CANADIAN TAX *Highlights*

Editor: Vivien Morgan, LL.B.

Volume 12, Number 10, October 2004

Profit Purpose for Interest Deductibility

The CBA-CICA Joint Committee on Taxation (JCT) recently followed up its February 2004 submission to Finance on the October 31, 2003 draft proposals on the deductibility of interest and other expenses. The JCT stands by its earlier view that the draft proposals fundamentally change tax policy from what was established by case law and administrative practice before the court decisions that prompted the proposals. Furthermore, the JCT says that Finance should aim its amendments specifically at the legislation that gives rise to policy concerns; if Finance maintains that only a general approach can achieve its objective, the JCT suggests a "profit purpose" test in lieu of the proposed "reasonable expectation of cumulative profit" test.

Draft section 3.1 sets a so-called REOP test: a reasonable expectation of cumulative profit from a business or property must exist before a taxpayer can deduct a loss therefrom. The draft legislation also clarifies that such profit does not include capital gains. The draft proposals thus curtail the deduction not only of interest expense but also of all business-related expenses.

The February 2004 JCT submission expressed the JCT's concern that the draft legislation could disallow losses resulting from legitimate business expenses that were deductible under prior case law or administrative practice and could create significant problems in the tax treatment of securities investments. The JCT says that any amendments to address policy concerns raised by recent court decisions should clearly focus on those specific areas. If Finance remains convinced that a general change is necessary, the JCT's latest submission proposes an alternative profit purpose approach. To restore the law to what it was understood to be before the SCC decision in *Ludco*, the phrase "for the purpose of earning profit" could be substituted for the phrases "for the purpose of earning income" and "for the purpose of gaining or producing income" in provisions where Finance and the CRA have historically interpreted "income" to mean "net income" or "profit." For example, paragraph 18(1)(a) would read:

> In computing the income of a taxpayer from a business or property no deduction shall be made in respect of
>
> (a) an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of earning profit from the business or property.

The substitution of "profit" for "income" in the relevant provisions would not raise doubt about the meaning of "income" elsewhere in the Act: "profit" has already been used in certain tests in the Act (for example, in subsection 111(5)) without creating confusion.

The JCT says that the substitution of "profit" for "income" directly addresses any uncertainty created by *Ludco* and complies with the implicit direction of the SCC in that case: "If Parliament had intended interest to be deductible only in circumstances where borrowed money was used for the purpose of earning 'net income,' it could have expressly said so." Following the SCC's guidance would clarify Parliament's intention in the relevant provisions. In accordance with Finance's policy intent, the status of capital gains for deductibility of expenses can be clarified by adding a provision to ensure that "profit" does not include capital gains or losses.

The JCT also recommends the addition of an application rule to provide legislative guidance where traditionally it was not clear whether the income or profit purpose test was satisfied. For example, such a rule would ensure the deductibility of expenses if there is currently no prospect of future profit, but the legal obligation giving rise to the expense arose at an earlier time when the taxpayer had a profit purpose. The suggested application rule would deal directly with deductions for capital expenditures and interest, but the JCT wishes to make clear that continued deductions are appropriate if capital property is acquired for the purpose of earning profit, and the anticipated profit-earning potential prematurely ceases to exist. For example, the profit purpose test may be met when a capital property is acquired, but profit potential may evaporate before the related capital expenditure deductions are taken in full. Similarly, a debt obligation may be incurred for the purpose of earning income from a business that subsequently loses its profit potential, but the taxpayer may choose nevertheless to continue carrying on the business for a time.

In This Issue

Furthermore, the JCT suggests the addition of a provision to clarify the deductibility of "termination costs"—outlays or expenses made or incurred in connection with the termination of a business or the disposal of property that was last carried on or held for the purpose of deriving income. By their very nature, such outlays or expenses are not made in pursuit of future income from the business or property.

In the absence of a current or previous profit purpose, outlays and expenses made or incurred to earn gross revenue are not deductible under the JCT's proposed alternative amendment and application rule. For example, interest on borrowed money used to acquire preferred shares is not deductible if the fixed dividend rate on the shares is less than the interest rate charged on the borrowed money. To ensure equity and to meet the objective of simplicity, the JCT recommends a mechanism that permits a deduction in computing income from a business or property of such expenses incurred in a year, up to the total of amounts included in computing the income from that source for the year. "Excess" expense over the annual income inclusion (effectively, the "loss" amount) could be carried over. The amendments' coming into force should be timed so that they do not apply to outlays or expenses incurred before the new rules take effect.

Paul Hickey
KPMG LLP, Toronto

Mistakes of Law

In the GST case, *L'École Polytechnique* (2004 FCA 127), the FCA confirmed that in addition to the "due diligence" defence for section 280 penalties, a limited "mistake of law" defence may hold for an "invincible mistake of law" and an "officially induced mistake of law." These defences are important additions to a taxpayer's arsenal and may be of particular interest to the many GST suppliers who sought guidance from the CRA when the GST came into effect over 12 years ago: in many cases, it now appears that the information received was incorrect or that the rules have been subtly altered or reinterpreted in the interim.

L'École Polytechnique was a teaching and research institute that agreed with four companies to perform scientific research and to buy the resulting intellectual property (IP) and license it back. L'École Polytechnique said that the resupply of the IP was taxable and claimed a 100 percent ITC on the GST it paid on the purchase, not just the 57 percent rebate generally available to it as an exempt supplier. The minister disagreed and automatically applied a 6 percent penalty under section 280; the penalty was implicitly upheld by the TCC. The FCA upheld the exempt characterization and the penalty, but took the opportunity to discuss "mistake of law" defences for GST purposes.

Without claiming that its survey was exhaustive, the FCA named four types of mistake-of-law defences: (1) mistakes of law made in good faith; (2) reasonable mistakes of law; (3) invincible mistakes of law; and (4) officially induced mistakes of law. Drawing on other precedents, the FCA concluded that a "mistake of law made in good faith" and a "reasonable mistake of law" about the existence or interpretation of legislation are not defences to tax penalties. However, two exceptions to the general principle exist and may be used to defend against a GST penalty: an invincible mistake of law and an officially induced mistake of law.

An invincible mistake of law is one that is impossible to avoid because the person cannot possibly know the law, either because it has not been promulgated or because it was not published in a manner that allowed its existence or contents to be known. An invincible mistake of law is a complete defence. An officially induced mistake of law occurs if a person relied on the "mistaken legal opinion or advice of an official who is responsible for the administration or enforcement of the particular law," and such reliance was reasonable. In *Jorgensen* ([1995] 4 SCR 55), the SCC set out the following test to determine the defence's availability: the accused must establish that "she made a mistake of law, that she considered her legal position, consulted an appropriate official, obtained reasonable advice and relied on that advice in her actions." The FCA in *L'École Polytechnique* said that the definition of "official" in this context is still evolving, but the defence does not appear to extend to a mistake based on a legal opinion or on judicial precedent. (However, the due diligence defence may apply in such cases.) On the facts, none of the defences were available.

The FCA's recognition of these mistake-of-law defences may have significant implications, not only for GST penalties, but also for those under other commodity tax systems, such as retail sales tax regimes. Although the "invincible mistake of law" was not discussed at length, that defence may be relevant in a number of current assessments in Ontario. The FCA's summary of existing precedents for GST purposes establishes a primer for the doctrine of "mistake of law" in tax penalty cases.

The decision also broke new ground in its interpretation of the phrase "adventure in the nature of trade," included in the definition of "commercial activity" in the Excise Tax Act. The FCA held that the phrase does not include non-profit activities. An adventure or concern in the nature of trade must involve a scheme for profit making; otherwise, an adventure or concern cannot satisfy the requirement and be a commercial activity. This is a significant conclusion and is contrary to the view previously taken by most commodity tax practitioners. "Commercial activity" is defined to mean, among other things, "an adventure or concern of the person in the nature of trade (other than an adventure or concern engaged in without a reasonable expectation of profit by an individual, a personal trust, or a partnership all the members of which are individuals)." By implication, the wording invites the interpretation that a corporation (and certain other persons) engaged in an adventure or concern without a reasonable expectation of profit is still in fact engaged in commercial activity for the purpose of the Excise Tax Act. It remains to be seen whether the FCA's view will evolve over time; in the interim, the conclusion creates a conundrum for practitioners.

Robert G. Kreklewetz and Wendy A. Brousseau
Millar Kreklewetz LLP, Toronto

GST: Carrying On Business

The CRA recently revised several key policy papers. (See, for example, "GST and PEs, Revisited," *Canadian Tax Highlights*, September 2004.) The concepts of "permanent establishment" and "carrying on business" are relevant in determining whether a non-resident must register for GST/HST purposes. The "carrying on business" concept is discussed in revised draft *GST/HST Policy Statement* P-051R2, September 8, 2004. Comments on the revised policy statement should be submitted to the CRA by November 30, 2004.

The revised policy statement reviews the factors relevant to the "carrying on business" analysis, including the location of employees, place of delivery, place of contract, and location of assets (profit-making apparatus). According to the policy statement, the importance of a particular factor depends on the nature of the business—for example, whether it is the leasing of goods or the provision of services, and whether it is conventional or electronic commerce. This view aligns with previous CRA policies outlined in *Technical Information Bulletin* B-090, "GST and Electronic Commerce," but appears to undervalue the relevant case law, which focuses on the place of contract and the profit-making apparatus as the key determinants.

In the case of a lease of property, the CRA notes that the key factors in carrying on business include the place where the non-resident lessor acquires the property and the place where the property is delivered to the lessee. On that basis, the fact that the profit-making apparatus (the leased property) is in Canada may not cause the non-resident to be carrying on business in Canada in the absence of other factors. However, if the leased property is real estate, the location of the profit-making apparatus in Canada is key. If the focus of a contract is the supply of services, the determining factors include the place where the service is performed and the place where employees are located.

The policy statement provides a number of examples to illustrate the CRA's views on the application of the "carrying on business" concept. In one example, a non-resident solicits orders in Canada through advertising and an independent sales agent and maintains inventory in a third-party warehouse: the non-resident is thus carrying on business in Canada. In another example, a non-resident purchases raw materials in Canada to be shipped to a Canadian manufacturer for processing into finished goods and draws on the finished inventory located at the manufacturer's premises to fill both local and export orders; in this case, the non-resident is carrying on business and thus must register for GST purposes. This scenario presents a perplexing contrast with the GST drop shipment rules, which were designed to eliminate the GST (and the need to register) for a non-resident non-registrant that acquires goods or services in Canada in relation to product that may, for example, be shipped to a Canadian consignee. Because the drop shipment rules apply only to non-residents that are not registered, there appears to be a lacuna between the drop shipment rules and the "carrying on business" analysis.

Audrey Diamant
PricewaterhouseCoopers LLP, Toronto

Tax Database

Those concerned about international tax comparisons continue to endure an interminable wait for the 2004 edition of *Revenue Statistics* from the Organisation for Economic Co-operation and Development (OECD). In the interim, the information can be accessed on the Tax Database at the OECD Web site (http://www.oecd.org). As is the case for simple tax-to-GDP ratios in *Revenue Statistics*, the information is useful if its limitations are understood.

The database shows tax rates for the OECD members for several recent years, mainly 2002 and 2003: seven tables provide personal income tax rates, both marginal and average; three tables detail corporate income tax rates; and two tables summarize value-added tax systems. A final table, summarized below, shows the effective rate of tax on dividend income.

Tax rates reveal only a small part of a country's tax system. Equally important is the definition of "income" for tax purposes, and deductions and expenses allowed to arrive at taxable income. The methods of financing social security systems and the extent of such programs' assistance can also cloud international tax comparisons. Personal income tax comparisons are further complicated by the tax treatment of dependent children: a supporting taxpayer may receive exemptions or credits, or, as in Canada, a system of allowances or transfers from

Net Tax Rate on Dividends, 2003

OECD member country	Personal income tax on gross dividends	Main corporate rate	Effective tax on dividend income
		percent	
Canada	46.4	36.6	56.5
United States	51.3	39.4	51.3
Japan	50.0	40.9	66.7
Britain	32.5	30.0	47.5
France	55.6	35.4	57.0
Germany	51.2	40.2	55.5
Italy	46.1	34.0	46.1

government may assist selected family income groups. The OECD tables include an analysis of the social security levies and cash benefits facing the typical production worker's family in OECD countries. In federal countries, averages are used in determining state or provincial taxes.

David B. Perry
Canadian Tax Foundation, Toronto

CCPC M & P Benefits

The income of a Canadian-controlled private corporation (CCPC) may be subject to any of four different corporate income tax rates: a small business rate, a manufacturing and processing (M & P) tax rate, a general tax rate, and an investment income tax rate. The small business rate is a preferential tax rate on up to $300,000 (or a higher threshold in some jurisdictions) of a CCPC's active business income. For a CCPC manufacturer and processor with income above the small business threshold, effective after 2003, the preferential federal M & P tax rate was eliminated by federal corporate tax rate changes, but lower provincial and territorial tax rates still apply in Newfoundland and Labrador, Ontario, Prince Edward Island, Saskatchewan, and Yukon.

In comparison with 2003, only Alberta, Manitoba, and Quebec CCPCs enjoy lower combined federal and provincial M & P tax rates in 2004. Alberta's and Manitoba's combined rates decreased because of lower provincial M & P rates. On April 1, 2004, Alberta's general and M & P rates fell from 12.5 percent to 11.5 percent, and are expected to decrease to 8 percent subject to affordability. After 2003, Manitoba's general and M & P rates fell from 16 to 15.5 percent, and will decrease to 15 percent after 2004. Both Alberta's and Manitoba's M & P rates will thus further decline in 2005. The marginal 2004 decrease in the Quebec M & P rate coincided with the Youth Fund surtax's expiry. Ontario and Northwest Territories imposed higher M & P tax rates in 2004.

M & P CCPCs can also benefit from non-refundable investment tax credits (ITCs) offered in Manitoba, Prince

Combined General and M & P Percentage Rates, Calendar Years 2003 to 2005

	2003		2004		2005	
	General*	M & P	General*	M & P	General*	M & P
Federal	24.12	22.12	**22.12**	22.12	22.12	22.12
Alberta	36.74	34.74	**33.87**	**33.87**	**33.62**	**33.62**
British Columbia	37.62	35.62	**35.62**	35.62	35.62	35.62
Manitoba	40.12	38.12	**37.62**	**37.62**	**37.12**	**37.12**
New Brunswick	37.12	35.12	**35.12**	35.12	35.12	35.12
Newfoundland and Labrador	38.12	27.12	**36.12**	27.12	36.12	27.12
Northwest Territories	36.12	34.12	36.12	**36.12**	36.12	36.12
Nova Scotia	40.12	38.12	**38.12**	38.12	38.12	38.12
Nunavut	36.12	34.12	**34.12**	34.12	34.12	34.12
Ontario	36.62	33.12	**36.12**	**34.12**	36.12	34.12
Prince Edward Island	40.12	29.62	**38.12**	29.62	38.12	29.62
Quebec						
Active/eligible income	33.05	31.05	**31.02**	**31.02**	31.02	31.02
Other income	40.42	na	**38.37**	na	38.37	na
Saskatchewan	41.12	32.12	**39.12**	32.12	39.12	32.12
Yukon	39.12	24.62	**37.12**	24.62	37.12	24.62

na Not applicable.

* The general federal rate reflects the general rate reduction, which does not apply to resource income, income of companies benefiting from the refundable tax provisions (a CCPC's investment income), or income of mutual fund and investment corporations. Year-over-year rate changes appear in boldface type. Ontario and Northwest Territories increased the 2004 M & P rate. Rates are subject to changes in spring 2005 budgets.

Edward Island, and Saskatchewan on the cost of qualifying M & P equipment acquired in 2004 and 2005 for use in the applicable province. Manitoba offers a 10 percent ITC on eligible M & P assets; the incentive's expiry date was extended in 2003 by three years from July 1, 2003 to July 1, 2006, and the carryforward period was recently extended from 7 to 10 years for ITCs earned after the 2003 taxation year. Prince Edward Island also offers a 10 percent ITC on such assets. Saskatchewan's ITC rate for M & P property acquired after March 31, 2004 increased to correspond with the increase in the province's sales tax credit from 6 to 7 percent. Unused ITCs in Prince Edward Island and Saskatchewan can be carried back 3 years and forward 7 years. For federal purposes, provincial tax credits are government assistance and reduce the asset's capital cost.

Some provinces offer other M & P tax incentives. For example, British Columbia offers a sales tax exemption on certain M & P equipment. In limited circumstances, tax holidays may reduce or eliminate provincial tax on M & P income in Newfoundland and Labrador, Prince Edward Island, and Quebec.

Louis J. Provenzano and Christine Damianidis
PricewaterhouseCoopers LLP, Toronto

SUTA Dumping Law Mandate

On August 9, 2004, President George W. Bush signed into law the SUTA [State Unemployment Tax Act] Dumping Prevention Act of 2004, which requires each state to enact legislation using mandated minimum requirements to prevent companies from avoiding their share of unemployment insurance taxes. States that fail to comply will lose federal contributions to the cost of administering state unemployment insurance (SUI) programs.

State unemployment insurance rates are driven by an employer's turnover experience (its experience rate): the higher its employee turnover, the higher the rate of tax it must pay on employee wages to a state fund to cover unemployment payments to persons laid off. SUTA dumping is the practice of restructuring operations to move employees from an entity with a high tax rate to one with a low rate in order to reduce SUI contributions. According to a 2003 survey by the US General Accounting Office, 14 states reported a loss of over US$120 million because of SUTA dumping. The act requires states to adopt legislation embodying minimum requirements. Experience rates must be combined if an employer transfers part or all of its business to another employer then under common control. Experience rates cannot be combined if the state finds that a person acquired a business (and became an employer) solely or primarily to obtain a lower contribution rate. The state Secretary of Labor must issue regulations to ensure that higher contribution rates are not avoided through transfer or acquisition of a business. Meaningful civil and criminal penalties must be imposed on persons (and their advisers) that knowingly violate or attempt to violate the law. Procedures must be established to identify the transfer or acquisition of a business for these purposes.

States must adopt the model act (or a stricter version) within 26 weeks after the next regular state legislative session that starts after August 9, 2004. Because the deadline varies with the start date of the session (some states have biennial legislatures) and the date on which the state's annual rate year begins, state legislation will take effect between January 1, 2006 and July 1, 2007. A state may adopt an accelerated timetable, as New Jersey and Michigan are considering.

On August 13, 2004, the federal Department of Labor issued Unemployment Insurance Program Letter no. 30-04 ("the DOL letter"). The DOL letter provides examples of SUTA dumping, sets mandatory minimum requirements for state legislation, provides model language for such state legislation, and interprets the act. The DOL letter seems to expand the act's scope in several ways. (1) The act provides no bright-line test defining common control; the DOL letter suggests that this factual determination should consider "the extent of commonality or similarity of: ownership; familial relationships; principals or corporate officers; organization structure; day-to-day operations; assets and liabilities; and stated business purposes." (2) A transfer that requires disclosure and effects a potential transfer of experience includes one that transfers employees and no other business assets or operations. The DOL letter may be interpreted to require a report and potentially the transfer of experience on the transfer of more than one employee between two affiliates, a significant expansion of prior rules: most states required the transfer of an "identifiable and segregable" portion of the business before a report and experience transfer were triggered. (3) The act requires an experience transfer if employees and/or a business are transferred between entities with substantially common ownership, management, or control. Current SUI laws often require the recalculation of SUI rates only for the next rating cycle after a transfer of employees: a January 1, year 1 transaction may not result in a consolidated rate until January 1, year 2. In recognition of the lag time in the use of the successor rate, the DOL letter "strongly recommends" the rate's immediate recalculation to avoid any benefit from the transfer. (4) The act requires states to enact "meaningful" civil and criminal penalties. The DOL model act includes a civil penalty on employers calculated on

(a) applying the maximum SUI rate prescribed by the state, or (b) a penalty of 2 percent of taxable wages for the year in which the violation occurred and for the subsequent three years. (5) The DOL letter expands SUTA dumping to include "payrolling," which includes an agreement under which, for a fee, an employer with a higher SUI rate reports its employees as belonging to an employer with a lower SUI rate, or under which one company reports payroll for other related companies for administrative convenience, not for tax-planning purposes. (The use of one company to report payroll for multiple companies may be permissible for FICA [social security] and FUTA [federal unemployment insurance] purposes, but not generally for SUI.) SUTA penalties now apply to payrolling.

Many normal business activities—restructurings, mergers, acquisitions, and the transfer of employees between related entities—may now have significant SUI reporting and disclosure requirements. Regardless of a state's timetable for adopting the mandated state law, taxpayers can expect that many state unemployment tax commissions will closely scrutinize the movement of employees between related parties.

Ian Bristol and Jeffrey Brown
KPMG LLP, Toronto

Cross-Border Personal Services Income

Proposed new IRS rules determine the source of income from personal services performed partly within the United States, applicable for tax years beginning on or after the date on which the regs are finalized. Under existing regs, the portion of the compensation treated as US-source income must be determined on the basis that, in the particular circumstances, "most correctly reflects" the proper source. Proposed regs issued in 2000 retained this facts-and-circumstances approach in some cases and were withdrawn by Treasury owing to a host of negative comments from tax practitioners.

The new proposals provide two new general bases—time and geography—for determining the proper source of compensation received by an individual employee. Non-fringe-benefit compensation for labour or personal services performed partly within the United States must be sourced on a time basis: the amount so sourced bears the same relation to the total compensation as the number of days the employee performed such services within the United States bears to the total number of days he or she performed such services. A unit of time less than a full day may be used; the proposal's preamble indicates that this may be a more appropriate unit, for instance, to source compensation paid to an airline flight crew member.

Under the second general basis of apportionment, fringe benefit compensation received by an employee for labour or personal services performed partly within the United States must be sourced on a geographical basis, which is linked to the employee's principal place of work as defined in Code section 217. The relevant fringe benefits are housing, education, local transportation, tax reimbursement, hazardous or hardship duty pay, and moving expense reimbursements; Treasury and the IRS plan to update this list periodically. The fringe benefit must be reasonable and substantiated by adequate contemporaneous records or other sufficient evidence, and must meet the IRS's definition of a permissible fringe benefit.

An alternative basis for apportionment, based on the facts and circumstances, may be used if the employee can establish to the IRS's satisfaction that it more properly determines the compensation's source. For example, an alternative method may more properly determine the source of an employee's compensation that is tied to the performance of specific actions rather than earned rateably over time.

The facts-and-circumstances basis is retained as the general rule for determining the source of compensation for labour and personal services performed partly within the United States received by non-individuals and non-employees (independent contractors). Treasury believes that a facts-and-circumstances test in this situation is more appropriate. For example, if a corporation is paid under a contract for services performed by numerous employees at various pay levels in different geographic locations, the income's source may be correctly reflected by payroll costs under the contract or on some other non-time basis.

The new proposals do not affect the existing de minimis rule that exempts otherwise US-source income from US tax. Code section 861(a)(3) treats compensation for services performed in the United States as foreign-source income if (1) the services are performed by a non-resident individual present in the United States for 90 days or less during the taxable year; (2) the aggregate compensation does not exceed $3,000; and (3) the worker performs the services as an employee of or under a contract with either (a) a non-resident individual, foreign partnership, or foreign corporation not engaged in a US trade or business, or (b) a US citizen, resident individual, partnership, or corporation if such services are performed for an office or place of business maintained by such a party outside the United States. The Canada-US treaty gives employees and independent contractors further relief from US tax. Article XV provides that income received by a Canadian resident for the performance of dependent personal services (as an employee) in the United States is exempt from US tax if (1) the amount does not exceed US$10,000 for the year, or (2) the individual is present in the United

States for no more than 183 days during the calendar year, and the income is not borne by a US employer or by the employer's US permanent establishment or fixed base. Article XIV also provides that income received by a Canadian resident for performance in the United States of independent personal services (as a consultant or independent contractor) is US-tax-exempt if there is no fixed base regularly available to him or her in the United States for the purpose of performing the services.

Leslie R. Kellogg
Hodgson Russ LLP, Buffalo

Paragraph 95(6)(b) Favoured?

Paragraph 95(6)(b) is a specific anti-avoidance rule in the foreign affiliate (FA) regime. Very generally, if a person or partnership acquires or disposes of a share or partnership interest and it can reasonably be considered that the principal purpose for the acquisition or disposition is to permit a person to avoid, reduce, or defer the payment of tax or any amount otherwise payable, the acquisition or disposition is deemed not to have occurred and any partnership interests or shares issued are deemed not to have been issued. It is hoped that the CRA's published version of the round table that was presented at the Canadian Tax Foundation's 2004 annual conference will provide details of the rule's application.

Because the characterization of an FA's income under subdivision i (in particular, paragraph 95(2)(a)) can depend upon the FA's relationship to another corporation, paragraph 95(6)(b)'s application can convert paragraph 95(2)(a) active business income into FAPI. The example in the technical notes to the 1994 amendments involves a Canadian-resident lender that, in lieu of a direct loan to an arm's-length foreign corporation, capitalizes a controlled FA (CFA) that makes the loan and acquires an 11 percent stock interest in the borrower to create a qualifying interest for the purposes of clause 95(2)(a)(ii)(B). Because the lender is deemed not to have acquired the 11 percent interest, the CFA's interest income becomes FAPI.

The CRA may be seeking to apply paragraph 95(6)(b) in a broader range of situations, including those arguably not a concern under GAAR. At the Foundation's 2004 annual conference, the CRA was asked to provide details of particular structures that it was seeking to attack by way of the provision. In oral remarks, Wayne Adams, Director General, Legislative Policy Directorate, did not detail all the specific arrangements of concern to the CRA, but indicated that he will reflect on the scope of those concerns. Mr. Adams acknowledged the CRA's longstanding objection to so-called second-tier finance structures and the use of paragraph 95(6)(b) to attack them. (It is assumed that the comment referred to the establishment of a subsidiary, such as a Barbados IBC, by a Canadian sub of a foreign multinational corporation to lend to a related non-FA. Before the recent section 17 amendments, taxpayers took the position that the financing FA's income could be structured as active business income under paragraph 95(2)(a)).

Some practitioners have been concerned that the CRA might seek to apply paragraph 95(6)(b) in so-called tower or reverse hybrid structures used by Canadian multinationals to finance their US operations (see CRA document no. 2002-0136855). Mr. Adams indicated that the CRA had been asked to rule on such a structure but had declined to do so after various discussions and the withdrawal of the ruling request. Although Mr. Adams did not categorically indicate that a tower structure is free from assessment under paragraph 95(6)(b), he did say that the CRA does not view that provision as precluding taxpayers, in the general sense, from establishing FAs to finance their foreign operations.

Paul Barnicke
PricewaterhouseCoopers LLP, Toronto

Estate Freeze with Partnership

The CRA recently released a technical interpretation dealing with the question whether a partnership can be used to implement an estate freeze (TI 2004-0070001C6). The CRA confirms that it has never issued a favourable advance tax ruling on such transactions, because subsection 103(1) or (1.1) would generally apply to alter the allocation of partnership income. The TI addressed two questions presented to a CRA round table at a recent conference of the Society of Trust and Estate Practitioners (STEP).

Under subsection 103(1), when partners agree to share partnership income or losses from any source or from sources in a particular place in a specified proportion, and the principal reason for the agreement may reasonably be considered to be the reduction or postponement of tax, then generally each partner's share is an amount that is reasonable in light of how they shared other income or losses. Under subsection 103(1.1), when non-arm's-length partners agree to share partnership income or losses and any partner's share is not reasonable in the circumstances (considering the capital invested in or work performed for the partnership or other relevant factors), then generally the partner's share is an amount deemed to be reasonable in the circumstances.

When asked whether it had any concerns about using a partnership to freeze an estate, the CRA replied, "We have never issued a favourable advance income tax ruling on proposed transactions involving the use of a partnership to implement an estate freeze." The CRA also said that it was asked at the Canadian Tax Foundation's

1992 annual conference round table (question 13) whether it would apply subsections 103(1) and (1.1) if a partnership were so used: could partnership interests analogous to "frozen shares" be issued to the person whose interest is being frozen, and could partnership interests analogous to common shares be issued to the person who will participate in the partnership's future growth? The CRA replied that when a partnership is used for estate-freeze purposes, if the allocation of income within a partnership does not recognize each partner's capital and non-monetary contributions, then subsection 103(1) or (1.1) may alter the allocation of the partnership income, loss, or other amounts. In the TI, the CRA confirms that it continues to hold this view.

When asked how its view on the application of subsections 103(1) and (1.1) could be addressed in practice, the CRA said that the provisions' application in any situation was fact-dependent and could be reviewed in an income tax ruling request. However, the CRA's overall position was that those provisions would apply.

Wayne Tunney
KPMG LLP, Montreal

Transocean Shored on Part XIII

In *Transocean Offshore Limited* (2004 TCC 454), the TCC concluded that US$10 million of part XIII withholding tax was payable under paragraph 212(1)(d) on US$40 million paid to TOL as damages: the payment was an amount on account or in lieu of payment of, or in satisfaction of, rent or a similar payment. TOL argued that damages paid for breach of contract do not take on the specific character of the income they replace: cases on termination of employment and on payments in respect of future interest suggest that damages for a lease's termination are not rent or unearned rent, particularly if the rental equipment has yet to be used. The TCC said that that case law did not apply to trade agreements; the court applied the surrogatum principle, which dictates that the tax consequences of a damage or settlement payment depend on the tax treatment of the item for which the payment is a substitute.

TOL, a non-resident corporation incorporated in the Cayman Islands, was in the business of chartering offshore drilling rigs and apparatus and providing related ancillary services. TOL owned the *Explorer*, a semi-submersible offshore drilling rig, which it made available to another affiliated company (TOI) so that TOI could enter into a bareboat charter agreement with Petro-Canada and other co-venturers. For tax purposes, TOI was resident in the United States but not in Canada. Under the bareboat charter agreement, the co-venturers chartered the use of the *Explorer* for about two years in connection with the Terra Nova project in Canada, to commence after the *Explorer*'s then current contract. The co-venturers entered into another drilling service contract with another of TOL's non-resident affiliates to secure personnel and equipment to maintain the *Explorer*.

The co-venturers agreed to pay a mobilization fee of US$11 million to cover all costs of mobilizing the *Explorer* from its existing location in the North Sea to the Canadian shipyard for the performance of upgrades so that the rig could withstand the harsher Canadian climate and meet stricter Canadian safety standards. The co-venturers became uncomfortable with the increases in the estimated costs of the upgrades and other matters and eventually negotiated a repudiation of the charter, entering into a deed of settlement to release them from their obligations for a payment of US$40 million; US$10 million was withheld under part XIII. The settlement linked the payment to TOI by the co-venturers as consideration paid for the charter's voluntary termination. The judgment said that no oral evidence was adduced that indicated how the amount of US$40 million was arrived at, and the documentation did not apportion the amount. Although the co-venturers solicited new bids for drilling rigs to be used in connection with the project, TOL was not a successful bidder. The *Explorer* stayed in the United Kingdom and continues to be idle; it was never used in Canada.

TOL argued that no obligations under the charter had arisen, but the Crown argued that the obligation was created when the contract was signed: if there were no obligations, there would have been no reason for the payment of damages. The taxpayer admitted that the case law has consistently held that damages may be income or capital, depending on what they replace, but argued unsuccessfully that part XIII withholding tax is imposed only on specific types of income or payments in lieu thereof. *Transocean Offshore* surveys the jurisprudence on termination payments and other payments for breach of contract and concludes that the case law regarding damages for breach of employment is not applicable to trade agreements. (The court also noted that the SCC had put those cases in doubt.) Similarly, jurisprudence with respect to unearned interest that turns on the term "interest," and thus connotes specific technical requirements such as daily accrual, is not applicable to trade agreements in general. The surrogatum principle was the relevant guideline, and if the damages were "'no more than a surrogatum for the future profits surrendered' then they should be treated as income." Thus, the damages were paid "as, on account or in lieu of payment of, or in satisfaction of, the rent" and were subject to part XIII tax.

John Jakolev
Goodman and Carr LLP, Toronto

CANADIAN TAX *Highlights*

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

Canadian Tax Foundation
595 Bay Street, Suite 1200
Toronto, Canada M5G 2N5
Telephone: 416-599-0283
Facsimile: 416-599-9283
Internet: http://www.ctf.ca
E-mail: vmorgan@interlog.com
ISSN 1496-4422 (Online)

Foreign Tax News

Treaties

A treaty with **Azerbaijan** was signed on September 7, 2004 and enters into force following ratification by both states. It is effective with respect to tax withheld at source on amounts paid or credited to non-residents after the calendar year of ratification, and with respect to other taxes for taxation years beginning after that calendar year. Withholding rates are 10 percent on dividends between affiliated companies and 15 percent for all others; 10 percent on interest; and 5 percent on royalties on computer software, patents, and commercial, industrial or scientific experience, and 10 percent for all others.

Following is an update on treaties under negotiation. **Barbados:** discussions were held in December 1997 and November 1998; **Bolivia:** negotiations set for June 2003 were postponed by Bolivia, and no new dates were set; **People's Republic of China:** negotiations were held in March 2002, and no further dates were set; **Colombia:** the last round of negotiations was in March 1999, and no further dates were set (Colombia is reviewing its policy on concluding income tax treaties); **Costa Rica:** the first round of negotiations took place in June 2003, and no further dates were set; **Cuba:** the second round of negotiations took place in September 2003, and no further dates were set; **Egypt:** negotiations were completed in August 1998 (Egyptian authorities have requested reopening negotiations, but no date has been set); **Finland:** negotiations were set to begin the week of September 27, 2004; **Greece:** the latest negotiations took place in May 2001; **Republic of Korea:** negotiations commenced in April 2004, and no further dates were set; **Mauritius:** the second round of negotiations (October 2000) was postponed by Mauritius because of elections; **Mexico:** negotiations for a new treaty are substantially completed, and no further dates have been set; **St. Lucia:** the opening round of negotiations was held in December 1997, and no further dates were set; **Serbia and Montenegro:** the opening round of negotiations was held in March 2004, and no further dates were set; **Singapore:** negotiations were to commence the week of August 16, 2004; **Turkey:** negotiations are completed, and ratification is underway in both countries; **United States:** the last round of negotiations on the protocol took place in July 2001 (see Finance *News Release* 2000-068 for details).

Russia

Under a new regulation from the Central Bank of Russia, foreign companies must register with tax authorities by January 1, 2005 and receive a single taxpayer identification number, or risk the freezing of their bank accounts.

Ireland

The European Commission approved Ireland's new holding company regime, which is retroactive to February 2, 2004. Chargeable gains from the disposal of shares are exempt; a flat 5 percent shareholding now meets the EC requirements. Tax credits on dividends now require only a 5 percent shareholding, including a drilldown if the Irish company's immediate and second-tier shareholdings are at least 5 percent. Foreign tax credits can now be pooled to reduce overall Irish tax on foreign dividends. The foreign company must be a resident in the European Union or in a country that has a treaty with Ireland. These changes, together with the low domestic corporate tax rate of 12.5 percent, will make Ireland a choice location for foreign holding companies.

Sri Lanka

The 100 percent tax on purchases of property by foreign nationals has been restored. The tax was removed in 2002 to encourage foreign investment, but the removal resulted in substantial land purchases by foreign nationals for personal use. Exemptions apply to companies listed on the Colombo stock exchange and may also be approved by Sri Lanka's Board of Investment.

Carol Mohammed
Canadian Tax Foundation, Toronto