CANADIAN TAX Highlights

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TCC Awards Charter Damages

The TCC in *Campbell* awarded compensatory damages under section 24(1) of the Canadian Charter of Rights and Freedoms to a taxpayer who unsuccessfully appealed the denial of his claim for the child tax benefit (2004 TCC 460). *Campbell* is the first case in which the TCC has awarded remedies under the Charter (other than more traditional remedies, such as striking out an impugned clause) and is thus likely to be appealed.

Mr. C was originally granted the child tax benefit on the basis that he cared for his son and had no spouse during the relevant years. The minister disallowed the benefit when he learned that throughout the period Mr. C had a spouse and they and their son lived in the same home. Under paragraph (f) of the definition of "eligible individual" in section 122.6 of the Income Tax Act, if a female parent resides with her dependant, she is presumed to primarily fulfill the responsibility for the child's care and upbringing. Mr. C testified at trial that he was the primary caregiver, contrary to testimony of the mother and an aunt. The TCC found that, on balance, Mr. C's evidence was not credible enough to rebut the presumption and that the mother was the primary caregiver. The appeal was thus dismissed, but the TCC also addressed Mr. C's claim that he had been discriminated against contrary to Charter section 15(1), by virtue of the discriminatory impact of the section 122.6 presumption, on account of his gender alone.

The TCC held that the presumption is constitutional and its different treatment of males is not discriminatory: in a contextual analysis, the presumption is saved from contravening section 52(1) of the Constitution Act by its ameliorative effect on children because it expedites payments for their benefit by reducing the attendant substantial delays of litigation over the benefit's availability. However, the TCC found that the minister's officials employed the presumption in a manner that amounted to substantive discrimination: the CRA sent a questionnaire to Mr. C to obtain information to assist in making an assessment, but the questionnaire was "seemingly ignored." The minister placed "unjustified, blind reliance on the presumption"; the best interests of the child were not considered.

When the TCC is faced with an infringement of Charter rights by reason of some action taken under a legislative provision that is not unconstitutional, does it have jurisdiction in an income tax appeal to award remedies other than those provided for in section 171 of the Income Tax Act? The TCC found that it has jurisdiction to "employ just and appropriate remedies pursuant to section 24 of the Charter." The court observed that striking down the impugned provision would not bring relief to Mr. C, because he would not in any event be entitled to the child tax benefit. Instead, the TCC awarded (1) a mandatory order regarding the handling of future appeals from the minister's determination of an "eligible individual," if the minister placed no reliance on the child's best interests, and (2) compensatory damages of $1,000, including costs. The mandatory order stipulates that if an assessment is based solely on the presumption, and no reasonable grounds exist to believe that its use is in the child's best interests, the court must determine on a balance of probabilities which parent fulfilled responsibility for the child's care and upbringing; in appropriate circumstances, the court may award compensatory damages to the male parent.

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In This Issue

Central Management and Control

In a recent UK decision, *Mr. R v. Holden* (SPC/00422), the special commissioners speak to the common law test of corporate residency as articulated in *De Beers Consolidated Mines* ([1906] AC 455) and highlight how directors must conduct themselves in order to constitute a corporation's central management and control. On the facts, the commissioners concluded that the sole director merely followed the taxpayer's wishes.

In *De Beers*, the House of Lords established that a corporation incorporated abroad was a UK resident for tax purposes only if it was centrally managed and controlled there. Notwithstanding past reliance on the place where legal formalities were carried out, including both the meetings approving the transaction and the signing of the documents, *Mr. R v. Holden* indicates that the mere physical acts of signing resolutions or documents do not suffice: the place where the actual effective decision is made to sign and execute the documents is the place where central management and control actually abides.

Mr. R entered into a sophisticated tax-saving scheme and set up foreign corporations in a series of transactions to avoid capital gains tax on the disposal of shares originally held by him. Essential to this plan was the determination that E BV, incorporated in the Netherlands, was not resident in the United Kingdom: E BV's presence in the structure occurred midstream because of a tax change designed to thwart strategies that had been originally devised. E BV acquired shares from its parent corporation, C Ltd., and later onsold them to a third party. Inland Revenue argued that the transactions were choreographed from the United Kingdom and that the director of E BV did not make the decisions but acted on behalf of Mr. R or his representatives.

The special commissioners sided with Inland Revenue and held that although the director signed or executed the appropriate documents and held directors' meetings abroad, the central management and control was exercised in the United Kingdom. In order for a court to find that the central control and management abided abroad, the director must be genuinely involved in the decision-making process related to the sale; that entailed an informed decision as to whether the resolution should be passed and the documents signed or executed. There were strong commercial reasons why the managing director of E BV would accept the sale of its shares, but it appeared that the managing director gave no consideration at all to the issues and did not even receive certain relevant documentation.

If Canadians set up offshore companies as part of an international tax plan, *Mr. R v. Holden* underlines the importance of involving the foreign directors in the decision-making process if their approval is required under corporate law. Foreign directors cannot simply rubber-stamp resolutions or documents that have been formulated or agreed to in Canada; they must actually participate in the decision if the foreign company is to maintain non-Canadian residence. The level of information necessary to decide on the merits of a particular transaction must be disclosed to those directors; failure to do so could result in a loss of non-resident status and serious adverse Canadian tax consequences.

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ONTARIO PST AND SOFTWARE

After more than two years of analysis and consultation with interested parties, Ontario released technical amendments to the PST regulations applicable to software, effective July 19, 2002. The changes will be welcomed by some, but the IT industry is likely to view them as largely ineffective in easing the burden of overly complex rules.

The regulations introduce a few new areas and tinker with some definitions. Taxable software upgrades are now defined as services to remedy problems within and between computer programs and as improvements that are available to all licensees. This new definition may be narrower, but it is still broad enough to capture program updates, upgrades, fixes, patches, and the like. Specifically excluded from taxation are project-planning services, including specification analysis, determination of hardware and software prerequisites, scheduling, and report preparation. Previously, there was no specific exemption for most of the design and development stages of an implementation project, but an exemption was allowed by administrative practice.

The de minimis fair value rules are also expanded. Previously, no tax was exigible if taxable and non-taxable computer services were sold together for a single price and the vendor's cost of, or the time spent on, the taxable portion was a maximum of 10 percent of the non-taxable portion. Given the difficulties inherent in calculations based on the vendor's cost, options are added to gauge the 10 percent threshold, including fair value and any other reasonable method. The de minimis rules now also apply to a bundled mix of computer services and programs, as well as to otherwise taxable program-testing services.

The exemption for "modifications," defined as changes to source code, is also expanded to include in-house modifications. Under this rule, modifications are not taxed if their accumulated value, including the salaries of employees directly involved in the process, exceeds the value of the original taxable software program.

The accompanying backgrounder provides a useful discussion of non-taxable computer services and custom programs. The need to identify the integral components of a supply for the purposes of sales tax analysis is also recognized; the components of a specific supply form the basis of its fair value, whether or not listed separately, but autonomous or ancillary components may be taxed as separate supplies or as inputs to the main supply. This discussion is reminiscent of the "single versus multiple supply" concept that is a GST mainstay, and may represent Ontario's first steps in acknowledging the concept's importance within the PST context.

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DEFICIT DROP: BRAGGING RIGHTS

Finance has released on its Web site its annual publication *Fiscal Reference Tables*, which contains detailed information on the financial operations of governments in Canada and a series of tables that show how Canada has turned its fiscal policy around.

The figures for international comparisons in the Finance release, summarized in the table below, are based on national accounts data compiled by the OECD. The figures show that the income of all levels of Canadian government dropped from 44.2 percent of GDP in 1992 to 41.3 percent in 2003. In aggregate, all G7 countries performed roughly similarly, but Canada's ratio of income to GDP did not drop as fast or as far as that of the United States. Spending shows a dramatic drop in Canada, from 53.3 to 40.1 percent of GDP. No other G7 country showed such a rapid drop in the relative importance of government spending; US government outlays dropped from 38.1 to 35.7 percent of GDP.

Not surprisingly, the Canadian government balance, on the OECD national accounts basis, shifted from a deficit of 9.1 percent of GDP in 1992 to a surplus of 1.2 percent in 2003. Canada's performance is all the more striking in comparison with the other G7 countries, which all recorded deficits in 2003 and, except for Italy, higher deficits than in 1992. Because of the improvement in Canada's annual financial results, the gross financial liabilities of all levels of government in Canada dropped from the equivalent of 100.8 percent of GDP in 1996—the peak year—to 75.6 percent in 2003. Of the other G7 countries, only the United States reduced the relative importance of its gross financial liabilities.

Canada, General Government Operations, National Accounts Basis, 1992 to 2003, as a Percentage of GDP

	Receipts	Outlays	Balances
		percent	
1992	44.2	53.3	–9.1
1993	43.5	52.2	–8.7
1994	43.0	49.7	–6.7
1995	43.2	48.5	–5.3
1996	43.8	46.6	–2.8
1997	44.5	44.3	0.2
1998	44.5	44.4	0.1
1999	44.1	42.5	1.6
2000	44.1	41.0	3.1
2001	42.8	41.1	1.7
2002	41.4	40.6	0.8
2003	41.3	40.1	1.2

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US INCENTIVES ON REPATRIATION

On October 22, 2004, President Bush signed into law the American Jobs Creation Act (JCA). The JCA phases out the extraterritorial income (ETI) tax regime, which, according to a WTO ruling, established illegal subsidies, and provides US$137 billion in new corporate tax incentives over the next 10 years. One principal relieving provision phases in a 9 percent deduction for domestic manufacturing income. International tax reforms include a reduction in the number of foreign tax credit (FTC) baskets from nine to two (passive and general); a 10-year FTC carryforward and a 1-year carryback; the repeal of the alternative minimum tax 90 percent FTC limit; and modified treatment of aircraft leasing and shipping income. From a Canadian perspective, possibly the most significant proposal is a temporary tax break for repatriated income in the form of an 85 percent dividends-received deduction under certain conditions (Code section 965).

A US corporation can elect to deduct 85 percent of the "cash dividends" it receives from a controlled foreign corporation (CFC) during its tax year that began before the JCA's enactment or within one year thereof. Cash dividends include cash included in gross income as dividends and cash distributed from a CFC during the election year and included in gross income as previously taxed income to the extent of subpart F inclusions by the US shareholder during the same year. The dividend must exceed a historical base period average of dividend and other repatriation amounts. The deductible amount is reduced by increased CFC indebtedness to a related person (other than another CFC) incurred to pay the dividend. The proposal's purpose is reflected in the requirement that an amount equal to the dividend (but generally not exceeding US$500 million) must be invested in the United States pursuant to a domestic reinvestment plan approved by the taxpayer's top officer before the dividend is paid. The dividend reinvestment may be satisfied through hiring and training, infrastructure, R & D, capital investment, or financial restructuring expenditures for the purpose of job creation or retention.

The dividends-received deduction presents US-based multinationals with significant new tax-planning opportunities and challenges. To evaluate the optimal quantum to be repatriated from a CFC in order to access the deduction, one must assess the level of cash dividends required to exceed a historical base-period average. That evaluation requires modelling to compare the new temporary measure with the standard deemed credit mechanism under Code section 902 and an assessment of the group's ability to distribute cash, the distribution's FTC impact, the Canadian part XIII tax cost of repatriation, and the actual need for the funds' US reinvestment. In a typical situation, if a Canadian sub of a US parent has undistributed retained earnings not previously subject to tax in the United States, a qualifying distribution may yield a result very similar to that under the current section 902, because the FTC is limited to the 15 percent portion of the dividend that is subject to tax. Naturally, the incentive to repatriate funds to the United States is significantly greater for subs that have not paid tax on earnings and profits (such as synthetic NROs and certain exempt resource companies) and for CFCs located in lower-tax jurisdictions, or if the ability to use US FTCs is limited. Tax and treasury officers must assess the short- and long-term impact of the temporary measure on their worldwide effective tax rates and determine whether a repatriation or redeployment opportunity exists; the analysis may be time-consuming and should begin as soon as possible.

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Ontario RST Prosecutions

Ontario's ever-widening retail sales tax (RST) net, which is meant to catch services related to computers or computer software, provides a lone exception for services related to custom computer programs. In practice, however, that exception has proved so elusive that when services are provided they often still require the charging, collection, and remittance of RST. Many Ontario recipients or providers of such computer services have taken a "heads down" approach, leaving it to Ontario to find any transgressions on audit. Now Ontario, it seems, has raised the stakes, taking full-scale criminal action against companies that it perceives as evading their RST obligations.

To help publicize this initiative, Ontario's October 28, 2004 press release draws taxpayers' attention to the successful prosecution of two computer companies on charges of tax evasion. The release notes that the computer companies (one in Burlington and one in Cornwall) were convicted of tax evasion for failure to remit RST collected from customers; the companies were fined $48,000 and $54,992, respectively. An officer of one company, who also pleaded guilty to directing and participating in the company's offences, was fined $12,500. The fines were in addition to the required payment of the original RST owing, plus civil penalties and interest.

These cases involved what appeared to be the collection and non-remittance of tax, but there is no reason why prosecution could not be extended to businesses that knowingly hide from their obligations to pay or collect RST due on services related to computers or computer software. Section 44(1) of the Ontario Retail Sales Tax Act (General Penalty) outlines the offence by which a person knowingly contravenes the obligation to pay RST: section 44(2) (Penalty for Failure to Collect Tax) is aimed at vendors that knowingly fail to collect the RST. It is likely that the Crown could succeed in a prosecution by proving something less than knowing non-compliance—for example, if the taxpayer or vendor was "wilfully blind" to its obligations.

By initiating voluntary disclosure, a taxpayer or vendor that is in a position of non-compliance can still escape criminal action and all related criminal or civil penalties. Although full and complete disclosure is required, the only obligations remaining are the original RST obligation and the payment of related interest. Time is of the essence: the disclosure "cannot be prompted by a request for access to a taxpayer's business records or other ministry action."

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Imperial Oil Reigns

The FCA recently allowed in part the appeal in *Imperial Oil* (2004 FCA 361) from the TCC decision that allowed a subparagraph 20(1)(f)(i) deduction and a subsection 39(2) capital loss for the foreign exchange (FX) loss associated with debt repayment. (See "Imperial Oil Reined In," *Canadian Tax Highlights*, April 2004.) The FCA allowed a deduction under subparagraph 20(1)(f)(ii) but not under subparagraph (i), and no deemed capital loss under subsection 39(2).

Imperial argued that the entire FX loss of $27,831,712 was deductible under subparagraph 20(1)(f)(i); alternatively, 75 percent thereof ($20,873,784) was deductible under subparagraph 20(1)(f)(ii) and 25 percent was a deemed capital loss under subsection 39(2). The Crown argued that subparagraph 20(1)(f)(i) permitted a deduction for the original issue discount of $1,229,181, and that the difference between that amount and the redemption cost was a deemed capital loss under subsection 39(2). The TCC allowed a deduction of $1,548,325 under subparagraph 20(1)(f)(i) and a capital loss of $26,283,387 under subsection 39(2). (Inco intervened in the appeal because of the similarity of its appeal pending in the TCC; Inco lost in the TCC a week before the FCA's decision in *Imperial Oil* [2004 TCC 468]).

At the FCA, Imperial relied solely on its alternative argument for a subparagraph 20(1)(f)(ii) deduction. The FCA upheld the *Gaynor* principle and rejected the TCC's view that *Gaynor* applied only to the computation of capital gains and losses: in a computation required by a statutory formula, the amount of foreign currency must be converted to Canadian dollars at the conversion rate prevailing at the time of the particular transaction, meaning at the time Imperial's debt was issued and again when it was redeemed or repaid.

Crown's position	*Imperial's position*
(A) Principal amount $102,517,158	(A) Principal amount $129,119,689
(B) 97% of (A) $99,441,463	(B) 97% of (A) $125,246,098
(C) Proceeds of issuance $101,287,977	(C) Proceeds of issuance $101,287,977
Is (C) less than (B)? If no, subparagraph (i) applies.	Is (C) less than (B)? If yes, subparagraph (ii) applies.

The meaning of "principal amount" was crucial to whether the deduction was allowed under subparagraph 20(1)(f)(i) or under subparagraph (ii); the phrase is defined in subsection 248(1) as "the maximum amount payable on account of debt immediately before it is redeemed." The Crown argued that the principal amount must be fixed at the date the obligation was issued, an assumption that on the facts led to a conclusion that subparagraph 20(1)(f)(i) applied. In applying *Gaynor* to the determination of the principal amount, the FCA said that a principal amount can increase between the time it was issued and the time immediately before it is repaid, but only if the increase is mandated by a contractual term governing the debt: the definition of "principal amount" refers to the "amount that, under the terms of the obligation or any agreement relating thereto, is the maximum amount . . . payable on account of the obligation." In the case of an FX loan, it is implicit that repayment in Canadian dollars will be different from the Canadian dollar equivalent borrowed.

The FCA said that the taxpayer's methodology was more straightforward; for the purposes of the first condition in subparagraph 20(1)(f)(i) (see the table above), the phrase "principal amount" must be determined at the date of redemption, because only at that later time can the maximum amount payable be determined. Accordingly, the first condition in subparagraph (i) was not met, and therefore subparagraph (ii) applied. Subsection 248(26) did not support the proposition that the principal amount of an FX debt is the amount at its date of issuance. Furthermore, nothing in the language of paragraph 20(1)(f) itself limited its application to original issue discounts; that position was also inconsistent with the Crown's position on commodity-based loans. Moreover, the FCA said that the Crown's interpretation did not correctly apply the *Gaynor* principle and amounted to a deduction measured in 1989 for an amount paid and deductible in 1999. However, the FX capital loss under subsection 39(2) was denied; subsection 248(28) (like its predecessor subsection 4(4)) precludes what amounts to a double deduction. The formula that allows 75 percent (now 50 percent) of the redemption cost as a deduction in subparagraph 20(1)(f)(ii) is basically a current deduction for a loss sustained on capital property; a further loss would be double counting.

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IRS on Qualified Dividends

IRS Notice 2004-70, October 8, 2004, provides guidance on the extent to which amounts received on or included in income after that date by US individual shareholders of foreign corporations may be treated as qualified dividend income eligible for the reduced (15 percent) dividend rate. (The US Jobs and Growth Tax Relief Reconciliation Act of 2003 reduced the rate, effective for tax years beginning after 2002 and before 2009. See "US Tax Bill: Dividends," *Canadian Tax Highlights*, June 2003; "US Dividend/Capital Gain Rates," *Canadian Tax Highlights*, November 2003; and "US Reduced Dividend Rate," *Canadian Tax Highlights*, December 2003.) Before regulations are issued, taxpayers may rely on the notice, which provides more definitive rules for US shareholders of Cancos subject to US anti-deferral rules.

Dividends received from domestic corporations and qualified foreign corporations qualify for the reduced rate; the latter includes any foreign corporation (1) that is incorporated in a US possession, (2) that is eligible for the benefits of a comprehensive US income tax treaty, and (3) whose stock is "readily tradeable on an established securities market in the United States." Excluded is a foreign corporation that, for its taxable year in which the dividend is paid or the preceding year, is a foreign personal holding company (FPHC), a foreign investment company (FIC), or a passive foreign investment company (PFIC); controlled foreign corporations (CFCs) are not excluded.

Generally, income earned by a foreign corporation, such as a Canco, from its foreign operations is not subject to US tax in the US shareholder's hands until it is actually distributed as a dividend, although the CFC, FPHC, and PFIC anti-deferral regimes may tax a US shareholder on undistributed earnings.

A CFC generally is a foreign corporation in which US shareholders own more than 50 percent of the total vote or value. A US shareholder is a US person who owns at least 10 percent of the combined voting power of all stock entitled to vote. A CFC's US shareholders must generally include their pro rata share of subpart F income (dividends, interest, rents, and royalties) in their gross income, whether or not it is actually distributed. If a US shareholder sells its CFC stock, any gain from the sale is generally reported as a section 1248(a) dividend to the extent of the CFC's untaxed undistributed earnings and profits. Because the Code does not exclude CFCs from the definition of "qualified foreign corporations," actual CFC dividends are treated as qualified dividend income if the CFC is otherwise a qualified foreign corporation and other requirements are met (section 1(h)(11)). Subpart F inclusions are not, however, treated as qualified dividends. Distributions from a CFC of previously taxed income are excluded from gross income and are thus not treated as a dividend and not subject to US tax.

A foreign corporation is an FPHC if (1) at any time during the tax year, more than 50 percent of the total combined vote or value is owned by five or fewer US persons, and (2) at least 60 percent (50 percent after the first year as an FPHC) of the corporation's gross income is FPHC income (dividends, interest, and royalties). US shareholders are taxed currently on their pro rata share of the FPHC's undistributed taxable income for the year. FPHCs are specifically excluded from the definition of "qualified foreign corporations"; thus, dividends therefrom do not enjoy the reduced dividend rate, nor do deemed distributions of FPHC income. Dividends from a CFC that is also an FPHC are tainted by the FPHC status and do not enjoy the reduced dividend rate. The American Jobs Creation Act of 2004, signed into law on October 22, 2004, repeals the FPHC rules, effective for taxable years after December 31, 2004; this is a welcome change for many caught by the broad FPHC attribution rules. Under the Code, a foreign corporation cannot be a qualified foreign corporation if it was an FPHC in the year preceding that in which the dividend is paid; thus, dividends from a Canco that was an FPHC in 2004 may not qualify in 2005 for the reduced rate even if all other requirements are met.

A foreign corporation is generally a PFIC if (1) 75 percent or more of its gross income for the taxable year consists of passive income (dividends, interest, rents, and royalties), or (2) 50 percent or more of its assets produce, or are held for the production of, passive income. In contrast to the CFC and FPHC regimes, US PFIC shareholders are taxed on excess distributions determined under section 1291. Amounts allocated to the current tax year and the pre-PFIC holding period (if any) are included as ordinary income in the current year. Amounts allocated to other years in the PFIC period are taxed at the highest US ordinary income tax rate (currently, 35 percent) plus an interest charge to reflect the benefit of deferral. US shareholders may elect qualified electing fund (QEF) treatment to generally avoid the excess distribution regime and be taxed currently on their pro rata share of the corporation's ordinary earnings and net capital gain, distributed or not; a mark-to-market election also generally avoids the excess distribution regime.

Like FPHCs, PFICs are specifically excluded from the definition of "qualified foreign corporation"; dividends therefrom do not qualify for the reduced rate, nor do amounts included in gross income under the QEF or the mark-to-market regime. PFIC status is determined vis-à-vis a particular shareholder; dividends from such a corporation may be qualified dividend income for some shareholders and not for others. A CFC that is also a PFIC is generally not treated as a PFIC vis-à-vis a US shareholder for tax years after 1997; actual distributions of its non-previously-taxed earnings and profits are treated as qualified dividend income if it is otherwise a qualified foreign corporation and other requirements are met.

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Section 116 Applications

The application requirements for a section 116 clearance certificate regarding the disposition of taxable Canadian property by a non-resident were recently changed in form T2062, "Request by a Non-Resident of Canada for a Certificate of Compliance Related to the Disposition of Taxable Canadian Property." The amended form includes a reference to a penalty for failure to comply, new types of information that must be provided on the form and in supporting documentation, changes in the required details concerning the property being disposed of, and new elections to be filed for the property. Submitting an incomplete form may delay the certificate's issuance.

■ A non-resident vendor is still expected to obtain a business number (BN) when applying for a section 116 certificate for use on the corporate return filed for the taxation year when the taxable Canadian property is disposed of. The new form specifies that a non-resident with no BN will be issued a temporary subsidiary ledger (SL) number until a Canadian tax account number is received. An application for a BN must be made to the Tax Services Office to which the application for the certificate was sent, and not, as previously, the International Tax Services Office.

■ A non-resident applicant for a certificate must now indicate its country of residence, but it need no longer include an affidavit signed by a commissioner of oaths or a notary public confirming its residency status.

■ The description of property being disposed of is expanded to include business property and designated insurance property. Applications for proposed dispositions of business assets, shares, or partnership property must now include a copy of the offer to purchase. All details of the property being disposed of must now be reported in Canadian dollars.

■ If the disposition relates to shares, a copy of the sales agreement is now required if the disposition has occurred: previously, the corporate resolution regarding the sale could be submitted as an alternative. A copy of any election previously made on the property must be provided, now including an election under subsection 45(2) or (3) regarding a change in the use from personal to income-producing or vice versa.

■ A trust applicant must now record its trust account number on the form.

■ Form 2062A, "Request by a Non-Resident of Canada for a Certificate of Compliance Related to the Disposition of Canadian Resource or Timber Resource Property, Canadian Real Property (Other Than Capital Property), or Depreciable Taxable Canadian Property," has undergone similar changes.

Effective after 2003, the CRA began to enforce the penalty for all non-residents that do not notify it within 10 days of disposing of taxable Canadian property, with certain exceptions.

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Shares Sold Under an Earnout

The CRA released *Interpretation Bulletin* IT-426R, "Shares Sold Subject to an Earnout Agreement," on September 28, 2004. Former *Interpretation Bulletin* IT-426 also allowed the cost recovery method of reporting capital gains or losses on a disposition of shares subject to an earnout agreement if certain conditions were met; the revised bulletin clarifies the method's application.

An agreement for the sale of a corporation's shares may stipulate that the quantum of proceeds of disposition be at least partially determined under an earnout clause, by reference to future earnings generated by the corporation's underlying assets. It is usually impossible to determine, accurately and within a reasonable time after the sale, the gain or loss realized on such a sale. The CRA confirms its acceptance of the cost recovery method to report such a gain or loss on the sale of shares if conditions in IT-426R are met.

■ Under the cost recovery method, the vendor reduces its adjusted cost base (ACB) of the target company shares as amounts on account of the sale price become determinable. Once an incremental amount exceeds the drawn-down ACB, that excess is considered a capital gain realized at the time that the amount became determinable, and the targetco shares' ACB becomes nil. All subsequently determined earnout amounts are treated as capital gains at that later time.

■ Paragraph 2(d) expands on the condition that the term of the sale agreement's earnout feature cannot extend more than five years from the end of the targetco's first taxation year after the sale. For this purpose, the CRA considers that such an earnout feature ends when the last contingent amount may become payable under the agreement.

■ Paragraph 2(f) adds the new condition that the vendor must be a Canadian resident for the purposes of the Act.

■ When the cost recovery method is used to report a capital gain on a share that was at the time of disposition a "qualified farm property" or a "qualified small business corporation share" per subsection 110.6(1), the taxpayer can claim the capital gains deduction as per subsection 110.6(2) or (2.1), respectively (paragraph 9 of IT-426R).

■ Paragraph 5 clarifies that an amount becomes determinable when it is capable of being calculated with certainty and the taxpayer has an absolute but not necessarily an immediate right to be paid.

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Owner-Manager: Year-End Tips

Year-end tax planning cannot usurp planning throughout the year, but there is still time for busy owner-managers to productively focus on some issues before year-end.

■ Submit requests for fairness relief related to the 1985 to 1994 taxation years before 2005, when a 10-year limit begins.

■ Draft rules on the deductibility of interest and other expenses, effective for tax years beginning after 2004, allow losses only for a business or property with a "reasonable expectation of profit"; disallowed losses cannot be carried forward. Changes to the draft are anticipated.

■ For Quebec tax purposes, deductions for investment expenses are limited to investment income earned in the taxation year, effective March 30, 2004; active business and rental income expenses are not affected.

■ Most government and court fines and penalties imposed after March 22, 2004 are not deductible; not covered are fines or penalties under private contracts (such as penalties for late performance), the Excise Tax Act, the Air Travellers Security Charge Act, and the GST/HST portions of the Excise Tax Act.

■ Make charitable and political contributions before 2005. Benefits are limited for a charitable donation under a tax shelter or other arrangement (for example, buy-low, donate-high arrangements).

■ The 10-year reserve for 1995 additional business income ends in 2004, when the remaining 15 percent (up from 10 percent in 2003) is included in income. Additional personal income tax may result.

■ Determine the salary-dividend mix for an owner-manager and other family members to minimize overall taxes. Consider the individual's marginal tax rate, the corporation's tax rate, provincial health and/or payroll taxes, and CPP contributions, and maximize RRSP contribution room. Salaries and bonuses are preferred if the combined federal/provincial corporate tax rate exceeds 20 percent (generally, taxable income above $250,000 for

2004). Tax is deferred if the corporation retains income when its tax rate is less than the individual's.

■ Salaries and bonuses should be accrued before the business's year-end—and paid within 179 days thereof—to be deductible; they can be loaned back (after tax) to satisfy cash needs. It may be beneficial to pay a reasonable salary to a spouse or child who provides services to the business and is in a lower tax bracket.

■ The corporation may pay out cash tax-effectively as capital dividends, return of capital, or dividends that generate a refund of refundable dividend tax on hand.

■ Shareholder loans to the corporation may carry deductible interest to reduce active business income to the $250,000 threshold (higher in some jurisdictions).

■ Depreciable assets must be purchased by and available for use at the corporation's year-end for the taxpayer to claim CCA. CCA rates have increased for new computer equipment and broadband, Internet, and other data network infrastructure equipment purchased after March 22, 2004.

■ Additional reserves for doubtful accounts receivable or inventory obsolescence should be identified and claimed at year-end.

■ Consider deferring dispositions that trigger income and tax until after year-end.

■ Taxes on doing business vary significantly across Canada, and may be reduced by tax incentives or holidays. For example, Ontario has a tax credit for salaries and wages paid to apprentices in qualifying skilled trades, and a 10-year holiday for business education, capital, and employer health taxes for businesses that invest in northern Ontario.

■ Goods sold to related businesses must be resold to third parties before year-end.

■ Intercompany charges should be reviewed for reasonableness given changes in the economy. To reduce overall taxes of a related corporate group, consider replacing intercompany interest-free loans and equity with interest-bearing debt and charging a reasonable markup for services.

■ A shareholder's debt to (or loan from) a corporation generally should be repaid no later than one taxation year after it is incurred.

■ Various strategies can reduce federal and provincial taxable capital.

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New Guidance on SR & ED

The CRA's "Pulp and Paper Sector Guidance Document," issued September 30, 2004, provides additional SR & ED guidelines for the industry. (See http://www.cra-arc.gc.ca/taxcredit/sred/publications/pulp/pulp-e.html.) Although specifically designed for the pulp and paper sector, many of the guidance document's principles apply directly to other manufacturing industries. The guidance is a valuable reference tool in the evaluation of project eligibility and the treatment of expenditures, which can be a very complex exercise in the manufacturing sector.

The guidance document is intended to help the pulp and paper industry determine whether activities are eligible for SR & ED investment tax incentives; the costing of an SR & ED claim and tax rules such as recapture on materials transformed are not addressed. Pulp and paper companies conduct significant experimental development to develop new processes and products to meet new market conditions, meet new product requirements, and comply with new regulations. Most experimentation is performed in a shop floor environment involving full-scale production equipment and processes comprising a sequence of complex steps, presenting a major challenge to distinguishing commercial activities from experimental SR & ED.

The guidance document provides much-needed assistance for the industry and the CRA to evaluate whether eligible SR & ED trials are experimental production (EP/ED)—which involves greater potential qualified expenditures—or commercial production (CP/ED). The guidance starts from the premise that, in this sector, any product resulting from a trial is very likely to be sold; thus, a sale is not confirmation of CP/ED and is in fact irrelevant in distinguishing EP/ED from CP/ED. Only technical factors should be used to distinguish them, such as changes to process inputs or in the combination of inputs; changes or potential changes to product, runability, or production rate; changes or process configuration or characteristics; and testing under application conditions (beta testing).

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Patronage Deduction

The September 16, 2004 draft amendments reflect proposals in the federal 2004 budget, including limiting patronage dividend deductions, effective for taxation years ending after March 22, 2004, to payments between arm's-length parties whether declared before or after that date (except for cooperatives and credit unions).

Under the current rules, taxpayers may deduct qualifying patronage payments made to customers. The allotment must be "pursuant to allocations in proportion to patronage," by reference to rates determined by quantity, quality, and/or value measures for each category of goods, products, or services. Allocations to members made out of

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profits from business with non-members cannot be deducted, although they may be carried forward. The patronage dividend is income to the recipient (if it relates to deductible costs from its business or property income); it suffers part XIII tax when it is paid to a non-resident.

In the past, some corporations have elected to pay patronage dividends as an economically effective means of reinforcing customer relationships in domestic and export markets. A corporation's board of directors in practice considers the business's cash needs and determines the profitability on a particular class of goods and whether a particular customer has contributed cash in excess of immediate business needs; the board may elect to share some (say, 25 to 33 percent) of any excess profitability with the customer. Producers may earn higher margins of profit on certain classes of products sold to customers who distribute those products into particular export markets due to factors such as exchange rates, local product preferences, differences in production and materials cost, and government investment and export incentives. Under OECD principles, these transactions may be considered arm's length, even if the producer and customer may be legally related parties.

Some taxpayers may have abused the current system by paying out a disproportionate amount of their overall profits as patronage payments. Finance is concerned that entities that are neither cooperatives nor credit unions may use patronage payments in ways that erode the Canadian tax base—for example, a payment by a wholly owned Canadian sub to its US parent that is designed to eliminate the sub's Canadian tax liability and leave behind only part XIII tax. However, the transfer-pricing rules and GAAR must also be navigated before such an allocation can pass muster. Nevertheless, the proposals prevent any persons, other than cooperatives and credit unions, from deducting patronage payments paid to non-arm's-length persons, as determined by the legal ownership of producer and customer regardless of whether the parties are economically at arm's length. The proposals deny a corporation the opportunity to share profitability with a customer that is at arm's length economically (but not by share ownership) as an inducement to continue its purchasing patterns, or with a corporate group member that has sourced some of its product from its Canadian sub or joint venture. The proposals thus disadvantage many economically arm's-length transactions that mirror third-party transactions and eliminate a valuable export incentive for Canadian producers to reward bona fide cross-border customer relationships.

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Foreign Tax News

Treaties

On September 7, 2004, Canada and **Azerbaijan** signed a tax treaty. The withholding rate for dividends between affiliated companies is 10 percent (15 percent otherwise); for interest, 10 percent; and for royalties on computer software, patents, and information concerning industrial, commercial, or scientific experiences, 5 percent (10 percent otherwise). The treaty enters into force following ratification in both countries and has effect in respect of tax withheld at source on amounts paid or credited to non-residents from the beginning of the first calendar year following. For all other taxes, the treaty has effect for taxation years following the entry-into-force calendar year.

A new treaty between Canada and **Belgium** entered into force on October 6, 2004, replacing the 1975 treaty. The treaty is effective for withholding taxes on amounts paid or credited to non-residents after 2003 and, for other taxes, for taxation years beginning after 2003.

Canada

In April 2004, Canada signed the multilateral Convention on Mutual Administrative Assistance in Tax Matters, agreeing only to the exchange of tax information, covering 83 bilateral tax agreements. The convention provides a stable framework for countries to share tax information multilaterally, assist in tax collection, and deliver documents. The agreement covers the Income Tax Act and the Excise Tax Act. The full text of the convention is available for download on the OECD Web site (http://www.oecd.org) or from the Foundation's library.

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