Canadian Tax Highlights

Editor: Vivien Morgan, LL.B.

Volume 13, Number 3, March 2005

No Duty To Amend Return

A recent technical interpretation (2005-0113241I7) concluded that a taxpayer had no duty to advise the CRA of a mistake made in a return if it was not aware of the error at the time of filing. The question was posed by a Tax Services Office (TSO) on a review of a taxpayer's file: could a taxpayer's tax return that was otherwise statute-barred be reassessed on the basis that the taxpayer had made a misrepresentation under paragraph 152(4)(a) by not filing an amended return when it became aware of an error after the original filing? The TI says that generally there is no obligation to inform the CRA of a mistake in these circumstances and no right to reassess after the normal limitation period.

Under subparagraph 152(4)(a)(i), a taxpayer can be reassessed beyond the normal statutory limitation period if he made a misrepresentation attributable to neglect, carelessness, wilful default, or fraud. In the TI request, the taxpayer, a CCPC, holds certain foreign investments. Its 2000 income tax return was initially assessed on June 6, 2001; the normal reassessment period expired on June 6, 2004. On or about July 20, 2004, the CRA was notified by the provincial tax authority of its reassessments of the taxpayer's 2000, 2001, and 2002 taxation years to include amounts in income from foreign investments under the provincial equivalent of subsection 94.1(1). In December 2004, the TSO proposed to reassess the statute-barred 2000 taxation year and the 2001 and 2002 taxation years under subsection 94.1(1), based on information from the provincial tax authority.

The TSO said that the taxpayer did not make any misrepresentation when it filed its 2000 tax return, but it did not object to the reassessments in 2002 of its 1995, 1996, and 1997 taxation years, which included income in each of those years under subsection 94.1(1). Furthermore, when the province reassessed its provincial returns for 2000, 2001, and 2002, it should have known that the corresponding federal returns should also be revised. By knowingly not requesting amendments to its tax returns, the taxpayer made a misrepresentation, and thus its statute-barred 2000 return may be reassessed. The TSO cited several court decisions.

The taxpayer argued that it had not made any misrepresentation to the CRA that was attributable to neglect, carelessness, or wilful default: the potential application of subsection 94.1(1) had not been resolved when it filed its 2000 tax return, and it had reasonable grounds to believe that subsection 94.1(1) did not apply to its foreign investments acquired before 1984. Not filing an objection to the reassessment of its 1995, 1996, and 1997 taxation years did not signify agreement with the CRA's position; it reflected the anticipated cost of pursuing this matter in the courts and an expectation that the 1999 budget's revised foreign investment entity proposals would soon be enacted. However, the taxpayer's 2002 and subsequent years returns were filed on the basis that subsection 94.1(1) applied.

The taxpayer cited an analogous situation in *Regina Shoppers Mall* (91 DTC 5101). In that case, the taxpayer sold real estate in 1976 and treated the proceeds as a capital receipt; the CRA reassessed as income, but the taxpayer filed for subsequent years as if the amount were a capital receipt until the FCA sided with the CRA in 1989. The CRA then reassessed the statute-barred 1979 and 1980 taxation years, arguing that the taxpayer should have filed its return consistently with the CRA position or should have filed a waiver of the four-year limitation period. The FCA said that the taxpayer was within its rights to file as it did for subsequent years while its original appeal for 1976 remained outstanding. The CRA could not reassess the statute-barred years. The FCTD said that "it is not the duty of the reporting taxpayer to alert the Department to a situation as to which any reasonable person would believe the latter is fully aware." The FCA approved these comments. The TI distinguished a TCC decision cited by the TSO in which "the prior audit had been finalized and it did not involve a dispute over whether a specific provision of the Act had application. [It] involved the taxpayer's bookkeeping system. Furthermore, the misrepresentation was made at the time the [taxpayer] filed its tax returns."

On the basis of its review of the jurisprudence referred to, the CRA said that it was quite clear that for an assessment under subparagraph 152(4)(a)(i) to be valid, any misrepresentation must be made at the time that the return is filed. Thus, the taxpayer's failure to file amended returns does not, by itself, constitute misrepresentation and the taxpayer's statute-barred return cannot be reassessed. The TSO

In This Issue

No Duty To Amend Return	1
GST/HST Printed-Book Rebate	2
Apples, Oranges, and Natural Gas	2
From Deficit to Surplus	3
From SPCs to Trusts	3
Generally Canadian GAAP	4
Dividend on Crystallization	5
Subsection 95(6): A GAAR?	5
Income-Splitting Savings	6
US Proposals Deny Valuation Discounts	7
"A" Reorgs Embrace Forco	8
Canada-US Personal Tax Traps	9
Foreign Tax News	9

acknowledged that the taxpayer did not make any misrepresentation when it filed its 2000 tax return.

Paul Hickey
KPMG LLP, Toronto

GST/HST Printed-Book Rebate

The federal book rebate was intended to support literacy in Canada, eliminating the GST on books purchased by schools, universities, qualifying libraries, and certain other institutions. Books also qualify for a point-of-sale rebate of the provincial component of the HST that is available to all persons in Nova Scotia, New Brunswick, and Newfoundland and Labrador. However, educational publishers are now encountering inconsistent CRA interpretations in the case of technical books that include a CD-ROM or online access capabilities and that are sold for a single consideration—a distribution format that is rapidly becoming the norm for technical and instructional publications.

The rebates apply to printed books as defined, certain audio recordings, and bound or unbound printed versions of scripture of any religion. If a printed book is supplied with CD-ROMs and/or online capability and they are sold together for a single consideration, does the combination qualify for the rebates? Or does it represent a non-qualifying supply with new forms or qualities? In explanatory notes to the GST rebate, Finance noted that "an item (sometimes referred to as a 'multi-media item') that consists of a book and another medium (e.g., a record, cassette or disc) that are packaged and sold together for an all-inclusive price is not generally considered a book." However, such items have not been treated consistently in recent application rulings. For example, one ruling said that the supply of the CD-ROM was incidental to the supply of the book, and thus the publication was a printed book as defined and eligible for the point-of-sale rebate when supplied in a participating province. In contrast, another ruling said that the supply of a printed book with a CD-ROM and sold for a single price was a single supply of a new product that was not a printed book. Both rulings dealt with very similar publications that were typical of the educational publishing standard.

The difficulty of drawing a distinction between a CD-ROM that qualifies as an incidental supply and one that is sufficiently dominant to create a new product is not new to the commodity tax area; the question has dogged customs, GST (and FST before it), and PST officials for decades. However, given the significance of the underlying incentive to the education system, any doubt should arguably be resolved in the industry's favour, perhaps in the form of a legislative amendment. As a policy matter, the resolution of this debate should accommodate the increasing use of technology in combination with traditional learning techniques in order to reaffirm the government's continuing efforts to support learning and education in Canada.

Audrey Diamant and Mary McKinney
PricewaterhouseCoopers LLP, Toronto

Apples, Oranges, and Natural Gas

A major headache for Canadian natural gas exporters and importers is making its way through the CBSA, the CRA, and the courts. A physical export and import of Canadian natural gas occurs as it moves from western to eastern Canada if it is transported via pipeline connections that pass through the United States.

Specific rules in both the Customs Act (CA) and the Excise Tax Act (ETA) appear to deem no import or export to occur (sections 23 and 144.01, respectively). CA section 23 deals with "transportation over territory outside Canada": goods transported from one place to another within Canada, but over territory or waters outside Canada, are deemed—for duty purposes only—to be transported entirely within Canada. ETA section 144.01, which was enacted to deal with "continuous transmission commodities" (CTCs) such as oil, gas, and electricity, effectively arrives at the same result for GST purposes, deeming the commodity not to be exported or imported. Thus, there seems to be no obligation on the owner to pay division III GST when "importing" the gas as it flows back into Canada in the east. (The provisions overlap somewhat, because "duties" in the CA include GST.)

Despite clear legislative wording and intent, the CBSA says either that these provisions do not apply or that it has no jurisdiction to apply them. The CBSA may be of the view that CA section 23 does not apply to CTCs because the actual good leaving Canada is not the same one entering Canada: the good has been "mixed" along the way with other like goods. ETA section 144.01 appears to deal with the fungibility issue, but the CBSA seems reticent to apply it, either on the basis that section 23 takes precedence or because section 144.01 does not relieve the GST applicable. The bottom line? The CBSA is currently assessing GST on such importations.

To make matters worse, although the GST assessed is generally soon recovered as an input tax credit, the assessment throws up unrecoverable interest on the GST owing, payable back to the original importation date. This interest penalty can be significant, and on large-volume transactions extends into millions of dollars for companies that move their natural gas in this fashion. Those affected perceive an injustice in the lack of resolution for what appears to be an easily resolved issue and in the imposition of ludicrously high and inequitable interest penalties.

What makes the situation even more egregious is the fact that the ETA seems to block an appeal of the GST-interest portion of a CBSA assessment under either the CA or the ETA. The ETA establishes the right to appeal CBSA assessments of GST and defines available appeals narrowly as involving the "determination of the tax status," such as whether goods are "included in Schedule VII," and thus may be imported on a non-taxable basis. No appeal is afforded regarding the application of ETA section 144.01, which deems no importation to occur in the first place; there is thus no effective appeal from a CBSA assessment that declines to apply the rule.

Current applications before the Federal Court on the jurisdictional issue should soon clarify matters, but in the meantime, affected natural gas producers, marketers, and traders face the prospect of substantial and continuous interest assessments. The only present realistic option is to apply for judicial review.

Robert G. Kreklewetz
Millar Kreklewetz LLP, Toronto

From Deficit to Surplus

The Canadian success story is now familiar: a frighteningly high government deficit has now become a comfortably large surplus. Data released late in 2004 revealed how well Canada compared with most of its G7 partners. (See "Deficit Drop: Bragging Rights," *Canadian Tax Highlights*, November 2004.)

The table shows a combined deficit of the federal and provincial governments of $64 billion at its maximum in 1992; by 2000, that had changed to a peak surplus of $32 billion. The shift is due to a number of factors, not the least of which has been the Canada and Quebec pension plans, which moved from a combined deficit of nearly $3 billion in 1997 to a surplus of $10 billion in 2003, the latest year available.

The federal government has also succeeded in turning a deficit of nearly $40 billion in 1993 into a surplus that grew to over $20 billion before it declined to $5 billion in 2003. The provinces have a more erratic history: beginning with a $28 billion deficit in 1992, they collectively attained a surplus of more than $8 billion in 2000, but have since slipped back into a deficit of nearly $5 billion. Local governments have not followed the pattern laid down in the overall public sector: after achieving three surpluses from 1997 to 1999, they fell back into deficit in the last four years. In recent years, the balances of each level of government have offset each other to some extent, but the key factor in bringing the entire public sector into balance has been health of the federal government and the pension plans.

David B. Perry
Canadian Tax Foundation, Toronto

Overall Government Surplus or Deficit, 1990 to 2003

	Federal	Provincial	Local	CPP/QPP	Total
			$ billions		
1990	–33.3	–8.4	<0.1	2.1	–39.6
1991	–37.2	–20.3	–1.1	1.4	–57.3
1992	–35.8	–28.2	–0.1	0.1	–63.9
1993	–39.7	–22.4	–0.3	–0.9	–63.4
1994	–35.1	–14.7	–0.3	–1.7	–51.7
1995	–31.7	–10.6	0.2	–1.0	–43.2
1996	–17.0	–4.2	<0.1	–2.2	–23.4
1997	6.5	–3.2	1.1	–2.7	1.6
1998	7.7	–9.7	4.0	–1.2	0.8
1999	8.8	2.8	3.5	0.8	15.9
2000	20.0	8.1	–0.4	4.0	31.7
2001	14.2	–6.9	–0.7	5.7	12.3
2002	9.0	–12.0	–1.7	8.0	3.3
2003	4.7	–4.8	–2.3	10.1	7.6

From SPCs to Trusts

The CRA's administrative policy of not assessing a shareholder benefit on the use of personal-use real property owned by a single-purpose corporation (SPC) ended on December 31, 2004; SPCs in place were grandfathered. (See "SPC Grandfathering," *Canadian Tax Highlights*, December 2004.) The prospective termination of the policy raises three questions: (1) The CRA said that the policy was terminated because the CRA perceived that the underlying US estate tax problems for Canadians had been generally resolved; is any special estate tax planning now required? (2) If the answer is yes, can a taxable benefit from an SPC be avoided? (3) Are there preferable alternatives?

Planning continues. The CRA says that article XXIX B of the Canada-US treaty, effective November 9, 1995, generally resolved the US estate tax problems that confronted Canadians who owned personal-use US real estate. A Canadian-resident non-US-citizen individual may be able to hold such property directly without incurring US estate tax on death if the US property is of modest value or the individual has a modest estate. Liability for US estate tax depends on the year of death and the value of the US and worldwide estates. The treaty credit against estate tax is the proportion of the unified credit for US citizens that the US gross estate value bears to that of the worldwide estate. The US-citizen unified credit is US$1,500,000 in 2005, US$2,000,000 in 2006-8, and US$3,500,000 in 2009. The estate tax is scheduled for repeal in 2010; but absent legislative change, it will reappear in 2011 with a credit of US$1,000,000. Thus, a Canadian-resident individual whose Florida condo has a fair market value of US$750,000 pays no US estate tax if he dies in 2005 and the condo is his only US asset and represents at least half of his worldwide estate's FMV. The condo's value for these purposes is reduced by any non-recourse mortgage on the property and its co-ownership by tenants in common. Improvements in both the treaty credit since 1995 and the unified credit since 2002 mean that many Canadians who directly hold US real estate can avoid US estate tax, but they must disclose their worldwide asset holdings to the IRS. Furthermore, the treaty credit is subject to the US Congress's control of the unified credit. The fate of the estate tax after 2010 remains unknown.

SPCs still alive? Prudent planning dictates that US real property not fall into an estate. Canadian planners are likely to continue to look at using the familiar Canadian-resident corporation to hold such property. If the shareholder finances the corporation's purchase with a non-interest-bearing loan and personally pays all operating costs, is there any taxable shareholder benefit? At the 2004 Association de Planification Fiscale et Financière (APFF) Round Table, the CRA deferred to the FCA's decision in *Youngman* (90 DTC 6322), dealing with the calculation of a shareholder benefit on corporate-provided residential real estate for personal use. (See also *Fingold*, 97 DTC 5449, and *Donovan*, 96 DTC 6085.) Youngman argued for an FMV rental versus the minister's equity rate of return: a "normal" rate of return multiplied by the equity (the greater of the cost and FMV) less consideration paid by the shareholder for the property's use. The court reduced the equity value by an interest-free loan from the shareholder to acquire the property. Thus, a property fully financed by an interest-free loan from the shareholder does not generate a shareholder benefit under the equity rate of return method unless the property appreciates in value—and perhaps not even then if the shareholder pays the operating costs, effectively consideration for the property's use.

However, it is not clear when the equity rate of return method prevails over the FMV rental approach. In *Fingold*, *Donovan*, and *Youngman*, the benefit was greater under the equity rate of return method. At the APFF round table, the CRA said that the benefit is "usually" FMV rent minus consideration paid for the property's use, but "the fair market rent may not . . . always be appropriate . . . particularly where it does not provide for a reasonable return," such as for a luxury residence or yacht. If the FMV rental method is used, it is not clear that the shareholder benefit is reduced by an appropriate rate of return on an interest-free loan to the corporation.

Corporate ownership also raises US concerns. If the US real property is sold, any gain is taxed at the 35 percent US rate, compared with the general 15 percent federal long-term capital gains tax rate on individuals. There is also the considerable risk that the IRS may consider an SPC to be ineffective to avoid estate tax. (See "Single-Purpose Corp Lookthrough?" *Canadian Tax Highlights*, November 2003.) It is not known whether the IRS takes the same position if the Canadian-resident corporation is not an SPC as formerly defined by the CRA policy.

The better way? The use of a properly structured spousal trust or discretionary family trust to hold the US real property should solve the issues connected with the Canadian shareholder benefit, the US corporate capital gains tax rate, and the US estate tax. Under the CRA's administrative policy, a taxable benefit from a trust under subsection 105(1) is not assessed on personal-use property (including real property) owned by the trust primarily for the use and enjoyment of a beneficiary or a person related thereto. (See also *Cooper*, 88 DTC 6525, where the FCTD applied subsection 105(1) narrowly.) A trust is taxed on long-term capital gains at the 15 percent US federal rate. Proper structuring of the trust can keep the property out of the settlor's estate: generally, the settlor must not be a beneficiary or hold a general power of appointment, and the trust may need an independent trustee.

A Canadian-resident trust's biggest drawback is the 21-year deemed disposition rule (or the deemed disposition in a spousal trust on the spouse's death). Payment of the tax may be preferable to a rollout of the property to a beneficiary immediately before the 21st anniversary if US estate tax still exists. If the capital gain can be triggered in the United States in the same year, the US capital gains tax can be claimed as a foreign tax credit in Canada. A non-resident trust cannot avoid the deemed disposition under the proposed non-resident trust rules (unless protection is available under a tax treaty).

James W. Murdoch
Thorsteinssons, Toronto

Generally Canadian GAAP

A recent technical interpretation (2004-0091181I7(e)) says that generally it is appropriate to use an unconsolidated balance sheet prepared in accordance with Canadian generally accepted accounting principles (GAAP) for the purposes of computing the various carrying values required to calculate large corporations tax (LCT).

A wholly owned Canadian subsidiary (Canco) of a US corporation was in turn controlled by a multinational parent. Canco prepared its financial statements in accordance with Canadian GAAP, but it also prepared US GAAP unconsolidated financial statements for its US parent; the US parent used those statements to prepare its consolidated US GAAP financial statements to be issued to its shareholders. The unconsolidated financial statements prepared in accordance with US GAAP were the statements that Canco presented to its US shareholder.

Under paragraph 181(3)(b), the balance sheet that provides the amounts relevant for LCT purposes is the one presented to the taxpayer corporation's shareholders. If the statements are not prepared in accordance with GAAP, or if no balance sheet is prepared, the rule states that the relevant amounts for computing LCT are those that would have been reflected if the balance sheet had been prepared in accordance with GAAP. However, there is no express requirement that the statements must comply with Canadian GAAP in particular.

After brief consultations with representatives from Finance, officials from Rulings concluded that the intention of the rule is that, where possible, the calculation of amounts and carrying values for purposes of computing LCT for all taxpayers should be determined under a similar set of rules, and those rules are Canadian GAAP. Although a US GAAP statement was presented to the shareholder, Rulings concluded that it would be appropriate to use "the Canadian GAAP prepared balance sheet," which the taxpayer had in fact also prepared. In Rulings' view, the reference to GAAP in subsection 181(3) generally means Canadian GAAP. However, Rulings went on to say that in some situations it might be acceptable to use a balance sheet prepared in accordance with foreign GAAP—for example, in the case of a non-resident that carries on business in Canada through a permanent establishment.

John Jakolev
Jet Capital Services Limited, Toronto

Dividend on Crystallization

A recent technical interpretation (2004-0106161E5) concerns the application of the subsection 55(2) anti-avoidance rule and the section 84.1 deemed dividend rule to transactions intended to crystallize capital gains on qualified farm property. The TI says that section 84.1 applies to the hypothetical transactions, yielding a taxable deemed dividend rather than a capital gain eligible for the capital gains exemption. It appears that the CRA continues to examine whether the parties in a crystallization are arm's length in fact.

In the TI hypothetical, Mr. A owns 100 percent of the outstanding common shares of Farmco, a CCPC, which have an FMV significantly higher than their adjusted cost base (ACB). On the shares' sale, Mr. A is eligible to claim the enhanced capital gains exemption for qualified farm property (defined in subsection 110.6(1)). An unrelated party, Mr. X, incorporates X Co, which purchases for $500,000 cash some of Mr. A's shares. Mr. A claims the capital gains exemption. Mr. A then lends the $500,000 to Farmco, which redeems the common shares owned by X Co for $500,000. After the redemption, X Co and Mr. A go their separate ways.

The TI request argues that the anti-avoidance rule in subsection 55(2) does not apply to recharacterize as a capital gain X Co's deemed dividend on the redemption of its Farmco shares, because the deemed dividend does not reduce a capital gain. Mr. A reports a capital gain on the share sale and on any future sale of Farmco. The sale price has not been reduced by the dividends; therefore, subsection 55(2) does not apply. Although it does not generally consider crystallization transactions undertaken to use a capital gains deduction to necessarily represent a misuse or abuse of the Act, the CRA believes that the steps taken must comply with section 84.1. That section applies when a Canadian-resident individual transfers shares of a corporation (Vendorco) to another corporation (Purchaserco) with which the individual does not deal at arm's length and, immediately after the disposition, Vendorco is connected with Purchaserco. To avoid triggering an immediate deemed dividend, the non-share consideration received on the transfer cannot exceed the greater of the transferred shares' paid-up capital and the individual's ACB of the shares immediately before the transfer. In the TI hypothetical, the CRA says that paragraph 84.1(1)(b) applies to deem Mr. A to receive a dividend of about $500,000 because Mr. A, Mr. X, X Co, and Farmco appear to be not dealing at arm's length. The transactions may also constitute avoidance transactions under subsection 245(3) and thus may be subject to GAAR. After outlining why subsection 84.1 applies, the CRA does not comment on the potential application of subsection 55(2).

The TI's position is consistent with *Interpretation Bulletin* IT-419R2, "Meaning of Arm's Length," which says that if one party to a transaction is merely accommodating the other in an attempt to obtain a certain tax result, the parties may not be dealing at arm's length. This follows because they are not acting in their own separate economic interests; maintaining separate economic interests is a hallmark of ordinary commercial dealing at arm's length.

Wayne Tunney
KPMG LLP, Toronto

Subsection 95(6): A GAAR?

Renewed interest in paragraph 95(6)(b) has been sparked by recent CRA comments and by expectations concerning TCC decisions in 2005 in *Kruger* and *Univar*. On a positive note, it is understood that *Kruger* was recently settled without the application of paragraph 95(6)(b) and that Finance and the CRA are engaged in discussions about the rule's appropriate interpretation.

Paragraph 95(6)(b) is an anti-avoidance rule enacted as part of the 1972 tax reform, as was the original framework of the foreign affiliate and FAPI provisions. If a person acquires or disposes of shares of a corporation (or of interests in a partnership) and "it can reasonably be considered that the [transaction's] principal purpose . . . is to permit a person to avoid, reduce or defer the payment of tax," the acquisition or disposition is deemed not to have taken place for the purposes of sections 91 through 95. The rule was modified in 1994 to replace the "one-of-the-main-reasons" test with the "principal-purpose" test. Example 16 in the accompanying technical notes outlined facts that Finance said attracted the rule. In the example, a wholly owned foreign subsidiary (FC) of Canco carries on an active business in a designated treaty country. Canco sells 11 percent of its FC shares to an unrelated Canadian resident (X Co), which then forms a foreign financing subsidiary (FX) to loan funds to FC. The 11 percent FC interest is sold back to Canco by X Co at a fixed price when the loan is repaid. Finance indicated that paragraph 95(6)(b) applies: the FC shares are deemed to have been neither acquired by X Co nor disposed of by Canco. As a result, FX's income earned is FAPI, because subparagraph 95(2)(a)(ii) does not apply.

Many income tax practitioners are surprised to see the CRA applying, or proposing to apply, paragraph 95(6)(b) to other structures in which the legal and economic rights associated with an investment in a controlled foreign affiliate are congruent, unlike the structure described in the 1994 technical notes. The 1994 example implies that Finance intended to restrict the rule's application to aggressive avoidance transactions in which the legal and economic rights of a shareholder did not match; the rule was not intended to serve as a broad anti-avoidance rule.

Arguably, the language of paragraph 95(6)(b) has broad application if read on a stand-alone basis (not in the context of subdivision i read as a whole). Almost any investment in a foreign affiliate could be challenged, such as the simple transfer of a foreign branch to a foreign affiliate. Applying the rule on a stand-alone basis appears to potentially deny the intended application of the other provisions in subdivision i, and it could create a significant level of uncertainty regarding any investment in a foreign affiliate. The CRA has subsection 245(2) at its disposal if it views particular structures to be offensive; using paragraph 95(6)(b) as a surrogate creates unnecessary uncertainty. At the time of writing, the Joint Committee on Taxation of the CBA and the CICA was finalizing a submission to the CRA respecting the ambit of paragraph 95(6)(b).

FAs owned by partnerships. CRA document 2004-0073101E5 (February 24, 2005) states, "Since in our example the partners have collectively acquired the shares of a non-resident corporation, the requirements for the application of subparagraph 95(2.2)(a)(i) have been satisfied." This position could alleviate concerns expressed in an earlier article regarding the application of paragraph 95(2.2)(a) (see "FAs Owned by Partnerships," *Canadian Tax Highlights*, September 2004).

Albert Baker
Deloitte & Touche LLP, Montreal

Income-Splitting Savings

Generally, for Canadian personal income tax purposes, the tax unit is the individual, not the family. Income splitting among family members can yield valuable tax benefits.

The almost ubiquitous federal and provincial graduated tax rates—except in Alberta—allow access to otherwise unused lower levels of the graduated rates by means of income splitting among family members or the use of a testamentary trust. Income splitting also generates significant tax savings through the use of various shelters available to family members, such as basic personal amounts and other non-refundable tax credits (including those for charitable donations, political contributions, tuition and education amounts exceeding the annual maximum transferable portion, and non-refundable medical expenses); loss carryforwards that would otherwise expire or be used to shelter income in a low tax bracket; capital gains deductions; investment tax credits; alimony payments; AMT credits; foreign non-business income tax credits; and exemptions from assorted provincial income-based premiums or taxes (such as the Ontario health premium). Income splitting with family members or a testamentary trust may sidestep federal and provincial clawbacks for payments such as Old Age Security and the guaranteed income supplement, provincial seniors' benefits, federal and provincial child tax benefits, GST credits, age credits, and some property and sales tax credits. Significant tax savings may also arise if the family members (or trusts) reside in another province or territory that has different income tax rates and bracket thresholds.

Changes to the federal personal tax rates and brackets over the past 10 years generally increased the system's progressiveness and thus increased the tax savings from income splitting. Most provinces and territories followed that route, except for the three most westerly provinces. The 10 percent flat tax in Alberta and significant reductions to top marginal provincial tax rates for British Columbia and Saskatchewan residents generally reduced—and in Alberta's case eliminated—the income-splitting savings attributable to graduated provincial rates. Nevertheless, the combined income-splitting savings available federally and in those three provinces (from graduated rates and the increased personal exemption amounts for residents) amount to more than in the past. Reindexation of the tax brackets and various non-refundable tax credits for federal tax purposes and in many provinces and territories will further boost such savings, absent changes to tax rates. However, Ontario's 2004 health premium and its corresponding rate structure reduced family tax savings from income splitting for certain Ontario-resident individuals, except trusts.

Table 1 Family Income Splitting, Ontario-Resident Splittor and Splittee

		Taxable income of splittee, $		
		25,000	50,000	115,739
Adult child with no other income				
Estimated income tax liability				
Federal		2,696	7,561	23,805
Ontario		1,017	3,025	13,028
Total estimated tax liability	A	3,713	10,586	36,833
Tax otherwise payable for splittor	B	11,602	23,205	53,714
Tax savings—preliminary	B−A	7,889	12,619	16,881
Less: estimated Ontario health tax		(300)	(600)	(750)
Tax savings—adjusted		7,589	12,019	16,131
Spouse with no other income				
Estimated income tax liability				
Federal		2,696	7,561	23,805
Ontario		1,017	3,025	13,028
Total estimated tax liability	D	3,713	10,586	36,833
Add: loss of spousal credit	E	1,764	1,764	1,764
Adjusted estimated tax liability	F=D+E	5,477	12,350	38,597
Tax otherwise payable for splittor	G	11,602	23,205	53,714
Tax savings—preliminary	G−F	6,125	10,855	15,117
Less: estimated Ontario health tax		(300)	(600)	(750)
Tax savings—adjusted		5,825	10,255	14,367
Testamentary trust with no other income				
Estimated income tax liability				
Federal		4,000	8,864	25,109
Ontario		1,513	3,521	13,802
Total estimated tax liability	H	5,513	12,385	38,911
Tax otherwise payable for splittor	I	11,602	23,205	53,714
Tax savings	I−H	6,089	10,820	14,803

Note: It is assumed that (1) the splittee's taxable income consists solely of ordinary income and/or taxable capital gains, (2) the income splittor is subject to the maximum level of the Ontario health premium before and after income splitting, (3) neither party receives any federal or provincial benefits subject to clawback, and (4) 2005 tax rates apply to both parties.

Table 2 Family Income Splitting, Alberta-Resident Splittor and Splittee

		Taxable income of splittee, $		
		25,000	50,000	115,739
Adult child with no other income				
Estimated income tax liability				
Federal		2,696	7,561	23,805
Alberta		1,048	3,548	10,122
Total estimated tax liability	A	3,744	11,109	33,927
Tax otherwise payable for splittor	B	9,750	19,500	45,138
Tax Savings	B−A	6,006	8,391	11,211
Spouse with no other income				
Estimated income tax liability				
Federal		2,696	7,561	23,805
Alberta		1,048	3,548	10,122
Total estimated tax liability	D	3,744	11,109	33,927
Add: Loss of spousal credit	E	2,559	2,559	2,559
Adjusted estimated tax liability	F=D+E	6,303	13,668	36,486
Tax otherwise payable for splittor	G	9,750	19,500	45,138
Tax Savings	G−F	3,447	5,832	8,652
Testamentary trust with no other income				
Estimated income tax liability				
Federal		4,000	8,864	25,109
Alberta		2,500	5,000	11,574
Total estimated tax liability	H	6,500	13,864	36,683
Tax otherwise payable for splittor	I	9,750	19,500	45,138
Tax savings	I−H	3,250	5,636	8,455

Note: It is assumed that (1) the splittee's taxable income consists solely of ordinary income and/or taxable capital gains, (2) neither party receives any federal or provincial benefits subject to clawback, and (3) 2005 tax rates apply to both parties.

The tables outline the estimated current tax savings from income splitting for Ontario and Alberta residents at various income levels. The income splittor is assumed to be taxed at top marginal tax rates and to have exhausted all available personal tax shelter; the income splittee is assumed to have nil taxable income and no personal tax shelter other than the basic personal amount. The tax savings vary according to the parties' province or territory of residence, but generally the greatest benefit arises when income is split with an adult child (or possibly a minor when the underlying income is not subject to attribution or the split tax). However, the tables illustrate the potential for thousands of dollars in annual tax savings for families when income is split with a spouse or testamentary trust.

Donald E. Carson and Iain D. Morris
PricewaterhouseCoopers LLP, Toronto

US Proposals Deny Valuation Discounts

On January 27, 2005, at the request of the chairman and ranking member of the US Senate Finance Committee, the US Joint Committee on Taxation issued a report, "Options To Improve Tax Compliance and Reform Tax Expenditures." The report includes a recommendation to deny certain valuation discounts in determining FMV for US federal estate and gift tax purposes: (1) minority (lack of control) discounts; (2) marketability (illiquidity) discounts; (3) fragmentation (fractional interest) discounts; and (4) investment company discounts. The proposal applies to transfers made and estates created on or after enactment.

The proposal limits such discounts in valuing inter vivos and testamentary gifts of shares, partnership interests, and other closely held business ownership interests. Aggregation rules and lookthrough rules apply to inter vivos gifts, transfers at death, and generation-skipping events for transfer tax purposes. A transferor or transferee is considered the owner of an interest in an asset owned by his or her spouse. Step-transaction principles may treat two or more transfers as a single event.

Under the basic aggregation rule, an asset's value is generally the transferor's pro rata share of its FMV immediately before the transfer. The transferee aggregation rule applies if a donor, or a deceased's estate, does not own a controlling interest in an asset immediately before its transfer, but in the recipient's hands the asset forms part of a controlling interest. In that case the state, gift, or generation-skipping transfer tax value is the pro rata share of the en bloc FMV of the interest to be owned by the donee or beneficiary. The transferee aggregation rule prevents the strategic sequencing of multiple gifts to the same donee.

Under the lookthrough rule, if at least one-third of a holdco's asset value comprises marketable assets, the value of a transferred interest in the holdco is the aggregate of the net value of the marketable assets (cash, marketable securities, precious metals, etc.) allocable to the transferred interest and the value of the transferor's interest in the holdco attributable to the non-marketable assets. The rule effectively denies a marketability discount on the holdco's issued shares to the extent of its marketable assets. A minority discount is not applicable because the lookthrough rule applies only if the transferred interest is part of a controlling interest either before or after the transfer; the rule assumes that a marketability discount results in the undervaluation if the shareholder owns a controlling interest and therefore has easy access to its marketable assets. The proposal does not eliminate minority and marketability discounts that are supported by the facts. The proposed aggregation and lookthrough rules are intended to restrict claims for minority and marketability discounts in situations that do not reflect the value of the ownership interest transferred. The US Joint Committee believes that estate and gift tax should focus on the amount by which a transfer depletes the value of the transferor's holdings. The report also notes that US courts have recognized blockage discounts, key-person discounts, and discounts for embedded taxes on accrued gains of a holdco.

Richard M. Wise
Wise Blackman, Montreal

"A" Reorgs Embrace Forco

On January 5, 2005, the IRS issued proposed regulations that allow certain mergers and consolidations effected pursuant to foreign law to qualify as tax-free "A" reorganizations, if they meet certain criteria in the US law and qualify as reorganizations under foreign law. The regs become effective when published as temporary or permanent regulations, and they will be welcome relief to practitioners.

Currently, certain transactions involving foreign corps qualify for tax-free treatment as "B," "C," or "D" reorganizations, but generally not as "A" reorganizations. This limitation adds complexity and restricts flexibility in structuring such transactions, because "A" reorg requirements are generally less stringent in matters such as the amount of non-stock consideration that can be given by the acquiror, the amount of unwanted assets of the target that can be retained or disposed of before the acquisition, and the treatment of option holders. For example, an "A" reorg generally does not restrict the use of cash (and other non-stock) consideration given by the acquiror, other than the general "continuity of proprietary interest" requirement, which generally permits at least 50 percent cash (most practitioners are comfortable with 60 percent); "B" and "C" reorgs generally impose lower thresholds or prohibit the use of cash altogether. Expanding the scope of "A" reorgs to embrace foreign corps will also ease internal restructurings in many cases, such as the merger of a US parent's two foreign subs.

At present, to qualify as an "A" (statutory merger) transaction, the merger must be effected pursuant to the laws of the United States, any state, or the District of Columbia. Mergers and consolidations arising under foreign law generally do not qualify, although some cross-border transactions may be structured to meet "A" requirements; for example, a foreign acquiror of a US company can form a US acquisition subsidiary to merge with the target. The proposals replace the US-law requirement with a requirement that the transfer of assets and liabilities be effected "pursuant to the statute or statutes necessary to effect the merger or consolidation." If the transaction is effected under foreign law, it must also qualify as a reorganization under that foreign law and must meet certain criteria found in the US law: most notably, the assets and liabilities of the participating corporations must be transferred by operation of law—that is, by statutory rule rather than by contract.

The new regs remove certain existing restrictions on statutory mergers and consolidations that involve foreign disregarded entities. In general, the ownership of such an entity (for example, an NSULC) by one merging party no longer prevents a merger from qualifying as an "A"

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

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

reorganization: previously, the "effected under US law" requirement created uncertainty even if both corporations involved in the merger were domestic.

The new regs encompass both foreign-to-foreign mergers and US-to-foreign mergers. Regarding the latter, the Delaware merger statute contemplates mergers of Delaware corporations and foreign corporations if the transaction is authorized under foreign-country law. The regs also appear to encompass a Canadian amalgamation; it does not qualify under the two-party US merger structure, where one corporation survives and the other disappears, but it may qualify under the consolidation structure, where a new third corporation is deemed created.

Jessica S. Wiltse and Thomas W. Nelson
Hodgson Russ LLP, Buffalo

Canada-US Personal Tax Traps

US-citizen spouse: Estate tax. For asset protection reasons, assets are accumulated in the name of a US-citizen Canadian-resident spouse. The non-US citizen's will grants an outright bequest to the US citizen with a gift over to children. Both spouses have personal life insurance. Although this planning is common in Canada, unless (1) assets are not accumulated in the US citizen's name, (2) the will provides only a life interest to him or her, and (3) the insurance is held in a trust, those properties are exposed to US estate tax on his or her death.

US insurance policy. If a Canadian citizen and resident purchases a US whole life insurance policy from a US agent while vacationing there, Canada will require annual reporting of the growth in the foreign insurance policy as income under the foreign investment entity rules using the mark-to-market approach.

IBC carries on a US business. A Canadian resident may form an offshore company in a treaty jurisdiction to carry on an active business. A Barbados IBC may benefit from a 2.5 percent tax rate in Barbados and no Canadian tax, but it is subject to US corporate and branch tax if it carries on a US trade or business with effectively connected income.

Estate freeze. In a traditional non-taxable Canadian estate freeze, a Canco's common shares are exchanged for preference shares, redeemable at the shareholder's option and perhaps yielding a non-cumulative dividend. New common shares may be issued for nominal consideration to children or to a trust for them. A US-citizen parent involved in such a freeze may incur substantial US gift tax, unless, for example, his shares yield a cumulative dividend at a reasonable rate and the children pay at least 10 percent of the business's value for the commons.

Freeze in favour of US children. Children of non-US citizens who are US citizens or residents and beneficiaries of a Canadian trust encounter the US throwback rule, which taxes prior trust income accumulated for their benefit.

Canadian trust windup. A Canadian-resident trust may distribute capital on a tax-deferred basis to a Canadian-resident beneficiary; in the case of non-resident beneficiaries, the assets are deemed disposed of at FMV and tax is payable on the gain. A Canadian personal trust also suffers a deemed realization every 21 years; most such trusts with appreciated assets dissolve before then. Alternatively, before the dissolution, a US beneficiary can roll the trust interest to a Nova Scotia unlimited liability company (NSULC) for both Canadian and US tax purposes. The trust may then roll its assets to the NSULC, a Canadian corporation that is ignored for US tax purposes.

Holdco. A US citizen who holds investments in a holding company may be exposed to the US subpart F or PFIC rules (if there are other shareholders) unless an NSULC is used.

Ontario company to NSULC. A US-resident or US-citizen Canadian resident who owns an Ontario company and converts it to an NSULC to gain US benefits may suffer a taxable liquidation for US purposes because the conversion involves a Canadian amalgamation.

Jack Bernstein
Aird & Berlis LLP, Toronto

Foreign Tax News

Treaties

Azerbaijan's parliament has refused to ratify its treaty with Canada, signed in 2004. Canada has apparently been advised that ratification is contingent on Canada's nullifying its contract to develop Turkmenistan's offshore Kapaz oil field in an area of the Caspian Sea claimed by Azerbaijan.

Carol Mohammed
Canadian Tax Foundation, Toronto