CANADIAN TAX *Highlights*

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SPC Grandfathering

Revised *Income Tax Technical News* (ITTN) no. 31R, released November 24, 2004, confirms the new effective date for the CRA's administrative practice change concerning single-purpose corporations (SPCs) and the details of the related grandfathering rules.

The revised ITTN confirms that the CRA will change its administrative policy of not assessing a taxable benefit on a shareholder for the use of an SPC's property, effective after December 31, 2004. (See "SPC Benefit Eliminated," *Canadian Tax Highlights*, July 2004.) The revised ITTN also includes a new paragraph on the transitional relief for dwellings that were under construction before and after the policy change.

The term "single-purpose corporation" is not defined; the CRA uses the term to describe a corporation that holds residential real property in the United States for the personal use or enjoyment of the shareholder. Under its previous administrative policy, the CRA did not subject the shareholder to the shareholder benefit rules in subsection 15(1) if certain conditions were met—for example, if the corporation's only objective was to hold the residential US real property for the shareholder's use or enjoyment.

The original version of ITTN no. 31, released on June 23, 2004, announces an end to that administrative policy. At the Canadian Tax Foundation's 2004 annual conference, the CRA said that it would delay the implementation of the new policy until January 1, 2005. ITTN no. 31 says that the previous administrative policy of not assessing a shareholder benefit will no longer apply for any new property acquired by an SPC or to a person who acquires an SPC's shares, unless the acquisition is the result of the death of the individual's spouse or common-law partner.

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The CRA says that its previous administrative policy continues to apply to any renovation or addition to the dwelling acquired before 2005 or under construction on December 31, 2004. For greater certainty, a dwelling is considered to be under construction when the foundation or other support has been put in place. Transitional relief is not provided if vacant land has been acquired but the foundation or other support has not been put in place. Similarly, the CRA will not provide transitional relief if land with an existing building was acquired before 2005 but the taxpayer intends to demolish the existing building and construct a new dwelling on the land.

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Newco GST Registration

In various types of corporate reorganizations, it is common for a new subsidiary corporation (Newco) to acquire an existing business's assets. For a variety of commercial reasons, Newco may not carry on the business; it may be wound up or amalgamated with its parent company immediately after the purchase. Given that GST is generally payable on most supplies of property and services, is Newco entitled to register for GST so that it can make a section 167 election to relieve the application of GST to the purchase of the business? In the absence of such an election, can Newco register and recover the GST payable on the purchase by claiming input tax credits?

The GST registration rules in ETA section 240 provide that a person who makes taxable supplies in Canada in the course of a commercial activity engaged in in Canada must generally register for GST. A person who is not required to register but is "engaged in a commercial activity in Canada" may apply to voluntarily register for GST. Although a "commercial activity" is defined rather broadly to include a business and an adventure or concern in the nature of trade, the commercial activity must exist before the registration rules begin to operate. Fortunately, special deeming rules in ETA subsection 141.1(3) deem anything done in relation to acquiring, establishing, or ceasing a commercial activity to have been done in the course of a commercial activity; thus, a person in the process of establishing a commercial activity is entitled to voluntarily register for GST before actually engaging in the commercial activity. (The CRA guidelines are set out in *GST/HST Memorandum* 2.3, "Voluntary Registration," May 1999.)

On the basis of these rules, the CRA indicated in *Policy Statement* P-045, "Butterfly Transactions," November 9,

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1992, that a newco incorporated "solely for purposes of facilitating the transfer of property between two other corporations" may voluntarily register for GST on "an administrative basis" even though it will be wound up immediately after the sale. However, the CRA recently indicated that it will not allow a newco to voluntarily register if it will be amalgamated immediately after the sale; the CRA distinguished P-045 because the newco in the example was subsequently wound up and not amalgamated with its parent. Given that the GST rules for amalgamations and windups are substantially the same, it is difficult to rationalize the different treatment. Similarly, the CRA has also concluded that a newco is not entitled to register for GST when it is incorporated for the purpose of purchasing assets from its parent and the parent immediately sells the newco shares to an unrelated third party who immediately thereafter winds up or amalgamates the newco.

The CRA's policy on registration is troubling because newcos are commonly used to effect various corporate reorganizations: in some cases, the CRA has cancelled GST registrations retroactively. Unfortunately, it may be prudent to consider delaying the amalgamation or windup of a newco until it has made taxable supplies in order to ensure the newco's entitlement to register for GST.

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Section 160 on Share Issue

Under section 160, a non-arm's-length transferee of property transferred for less than FMV is jointly and severally liable for any tax owed by the transferor at that time, up to the FMV less any amount paid by the transferee. The rule is intended to prevent a taxpayer from transferring property to a non-arm's-length party to prevent its seizure to pay a tax liability. In *Pendico Investments* (2004-361(IT)G), the CRA employed section 160 in an aggressive and unprecedented manner.

Pendico Investments was a company controlled by a taxpayer's three children; a judgment for outstanding tax had been registered against the taxpayer for about 10 years before the alleged transfer. When the judgment was registered, the taxpayer and his brother were the owners of shares of Laconia Gulf Investments, which over many years owned and developed real estate and owned and managed beverage rooms and clubs. Laconia incurred substantial losses and had outstanding liabilities and contingent liabilities, but no tax liability; it was insolvent, but it owned real estate (with an FMV less than its liabilities). The taxpayer acquired his brother's shares in Laconia. Laconia continued to manage its real estate for several years; the real estate was eventually sold. After payment of encumbrances against the property, Laconia received proceeds of about $235,000, substantially less than its liabilities. Laconia invested in Pendico preferred shares that were redeemable and retractable if non-cumulative dividends were not paid for five consecutive calendar years; on windup, the shares had priority on return of capital over all other share classes.

The CRA assessed Pendico and its shareholders under section 160 on the basis that the subscription for shares by Laconia was a transfer of property by the taxpayer, Laconia's sole shareholder, for the full subscription amount. The CRA said that the preferred shares had an FMV substantially less than the subscription cost, and thus the taxpayer, as Laconia's sole shareholder, transferred the difference to a non-arm's-length transferee. Presumably the CRA assumed that Laconia's cash was the taxpayer's property, which he transferred to Pendico and its shareholders. Pendico and its shareholders appealed, saying, inter alia, that the share subscription by Laconia did not constitute a transfer by the shareholder of any of his property. The parties agreed to allow the appeal but settled the case: judgment was consented to on the basis that Pendico's assessed amount should be the reduction in value of the taxpayer's shares of Laconia, an amount substantially less than both the preferred share subscription price and the difference between that price and what the CRA alleged was the preferred shares' FMV.

The CRA's application of section 160 in this case was novel. If it now represents the CRA's position, great care must be taken in any capital reorganization to determine whether any party has an outstanding tax liability: the CRA may argue that property was transferred for less than FMV to a non-arm's-length party, thereby exposing the transferee to a tax liability and undercutting the perceived net benefits of the reorganization.

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Oil Helps Tax Burden

Statistics Canada's most recent analysis of provincial economies shows that the overall tax burden is still lowest in Alberta; but for the first time Newfoundland and Labrador has the next lowest burden.

There is no perfect single measure of the tax burden in similar jurisdictions, but the ratio of tax collections to gross domestic provincial product (GDPP) provides a rough measure of the relative importance of the tax system in each province. The table shows that once again Quebec had the highest tax burden; in 2002, the latest year for which detailed data are available, collections represented 37.8 percent of GDPP. Reflecting the drop in

Tax Collections as a Percentage of Gross Domestic Provincial Product, 2001 and 2002

	Federal	Provincial	Local	2002 Total	2001 Total
Nfld.	12.3	12.9	1.4	29.2	34.1
PEI	16.7	14.8	1.1	36.0	39.2
NS	15.4	13.3	2.9	34.6	36.3
NB	14.8	13.7	1.7	33.6	34.3
Que.	14.8	16.9	3.2	37.8	40.0
Ont.	16.3	12.0	3.7	34.8	36.8
Man.	14.0	13.8	3.0	33.7	35.3
Sask.	12.6	12.5	3.8	31.4	32.5
Alta.	14.3	7.9	1.9	26.4	26.2
BC	15.5	11.6	2.2	32.2	33.3
Canada	15.4	12.6	3.0	33.7	35.3

the national average ratio from 35.3 percent in 2001 to 33.7 percent in 2002, Quebec's ratio dropped from 40.0 percent in 2001. Alberta's ratio was almost constant at 26.2 percent in 2001 and 26.4 percent in 2002—the lowest of the 10 provinces in each year. Newfoundland and Labrador moved from the third lowest ratio (34.1 percent) in 2001 to the second lowest (29.2 percent) in 2002.

The table also illustrates the relative importance of taxes imposed by the three levels of government and the collections of the public pension plans. Federal tax collections exceed provincial tax collections in all provinces except Newfoundland and Labrador and Quebec; the two ratios are close in most other provinces, except in Alberta, where federal collections are roughly double provincial collections. Local government taxes are small relative to those of the senior levels, and vary from 3.8 percent of GDPP in Saskatchewan to 1.1 percent in Prince Edward Island. Canada and Quebec pension plan collections are more uniform, averaging 2.8 percent of GDPP across the nation.

Further details on these statistics will be available in appendix B of *Finances of the Nation 2004*, to be posted on the Foundation's Web site early in the new year.

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AG on Voluntary Disclosure

The auditor general's November 2004 report on her audit of the CRA Appeals Branch says that the CRA is resolving most income tax and GST objections fairly and impartially, but not always within the CRA's timeliness guidelines. Chapter 6, "Canada Revenue Agency—Resolving Disputes and Encouraging Voluntary Disclosures," discusses the CRA's voluntary disclosure program. The AG found that the program is not applied consistently across the country and that the CRA's administration of the program may go beyond Parliament's intention.

Appeals Branch. The CRA's Appeals Branch reviews objections filed by taxpayers and GST registrants in response to CRA assessments. The AG notes that as of March 31, 2004, the CRA had more than 65,000 unresolved objections worth almost $7.6 billion. In 2003-4, Appeals officials rendered about 48,000 decisions on income tax and GST objections: 37 percent confirmed assessments, 36 percent allowed objections in full, and the remaining 27 percent varied assessments.

Historically, over 93 percent of the Appeals Branch's decisions are accepted by the taxpayer or registrant who objected; in the other 7 percent of cases, the taxpayer or registrant appeals to the TCC or the Canadian International Trade Tribunal. Taxpayers have a right to appeal to the TCC if they have not received a decision from the Appeals Branch within 90 days of filing an objection. However, the AG found that the CRA's timeliness goals for income tax objections exceed 90 days by a wide margin, and that those goals include only the time that an Appeals officer actually spends working on the objection: the time spent waiting for responses from other CRA departments or for issues to be resolved in the courts is not counted. The AG says, "It is not difficult to see why a complicated dispute can take one or two years to resolve." However, the AG observes that most taxpayers appear willing to wait for an administrative decision before they appeal to the courts.

The AG notes that Appeals officers must follow the law and CRA policies, but they can settle when appropriate. For example, an auditor disallowed a large portion of a taxpayer's automobile expenses because the taxpayer had not kept a travel log separating business and personal distances travelled: the taxpayer claimed that the vehicle was used mainly for business purposes. Following a discussion and a review of supporting documents, the Appeals officer and the taxpayer settled on a figure that fell midway between their respective positions.

Voluntary disclosure program. The AG also examined the voluntary disclosure program, which allows taxpayers and GST registrants to correct past errors or omissions without penalty or prosecution and sometimes with reduced interest. The AG noted that in the last four years, the number of voluntary disclosure requests had more than doubled—from 2,500 in 2000-1 to 6,100 in 2003-4. The issues most frequently disclosed by taxpayers and registrants are unreported domestic business income, failure to collect and remit GST, information returns not previously submitted, unreported foreign wages and benefits, and unreported domestic and foreign interest and dividends.

The AG found that requests to disclose errors and omissions are treated differently across the country, and that changes to the program's administration are not reflected in *Information Circular* 00-1R, "Voluntary Disclosures Program," September 30, 2002. For example, the IC does not mention interest relief under the program, although the guidance given to officers says that taxpayers and registrants are expected to pay a reasonable amount of interest. However, that guidance also authorizes officers to consider relief of part of the interest charged on assessments of earlier-year returns by reducing to 4 percent the interest rate for income tax assessments on the years preceding the latest three years for which returns were required under the voluntary disclosure. The guidance also says that exceptional circumstances may warrant interest relief of more than 4 percent, without giving any criteria to consider in making that decision.

The AG found that officers were automatically reducing the interest rate by 4 percent on all voluntary disclosures that covered more than three taxation years, without considering whether the reduced interest was a reasonable amount based on the facts and nature of the disclosure. That approach was thus inconsistent with the CRA's practices in providing interest relief under the fairness provisions. The AG is also concerned about the use of the program's legislative authority to waive or cancel interest and penalties. When the legislation was introduced in 1991, Parliament was told that that authority would generally be used in extraordinary circumstances that were beyond the taxpayer's control, such as disasters, illness, or accidents, and only if the taxpayer had taken a reasonable amount of care in attempting to comply with the tax law. However, the AG found that many disclosures relate to income that was intentionally never reported in circumstances beyond those that Parliament intended to relieve: granting concessions in such cases may not be fair to taxpayers who are in full compliance with the tax laws. The CRA disagrees and says that it has not exceeded Parliament's intentions. The CRA maintains (with the reassurance of Justice) that Parliament's intent is expressed in the bills as passed. Moreover, various parliamentary debates since the enactment of the voluntary disclosure legislation in 1991 have further clarified Parliament's intent regarding the circumstances covered by the program.

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AG Chills Voluntary Disclosures?

The November 2004 report of the auditor general (AG) contained a special section on the voluntary disclosure programs for income tax and GST. Much of the commentary centred on issues such as the difficulty in administering "no-name" disclosures, inconsistency in the years to be assessed, and the disparate treatment across the country of issues such as the waiver or cancellation of interest. However, the AG suggested that the CRA has overstepped legislative bounds by inappropriately waiving or cancelling interest and penalties in situations unintended by Parliament, because they were not beyond the taxpayer's control and the taxpayer had not taken a reasonable amount of care to comply with the Income Tax Act.

Contrary to the AG's viewpoint, both subsection 220(3.1) of the Income Tax Act and section 281.1 of the Excise Tax Act are unrestricted and provide the CRA with unfettered discretion to waive interest and penalties in circumstances that the CRA considers appropriate. The AG based her commentary on the technical notes accompanying the legislation and ignored the basic legal proposition that it is the words of the statute that govern. There are also good tax policy reasons for making the voluntary disclosure policy as broad and receptive as possible, especially in the GST context, where under-the-table operators are costing the government hundreds of millions of dollars in tax revenue. For example, voluntary disclosure brings into the tax system persons who would otherwise remain outside it, either intentionally or inadvertently. The theory is that it is better to encourage those persons to come forward voluntarily than to invest in audit and enforcement efforts that may have a minimal chance of discovering the non-compliance. The CRA has administered the voluntary disclosure policy in a broad and inclusive manner, asking at a minimum that the disclosures be "voluntary"— that is, not precipitated by CRA enforcement action.

Damping the CRA's broad administration of the voluntary disclosure program also risks chilling initiatives by other government departments that employ their own voluntary disclosure programs. A case in point is the Canada Border Services Agency (CBSA), which is in the midst of expanding its own voluntary disclosure policies to cover situations such as GST "wash transactions" on importations. In such cases, GST is not paid on a non-dutiable importation, putting the CBSA out of pocket for GST only (no duties otherwise applying). In many cases, that GST, technically payable by the importer, is fully recoverable by the importer by way of input tax credit (ITC) if the importer imported the goods for consumption, use, or supply in the course of commercial activities. Moreover, if that ITC is not paid within 21 days, interest is payable to the importer. However, the technical operation of customs and GST rules seems to start the clock on interest when the GST becomes payable, and it does not stop until the GST is finally paid, without regard for the maximum of 21 days that the government was out of pocket. (In one case, the potential interest reached $1.3 million over a four-year period). The CBSA is now in the process of expanding its voluntary disclosure policy to waive or cancel this interest charge if the GST owing is disclosed on a voluntary disclosure. This is a sensible move from a policy viewpoint if only because, absent a waiver of interest, the interest penalty alone would be sufficient incentive to discourage an importer from coming forward if it had inadvertently not paid the GST (perhaps because it failed to properly report the importations).

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Back-to-Back Withholding Relief

Two recent favourable advance income tax rulings with separate fact patterns dealt with the question whether the withholding tax exemption in subparagraph 212(1)(b)(vii) (the 5/25 rule) applies on interest paid on cross-border debt if the funds borrowed by a Canco were on-lent through a back-to-back arrangement to a trust or partnership. Neither a trust nor a partnership can directly avail itself of the 5/25 rule.

Under the 5/25 rule, no Canadian withholding tax is exigible on arm's-length interest paid on indebtedness by a Canadian-resident corporation if the terms of the obligation or any related agreements do not require payment of more than 25 percent of the principal amount within five years from the debt's issue. Exceptions exist, for example, in the event of a failure or default under the agreement or if the terms of the obligation or any related agreement change by virtue of legislation or a court decision.

Trusts, which are popular as securitization vehicles because, for example, they can be structured to mitigate capital tax, are not eligible for 5/25 relief, and their financing has traditionally been confined to Canadian sources. (See "Canada-US Treaty: Interest," in *Canadian Tax Highlights*, May 2002.) One ruling (document no. 2004-0094751R3) involved a "back-to-back" lending arrangement with a trust. Canco, a financial services company, originated receivable streams that were sold under a securitization arrangement using a special-purpose trust (SPT) that had a registered charity as its beneficiary. The SPT was formed to purchase and hold receivables in a portfolio of accounts consisting of the revolving arrangements entered into by Canco. Certain Canadian financial institutions extended credit to the SPT to allow it to finance the purchase of receivable streams originated by Canco. The debt was evidenced by investor certificates and consolidated by Canco in its financial statements. The financing conditions of the investor certificates reflected the purchase price that Canco received on the sale of receivables to the SPT. The Canadian lenders informed Canco that they would not extend or renew the existing investor certificates unless the SPT, and ultimately Canco, accepted a substantial increase in the cost of funding and more onerous terms and conditions. Canco attempted to raise financing in Canada, but the most favourable financing for the SPT that maintained the economic viability of the securitization arrangement was obtained from a foreign lender. Canco decided not to borrow because, inter alia, prospective lenders would want to consider Canco's entire business; in contrast, if a trust was the borrower, the lender's credit risk would be isolated. If financing could not be obtained, unwinding the existing securitization platform and implementing a replacement structure would entail significant costs and delays.

To maintain competitive financing and continue the SPT's existence, Canco proposed that a new Canco (Newco) be formed with a head office and principal place of business in a province. The assumption is that Newco borrows from an arm's-length foreign lender and has no other activities. The repayment and other terms of the loan fit the 5/25 rule. The note issued by Newco to the arm's-length foreign lender is assignable. Newco on-lends the funds to the SPT on substantially the same terms and conditions as those entered into with its foreign lender, and a note from the SPT evidences its debt. The CRA ruled that the 5/25 rule applied and that GAAR did not.

A second favourable ruling (document 2004-0092731R3) was issued to a Canadian corporation that borrowed from an arm's-length US source and on-lent to a limited partnership. The terms and conditions of the borrowing were structured to fit the 5/25 rule. The facts were somewhat complicated, but apparently a favourable ruling was issued because the proposed lending arrangement resulted in a lower cost of financing to the project owned by the partnership and a better security arrangement for the partners than would have been available had Canadian lenders been involved.

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Anti-Inversion Hits Canadians

The American Jobs Creation Act contains, inter alia, an anti-inversion provision designed to stop US multinational corporations from expatriating, but many transfers may be caught unwittingly and in some cases retroactively. The impact for a calendar-year taxpayer caught by a 2003 transaction is significant because the filing deadline (including extensions) recently expired.

A corporate inversion is generally a transaction in which either the stock or assets of a US corporation or partnership are transferred to a non-US incorporated entity (a holdco) located in a low-tax or no-tax jurisdiction. A holdco is generally a shell company that is newly formed for the purposes of the inversion; the transaction is primarily motivated by a desire to decrease the US group's worldwide effective tax rate. However, the new anti-inversion provision—generally effective for tax years ending after March 4, 2003—is much broader than the typical inversion transaction and can adversely affect transfers by Canadians of their US operations to a holdco. The anti-inversion provision applies in respect of a USco or interests in a US partnership if either an 80 percent or a 60 percent ownership test is met.

If the 80 percent ownership test is met, the holdco is deemed to be a US domestic corporation for all purposes of the Code and treaty obligations. The 80 percent ownership provision applies in the case of a USco if certain conditions result pursuant to a plan or series of transactions: (1) a holdco acquires directly or indirectly substantially all the assets of a USco (including the stock thereof) after March 4, 2003; (2) the USco's former shareholders hold 80 percent or more (by vote and value) of the holdco stock after the transfer; and (3) the holdco, together with all companies connected to it by a chain of greater than 50 percent ownership (the expanded affiliated group), does not have substantial business activities in its country of formation compared with the worldwide business activities of the expanded affiliated group.

To a limited extent, intragroup transfers are not caught by this provision: for the purposes of the second condition above, holdco stock held by members of the expanded affiliated group is disregarded. For example, if a Canco transfers all of the stock of its wholly owned US sub to a Luxembourg holdco, the anti-inversion provision does not apply because the second requirement is not met: the holdco shareholder who was a shareholder of the USco is ignored because Canco held more than 50 percent of the USco's shares. Unfortunately, in practice many transactions are caught retroactively or will be caught prospectively. For example, if, instead of a single shareholder, the USco has two unaffiliated shareholders who each transfer their shares to the Luxembourg holdco, the provision applies unless the Luxembourg company carries on substantial business activity in Luxembourg. Similarly, if two Cancos (each owned by a husband and wife) both transfer their USco shares to a Canadian holdco, the transfer is caught if the holdco has no substantial business activities in Canada.

Because the "expanded affiliated group" definition does not attribute ownership through a partnership, the provision also applies in the initial example if Canco is the ultimate 100 percent owner, but a partnership (including a hybrid partnership) is interposed as the owner of either the USco or the holdco, and the holdco does not conduct substantial business operations in Luxembourg.

Because the holdco is a US domestic corporation, it is liable for US tax on its worldwide taxable income computed under US rules, including subpart F on account of any holdco subsidiaries; in addition, non-US persons are potentially subject to US withholding tax on any periodic payments, such as dividends, interest, or royalties, paid by a holdco. The provision specifically applies notwithstanding any US treaty obligations. In the case of Canada, the rule directly overrides the residence tiebreaker rule in article IV(3) and the consequent overrides to articles VII, X, XI, and XII. Thus, a Canadian holdco remains subject to Canadian tax: there is no relief from double taxation under the treaty or under subsection 250(5). It is hoped that this new US rule has prompted discussions between the Canadian competent authority and its US counterparts pursuant to article XXIX(2) with a view to broadening the exemption for transfers to a Canco.

If the ownership percentage under the second condition is at least 60 percent but less than 80 percent, the holdco is not treated as a US domestic corporation; however, any applicable corporate-level "toll charges" for establishing the inverted structure are not offset by tax attributes such as net operating losses or foreign tax credits.

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REOP Transition: Losses

On October 31, 2003, Finance issued proposed section 3.1, introducing a statutory "reasonable expectation of profit" (REOP) test for the deduction of business or property expenses. As drafted, the proposal effects a substantive change regarding the availability of losses, even if the losses are incurred in the process of gaining or producing income. The proposal is effective for taxation years that begin after 2004. It may be prudent to set in place precautionary measures before the first affected year begins—before 2005 for taxpayers with a calendar year-end. Where possible, taxpayers should take the time to identify and realize the inherent or suspended losses that may otherwise be extinguished.

Assume that a taxpayer's taxation year is the calendar year. If the taxpayer incurs a loss during its 2004 taxation year in the pursuit of income from a business or property, that loss can be carried back or forward and applied against taxable income of other taxation years. In contrast, a loss incurred during the 2005 taxation year can be applied only against income from other sources in that year, or carried back or forward against taxable income of other taxation years, if the REOP proposal's prerequisites are met. This additional statutory limitation exists notwithstanding that hard (cash) costs were incurred in a bona fide attempt to gain or produce income: it must be reasonable to expect, in that year, that the taxpayer will realize a cumulative net profit over the whole period in which the taxpayer carries on (and is likely to carry on) the business or holds (and is likely to hold) the income-producing property. If the REOP test is not met, the loss otherwise determined for the year from a business or property is eliminated.

Assuming that the REOP proposal is enacted in its current form, existing losses that are inherent in assets currently held by taxpayers (pregnant losses) or losses that have been suspended by technical provisions should be of immediate concern: if those losses are allowed to continue into the post-2004 system without being crystallized, they could be eliminated.

If a taxpayer realizes an inherent loss before the commencement of its post-2004 taxation year, that loss should either be available as a deduction against income from other sources in the year or carried forward or back against such income. Assume, for example, that a taxpayer has a large inherent terminal loss related to a business (a source) that was terminated some time ago because it was not profitable; a few depreciable assets in a particular class represent the loss inherent in the UCC pool. If this inherent terminal loss is at risk of being effectively extinguished through the application of the REOP proposal, the assets remaining in the UCC class should be sold before the commencement of the first post-2004 year. The purchaser must be a person that does not cause the stop-loss rule to apply.

Similarly, a taxpayer with a suspended loss may be at risk of its being extinguished by the REOP proposal. The realization of this suspended loss before the commencement of the first post-2004 year may be more of a challenge than the straightforward sale of remaining assets in a UCC pool. It may be possible to crystallize the suspended loss via an acquisition of control of the taxpayer or a sale of the relevant asset to a person outside the affiliated group. However, acquisition of control raises a number of additional issues. Likewise, the initial sale within the affiliated group may indicate a desire to retain the property for business purposes; it may be possible to effect a sale to a non-affiliated person with a delayed buyback to avoid the superficial-loss rules, although the issues of agency and GAAR must be considered. Depending on the magnitude of the suspended loss, the decision may be a practical one: does the taxpayer accept the extinguishment under the proposals of a future loss that was funded by hard cash or hope that the REOP proposal is amended favourably, or does the taxpayer crystallize the suspended loss and face possible non-recognition because of the risk of an agency or GAAR attack?

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Finance: The Section 119 Fix

Section 119 is a relieving provision intended to prevent effectively the same amount from being taxed under both part I and part XIII, but that intent can be frustrated when section 119 interacts with alternative minimum tax (AMT). Finance has promised to recommend a corrective change.

Under subsection 128.1(4), an individual who emigrates from Canada is deemed to have disposed of most properties held by him at that time for their FMV; any accrued gains deemed realized are taxable under part I. If the individual then receives one or more taxable dividends on such property and later disposes of it, subsection 40(3.7) disallows all or part of any loss otherwise realized on the actual disposition equal to the taxable dividend amount; the disallowed loss cannot be used to offset any gain realized on the deemed disposition on emigration. The accrued gain on the date of departure is taxed under part I at that time and under part XIII when the retained earnings underlying the accrued gain are distributed in the form of taxable dividends.

Section 119 is intended to prevent this double taxation. In computing the tax otherwise payable under part I for the year of departure, section 119 allows a deduction for the lesser of the part I tax attributable to the deemed gain on departure and the part XIII withholding tax that was paid on any dividends received after the individual was last resident and that reduced the loss the individual would otherwise have realized on the property's subsequent actual disposition. However, section 119 does not reduce the individual's AMT for the year of departure, an omission that largely negates the relief from double taxation that section 119 is intended to provide. If an individual is required to pay both AMT and withholding tax on what is effectively the same amount, the effective rate of tax is onerous.

An individual was reassessed for AMT in respect of his year of departure. He had paid part I tax on the deemed disposition of shares of a private corporation that he held at the time of his emigration from Canada. The corporation was subsequently wound up, the individual was deemed to have received dividends on the shares, and part XIII tax was withheld. The deemed dividends reduced his proceeds of disposition, but subsection 40(3.7) prevented him from claiming a capital loss on the disposition of the shares. When he subsequently claimed a section 119 credit against the part I tax on the accrued gain deemed realized on departure, the CRA reassessed him on the basis that he owed AMT in the departure year because the AMT in that year exceeded his part I tax after the section 119 credit was taken into account. The total of the part XIII tax and the AMT far exceeded the part I tax he would have had to pay if he had remained in Canada and disposed of the shares. Fortunately, Finance officials are willing to both discuss and address technical problems with the Act, and they agree that permitting the AMT to prevent a taxpayer from claiming a section 119 credit for the year of departure could result in the double taxation that section 119 was designed to prevent. The director of the Department of Finance's Tax Legislation Division has issued a comfort letter undertaking to recommend to the minister of finance that an amendment be made that will prevent a taxpayer who has emigrated from Canada from being assessed for AMT in the taxpayer's year of departure from Canada due solely to the application of a section 119 credit to that year. It is very likely that the director's recommendation on this technical issue will be followed and that the amendment will bring considerable relief to other former Canadian residents.

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Only in Quebec (Part 3)

Earlier articles discussed the impact of Quebec alternative minimum tax (QAMT) on taxable dividends received from Canadian-resident corporations, and capital gains and stock option benefits realized by Quebec-resident individuals. (See "Dividends Still Preferred (Part 2)," "Only in Quebec," and "Only in Quebec (Part 2)," *Canadian Tax Highlights*, September, October, and December 2001, respectively.) On June 30, 2004, Quebec Finance announced changes that affect the calculation of QAMT retroactive to 2003 and correct the potential QAMT tax costs noted in those earlier articles and summarized below. To date, draft legislation implementing this announcement has not been released.

In the first article, Quebec-resident owner-managers were cautioned that QAMT could apply to taxable dividends received by a Quebec-resident individual because 100 percent of Canadian dividends were taxable for QAMT purposes. For example, in 2002 the effective QAMT rate of 20 percent was higher than the top 16.5 percent marginal Quebec provincial tax rate applicable to dividend income for regular tax purposes. However, Quebec Finance has announced that the QAMT rate will decrease from 20 percent to 16 percent after 2002, when it will be less than the top marginal Quebec provincial tax rates on dividends. The second article cautions Quebec-resident individuals that if a capital gain is realized, a permanent QAMT liability may occur because of the 70 percent QAMT capital gain inclusion rate. For example, in 2002 the effective QAMT rate of 14 percent was higher than the 12 percent top marginal Quebec provincial tax rate applicable to capital gains for regular tax purposes. The Quebec Finance announcement also corrects this problem by adjusting the QAMT rate to 16 percent and increasing the QAMT capital gains inclusion rate from 70 percent to 75 percent after 2002. As a result, after 2002 both the QAMT rate and the top marginal Quebec provincial tax rate are 12 percent. Quebec Finance has also announced an increase in the basic QAMT exemption from $25,000 to $40,000 (not applicable to inter vivos trusts).

Quebec Finance has confirmed that Revenue Quebec will automatically reassess any taxpayer (except a trust) who filed a 2003 Quebec return showing QAMT payable; a trust is not automatically reassessed and must request in writing an adjustment of the affected 2003 return.

Quebec's 2004 budget. An additional compliance burden was introduced in the 2004 Quebec budget for Quebec employees with employer-provided automobiles. Beginning in 2005, such an employee must record in a logbook the number of days an automobile was available to him during the year and the number of personal and employment-use kilometres driven each day. The employee must provide the employer with the logbook by the 10th day following the earlier of the end of the year and the date on which the automobile was last available to the employee. A $200 penalty applies for failure to provide the logbook.

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SR & ED Filings

Under the Income Tax Act, a valid SR & ED claim must include all the prescribed forms, contain all the required information, and be filed on or before the filing due date (18 months after year-end). *Application Policy* SR & ED 2004-02, "Filing Requirements for Claiming SR & ED Carried Out in Canada," dated October 5, 2004, further clarifies the CRA's position on filing requirements.

Filing requirement failure. If prescribed forms are filed on time but do not contain all the prescribed information, the taxpayer is considered not to have met the filing requirements. Similarly, a claim using estimated amounts, a partially completed claim, or a letter expressing an "intent to file" does not meet those requirements. Missing information can be provided up to the filing due date. No extensions are allowed if, by the filing due date, the prescribed forms are not filed or do not contain all the required information. On filing, the CRA reviews SR & ED claims for completeness and advises taxpayers if information is missing. The application policy states that if an SR & ED claim is filed 90 days before the filing deadline, the CRA has sufficient time to determine whether the claim meets the filing requirements and to advise the taxpayer of any deficiencies. Claims for SR & ED expenditures and

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related investment tax credits are denied if filing requirements are not met: current expenditures are general expenses deductible in computing income, and capital expenditures are generally depreciable property included in an appropriate CCA class.

Receipt of a claim. The application policy states that hand-delivered claims will be date-stamped and regarded as filed on that day. Claims filed through first-class mail or daily service are considered filed on the date of the postmark. If the reporting deadline falls on a Saturday, a Sunday, or a statutory holiday, claims are considered filed on time if they are delivered to the CRA or postmarked on the first working day after the deadline; provincial tax administrations may have different requirements.

Amending a claim. If a taxpayer wants to amend a claim during its review, the CRA will consider any information that is related to additional projects or expenditures and provided by the filing due date.

Claim denied for non-filing. The new guidelines allow the CRA virtually no latitude in marginal cases. If an SR & ED claim is denied because it did not meet the filing requirements, a taxpayer may request from the CRA a waiver of the filing requirements under the Act's fairness provisions. Such a request is generally granted in extraordinary circumstances—for example, if flood, fire, postal strike, or other similar events prevent the taxpayer from meeting the filing requirements. It is thus essential for taxpayers to ensure that the prescribed forms are complete in every respect at the time of filing.

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FOREIGN TAX NEWS

United Kingdom

The chancellor's pre-budget report includes new anti-avoidance measures for controlled foreign corporations (CFCs) to ensure that profits are identified according to UK tax rules and that double taxation relief and CFC exemptions are not used for tax avoidance. Other schemes, such as those avoiding tax on debt securities by adjusting repossession and stock-lending arrangements, are also targeted, as are schemes using stripped corporate bonds. Life insurance companies will no longer be able to reduce profits by transferring business from one company to another; draft legislation updates the taxation of life insurers' profits and gains.

Netherlands

A new resolution clarifies the state secretary of finance's position on several international aspects of corporate taxation, including the following: (1) article 12 of the Indonesia treaty applies only to knowhow, not to services; (2) articles 10, 11, and 12 of the Indian treaty contain a most-favoured-nation clause, and the Swiss treaty provides that payments for specialists' services are governed by article 7; (3) to accelerate refunds of Swiss dividend tax, a Dutch parent can forgo 2 percent of the refund, a cost that is said not to be deductible for the purposes of Dutch corporate income tax; (4) transparent limited partnerships resident in a non-treaty state such as Guernsey cannot claim benefits similar to those offered under treaties; and (5) financing activities qualify as a permanent establishment under the Swiss treaty.

People's Republic of China

Revisions to the 1998 transfer-pricing rules bring them into line with current legislation and China's practical issues and attempt to abate increasing revenue loss through "artificial losses." Revisions include a requirement to provide accurate information during an audit and a penalty for failure to do so; authorization for tax authorities to travel abroad to conduct treaty audits; an emphasis on the comparability of "other reasonable" methods to determine arm's-length prices; specific reference to advance pricing agreements; limiting of transfer-pricing investigations and adjustments to three years' duration in normal circumstances and up to five years in unusual circumstances with approval; and the tax characterization of amounts adjusted by audits according to the specific circumstances and with reference to domestic law and treaties.

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