CANADIAN TAX Highlights

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US Headquarters Taxed as US Corp

On January 27, 2005, the US Congress's Joint Committee on Taxation released a report, "Options To Improve Tax Compliance and Reform Tax Expenditures," containing a proposal that would tax a Canadian public corporation with US headquarters as a US corporation. The proposal appears to target, but is not limited to, US corporate groups that inverted but were not caught by the 2004 anti-inversion rules. (See "Anti-Inversion Hits Canadians," *Canadian Tax Highlights*, December 2004.) The proposal becomes effective for taxation years beginning at least two years after enactment.

Currently, only US-organized corporations are subject to US tax on a worldwide basis; a foreign corporation is generally taxed only on its US-source income, such as income earned through a US trade or business. The proposal does not alter the taxability of US corporations, but overlays a residency-based rule for the taxability of foreign corporations that is broadly similar to Canada's rule that a foreign corporation with central management and control in Canada is resident and taxable here. The new rule—which is based on the corporation's primary place of management and control—applies only to publicly traded foreign corporations, but the definition of "primary place of management and control" raises concerns. The definition is not board-of-director-based—a criterion that is viewed as susceptible to manipulation through infrequent meetings in a location remote from operations—but focuses on the place where "the executive officers and senior management of the corporation exercise day-to-day responsibility for the strategic, financial and operational policy decision making for the company (including direct and indirect subsidiaries)." Nor is the test restricted to the public company's employees: senior management personnel who operate in subsidiaries are included. The IRS must make a facts-and-circumstances determination, but the committee's expectation that there would be few disputes prompted it to abandon the incorporation-based test, which had offered certainty and ease of administration. In imposing the rule on foreign incorporated corporations that are effectively US-headquartered, the committee may not have focused on the many Canadian public corporations that have moved to a single North American business platform operating from within the United States.

A determination that a Canadian public corporation is a US tax resident should trigger dual residence and a determination under article IV(3) of the Canada-US treaty that it is a Canadian resident only, because it was created in Canada. However, under the US "later-in-time" rule, a treaty is overridden by a change in the law subsequent to the signing of or an amendment to a treaty; thus, the proposal results in the corporation being taxed in both jurisdictions.

The report, requested but not yet endorsed by the Senate Finance Committee, contains many other proposals. The proposal's reach exceeds its policy justification of shutting down abusive inversions. It is a revenue-raising proposal that could offset revenue-losing items in any proposal package. Thus, although enactment is far from certain, some Canadian public corporations should be concerned about the proposal's impact.

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Ohio ITC Unconstitutional

A September 2, 2004 case raises concern for enterprises, including Canadian-owned companies, claiming state tax incentives in Kentucky, Michigan, Ohio, and Tennessee.

The US Court of Appeals for the Sixth Circuit held in *Cuno v. DaimlerChrysler* that Ohio's investment tax credit (ITC) violated the commerce clause of the US constitution. DaimlerChrylser entered into an agreement with Ohio and the city of Toledo to construct a new vehicle assembly plant in exchange for an estimated US$280 million in tax incentives, including a non-refundable ITC against Ohio corporate franchise tax for the purchase of new manufacturing equipment to be installed in Ohio. A 10-year 100 percent personal property tax exemption was also granted by Toledo in return for DaimlerChrysler's establishing a facility and preserving employment in an economically depressed area.

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The court agreed that the incentives unfairly coerced in-state corporations to further invest in Ohio to the detriment of development in other states and hindered free trade: a corporation's Ohio tax was reduced in return for its locating new machinery and equipment in Ohio, but not out of state. However, the court determined that the Toledo personal property tax exemption did not hinder free trade interstate because there was no disparate treatment of taxpayers: by locating new investments in Ohio, a taxpayer could avoid personal property tax liability for new property put into use with a qualified new investment, but a taxpayer that did not locate new investments in Ohio was simply not subject to property taxation there. The tax paid in Ohio was the same in either case.

On January 18, 2005, the court refused to grant a rehearing of the decision, and on January 31 it granted DaimlerChrylser's motion to delay enforcement of the original decision. As a result, the Ohio Department of Taxation's *Information Release* 2004-3, issued in response to the original September decision, still stands: it indicates that taxpayers may continue to claim the Ohio ITC pending further review by the US Supreme Court. The parties have until April 18, 2005 to seek such review. If appealed, the original order will be delayed until the US Supreme Court ultimately disposes of the matter.

It remains unsettled whether *Cuno* applies to all taxpayers or just to DaimlerChrylser, and whether it applies retroactively or prospectively if the US Supreme Court decides not to hear the case. Taxpayers should continue to follow the information release until Ohio tax authorities publish further guidance. Companies that have ITCs in Ohio, Tennessee, Michigan, and Kentucky are advised to monitor developments closely: the final outcome may have financial statement implications.

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Ontario PST: Related Parties, Part 2

On December 13, 2004, Ontario promulgated amended regulation 1013 under the Ontario Retail Sales Tax Act (the PST treatment of assets transferred between related parties and between partnerships and partners). The final rules in large measure conform to the draft rules released for public comment in July 2004 ("Ontario PST: Related Parties," *Canadian Tax Highlights*, August 2004). Some changes were made in response to submissions. Most importantly, transactions are grandfathered if a written agreement for the sale was entered into before July 20, 2004, the amendments' effective date: the purchaser can rely on the old rules or elect to use the new. The final regs should be reviewed closely to identify differences from prior administrative practice.

One key addition carried through from the draft was intended to codify previous administrative rules for the transfer of assets between partners and their partnerships, but some deviations are notable. In particular, an exemption was previously allowed on the transfer of tax-paid assets on a partnership's formation if the new partner's consideration received included a partnership interest; the new rules provide full exemption only if such an interest is the sole consideration received. Excess consideration—presumably applied pro rata to the taxable and non-taxable assets transferred in—is taxed on the basis of the percentage share of the partnership income or loss not owned by the new partner after the transfer. This change follows the exemption for share takebacks and reflects the principles outlined in the 1980 BC Court of Appeal decision in *Seven Mile Dam Contractors*, which said that each partner owns a pro rata interest in the partnership's underlying assets.

The new rules also exempt the transfer of an interest in a partnership from a partner to another person. This is welcome confirmation of previous administrative practice.

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Provincial Indexing Variations

As Canadian provinces achieve more flexibility under the personal income tax collection agreements, the design of their tax systems displays more variety. The basic outline remains uniform across the country; the diversity is in the details, such as the indexation of rate brackets and credit amounts.

The federal government now provides full and automatic indexing of non-refundable credit amounts and tax brackets, adjusting the amounts annually by the increase in the national consumer price index (CPI) from September to September. The table summarizes the result of federal indexing of the basic credit from 2001, when the provinces moved to the tax-on-income (TONI) system, to 2005: the federal credit increased by 9.9 percent.

The 13 provincial and territorial governments take several different approaches to the indexation of rate brackets and credit amounts, and the table reveals considerable variation in its extent. Three provinces have not yet changed their systems since adopting TONI: Newfoundland and Labrador and Prince Edward Island, which do not index, use the equivalent of the 2001 federal values; Nova Scotia also has no indexing but uses federal values for 2000. New Brunswick now uses the national

Effect of Indexing, 2001 to 2005

	Basic credit		
	2001	2005	% increase
	$	$	
Newfoundland & Labrador	7,410	7,410	—
Prince Edward Island	7,412	7,412	—
Nova Scotia	7,321	7,321	—
New Brunswick	7,412	7,888	6.4
Quebec	5,900	9,463	60.4
Ontario	7,426	8,196	10.4
Manitoba	7,412	7,634	3.0
Saskatchewan	8,000	8,404	5.1
Alberta	12,900	14,523	12.6
British Columbia	8,000	8,676	8.5
Yukon	7,412	8,148	9.9
Northwest Territories	7,412	11,609	56.6
Nunavut	7,412	10,674	44.0
Federal	7,412	8,148	9.9

CPI. Quebec, the Northwest Territories, and Nunavut, on the other hand, have changed the basic credit amount over and above indexing.

Quebec now has automatic indexing using the provincial CPI, but it excludes the effect of changes in the prices of (and taxes on) tobacco and alcoholic beverages. Ontario, Manitoba, Alberta, British Columbia, and the three territories index annually on the basis of changes to each jurisdiction's CPI. Saskatchewan recently changed its indexing by removing the automatic feature and set the indexation factor annually according to the appropriate fiscal policy.

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Restrictive Covenant Proposals

The CBA-CICA Joint Committee on Taxation recently submitted comments to Finance on the general (non-foreign affiliate) draft technical amendments released on February 27, 2004. The submission offers detailed commentary on the proposals affecting restrictive covenants, first announced in an October 7, 2003 press release.

Proposed section 56.4 generally provides that a payment received or receivable by a taxpayer for a restrictive covenant (a non-competition payment) is included in the taxpayer's income unless the taxpayer and the payer are at arm's length and (1) the payment is jointly elected to be cumulative eligible capital for both the purchaser and the vendor; (2) it is jointly elected to be additional proceeds of disposition of an "eligible interest"; or (3) it is included in the taxpayer's employment income. An eligible interest means capital property that is a share of a corporation (or an interest in a partnership) that carries on a business.

Restrictive covenant defined. A restrictive covenant is defined as an arrangement entered into, an undertaking made, or a waiver of an advantage or right by the taxpayer (other than an arrangement or undertaking for the disposition of the taxpayer's property) that affects, in any way whatever, the acquisition or provision of property or services by a taxpayer or by another taxpayer that does not deal at arm's length with the taxpayer. The committee says that this definition is too broad and could apply to a wide range of commercial contracts. Furthermore, the parenthetical exception is too narrow: the definition should clarify exactly the type of arrangement included. The proposals should not apply to amounts otherwise included in computing income; but if they do, they should clarify the continued status of amounts otherwise included in income under section 9 as being from a business or property.

Asset sales penalized. The committee says that the proposals appear to penalize transactions structured as asset sales, not as share sales. Under the proposals, a non-competition payment received by a vendor in a share transaction can be taxed wholly or partly as capital gains. However, such a payment to the shareholder in a sale of the corporate assets is treated as ordinary income; this is clearly disadvantageous if the recipient is the sole shareholder. If the non-competition payment is received instead by the vendor corporation on an asset sale, it is more favourably taxed as an eligible capital receipt. A distribution of the net payment to the shareholder as a combination of ordinary and capital dividends results in a significantly lower overall tax than the tax on full inclusion as ordinary income to the shareholder. The policy reason for favouring share sales over asset sales is not apparent; Finance should consider a rule similar to that in proposed paragraph 56.4(3)(c).

Joint elections. The joint election required in the exceptions raises several concerns. For example, the requirement for filing in both the purchaser's and the vendor's tax returns is unusual and exposes a vendor to a compliance risk beyond its control without adding much to the monitoring of the rules' application. Compliance is seemingly impossible if one party is not obliged to file a Canadian tax return for the year. If an election is required, some other filing mechanism may go further to ensure the rules' fair application.

Non-arm's-length test too restrictive. In an addendum, the submission notes that the exceptions apply only to restrictive covenants granted at arm's length. Thus, no relief may prevail if, as commonly occurs, a vendor corporation's transfer of target assets to a wholly owned

sub is followed by a sale of the sub's shares to an arm's-length purchaser, even though the overall transaction is clearly at arm's length. In policy terms, such a denial seems inappropriate because the transaction's form is frequently not tax-driven but based on commercial and employment law considerations. Proposed subsection 56.4(3) should be amended accordingly.

Other items. The submission also addresses trust and deferred income plans, corporate reorganization, the definition of foreign property, charitable and political gifts, and credit unions.

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US Domestic Production

In Notice 2005-14 of January 19, 2005, the IRS provides interim guidance on the new section 199 deduction for income attributable to US domestic production activities for tax years beginning after 2004. The deduction appears similar to Canada's manufacturing and processing (M & P) mechanism.

A deduction is allowed for 3, 6, or 9 percent (phased in) of the lesser of qualified production activities income (QPAI) and taxable income, to a maximum of 50 percent of qualified W-2 wages. QPAI is domestic production gross receipts from qualifying activities, less the cost of goods sold and allocable and apportionable expenses. All calculations cover the expanded affiliated group. Apart from the taxable income and wage limitations, every $1 million of QPAI generates US federal income tax savings of $10,500 (tax years 2005 and 2006); $21,000 (2007 to 2009); and $31,500 (after 2009).

The notice defines W-2 wages and provides three alternative calculations. Qualified production activities are defined and include the manufacture, production, growth, or extraction in whole or in significant part in the United States of tangible personal property, software development, and sound recordings. Generally, only the taxpayer with the burdens and benefits of ownership of the property during the manufacturing process is treated as the manufacturer. Computer software includes software for computers and video games, for example; but receipts for fees for online use of software and embedded services are generally not taken into account. A "substantial-in-nature" test assists in determining whether property is manufactured by the taxpayer in the United States in significant part. A safe harbour is established if conversion costs (excluding certain design and development and packaging costs) are 20 percent or more of the property's total cost. Qualifying construction activities are included as defined; more than one taxpayer may be regarded as constructing real property with respect to the same activity. Gross receipts derived from the rental of property constructed by the taxpayer are not considered derived from construction.

In allocating and apportioning deductions, generally taxpayers must follow the section 861 regulations and use the same method and principles, if any, that they use under those rules for another operative section of the Code (such as the foreign tax credit, computation of earnings and profits, and branch profits). Two simplified methods apply to small taxpayers.

The notice also provides rules for passthrough entities, and definitions and rules for determining an expanded affiliated group (EAG) and allocating the deduction between its members. For example, a consolidated group is treated as a single member of the EAG, rather than each consolidated group member being a separate EAG member. The EAG includes corporations 50 percent or more owned, an inclusion that introduces enormous complexity.

The notice provides substantial guidance that allows many companies to start implementing section 199. Most methods apply to all taxpayers, but some simplified methods exist for smaller taxpayers. Most taxpayers must apply facts-and-circumstances tests, such as the "benefits and burdens of ownership" test and the "substantial-in-nature" test, to determine whether an activity qualifies. Transfer pricing may play a key role in determining the split between qualified gross receipts and non-qualified gross receipts.

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Holdco Disintegration, Part 2

To mitigate the impact of US federal and state estate taxes, many Canadian-resident individuals who are neither US citizens nor green-card holders hold US securities and real property investments in a Canadian-resident holdco. This structure can reduce a taxpayer's overall tax burden and potentially avoid double tax, but it may also entail substantially higher annual Canadian income tax and ongoing compliance costs. And if Holdco disposes of a US-situs real property interest, the aggregate US and Canadian tax may be about double that on a direct sale. A holdco also generally precludes efficient loss utilization and can attract capital taxes. Furthermore, the CRA's administrative position—that a taxable benefit will not be assessed under subsection 15(1) on a shareholder of a single-purpose corporation established to hold US-situs real property—generally no longer applies after 2004. Accordingly, a shareholder should carefully consider the annual tax cost associated with acquiring US-situs property in a holdco.

In theory, a top marginal rate Canadian-resident individual should be indifferent to whether investments are

Income Tax Payable on $10,000 of Foreign Investment Income Earned Through a Corporation and Directly, December 31, 2005 Taxation Year

	Foreign non-business income tax credit percentage		
	10%	15%	25%
		dollars	
BC-resident individual and corporation			
Corporate tax	4,929	4,929	4,929
Refundable tax	(1,926)	(1,555)	(815)
Individual tax on dividend	2,210	2,092	1,859
Combined tax	5,213	5,466	5,973
Individual tax (including withholding tax)	4,370	4,370	4,370
Tax cost with Holdco	843	1,096	1,603
Tax deferral/(prepayment) with Holdco	(559)	(559)	(559)
Alberta-resident individual and corporation			
Corporate tax	4,729	4,729	4,729
Refundable tax	(1,926)	(1,555)	(815)
Individual tax on dividend	1,733	1,644	1,466
Combined tax	4,536	4,818	5,380
Individual tax (including withholding tax)	3,900	3,900	3,900
Tax cost with Holdco	636	918	1,480
Tax deferral/(prepayment) with Holdco	(829)	(829)	(829)
Ontario-resident individual and corporation			
Corporate tax	4,979	4,979	4,979
Refundable tax	(1,926)	(1,555)	(815)
Individual tax on dividend	2,177	2,061	1,829
Combined tax	5,230	5,485	5,993
Individual tax (including withholding tax)	4,641	4,641	4,641
Tax cost with Holdco	589	844	1,352
Tax deferral/(prepayment) with Holdco	(338)	(338)	(338)
Quebec-resident individual and corporation			
Corporate tax	5,204	5,204	5,204
Refundable tax	(1,926)	(1,555)	(815)
Individual tax on dividend	2,205	2,084	1,841
Combined tax	5,483	5,733	6,230
Individual tax (including withholding tax)	4,822	4,822	4,822
Tax cost with Holdco	661	911	1,408
Tax deferral/(prepayment) with Holdco	(382)	(382)	(382)

Note: The figures assume that (1) the individual is taxed at the top marginal tax rate; (2) Holdco only earns foreign investment income; (3) the taxable dividend paid is the net after-tax amount; (4) for the 25 percent column, the foreign non-business income taxes relate to a disposition of real property so that subsection 20(11) of the Act does not restrict the individual's tax credit; and (5) for Ontario residents, it is assumed that the taxpayer's taxable income already exceeds the top threshold for the Ontario health premium ($200,600).

held in a holdco or directly. Integration holds for top marginal rate individuals who receive dividends from a taxable Canadian corporation and generally also for interest income and capital gains; although the taxpayer's and Holdco's province or territory of residence are important, the refundable dividend tax on hand (RDTOH) account and the dividend refund mechanism for Canadian investment income largely alleviate double taxation. Unfortunately, the integration of foreign-source non-business income is not so easy, and considerable tax costs may adhere. Integration fails primarily because the refundable portion of part I tax is reduced disproportionately when a holdco claims foreign non-business income tax credits, and the tax costs of earning such income through a holdco increase with the effective foreign tax rate. The table shows the tax cost of earning foreign non-business income for individuals and holdcos that are resident in British Columbia, Alberta, Ontario, and Quebec.

December 20, 2002 draft legislation proposed to modify the reduction of the RDTOH addition for foreign non-business income to "better reflect the underlying corporate tax rates" and effectively tax such income at even higher integrated tax rates in 2003 and subsequent taxation years. (See "Holdco Disintegration," *Canadian Tax Highlights*, February 2003.) The rationale for such changes was not clear, because the underlying Canadian federal tax on a holdco's Canadian and foreign investment income remained at about 35.79 percent (28 percent plus 1.12 percent federal corporate surtax plus the additional 6.67 percent tax on a CCPC's investment income). Fortunately, Finance withdrew the amendment. It is hoped that Finance will amend the existing RDTOH formula to mitigate the double taxation of foreign non-business income and return to the principles of integration.

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US Expatriates

The Jobs Creation Act of 2004, signed into law on October 22, 2004, substantially altered the expatriation tax rules (Code section 877) applicable to US citizens and long-term permanent residents who commit an expatriating act after June 3, 2004. Inter alia, the subjective tax-avoidance test is replaced by an objective standard; the ruling request procedure to rebut the presumption of a tax-avoidance motive is eliminated; a new physical presence test results in certain individuals being taxed as US residents for the year the test is met; and reporting requirements for both the initial expatriation and the next 10 years are enhanced.

The expatriation regime applies to certain US citizens who renounce their citizenship and to long-term residents

(individuals who were lawful US permanent residents in at least 8 of the preceding 15 years) who surrender their green card, if they are found to have a tax-avoidance motive for doing so. Some US income, estate, and gift tax consequences from which expats are normally exempt, may, if applicable, follow such individuals during the 10 years after expatriation.

The determination of the tax-avoidance motive was previously more subjective. Individuals with a net worth or income tax liability above certain thresholds were presumed to have such a purpose, although some such persons could request an IRS ruling to the contrary. Individuals who did not meet the thresholds could in certain circumstances be deemed to have a tax-avoidance motive. The new test is entirely objective. A tax-avoidance motive is deemed to exist only if (1) the individual's average annual net US income tax during the five prior years is greater than $127,000 (indexed for inflation); (2) his net worth as of the expatriation date is at least $2 million; or (3) he fails to certify under penalty of perjury that he has complied with the US tax laws for the previous five years, regardless of his motivation. Narrow exceptions to the average tax liability and net worth tests exist for certain expatriating citizens (not long-term residents) who became dual citizens of the United States and another country at birth, and for certain minors; however, such individuals are still subject to the requirement for certification of tax compliance.

An expatriating act, formerly defined with reference to US immigration law and deemed to occur on the happening of specifically enumerated acts (such as renunciation of US nationality before a US diplomatic or consular officer) now requires formal notice. A citizen or long-term resident continues to be taxed as such until he gives notice of an expatriating act or termination of residency (with the requisite intent to relinquish citizenship or residency) to the secretary of state or the Department of Homeland Security and provides a tax statement to the IRS under Code section 6039G. Formal notice must be given by all citizens and long-term residents who expatriate, not just those who are deemed to have a tax-avoidance motive.

A new rule treats an individual as a US citizen or tax resident, taxable on worldwide income, if he is physically present in the United States for more than 30 days in any of the 10 calendar years after expatriation. Up to 30 days' presence while the individual is working for an employer is excepted; the employee must not be related to the employer and must be actually performing services for his employer on those days. Furthermore, the individual must have certain ties to another country or have minimal prior US physical presence.

An expatriating individual must provide certain information to the IRS, including his TIN; the mailing address of his principal foreign residence; the foreign country of which he is a citizen; details of his income, assets, and liabilities; and the number of days he was present in the United States during the taxable year (Code section 6039G). Previously, a statement was filed only at the time of expatriation on form 8854 (Expatriation Initial Information Statement); to have a valid expatriation for tax purposes, expatriating citizens and long-term residents must now also file a section 6039G information statement annually during the subsequent 10 years, even if no US federal income tax is due. Failure to file can result in a $10,000 penalty, unless the failure is due to reasonable cause and not wilful neglect.

The considerable changes in reporting requirements necessitate substantial revisions to form 8854 to provide for new and additional information and updated filing procedures. For instance, current form 8854 instructs former long-term residents to file the form as an attachment to their dual-status income tax return for the year of expatriation; but now an individual is not considered expatriated for tax purposes until the information required by section 6039G is filed with the IRS. Thus, a long-term resident who intends to expatriate in January 2005 but follows the current filing instructions is not expatriated for tax purposes until his 2005 income tax return is filed in 2006. The form's current instructions require only individuals who meet the net worth threshold for tax-motivated expatriation to disclose information about their assets and liabilities; now, however, all citizens and long-term residents must disclose such information.

Procedures for providing official notice of expatriation to the secretary of state or Department of Homeland Security in order to effect expatriation for tax purposes must be clarified. For example, does the provision of form I-407 (Abandonment of Lawful Permanent Resident Status) to the Department of Homeland Security or consular officials constitute such formal notice for long-term residents? What is the analogous procedure for expatriating US citizens? The IRS is giving priority to the required changes—it is currently revising its forms (including form 8854) and filing procedures—and is expected to publish amended forms soon.

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Stop-Loss Rules: Certain Trusts

The CBA-CICA Joint Committee on Taxation recently made a submission to Finance regarding the proposal in subsection 40(3.61) (in Bill C-33) to provide relief to an estate from the application of the stop-loss rules to a loss carried back from a deceased's estate to his or her terminal return under subsection 164(6). The proposal is welcome, but

the committee says that relief should extend to other situations of equal policy merit—for example, a bequest of shares from a spouse to a qualifying spousal trust and situations involving alter ego trusts and joint spousal or common-law partner trusts.

The proposal relieves double tax by ensuring that the stop-loss rules in subsections 40(3.4) and (3.6) applicable to affiliated persons do not apply to any capital loss carried back under a subsection 164(6) election, effective for dispositions from the March 23, 2004 budget date. (Proposed paragraph 251.1(1)(g) describes when a person and a trust are affiliated: a trust is affiliated with any beneficiary entitled to a majority of the trust income or capital (a "majority interest beneficiary," per subsection 251.1(3)) and generally with any person affiliated with such a beneficiary). The stop-loss rules in subsection 40(3.6) can still apply to a spousal trust and an alter ego and joint partner trust on the death of the surviving spouse when a loss occurs on a share redemption. Such trusts are alternative and analogous vehicles for dealing with property on the taxpayer's death: from a tax policy perspective, the same tax relief should apply to such losses whether the shares redeemed post mortem are held by such trusts or by an estate.

The submission gives an example of an individual, Mr. X, who owns the preferred shares and related voting control of a corporation (Holdco); his only child holds the common shares. The structure was created in a typical estate freeze undertaken a few years ago. Under Mr. X's will, the preferred shares fall into a spousal trust. The child is the trust's only other beneficiary and is the beneficiary of Mr. X's estate if he survives his spouse.

If Mr. X survives his spouse, Mr. X's executors can redeem the preferred shares post mortem to trigger a capital loss for carryback under subsection 164(6) to offset the gain from the deemed disposition on death in Mr. X's final personal income tax return. Proposed subsection 40(3.61) prevents the application of the stop-loss rules. If, on the other hand, the spouse survives Mr. X and his preferred shares are transferred to a spousal trust, then the estate plan calls for their redemption in the year of Mrs. X's death or any of the subsequent three taxation years. The spousal trust's resulting capital loss should be applied against its deemed capital gain realized on the shares in the year of Mrs. X's death (paragraph 104(4)(a)). If the shares are disposed of after the taxation year of Mrs. X's death, the capital loss may be carried back to that year (paragraph 111(1)(b)). However, the capital loss on redemption is technically denied. Under the proposed amendments to subsections 251.1(1) and (3), immediately after the redemption Mr. X's child is affiliated with Holdco because he controls it and is also affiliated with the spousal trust (proposed subparagraph 251.1(1)(g)(i)). Thus, at that time the spousal trust is affiliated with Holdco (proposed subparagraph 251.1(1)(g)(ii)), and subsection 40(3.6) denies the capital loss.

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Anti-Avoidance and Treaties

Different countries are taking different approaches to combat tax avoidance via treaty shopping.

Canada. A 2004 federal budget proposal "clarifies" that GAAR applies to treaty shopping, raising concerns about its retroactivity and the overriding of existing treaties. Moreover, it is not clear that the approach can succeed without an anti-avoidance rule in the treaty. The Canada-US treaty is Canada's only treaty with a limitation-on-benefits provision, the US approach of choice; the recent Canada-UK treaty contains the UK anti-avoidance rules.

As a general principle, a treaty prevails over Canadian domestic legislation; this rule is codified in paragraph 110(1)(f) of the Income Tax Act. Parliament may be able to enact specific legislation to override treaties; the Income Tax Conventions Interpretation Act was enacted in response to the SCC decision in *Melford* (82 DTC 6281). The CRA is challenging treaty shopping under GAAR, saying that treaty relief is covered by the Act, although arguably treaty shopping is not an abuse of the Act or of a treaty read as a whole. Alternatively, the CRA says that the Vienna Convention on the Law of Treaties should prevent treaty abuse; arguably, that convention should not apply to a taxpayer—not a contracting state—that abuses a treaty. To date, the courts have not accepted the CRA's arguments, but the GAAR proposal may empower the CRA. Jurisprudence says that GAAR requires a clear and unambiguous policy to deny a specific tax benefit, but the OECD commentaries issued at the time the treaties were entered into, and Canada's treaties generally, do not deny treaty shopping. The Act itself, for example, encourages the use of international finance companies, which often are structured to take advantage of treaties.

Switzerland. In 1962, the Swiss federal tax administrator introduced an abuse decree (updated in 1998-99) to prevent the excessive use of treaty-benefited payments by Swiss corporations to persons not entitled to Swiss treaty benefits because they are not residents of the contracting states. The decree targets the interposition of a holdco in a favourable jurisdiction (of which the beneficial owner is not a resident) to eliminate Swiss withholding tax on dividends.

Switzerland generally applies maximum withholding tax; the "effective beneficiary" files a formal and timely request for a treaty-based refund, which may be denied under an express anti-abuse rule. Tax avoidance, as defined

by the Swiss Supreme Court, includes transactions whose legal form is unusual and contrary to ordinary business practice, if the structure's primary motive and result is substantial tax savings. Some Swiss treaties—such as those with France, Germany, Italy, and Belgium—have anti-avoidance rules; the Switzerland-US treaty has a limitation-on-benefits clause (to which the domestic anti-abuse rule is not applied).

The abuse decree focuses on the use of Swiss residents as intermediaries for non-residents who would otherwise suffer withholding tax: the Swiss intermediary is not recognized as the true beneficial owner of the income and cannot claim treaty relief from foreign withholding tax. Relief may not be available if a Swissco is not engaged in a Swiss "active business" and is controlled by non-Swiss-resident interests. Additional tests include a debt-equity financing rule, a "base erosion" limitation to 50 percent of treaty-benefited income, and a minimum distribution requirement. These rules responded to pressure from countries such as the United States and Germany.

A general anti-treaty-shopping concept accepted by the courts and embedded in tax authorities' practices is designed to preserve the Swiss revenue base, particularly the 35 percent federal withholding tax on outbound dividends and bond interest. A refund is denied unless the foreign payee is the true beneficiary and not, for example, a company whose capital is controlled by residents of a third state and that has no sufficient "business substance" in its claimed country of residence.

As of 2005, withholding relief at source applies to parent-subsidiary payments; the foreign parent must demonstrate eligibility in advance, typically holding a minimum threshold of shares in the Swiss sub to obtain the best treaty withholding rate on dividends. (Relief at source was previously limited to domestic parent-subsidiary dividends and to situations under the US and German income tax treaties). The parent's true beneficial ownership is key; relief is in doubt if the parent is controlled by third-country interests and cannot prove a non-tax business reason for its being based in the treaty jurisdiction.

Germany. The income tax statute's 1994 anti-treaty-abuse rule denies tax relief if persons interested in the foreign company could not claim a refund or exemption on direct receipt, and if there are no economic or other good reasons to insert such a foreign company that does not develop any economic activity. Formal guidance on the rule has not been released. In 1997, the first panel of Germany's Supreme Tax Court overruled its earlier decision and said that the general anti-avoidance rule applies to treaty shopping: the specific treaty-shopping rule is mere clarification. The Federal Tax Court decided in 2002 that the provision did not violate the EU treaty. The anti-treaty-shopping provision is strictly and aggressively enforced. Withholding tax is initially imposed at the maximum rate; refunds must be requested. Applicants for refunds and exemption certificates are routinely asked for information on their shareholder base and the applicant's activities; a company should have an office, personnel, telephone, etc.

Germany's newer treaties either contain specific anti-abuse rules or incorporate domestic rules. The US-Germany treaty contains a limitation-on-benefits provision to which the anti-abuse rule is not applied. A refund of German withholding tax may be problematic if the foreign investor uses Luxembourg, the Netherlands, or another tax haven to invest in Germany. For example, a Dutch BV owned by a Bermuda corporation (in turn owned by a USco) is denied an exemption from German withholding tax on licence income if it cannot prove its economic substance. Because there is no treaty with Bermuda, it is irrelevant that there would be no withholding tax on direct receipt by the USco.

Other. *Union of India et al. v. Azadi Bachao Andolan et al.* (2003 SOL Case no. 619) concluded that there is no implied anti-abuse rule in India's treaties and that treaty abuses should be addressed by a limitation-on-benefits clause. Several years ago, the United Kingdom decided against enacting a GAAR; recently proposed disclosure rules deal with tax-motivated arrangements in employment situations and financial products.

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NAFTA Rules of Origin

Among other things, NAFTA provides for duty-free trade between Canada, the United States, and Mexico for so-called NAFTA-originating goods. Some changes were made to the underlying rules of origin as of January 1, 2005.

NAFTA originating goods are those deemed to originate in one of the NAFTA countries and are thus eligible for the preferential nil rate of duty when traded between the countries. Simple manufacture or assembly of a good in one of those countries does not confer originating status on the good; reference must be made to the NAFTA rules of origin. The latest changes to those rules affect certain classes of goods, including precious metals, household appliances, speed drive controllers (and their printed assemblies), thermostats, and a number of parts for various types of machinery and equipment. Other goods-specific rule changes cover toys, loudspeakers, tea, spices, carrageenan, and seasonings. (These products represent an estimated US$20 billion in total trilateral trade.)

The changes are generally "liberalizing" in nature, aimed to ensure that more goods qualify as NAFTA goods and thus promote further duty-free trade between NAFTA

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countries. For example, under the old rules, if a Canadian manufacturer of children's tricycles that imported pedals and accessories from China and merely assembled the tricycles in Canada, the goods were not eligible for NAFTA benefits: the rules required a tariff shift, which flows from actual manufacturing. The new rules add a regional value content (RVC) test that deems the goods to be NAFTA-originating if sufficient Canadian, US, or Mexican value is added. RVC must be at least 50 percent of the tricycle's net cost or 60 percent of the tricycle's selling price. Using the net cost approach, if the non-NAFTA-originating pedals and accessories cost $15 and the tricycle's net cost is $50, the assembled tricycles qualify as NAFTA goods because the RVC is 70 percent.

The changes are expected to affect NAFTA exporters favourably by facilitating the conferring of NAFTA status on goods that are being imported or exported, thus helping to reduce the cost of those goods and improving the competitiveness of businesses that use them in further production processes. The impact on other persons in the relevant industries may be less than favourable. The changes are also a part of a continuing effort on the part of the three countries to liberalize trade, and they come two years after similar liberalizing changes to seven other classes of goods, including alcoholic beverages and petroleum and topped crude oil. However, the NAFTA rules of origin remain quite complex and are often difficult to understand; affected persons should seek professional advice on the rules' application.

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Foreign Tax News

Russia

The Tax Service clarified the scope of the single social tax to foreign entities in a letter that defines "organization" to include a foreign incorporated legal entity and also an international organization with branches and offices in Russia. A foreign entity's subdivisions and representative offices in Russia with separate banking arrangements must meet the same conditions as the parent company for the payment of the tax and reporting. A foreign organization with only some Russian offices that meet the requirements of article 243(8) can assign the payment and reporting of the tax to one of those offices for others that do not meet the requirements.

The Economic Development Ministry developed draft proposals to enhance the special economic zone in Kaliningrad. New benefits include a corporate income tax exemption for income from investment projects for six years from the date of registration in the zone and a 50 percent reduction in the next six years; an exclusion of residents from real estate taxes for six years; and an exemption from customs duties on the import of foreign goods. Goods manufactured in the zone and exported are subject to all applicable taxes and charges. The proposals may change before being adopted by both parliamentary chambers.

OECD/United States

US and OECD officials met in January 2005 to discuss methods of resolving treaty disputes under the OECD model treaty's mutual agreement procedures (MAPs). OECD officials continue their efforts to improve the procedure, in particular updating the transfer-pricing guidelines and the MAPs in model treaty article 25, and they recommend exploration of mediation and arbitration, transparency of process, timeliness, and solutions based on solid principles. A US official said that the competent authority process has produced unreasonably long delays because of substantive disagreements; cases not fully developed by examiners and auditors; position papers that are not properly developed or never exchanged; and over- and understaffing. The IRS plans to update its procedures to conform to the OECD model. One US official said that the IRS may consider alternative dispute resolution techniques, such as mediation and binding arbitration built into treaties, but another US official said that such techniques should not replace or impede the mutual agreement procedure.

New Zealand-United States

The New Zealand-US treaty is clarified as it relates to income passing through an entity treated as fiscally transparent only by one of the states. The competent authorities agreed that such income is considered derived by a contracting state's resident that is a member of such an entity, to the extent of its share of the income.

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