CANADIAN TAX *Highlights*

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AUDIT WORKING PAPER REQUESTS

A task force established by the Canadian Institute of Chartered Accountants (CICA) to consider the CRA's policy on requesting access to accountants' and auditors' working papers recently made a submission to the CRA on the issue. The submission sets out the task force's concerns about the lack of a consistent policy on access to working papers, details international developments that the task force believes are critically relevant to CRA policy and Canadian competitiveness, and offers a principled rationale for limiting requests for access to accountants' and auditors' working papers to exceptional circumstances such as fraud or misrepresentation.

At the Canadian Tax Foundation's 2004 annual conference, CRA officials stated that the CRA would conduct a broad-based consultation with the tax, accounting, and business communities on clarification of its policy, particularly with respect to access to working papers that deal with the analysis of tax provisions, tax liabilities, or reserves. Traditionally, as a matter of policy, requests to examine accountants' or auditors' working papers were not routine, a policy that the task force understands was included in CRA guidelines for obtaining information from accountants. The guidelines also provided that "it is not the policy of the CRA to request a general access to accountants' working papers for the purposes of scrutinizing them in the course of conducting an audit." According to the task force, this policy recognized the inherent tension between an auditor's need to access all relevant tax information for the purposes of preparing an audit of the company's financial statements and the legitimate desire of the company to protect communications with its professional advisers in addressing its need for tax advice.

Despite this longstanding policy, the task force points out that certain regional CRA offices have apparently adopted an administrative practice of initiating broad requests for auditors' working papers. In 2003 and 2004 there were anecdotal reports that general requests for audit working papers frequently emanated from certain CRA offices. The task force says that such broad requests impede efforts by accountants and auditors to facilitate responsible and legitimate disclosure within the self-assessment tax system.

Working papers prepared by an auditor reflect its views on fulfilling its responsibility to probe, question, and exercise its professional judgment for the purposes of forming an opinion relative to a corporation's financial statements. The task force points out that it is important to distinguish between those papers and the working papers generated when the annual tax return is prepared.

The task force recommends that the CRA adopt a clear national policy of requesting working papers and information only in exceptional and well-defined circumstances in order to preserve important values—open and frank communication between auditors, accountants, and their clients (which is critical to the proper functioning of the self-assessment tax system and to an atmosphere of disclosure and compliance), and access to the information required for high-quality audits (which are essential for public confidence in the capital markets). Accordingly, the task force presents a proposed draft policy and protocol, which recommends that the CRA adopt a policy of seeking access to certain information and documents from the taxpayer, its auditors, or its accountants only in "exceptional circumstances." Such circumstances are defined as those in which (1) the CRA has a reasonably well-founded suspicion of fraud, evasion, or other offence under the Act; (2) the taxpayer's source documents have been lost or destroyed, are otherwise unavailable, or are not made available by the taxpayer; and (3) the CRA cannot otherwise obtain sufficient information to evaluate the taxpayer's income tax arrangements, or the taxpayer's source documents do not provide sufficient information for the CRA to properly evaluate a taxpayer's arrangements.

In conclusion, the task force says that the CRA's current regional administrative practice on access to working papers creates a conflict between an accountant's role in the reporting of financial information to capital markets and the efficient functioning of the tax system. Broad CRA powers to question auditors and professional advisers

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about a client's subjective intentions and to obtain access to audit working papers create a paradox, according to the task force. Auditors are being held to a much higher standard of accountability for the accuracy of financial information being provided to capital markets; on the other hand, if left unchecked, the CRA practice of requesting access to audit working papers will create disincentives for clients to speak openly with their auditors and advisers.

According to the task force, other countries, especially Australia and the United States, have crafted a balance between the concerns of capital markets and those of tax authorities that the task force believes the CRA would be wise to replicate. For example, the task force says that limiting requests for working papers to unusual circumstances and otherwise confirming a policy of restraint in the manner articulated by US authorities would achieve the balance of candour and confidentiality that a national policy must recognize. The submission also outlines developments in the United Kingdom and New Zealand that it says the CRA should consider.

The task force recommends the establishment of an internal national review committee within the CRA to assess proposed instances of exceptional circumstances in order to achieve a consistently applied national policy.

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Contemporaneous Documentation

In October 2004, the CRA issued a revised directive instructing field auditors to make formal, time-sensitive requests for a taxpayer's contemporaneous documents at the outset of an audit.

Effective immediately, all CRA field offices have been instructed to issue formal requests for transfer-pricing documentation to taxpayers at the initial stage of an audit and to enforce specific three-month periods for its provision. Such a request by a field auditor is mandatory: the previous directive, issued in March 2003, strongly suggested to the field offices that they obtain the transfer-pricing documentation at the start of an audit. This change in policy is intended to rectify a perceived inconsistency in the use of these letters by various CRA field offices and to increase transfer-pricing compliance.

Field auditors must request the contemporaneous transfer-pricing documentation in all cases in which transactions exist between a taxpayer and a non-resident that does not deal at arm's length with the taxpayer. The CRA will do no pre-screening to determine which taxpayers should receive this request letter, and no distinction is made between taxpayers by virtue of their size or level of revenue: all taxpayers can now expect to receive documentation request letters. This directive is part of the CRA's more assertive approach to transfer pricing; the new mandatory approach does not consider whether taxpayers have been cooperative and compliant in previous transfer-pricing audits.

The request for documentation, pursuant to subsection 247(4), may be in the form of a letter or a query sheet, but it must be either hand-delivered to the taxpayer or sent by registered or certified mail, and it should be made before the field work commences on the transfer-pricing audit. Taxpayers have three months from the date of the letter or query sheet to submit the documentation, with no provision for extensions. If a taxpayer fails to provide the contemporaneous documentation containing the required minimum information within the three-month period, then, for the purposes of the application of the penalty provision in subsection 247(3), the taxpayer is deemed not to have made reasonable efforts to determine and use arm's-length transfer prices. In general terms, a 10 percent penalty applies to the excess of transfer-pricing adjustments (for which the taxpayer did not make reasonable efforts to determine and use arm's-length transfer prices) over a threshold amount (the lesser of 10 percent of gross revenue and $5,000,000).

Three months is a relatively short period in which to respond to such demands for documentation: a taxpayer should regularly review existing documentation to ensure that it has prepared the documentation contemporaneously with the filing due date for the particular taxation year, thus forestalling possible penalties for failure to provide documentation in the event of a transfer-pricing adjustment.

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Trom Electric: Estoppel

The TCC recently considered the role of estoppel in tax appeals in *Trom Electric* (2004 TCC 727). In reporting its income from 1989 to 1994, the taxpayer erred in deducting construction lien holdbacks that were payable but not due to it at its year-end and then adding them back in the following year. In one year, that following the latest statute-barred year, the minister reversed only the deduction of the holdback and argued unsuccessfully that the taxpayer was estopped from reversing the addback of the prior year's deduction.

GAAP permits construction contractors to use the completed contract method to calculate income; the CRA also allows the method as a matter of administrative practice,

but allows no deduction for holdbacks outstanding at year-end. (Although the matter is not discussed in the case, no deduction could have been taken under judicially developed rules related to receivables.) The mistakes did not come to the minister's attention until after the earlier years were statute-barred. The minister reassessed the 1992, 1993, and 1994 years to correct the errors, reversing both the deduction and the inclusion of the prior year's holdback for 1993 and 1994. But for 1992, the minister reversed only the deduction of the holdback, because the addback of the 1991 holdback could not be properly assessed in the statute-barred 1991 year. The taxpayer did not dispute its lack of entitlement to a deduction for the holdbacks, but it argued that the errors in its 1992 income must be corrected by reversing both the deduction of the current reserve and the addback of the prior year's reserve. In response, the minister argued that the taxpayer was estopped from claiming that the holdbacks were wrongly added back in 1992 because the elements of estoppel had been proved: adding back the 1991 holdbacks in the 1992 income was a representation made by the taxpayer; the minister had relied thereon in assessing the 1992 year; and that reliance was to the minister's detriment because 1991 was now statute-barred.

The minister relied on the FCTD decision in *Wilchar Construction* (79 DTC 5086). In *Wilchar*, the taxpayer was estopped from seeking to change its method of reporting income because it had made representations as to its profits for the year in question "by the consistent way in which it calculated them," and the minister had acted on those representations to what would have been his detriment if the taxpayer were permitted to deny those representations. The FCA upheld the decision: there was no legal bar to estoppel because the original method of accounting followed by the taxpayer in reporting its income was not contrary to law; the taxpayer was entitled to defer the recognition of the holdbacks as income but was not required to do so. The TCC in *Trom* also referred to observations in *Goldstein* ([1995] 2 CTC 2036, at 2046):

> Although estoppel is now a principle of substantive law it had its origins in the law of evidence and as such relates to representations of fact. It has no role to play where questions of interpretation of the law are involved, because estoppels cannot override the law. . . . [C]ourts, who have an obligation to decide cases in accordance with the law, are not bound by representations, opinions or admissions on the law expressed or made by the parties.

On the facts, the taxpayer's calculation of its 1992 income was not made in accordance with the Act—in particular, with section 9, which requires the determination of an accurate picture of a taxpayer's profit. Whether an amount must be included in or deducted from income in the determination of profit is a question of law. Because the minister's reassessment was contrary to law, the taxpayer could not be estopped from challenging it. The court acknowledged that the taxpayer may escape taxation as a result, but that fact was simply not relevant and could not be used to justify a reassessment that the minister did not otherwise have the power to make.

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OECD Tax Burdens

The OECD's annual review of revenue statistics was released late last fall. Its measurement of the tax burden—tax collections as a percentage of gross domestic product (GDP)—is a standard commonly used to approximate the overall impact of government in each of the 30 OECD member countries. By this measure, Canada's tax burden is still well below the average, and falling.

On the basis of preliminary figures for 2003 (the latest available), collections of tax by all levels of government

Taxes as a Percentage of GDP
OECD Countries, 2003

Country	%
Sweden	50.8
Denmark	49.0
Belgium	45.8
Finland	44.9
France	44.2
Norway	43.9
Italy	43.4
Austria	43.0
Luxembourg	41.6
Iceland	40.3
Czech Republic	39.9
Netherlands	38.8
Hungary*	38.3
Germany	36.2
Greece*	35.9
Spain	35.8
United Kingdom	35.3
New Zealand	34.8
Canada	**33.9**
Portugal*	33.9
Slovak Republic*	33.1
Turkey	32.9
Poland*	32.6
Australia*	31.5
Ireland	30.0
Switzerland	29.8
Japan*	25.8
Korea	25.5
United States	25.4
Mexico	19.5

* 2002 figures; 2003 data not available.

in Canada represented 33.9 percent of GDP, the 19th highest of all members. The ratios calculated by the international organization differ slightly from those developed by each country's statistical agency: according to Statistics Canada, the ratio of tax collections to GDP was 33.6 percent in 2003. The table shows the relative importance of tax collections in the OECD member countries for 2003 (2002 for nations whose later information is not available). The simple average of the 30 countries, approximately 36.5 percent, is still well above the Canadian level.

In Canada, the ratio of tax collections to GDP dropped from 35.6 percent in 2000, but one of its component parts—the ratio of taxes on personal and corporate income to GDP—registered a larger decline from 17.8 to 15.6 percent over the same period. The 2003 Canadian ratio for taxes on personal and corporate income still represents a relatively high tax burden on personal and corporate income—the 8th highest in the OECD and lower only than that in the Scandinavian countries, Belgium, Ireland, and New Zealand.

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Non-Business Transfer Pricing

When the transfer-pricing rules in section 247 were introduced for fiscal years beginning after 1997, informal assurances were given that the CRA would not apply the rules to loans in non-arm's-length non-commercial transactions. Recently, CRA auditors threatened to impute interest on a non-arm's-length non-commercial cross-border loan.

In many situations, a Canadian resident who lends to a non-resident is not expecting a return on investment and is not motivated by commercial considerations. For example, a parent who lives in Canada may lend money interest-free to a non-resident child to assist the child in acquiring a home or business; unlike a gift, a loan provides protection against the child's creditors (including an estranged spouse). Alternatively, a resident individual may loan money interest-free to a non-resident trust or a foreign corporation owned by a non-resident family member. Subject to our attribution rules, such interest-free loans could be made to a resident individual, corporation, or trust without transfer-pricing concerns. Canada does not levy a gift tax, and the Act imputes interest at a prescribed rate only in specific cases. If a minor child or spouse was a shareholder of a borrowing corporation, the corporate attribution rule could require the lender to report an imputed return; otherwise, there is no imputed interest. Although the CRA gave verbal assurance that it would not apply section 247 to non-commercial transactions, just as the rules' predecessors (sections 69 and 245) were never applied to cross-border non-commercial transactions, it has now threatened to apply the transfer-pricing rules to a taxpayer who, for estate-planning and creditor protection purposes, made an interest-free loan to a non-resident corporation beneficially owned by a non-resident family member.

Subsection 247(2) allows adjustments to a transaction in which a taxpayer and a non-arm's-length non-resident participate either if the terms and conditions are not arm's-length or if arm's-length parties would not have entered into the transaction, which can be reasonably considered not to have been entered into primarily for non-tax purposes. In the former case, adjustments can be made to the quantum or nature of amounts determinable if arm's-length terms and conditions had prevailed; in the latter case, such adjustments presuppose that the parties entered into arm's-length transactions under arm's-length terms and conditions. The former case does not apply because arm's-length parties would not have entered into a non-interest-bearing loan; the latter case does not apply because the loan was clearly entered into primarily for non-tax purposes.

Even if subsection 247(2) technically applied, it would be unfair to apply section 247 in situations where the predecessor rules were sufficiently broadly worded but never applied. The CRA policy is widely known and relied on in non-commercial situations, and taxpayers must be treated consistently vis-à-vis other taxpayers as a basic policy matter. The CRA should carefully consider potentially opening up the rules' application to a multiplicity of loans made by parents to non-resident children.

Information Circular 87-2R (September 27, 1999) places limitations on the application of subsection 247(2), stating that, as a general rule, specific provisions relating to loans to or from non-residents are applied before the more general provisions of section 247. The specific provisions noted cover interest-free or low-interest loans to or from a Canco that may be thinly capitalized. The IC states that it would usually be inconsistent with the spirit of the Act for the CRA to apply the more general provisions of section 247, thereby deeming interest to be received or receivable on intercorporate loans when a loan is made by a foreign affiliate (FA) of a Canco to the corporation, or when a loan is made between a Canco's FAs and subsection 80.4(2) does not apply.

Many specific provisions not mentioned in the IC impute interest on non-interest-bearing loans between non-arm's-length persons, but none apply to a loan to a non-resident corporation owned by a family member. As the FCTD noted in *Cooper* (88 DTC 6525), interest-free and low-interest loans do not constitute taxable benefits in the absence of a specific provision. The CRA should not attempt to impute interest under the general provision in section 247, which is arguably broader than the general anti-avoidance rule in section 245 and contains fewer conditions to its application; in the IC's words, it is

"inconsistent with the spirit of the Act" to apply subsection 247(2). Moreover, a Canadian individual can lend money interest-free to a Canco owned by his or her sibling without the imputation of interest; there is no apparent and clear policy reason for taxing a similar loan to a non-resident company owned by a sibling or a trust of which that sibling is a beneficiary.

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Retroactive Tax Planning

A recently issued technical interpretation (2004-0083251i7, November 18, 2004) says that taxpayers cannot rely on an intergroup management services agreement amended after the fact to report a lower amount of management fees for the year. The CRA said that the amended agreement was unacceptable because it attempted to retroactively change the accounting for the management fees receivable with the sole intention of avoiding an income inclusion for tax purposes. The TI illustrates the importance of ensuring that intergroup agreements as originally drafted produce the desired result, because the CRA may not accept after-the-fact amendments that adjust those results retroactively.

In the TI, two corporations, Holdco and Opco, entered into a written management services agreement under which Holdco was to provide Opco with management services through Holdco's employees, the taxpayers (Mr. and Mrs. X). The original agreement required Opco to pay to Holdco a management fee per annum equal to a certain percentage of Opco's net merchandise sales before taxes, payable monthly or at such other time as agreed. Opco recorded the fees payable to Holdco, which reported them as income offset by wage expense to Mr. and Mrs. X, who in turn reported the wages as employment income.

Mr. and Mrs. X outlined amendments to the original agreement in a letter, presumably to their lawyers, and requested the preparation of the amended agreement. The reply stated, "Further to our recent discussion, we enclose . . . an amended and restated management agreement as of [date]." Fees under the amended agreement were calculated on Opco's monthly sales and were payable monthly (or credited in arrears from time to time throughout the year); they included a performance bonus declared at Opco's sole discretion, determinable and payable or credited as of Opco's fiscal year-end. As a result, according to the amended agreement, Holdco reported lower management fee income in its return for the taxation year already ended.

The CRA said that the real audit issue was whether the amended agreement was valid as of a certain date or whether it was an attempt at retroactive tax planning that was not legally put in place until early in the following taxation year, as suggested by the correspondence. If the amended agreement is valid, the CRA says that the taxpayer should seek a rectification order through the courts; but in the CRA's opinion, the amended agreement was simply retroactive tax planning, an attempt to avoid the consequences of the original agreement. The parties were thus bound by the original agreement, and Holdco must report a higher amount of management fees in income.

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UK: Ramsay and Sale-Leaseback

While the parties in *Canada Trustco* (2004 DTC 6119 (FCA)) were filing their factums in the SCC for the Crown's appeal from the unanimous decision of the FCA, the House of Lords unanimously decided in the taxpayer's favour on similar facts in *Barclays* ([2004] UKHL 51). *Ramsay* ([1982] AC 300 (HL)) did not apply to deny capital allowances (CCA) claimed on a sale-leaseback arrangement, notwithstanding the Inland Revenue's protest that the transaction was not a financing transaction but part of a prearranged scheme to obtain CCA.

Barclays Mercantile Business Finance Ltd. (BMBF), a member of the Barclays banking group, carried on the business of finance leasing. Bord Gáis Éireann (BGE) was building a high-pressure pipeline for transporting natural gas from Scotland to Ireland, financed through a 35 percent EEC grant and loans from a consortium of banks. BGE sold the pipeline to BMBF for approximately £91 million (the actual cost net of adjustments, particularly the EEC grant) and was granted a leaseback. On the same day, BGE entered into a sublease, an assumption agreement, and a transportation agreement with a related company, BGE (UK), which was directly liable to pay the rent due to BMBF under the head lease but was not subject to adjustments in the head lease related to corporate tax matters (mainly tax rates and CCA). If head lease rent increased, BGE (UK) paid the regular sublease rent to BMBF, and BGE covered the increase; if that rent declined, BGE (UK) paid the reduced rent to BMBF and the balance, up to the regular sublease rent, to BGE. There followed a series of transactions formally designed as "security arrangements." The net effect of all the transactions was that the funds passed from Barclays to BMBF, to BGE, to Deepstream (managed by the Barclays' group), to BIM (Barclays' Isle of Man financing company), and back to Barclays. The purchase price did not stay in BGE's hands, the rent was paid from the Deepstream deposits, and BMBF passed to BGE some of the benefit of its CCA. The evidence

was clear that the transactions were part of a larger coordinated scheme, a composite whole, that had been organized and set in motion by an investment banking company in the Barclays group. Accordingly, the Inland Revenue attacked the scheme, relying on the *Ramsay* principle.

The Special Commissioners found that *Ramsay* applied: the sale-leaseback had no commercial purpose or reality. In contrast to commercially driven finance leasing, which provides working capital to the lessee, the capital was unavailable to BGE. BGE sold an asset to BMBF for £91 million, but received no financing: the funds were deposited with Deepstream, which repaid BGE in accordance with the deposit agreement. If the scheme succeeded, BGE received only £8.1 million net (from BMBF's CCA); if the scheme failed, BGE received nothing, because the rent increased to take account of the CCA's non-availability. The trial judge agreed: finance leasing "ordinarily involved the provision of 'up-front finance' to the lessee: a capital sum used to buy the plant or refinance its previous acquisition." BGE owned the pipeline, which was paid for with a loan from a syndicate of banks for which it remained liable even after the transaction with BMBF. The £91 million that BGE purportedly borrowed from BMBF was not available for use in its business.

The Court of Appeal reversed the trial judge, saying that he had erred in law. (See "A New Lease on Life?" *Canadian Tax Highlights*, February 2003.) The House of Lords agreed: *Ramsay* did not introduce a new doctrine to interpreting revenue statutes but "rescued tax law from being 'some island of literal interpretation' and brought it within generally applicable principles." The essence of the *Ramsay* approach was "to give the statutory provision a purposive construction in order to determine the nature of the transaction to which it was intended to apply and then to decide whether the actual transaction (which might involve considering the overall effect of a number of elements intended to operate together) answered to the statutory description." Nor did *Ramsay* stand for the proposition that transactions or elements thereof that had no commercial purpose were to be disregarded. The question is "whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction, viewed realistically," and requires a two-step test: first, on a purposive construction, determine exactly what transaction answers to the statutory description; second, determine whether the transaction in question so answers.

The House of Lords noted that the purpose of CCA is to provide a tax equivalent to depreciation. The legislation requires that a trader incur capital expenditure on the provision of machinery or plant "wholly and exclusively" for the purposes of its trade. In a finance lease, the capital expenditure must be incurred to acquire the machinery or plant for the purpose of leasing it in the course of the trade; the focus is on the lessor as owner, who suffers depreciation and is thus entitled to CCA. The requisite purpose is that of the lessor in making the outlay; BMBF's unchallenged evidence was that the purchase and leaseback was part of its ordinary trade of finance leasing. Arrangements made by the lessee, even if a preordained part of the transaction (what it did with the purchase price, how it funds the rent or uses the plant), have no impact on the lessor, for whom "the transaction is exactly the same"; whether the lessee benefited from the financing or obtained upfront finance is not relevant. Neither the reality of the expenditure nor the acquisition was affected by what happened to the purchase price after BMBF paid it to BGE, by the fact that the money was borrowed from Barclays Bank, or by the character of the collateralized guarantee. The taxpayer was entitled to the CCA claimed.

For GAAR to apply in *Canada Trustco*, the Crown may need to persuade the SCC that economic reality is not only relevant when a transaction is recharacterized under GAAR, but, as recently argued, is also relevant in determining whether there has been misuse or abuse of the statute. In *Barclays*, having regard to the legal and economic reality of the transactions, the House of Lords said that a financing company that acquires and leases assets and receives rent in a financing arrangement involving no actual financing to the borrower can satisfy the purposively interpreted requisites of a statute that allows CCA only on assets acquired "wholly and exclusively for the purposes of the trade," even if the anticipated "return" from engaging in the trade is the benefit from a CCA claim. Given the House of Lords' purposive interpretation of the *Barclays* transaction legally and economically, it may be difficult for the Crown in *Canada Trustco* to persuade the SCC that there is a "clear and unambiguous" tax policy that was misused or abused.

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IRS: Treaty Benefits

IRS Revenue ruling 2004-76 (2004-31 IRB 111) provides guidance on the determination of the applicable US income tax treaty for a foreign corporation that is otherwise treated as a resident of two foreign countries. Revenue ruling 73-354 (1973-2 CB 435), rendered obsolete by the new Revenue ruling, allowed such a foreign corporation to elect to apply the US treaty with either foreign country.

The new ruling analyzes two specific situations in which a foreign corporation, resident under the local law of two foreign countries, is treated as a resident of only one of the countries and is thus not liable for tax in the other, because of an income tax treaty in force between those countries. The foreign corporation is incorporated under the laws of one foreign country (country X) in which it either does or does not have a fixed place of

business to which income is attributable, and its place of effective management is situated in the other foreign country (country Y). Purely under the domestic law of each country, the foreign corporation is liable for tax because of its status as resident in each country. However, under the income tax treaty in force between country X and country Y, the foreign corporation is liable only for tax in country Y: under that treaty's residence article, a foreign corporation otherwise resident in both country X and country Y is "deemed to be a resident only of the [country] in which its place of effective management is situated." Furthermore, the residence articles of the US income tax treaties in force with each of country X and country Y define "resident" to include only a corporation that is liable for tax in the relevant contracting country "by reason of [its] domicile, residence, . . . place of management, place of incorporation, or any other criteria of a similar nature"; the definition does not include a corporation taxable solely on income from sources in that country.

The ruling concludes that in both fact situations, the foreign corporation is a resident under the US income tax treaty with country Y because it is treated as a resident there for the purposes of the X-Y treaty. But under that treaty, the foreign corporation is not subject to comprehensive tax in country X, and is thus not a resident there as defined in the US-X treaty. Accordingly, the foreign corporation is entitled to benefits only under the US income tax treaty with country Y (provided that it meets the limitation-on-benefits article, if any, and other applicable requirements).

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US Deferred Comp Rules

Americans who work in Canada and Canadians who move to the United States may be adversely affected by recent changes to the US deferred compensation tax rules in the American Jobs Creation Act of 2004. The statute tightens the requirements for non-qualifying deferred compensation (NQDC) plans (including arrangements that are not formal plans) for employees, directors, and independent contractors to qualify for a tax deferral, and it imposes potentially large penalties for non-compliance. The new law has significant consequences for executives in the United States; Canadian companies should review their deferred compensation plans to determine the consequences to their US-citizen employees and their Canadian employees who are moving to the United States.

US tax law currently allows employees to defer receipt of all or some compensation and thus defer tax through NQDC plans, which are generally "unfunded, unsecured" promises to pay an amount in the future. Compensation from unfunded plans falls into income on actual or constructive receipt; in a funded arrangement (a secure trust), the income is taxable in the year that the individual's rights are transferable or are not subject to a substantial risk of forfeiture (generally, when the rights are vested). Now, unless an NQDC plan meets the requirements of new Code section 409A, deferred amounts are included in the employee's income and are subject to an additional 20 percent tax and interest at the underpayment rate plus 1 percent on the tax on the deferred amount, from the later of the date of the deferral and the date when there was no substantial risk of forfeiture. New requirements for participant elections, distributions, acceleration, and funding will likely require amendments to most plans.

■ **Participant elections.** If an NQDC participant wants to elect to defer compensation, he must do so by the end of the taxable year preceding the year in which he will perform the underlying services; a newly eligible individual must elect within 30 days of attaining eligibility (applicable for subsequently earned compensation). For performance-based compensation for services provided over a performance period of at least 12 months, the election must be made at least 6 months before the end of the period. The plan or election must include the timing and form of distribution.

■ **Distributions.** Subject to exceptions in regs yet to be issued, plan distributions are permitted only on separation from service (for a key employee of a publicly traded company, no earlier than 6 months thereafter); on the participant's death; at a specified time or pursuant to a fixed schedule (but not on a specified event); on a change of control of the corporation; on an unforeseeable emergency; or on the participant's disability.

■ **Accelerated distributions restricted.** Except as provided by regs, distributions cannot be accelerated; this puts an end to formerly common practices such as "haircuts," in which a participant could receive a distribution at any time if he forfeited a portion of the account balance exceeding the distributed amount.

The new law generally applies to amounts deferred after 2004. Deferrals and earnings on amounts deferred before then (grandfathered amounts) are not caught unless an existing plan is "materially modified" after October 3, 2004. On December 20, 2004, the IRS publicly released an advance copy of Notice 2005-1, the first in a series of guidance directives expected from the IRS and Treasury on new section 409A. The notice provides guidance on the termination and amendment of certain arrangements; defines the arrangements considered to be deferred compensation and defines a change in ownership and control for such purposes; and outlines employers' new reporting and employment tax obligations.

Common Canadian deferred compensation plans may be affected.

■ **Stock options.** Generally, stock options do not trigger NQDC if the plan meets the US incentive stock

option or employee stock option provisions, or if the option's exercise price is not less than the shares' FMV at the date of grant. Many plans meet the FMV test so as to benefit from the 50 percent deduction under paragraph 110(1)(d) of the Act, but options issued by CCPCs need not meet the FMV test to qualify for the deduction. A plan is also problematic if it allows for settlement in cash rather than shares or if it is modified to so allow.

■ **Stock appreciation rights (SARs).** SARs that are granted at FMV and deliver only publicly traded shares upon exercise are not subject to the new rules, because they are similar to stock option plans. There can be no further deferral after exercise; any other type of SAR is likely to be subject to the section 409A rules.

■ **Deferred share unit plans (DSUs).** Many Canadian companies set up phantom stock plans under regulation 6801(d) to provide an employee with phantom units that track the value of shares of the employer or a related company. The DSU value must be distributed within one calendar year after the date of separation from service, death, or retirement. In most cases the income can be deferred for US purposes because the distribution rules are met, although a key employee of a publicly traded company cannot receive a distribution within six months from the date of separation. A key employee includes an officer who is paid annual compensation greater than US$130,000 (adjusted for inflation); a 5 percent owner; and a 1 percent owner who is paid annual compensation greater than US$150,000.

■ **Supplemental employee retirement plans (SERPs).** SERPs typically provide executives with a retirement benefit in excess of a registered plan's limits. A SERP is generally a deferred compensation plan for US tax purposes and must meet the new requirements.

■ **Tax reimbursement plans.** To encourage US-citizen employees to accept a Canadian assignment, many Canadian companies reimburse their US-citizen employees for the additional income taxes incurred over and above a hypothetical tax liability they would have incurred had they remained in the United States. Frequently, these payments are deferred until tax returns are filed and a reconciliation is prepared. The exact date of settlement is typically not specified; thus, such plans technically infringe the new rules. If the regs do not provide guidance, companies should ensure that the plan specifies a settlement date.

A non-US beneficiary of a deferred compensation plan who moves to the United States is subject to the new rules; it is hoped that the regs will provide relief for amounts deferred before such a move. A Canadian resident who now works in the United States and whose employment income is taxable there is subject to the new rules on NQDC from US sources.

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MFTs with Non-Resident Beneficiaries

A notice of ways and means motion tabled on December 6, 2004 to implement the March 2004 federal budget contains a number of proposals aimed at Canadian mutual funds with non-resident investors that apply to dispositions after March 22, 2004. The draft amendments do not apply to personal trusts; they are limited to mutual fund trusts (MFTs). Parallel amendments apply to mutual fund corporations.

Over the past 10 years, indirect ownership by non-residents through MFTs of taxable Canadian property (TCP), such as real estate, has grown considerably. A key contributing factor in that growth was the benefit of indirect ownership through an MFT: the non-resident escaped Canadian tax on gains from TCP. The existing rules were no longer considered effective. Consequently, the budget took aim at Canadian MFTs with non-resident unitholders to ensure that they paid the appropriate amount of tax on distributions relating to the MFTs' capital gains on TCP dispositions.

Tax planners had been careful to limit the participation of non-residents in trusts that qualified as MFTs, which cannot be established primarily for the benefit of non-residents. Using an MFT as the investment vehicle was key to the tax result for the non-resident because part XII.2, which normally imposes a special tax on a trust in respect of a Canadian trust's designated income to the extent that it deducted amounts paid or payable to one or more non-resident beneficiaries, did not apply to an MFT. Further, an MFT unit is not considered TCP to a non-resident unless the non-resident (either alone or with other persons not at arm's length with the non-resident) owned, at any time in the five years preceding the disposition, at least 25 percent of the trust's issued units. In most circumstances, therefore, a non-resident who owned a unit with a negative adjusted cost base from distributions did not suffer Canadian tax consequences.

The proposals ensure that a non-resident who invests in TCP indirectly through an MFT does not escape the Canadian tax otherwise applicable to TCP held directly. Rather than making the MFT subject to part XII.2 tax, the approach adopted should result in a less cumbersome administrative burden for the trust. An MFT must maintain a TCP balance representing net capital gains from TCP dispositions (plus any such distributions received). Generally, to the extent that an MFT has a positive TCP balance and distributes a capital gain to a non-resident beneficiary (and makes a capital gains designation in respect thereof), the full distribution is subject to part XIII withholding tax. A new part XIII.2 tax applies to distributions paid or credited to a non-resident after 2004. Part XIII.2 tax is limited in its application to interests held by non-

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residents in certain Canadian mutual funds, including REITs and royalty trusts listed on an exchange. The new part XIII.2 tax generally imposes a 15 percent tax on distributions to non-residents that are not otherwise taxed under part I or part XIII and should close off the planning opportunities discussed above. A non-resident may also carry back mutual fund losses against part XIII.2 tax paid or payable if filing requirements are met.

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Ontario Apprentice Credit

A refundable apprenticeship training tax credit (ATTC) was recently enacted for salaries and wages paid after May 18, 2004 (and before 2011) to apprentices in qualifying skilled trades. The ATTC is available to both corporations and unincorporated businesses and presumably is claimed on the employer's annual income tax return. A similar apprenticeship credit was announced by the former Conservative government in its 2003 budget but was never implemented.

The ATTC is calculated as shown in the accompanying table. A formula gradually reduces the ATTC rate from 30 to 25 percent for businesses that paid salaries and wages in the previous year of between $400,000 and $600,000. The maximum annual credit is prorated for the number of days in the year that the apprentice is employed by the employer. With the introduction of the ATTC, the co-operative education tax credit (CETC) will be revised. The CETC is a 10 percent refundable tax credit (15 percent for small businesses) on salaries and wages paid to eligible employees in qualifying work placements and will continue for co-op placements. The minister may prescribe as yet unreleased transitional rules for apprentice placements straddling May 18, 2004; however, the budget said that apprenticeship salaries and wages paid before May 19, 2004 qualify for the CETC, but those paid subsequently do not. The ATTC is intended to encourage employers to hire and train apprentices in certain skilled trades and to create jobs in strategic sectors of the Ontario economy, such as manufacturing and construction. *Ontario Tax Bulletin* 04-2, "Apprenticeship Training Tax Credit," dated July 13, 2004, lists the qualifying types of trades by apprenticeship trade codes. Qualifying apprentices must be employed before January 1, 2008 and registered under the Apprenticeship and Certification Act, 1998 or the Trades Qualification and Apprenticeship Act.

ATTC Calculation

Salaries and wages paid in previous taxation year	Rate	Maximum credit per apprentice
≤$400,000	30%	$5,000 per year
$400,001 to $599,999	25% + up to 5%	(maximum $15,000
≥$600,000	25%	over 36 months)

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Foreign Tax News

Treaties

A treaty with **Romania** entered into force on December 31, 2004, replacing the 1978 treaty. The treaty is effective for withholding taxes on amounts paid or credited to non-residents after 2004, and in respect of all other taxes for taxation years beginning after 2004.

United States

The IRS will hold meetings in February with the private sector to discuss how to improve the advance pricing agreement (APA) program—particularly its technical aspects, such as the APA standard contract—and to ensure consistency in the treatment of taxpayers.

Romania

To stimulate investment, the government enacted a 16 percent flat tax, effective January 1, 2005, to replace the 25 percent corporate rate and the 18 to 40 percent individual rate. To offset any revenue loss, the current 1.5 percent rate on small businesses with fewer than nine employees is doubled.

Indonesia

The government plans to modify the tax system to make the oil and gas industry more attractive to foreign investors. Import duties on equipment used by the government and foreign partners in the oil and gas industry will be eliminated, and energy sector investors will be exempt from VAT. No implementation date has been set.

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