination, or amalgamation) or if its Ontario remuneration exceeds $400,000 and is paid all in one month. (Employers with Ontario remuneration between $400,000 and $600,000 are liable for EHT but need not make instalments; employers with Ontario remuneration under $400,000 are not subject to EHT.) Previously, if the tax owing exceeded $1,000 at the return's due date, a late-filed return resulted in penalties equal to 5 percent of that tax. Effective for taxation years ending after May 18, 2004, penalties for late-filed EHT returns increase to the levels imposed under the Corporations Tax Act: 5 percent of the tax owing on the return's due date, plus 1 percent per month (up to 12 months) for every month the return is late, to a maximum penalty of 17 percent. The penalty doubles for a repeat failure: 10 percent plus 2 percent per month overdue (up to 20 months), to a maximum penalty of 50 percent. (Any penalty for late-filed instalment remittance statements—which are levied if the underpayment is at least $1,000—appears to remain at 5 percent of the related unpaid instalment.)

Late-filing penalties do not apply unless tax is owing at the return's due date. Under the new instalment rules, an employer with Ontario remuneration exceeding $600,000 should have no tax owing when the annual return falls due. Not only do the increased penalties provide an incentive for employers to remit their instalments on time, but a 2004 federal budget proposal has confirmed that penalties imposed by a government agency after March 22, 2004 are not deductible for income tax purposes.

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CBSA Makes Barbequing More Expensive

The summer became a bit gloomier when the Canada Border Services Agency (CBSA, formerly Canada Customs) announced on August 27, 2004 that it will impose a provisional anti-dumping duty on imports of outdoor barbeques originating in or exported from the People's Republic of China (PRC) to prevent injury to Canadian production. The CBSA says the Chinese barbeques were dumped into Canada at prices that were also subsidized, resulting in a flood of low-priced barbeques into the Canadian market. The ensuing harm to Canadian barbeque manufacturers—price erosion, price suppression, lost sales, lost market share, lower capacity utilization, reduced employment, and reduced profitability—reflected a classic dumping situation.

Dumping occurs when goods are sold to importers in Canada at prices less than the selling prices in the exporter's domestic market or at unprofitable prices. Subsidizing occurs when goods imported into Canada benefit from foreign government financial assistance. The Special Import Measures Act protects Canadian producers from the damaging effects of both such unfair trade practices. An earlier complaint from a Canadian barbeque manufacturer instigated a preliminary investigation by the CBSA, which concluded that imported barbeques from the PRC were dumped into Canada at an estimated margin of dumping of 34.6 percent (as a percentage of export price); the estimated government subsidy was 16.0 percent. On June 11, 2004, the Canadian International Trade Tribunal (CITT) also made a preliminary determination that the evidence then available disclosed a reasonable indication that the imports had caused injury to the domestic industry. The CITT will now begin its inquiry into the question of injury to the Canadian industry; the CBSA will continue its investigation regarding dumping and subsidizing and issue a final decision by November 25, 2004.

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Double Tax on Rental Income

In the recent informal procedure decision of the TCC in *Finch* (2004 TCC 353), the taxpayer was subject to potential double taxation of rental income because the legal ownership of the underlying property was inconsistent with the rental income's accounting treatment. Poor documentation by the taxpayer's professional advisers forced the TCC to find that the legal form prevailed, leaving rental income exposed to tax once in a family company and a second time in the taxpayer's hands directly. *Finch* illustrates the importance of properly documenting transactions between family members and following the documented legal form of transactions.

The taxpayer, Mr. F, purchased a property in Waterloo, Ontario, in 1990 when he was a university student, and he registered it in his name. The downpayment and a first mortgage were provided by Finch Travel Ltd., a company owned by Mr. F's parents. From 1990 to 1994, Mr. F lived in the property and rented part of it to other students; he used the rent to pay expenses, including the mortgage. When Mr. F moved to Scotland in 1994, he gave his father a power of attorney. The property continued to be rented to students, but the rents were deposited to the account of Finch Travel and declared as part of its rental income or loss. In 1993, Finch Travel's chartered accountants wrote to its lawyers about updating the corporate minute book, saying that Mr. F purchased the property in trust for the company and requesting that a clarifying trust deed be executed between Mr. F and Finch Travel. No trust deed was executed. Finch Travel continued to receive the rental income and paid tax on it from 1994 to 2000, when the property was sold. Mr. F's lawyers requested a non-resident clearance certificate from the CRA, which examined the file carefully and assessed Mr. F for non-resident withholding tax on rent from 1997 to 2000 under paragraph 212(1)(d). Mr. F argued that the property belonged to Finch Travel and that nothing was paid or credited to him.

The TCC said that the issue boiled down to who the property's beneficial owner was, but the situation was rife with inconsistencies. The property was bought in the name of Mr. F, who gave a mortgage to Finch Travel for the downpayment. The accountants treated the property and the income as belonging to Finch Travel, an assumption inconsistent with both the taking of a mortgage and Mr. F's request for a clearance certificate. The TCC said, "The clients find themselves in this situation because the lawyers and accountants were unable to get their acts together." As a result, the TCC could only find that the legal form of the documents took precedence over vague and unexpressed intents.

Although no amounts were physically transmitted to Mr. F in Scotland, the rent was paid to his father as his agent and thus constituted payment to a non-resident. Although double taxation was undesirable, it arose not by any act of the CRA but by the acts of the taxpayer's professional advisers; thus, the TCC held the amounts subject to withholding tax. Moreover, the double tax was "more apparent that real": from 1992 to 2000, Finch Travel deducted about $17,000 of net rental losses ($40,000 of losses net of $23,000 of income over four of those years). The TCC noted that if Mr. F had elected to be taxed on a net basis under section 216, the losses would probably have been of no use to him as a non-resident. Although measures such as subsection 248(28) eliminate double tax, *Finch* illustrates that they may not apply if the transactions are not properly documented and the legal form not respected. Other remedies may be available if the taxation years are not statute-barred.

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FAs Owned by Partnerships

In a round table discussion at the International Fiscal Association's Canadian Branch tax seminar in Montreal in May 2004, the CRA addressed certain issues affecting cross-border structures. (Two issues were outlined in "Partnership Treaty Benefits," *Canadian Tax Highlights*, July 2004.) Time constraints prevented the CRA from addressing a question on the limited purposes for which section 93.1 deems the shares of a non-resident corporation owned by a partnership to be owned by the partners.

Under section 93.1, added in 2001, a non-resident corporation's shares owned by a partnership are deemed owned by the members for the purposes of determining whether the corporation is a foreign affiliate (FA) of the Canadian partners in the context of certain enumerated provisions. As a result, tower structures used to finance US subs of Canadian parents were sometimes set up with a partnership of Cancos holding the shares in a foreign corporation directly rather than through an interposed Canadian corporation (a Nova Scotia unlimited liability corporation [NSULC]). Proponents of this streamlined tower structure concluded that section 93.1 not only ensured that the Canadian corporate partners were deemed to own the foreign corporation's shares and thus establish FA status for the purposes of section 113 and certain other provisions, but also ensured that qualifying income earned by the FA was deemed to be active business income under paragraph 95(2)(a). In addition, paragraph 95(2)(a) requires a non-resident corporation to be an FA of a taxpayer, but it also requires that the taxpayer have a qualifying interest in the non-resident throughout the year (or be related to it throughout the year, under the technical bill proposal). Thus, some practitioners said that an NSULC, or another entity treated as a corporation for Canadian tax purposes, must still hold the FA shares.

Subparagraph 95(2)(m)(iv) provides that shares owned by a partnership are deemed owned by the partners in determining whether a taxpayer has a qualifying interest in an FA. This rule may allow the qualifying interest test to be met during the period that the partnership owns the shares, on the assumption, which is not clear, that it deems FA status as well as qualifying interest status. However, the concern remains that there is no deeming of FA status in the first place, because section 93.1 applies for limited purposes. There is also some doubt about whether a corporation owned by a partnership is related to the partners.

CRA officials have indicated informally that they are reviewing the effect of section 93.1 on surplus computations in the year of acquisition and disposition of the FA shares by a partnership. Paragraph 95(2.2)(a) provides that, for the purposes of subsection 95(2), a non-resident corporation is deemed to be an FA in which a taxpayer has a qualifying interest throughout the year if "a person" acquired or disposed of the shares in the year and the corporation was an FA in which the taxpayer had a qualifying interest either at the beginning or at the end of the year. (Paragraph (b) provides a similar rule with respect to the relationship test.) The CRA is currently examining whether the reference to "a person" rather than "a person or partnership" limits the availability of the active business income deeming provisions in paragraph 95(2)(a) for surplus computation purposes; it will publish its conclusions in an issue of *Income Tax Technical News*. In the interim, when establishing a tower structure, it may be prudent to ensure that the FA's shares are held by an entity that is treated as a corporation for Canadian tax purposes.

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IRS: Multiple-Chartered Entities

The IRS has just issued temporary regulations under Code section 7701 clarifying the definitions of "corporation" and "domestic entity" for US federal tax purposes if a business entity is considered to be created or organized in more than one jurisdiction (a multiple-chartered entity). According to the regs' preamble, several jurisdictions have recently enacted continuance or domestication legislation that make it possible for a business entity to be treated as created or organized under the laws of more than one jurisdiction.

The regs provide that if a multiple-chartered entity's formation in any of the jurisdictions causes it to be treated as a per se corporation under regulation 301.7701-2(b), the entity is treated as a corporation for US federal tax purposes, applicable to business entities on or after August 12, 2004, the regs' publication date. Temporary regulation 301.7701-2T(b) states explicitly that the determinations of the entity's classification as a per se corporation and of its domestic or foreign status are made independently. Assume that X is an entity with a single owner organized under country A's laws; X is a per se corporation as defined in regulation 301.7701-2(b)(8)(i). Several years after its formation, X files a certificate of domestication in a US state (state B) as a limited liability company (LLC). Under state B's laws, X is considered to be created or organized there as an LLC upon the certificate's filing. Neither country A nor state B requires X to terminate its country A charter as a result of the domestication, and X does not terminate it; X is now a multiple-chartered entity. X is treated as a corporation for US tax purposes because of its formation in country A.

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

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E-mail: vmorgan@interlog.com
ISSN 1496-4422 (Online)

Under current law, the term "domestic," when applied to a corporation, means created or organized in the United States or under the law of the United States or any state; a "foreign" corporation is one that is not domestic. Thus, under current law, a business entity cannot be both domestic and foreign. The regs also clarify that an entity (including a multiple-chartered entity) is a domestic entity if it is organized in the United States, regardless of whether the entity is also organized abroad. Whether an entity is domestic is a determination independent of its classification for US federal tax purposes. To confirm this position, new temporary regulation 301.7701-5T(a) provides that a business entity (including a disregarded entity) is domestic if it is created or organized as any type of entity in the United States, or under the laws of the United States or of any US state. Accordingly, a multiple-chartered entity created or organized both in the United States and in a foreign jurisdiction is a domestic entity regardless of its status in the foreign country. For example, Y, an entity created or organized under the laws of country A as a public limited company, is classified as a corporation for US federal tax purposes. Y also is an entity that is treated as organized as an LLC under the laws of US state B, and for that reason it is treated as a domestic corporation.

The preamble to the regs states that the regs clarify current law and do not change the outcome that would result under "a proper application of the existing rules" to multiple-chartered entities. Further, the regs do not determine an entity's place of residence for the purposes of applying the provisions of a tax treaty. Thus, article IV(3) of the US-Canada treaty is not overridden by these new rules.

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Foreign Tax News

Treaties

On September 27, 2004, Canada begins negotiations to update its treaty with **Finland**. Concerns regarding the treaty or the Finnish tax system should be directed to David Senecal, Tax Legislation Division, Department of Finance, at 613-947-9860.

Germany

The OECD says that although Germany has reduced personal and corporate income tax rates and slightly broadened its tax base, further reductions and base broadening are necessary to foster economic activity. The OECD suggested that the cost of reform should be offset with reductions in tax expenditures and that granting states and communities greater autonomy on local tax issues will simplify federal decision making.

Netherlands

A new decree on the application of the arm's-length principle and the OECD transfer-pricing guidelines for multinational enterprises and tax administrations is effective immediately. The decree eliminates uncertainty and allows for more flexibility. A detailed list is provided of shareholder activities, the costs of which must be borne by the shareholder and are deductible in the case of a Netherlands company. The decree clarifies which support services may be charged out at cost.

The government plans to cut the corporate tax rate, currently the second highest in Europe, from 34 to 31.5 percent, effective 2005, to encourage employment and foreign investment. A further cut to 30 percent is being explored for 2007.

New Zealand

To boost gas exploration, a proposal in November 2004's tax bill will eliminate until late 2009 the 183-day rule that imposes local taxes on non-residents from certain treaty countries that drill offshore for more than 183 days.

To curb income tax evasion, a proposal offers a limited tax amnesty from the Inland Revenue in exchange for repayment of a certain number of years' back taxes. Intensive enforcement would follow for those not taking part in the amnesty.

US Virgin Islands

In June 2004, the Economic Development Commission extended the tax benefits period for businesses locating in Christiansted, St. Croix (for 10 more years) and Frederiksted, St. Croix (for 15 more years). To qualify, applicants must employ at least 10 full-time employees, 80 percent of whom are residents; invest capital in St. Croix of at least US$100,000 within the first year of operation; provide employee training, health benefits, and retirement plans; and engage in certain businesses, such as hotel and recreational businesses, manufacturing, and businesses that provide services from within the territory to clients abroad.

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