Canadian Tax Highlights

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United Kingdom: Corporate Residence

In *Wood*, the UK Chancery Division ([2005] EWHC 547) overturned a decision of the Special Commissioners and concluded that a company incorporated in the Netherlands was not a UK resident at the relevant time in spite of influence from the UK parent. We understand that Her Majesty's Revenue and Customs (formerly Inland Revenue) will appeal.

The court agreed with the longstanding principle that the test of a corporation's residence was its central management and control and said that the commissioners arrived at a conclusion that was not supported by the test that they had purported to use. If a corporation is created under the laws of a local jurisdiction and maintains a board of directors that meets there, the corporation may still be viewed as an extension of its parent; but the court distinguished between exercising management and control and influencing those who do so. Furthermore, a corporation may be established to fulfill particular purposes, and local management may respond to proposals put before them rather than initiate transactions and activities: local residence is not usurped if a parent tells local management what it wants management to do, so long as the matter is left to the local board to conform or not.

The parties in *Wood* agreed that E Co (acquired from a well-known Netherlands banking and financial group) was a Netherlands resident before the series of transactions under review. A Netherlands trust company (Trustco) was appointed corporate managing director of E Co under a management agreement. The transactions included the acquisition of shares of a company (Holdings) by E Co, followed by their sale about three months later. Trustco received advice from the corporate finance group of a professional services firm, but the evidence showed that Trustco would not implement any decision that was not acceptable to it. The court reviewed the "style" of the communications between E Co's management and its advisers and concluded that the recommendations on the proposals to buy and sell were recommendations only. E Co's management was free to back away from the transaction should it choose to do so: receiving and accepting advice from UK advisers did not make E Co a UK resident.

Her Majesty's Revenue and Customs and the commissioners emphasized that after E Co acquired the shares, its only business was holding them until their eventual sale to a third party. In response, the court said, "I would ask: 'So what?'" But in any event the court disagreed: E Co purchased the shares with a view to resale, sought services for advising on and negotiating the sale, received such advice, and accepted an offer to purchase. In fact, all the evidence showed that all necessary decisions were made in the Netherlands. "If directors of an overseas company sign documents mindlessly, without even thinking what the documents are, . . . it would be difficult to say that the national jurisdiction in which the directors do that is the jurisdiction of residence of the company. But if they apply their minds to whether or not to sign the documents, the authorities . . . indicate that it is a very different matter." Although it was largely true that Trustco "simply fell in with the wishes of Mr. Wood expressed by his advisers . . . it seems . . . to ignore the realistic recognition in the authorities that, when companies are established in overseas jurisdictions in order to carry through some element in a wider scheme or business structure the idea for which originated with the parent company, their directors customarily do fall in with the overall plan: but the companies do not thereby fail to be resident in their own jurisdictions."

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In This Issue

Third-Party Privilege

In Canada and Australia, it is established law that communications made and materials prepared by accountants are privileged when the accountant is the client's agent for the purpose of obtaining legal advice. The test is difficult to apply and creates barriers to ensuring that privilege cloaks an accountant's advice in the tax context. In *Pratt Holdings* (2004 ATC 4526), the full court of the Australian Federal Court recognized the dilemma and dispensed with the requirement of agency on the accountant's part, focusing instead on the function that the advice served: was the knowledge, skill, and expertise truly required in order to instruct the legal advisers fully?

Between 1990 and 1995, the Pratt group engaged in a major balance sheet reconstruction and refinancing exercise. Pratt sought advice from a law firm regarding significant losses experienced by a group member. The law firm recommended that Pratt obtain an asset valuation from an independent accounting firm to determine the quantum of losses. An accounting firm was retained; the firm delivered its findings to Pratt, which passed the report on to its solicitors. The Commissioner of Taxation sought access to documents prepared by the accountants, including internal working notes (for example, e-mails exchanged between accounting personnel, notes on calculations, and records of research); memoranda and other notes of discussions between accounting personnel and Pratt's personnel; documents created by accounting personnel; and final and draft versions of the accountants' paper. In determining whether privilege attached to the communications between Pratt and the accountants, the issues were whether the firm was Pratt's agent and the purpose for which it was consulted.

The trial judge did not consider purpose, having found that the accounting firm was not an agent: privilege could thus not attach to the communications. The full court overturned the decision. After a useful review of the roots of privilege in British and Australian law, the full court said that the complexity of commercial arrangements was matched by the increasing volume, complexity, and technicality of the law. A company that wished to obtain legal advice on its tax obligations might need to rely on various experts to assist in instructing its legal advisers. The full court found no meaningful distinction between experts who were agents and those who were not: it was arbitrary to determine the availability of privilege on the basis of whether the expert opinion is delivered to the lawyer directly by the expert or by the client. The court's role is to determine "exactly what function was served by the expert advice and whether it was really required in order to instruct the legal advisers fully." The complexity and technicality of modern commercial transactions require the law to facilitate effective communications with one's legal advisers; having to forgo privilege in relation to that information would undercut the privilege itself.

The court rejected the floodgates argument. The purpose of obtaining advice on the most commercially advantageous structure for a transaction is in most cases independent of the need for legal advice even if the parties intended to submit the structuring advice to a lawyer for comment; the party claiming privilege still has the onus to prove that obtaining legal advice was the dominant purpose. The court said that there was no policy reason why privilege should be withheld from the documentary communication created by a third party if obtaining the information was necessary to enable the principal to garner the necessary expertise to obtain the legal advice required; persons who cannot rely on their own knowledge or resources are thus placed on an equal footing with those who can. To deny the right to use third-party services unless privilege is forgone disadvantages persons in need of such services and assistance, which in turn undermines the policy's underpinnings.

In *Susan Hosiery* (69 DTC 5278), the Canadian Exchequer Court recognized that privilege should attach where an accountant is used as a representative or one of the group of representatives for the purpose of placing a situation before a lawyer to obtain legal advice or where communications are received by such a representative from a lawyer whose advice has been sought. As the Australian Federal Court recognized in *Pratt*, in determining whether privilege attaches, the focus should be on function, not on formalities.

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Continued USco: No Treaty Benefits

In TAM 200509023, the IRS said that a taxpayer is not eligible for treaty benefits if it remained a USco that was included in its US parent's (USP's) consolidated US federal income tax return for years after its continuation into a foreign country (apparently Canada) and its treatment as a corporation under the foreign country's laws. The conclusion seems inconsistent with the current Canada-US treaty, but it coincides with the as yet unratified changes to the treaty proposed in 2000.

A USco (X Co) entered into a series of transactions whereby its USP contributed intangible property to X Co. Later that year, X Co continued into country A, and the basis of its intangible property was stepped up for country A tax purposes. X Co then contributed the property to a country B entity, B Co, in exchange for stock (later redeemed), cash, and two notes. X Co continued to be included in USP's US consolidated return. X Co also took the position that it was not subject to US tax on the gain realized on its contribution to B Co or on the B Co stock redemption. X Co said that it was a country A treaty resident and under that treaty only country A could tax those items. (Because of the basis step-up, country A did not recognize any gain on the contribution (or on the redemption, apparently).)

The IRS concluded that X Co was not entitled to treaty benefits: X Co should be considered a US resident for treaty purposes. On the relevant facts and circumstances, X Co effectively elected to be treated as a US corporation, and the IRS could invoke the treaty's saving clause and tax X Co as a US corporation as if the treaty had not come into effect. The IRS further reasoned that X Co's claim to treaty benefits was inconsistent with its inclusion on USP's consolidated federal income tax return and with the treaty's intent and purpose. The IRS also said that allowing X Co to claim treaty benefits would result in the treaty's abuse, and the United States may deny such benefits under the treaty's limitation-on-benefits clause.

The IRS's determination may be somewhat surprising: article IV(3) of the Canada-US treaty provides that "a company that was created in a Contracting State [say, the United States], that is a resident of both Contracting States and that is continued at any time in the other Contracting State [Canada] . . . shall be deemed while it is so continued to be a resident of that other State [Canada]." In 2000, US Treasury News Release LS-883 (September 18, 2000) announced proposed changes to the Canada-US treaty relating to the residence of continued corporations. The release states that the amendments clarify that a company incorporated in one country and continued into the other country is still treated as a resident of the former, unless that country's internal law no longer treats it as such. According to the release, these proposals were effective as of September 18, 2000, although no amending protocol has yet been signed or released. The TAM appears to take the view that because the news release merely clarifies the current treaty, the United States can now apply the clarification regardless.

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A New Player: StatsCan Study

A recent study published by Statistics Canada (http://www.statisticscanada.ca) summarizes changes in income and tax paid for all individuals who filed personal income tax returns from 1990 to 2002 (see catalogue no. 11-621-MIE). The study focuses on federal tax, ignoring significant changes in provincial income taxes over the same period and the effect of inflation.

The tax-filing population was divided into three groups—the top 10 percent, the bottom 50 percent, and the middle 40 percent. The bottom 50 percent's income rose from less than $19,000 in 1990 to $23,000 in 2002; the top 10 percent's income rose from over $48,700 to $64,500. As shown in the table, the top group's share of income increased from 32 to 36 percent over the period, and its share of federal tax increased from 46 to 53 percent.

Percentage Distribution of Tax Filers, 1990 and 2002

	1990	2002
Share of federal tax from:		
Bottom 50 percent	6.7	4.4
Middle 40 percent	47.3	43.0
Top 10 percent	46.0	52.6
Share of total income from:		
Bottom 50 percent	19.0	16.9
Middle 40 percent	49.3	47.4
Top 10 percent	31.7	35.7

The brief report from Statistics Canada contained interesting comments on the effective rates of tax for each group. The top 10 percent paid an average of 17.8 percent on their 1990 income and 16.5 percent in 2002. The effective rates for the other two groups declined even more, however, reflecting the major changes in rates in the last two years of the study. Because the top 10 percent includes many taxpayers with taxable incomes under the top rate bracket (unchanged in the series of tax cuts), this group shows a reduction in tax paid greater than that which could be expected from other changes, such as the reduction in capital gains inclusion rates.

Many observers may bemoan the lack of similar attention to provincial taxes. It is encouraging, however, that Statistics Canada is willing to devote its resources to the analysis of taxation statistics and to make the results easily available. We look forward to further studies based on Statistics Canada's extensive database and hope that more detail will be shown.

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EU R & D: No Territorial Restrictions

The European Court of Justice (ECJ) recently ruled in *Laboratoires Fournier SA* (C-39/04, March 10, 2005) that the French R & D tax credit was contrary to section 49 of the Treaty Establishing the European Community (TEEC) because it restricted the credit to activities carried out in France only.

The taxpayer, a manufacturer of pharmaceuticals, subcontracted out some R & D activities to EU locations outside France and included costs related thereto in its R & D credit calculation for its 1995 and 1996 taxation years. The ECJ ruled that the French R & D tax regime was contrary to the freedom to provide services contemplated by TEEC section 49 because it encouraged R & D activities carried out in France and discouraged taxpayers from using R & D centres outside France. (Although the French government modified its R & D tax credit before the ECJ's decision—to cover R & D activities carried out in other European Union states and within the European Economic Area after 2004—eligible expenditures are limited to €2 million, 25 percent of the maximum permissible claim in a year.)

The decision may affect other European tax incentives with territorial restrictions. In Canada, many provinces offer additional incentives for R & D work done solely within their borders: might taxpayers with PEs in more than one province challenge these territorial restrictions?

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In Lieu of Rent

The FCA in *Transocean* (2005 FCA 104) recently upheld a TCC decision that allowed withholding tax on a settlement paid by a Canadian-resident corporation to a non-resident for damages pertaining to the anticipatory repudiation of an agreement for the use of an offshore drilling rig. The decision confirms that paragraph 212(1)(d) is broad enough to impose withholding tax even if the property was never used in Canada; it also reinforces the need to consider the withholding tax implications of any cross-border payment, including damages and settlements.

Transocean was in the business of chartering offshore drilling apparatus and providing related and ancillary services. In 1997, on behalf of itself and a number of co-venturers, Petro-Canada entered into an agreement with Transocean's US affiliate to charter an offshore drilling rig for use in Canada. Before the rig was delivered, the co-venturers repudiated the agreement; the parties entered into a settlement and release that required the co-venturers to pay US$40 million to Transocean in full and final consideration for the agreement's voluntary termination. The co-venturers withheld and remitted 25 percent of the settlement, and the CRA denied Transocean's application for a refund. The TCC agreed that the settlement payment was subject to withholding tax: it was paid as, on account of, or in lieu of payment of rent or a similar payment for the use of, or for the right to use, a property in Canada.

The FCA examined whether paragraph 212(1)(d) was broad enough to cover an amount paid to compensate for rent that would have been paid for the use of property in Canada: the agreement was repudiated before the commencement of the rental term, and thus there was no use of the property and no rent payable. The FCA defined "rent" as an amount paid as compensation for the use or occupation of property, or for the right to use or occupy property. If the phrase "in lieu of rent" was interpreted to include only compensation for the past or current use of property, it would add nothing to paragraph 212(1)(d), and thus would have no meaning. Paragraph 212(1)(d) applies not only to an amount paid on account of, or in satisfaction of, such compensation for the use of property in Canada, but also to an amount paid in lieu of such compensation. A conflicting decision in *Puder* (63 DTC 1282 (Ex. Ct.)) was said to have been made without analysis and perhaps reflected the then prevailing strict construction of taxing statutes.

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Kentucky Tax Reform

Canadian businesses may be affected by recently enacted broad corporate tax reform in the state of Kentucky, located in the heart of the US automotive manufacturing belt. Out-of-state companies without a Kentucky PE can no longer easily escape Kentucky income taxation. The new law changes corporate income tax rules, expands the reach of the state's sales and use tax, imposes new taxes on communications and other technology services, and creates numerous economic development incentives.

- A new "doing business in the state" income tax nexus standard, comparable to that in other states, replaces a "physical presence" standard and exposes many out-of-state companies to Kentucky income taxation.
- The definition of "corporation" is expanded to include S corporations, LLCs (regardless of federal treatment), limited partnerships, and REITs. Some of those newly considered corporations must be included in a new mandatory consolidated return; others must file separate company returns.
- Affiliated group member corporations doing business in Kentucky must file a consolidated Kentucky return on a pre-apportionment basis, effective for taxation years beginning after 2004. An "affiliated group" consists of one or more chains of includible corporations doing business in Kentucky (with an 80 percent ownership requirement), excluding REITs, S corporations, loss companies with de minimis Kentucky apportionment factors, and companies with no Kentucky apportionment factors.
- A taxpayer must pay the greater of its income tax and a new alternative minimum tax.
- Net operating losses (NOLs) can no longer be carried back, effective for taxation years beginning after 2004. Taxpayers filing on a consolidated basis can deduct NOLs only to the extent of 50 percent of the income of filing group members; unused NOLs may be carried forward.

■ A corporation may apportion business income only if it is required to file a tax return or pay a tax based on income or capital in another state; the old rule only required payroll or property outside the state.

■ Certain related-party expenses are disallowed, such as interest that relates to intangible property and an addback for management fees, which are broadly defined. Certain exceptions apply for intangible expenses and for intangible interest and management fee addbacks.

■ An affiliate nexus collection obligation is imposed on out-of-state sellers for sales and use tax, effective August 1, 2005. The definition of a "retailer engaged in business in the state" now includes a person using a representative in the state who helps establish an in-state marketplace for the retailer, including the receiving or exchanging of returned merchandise.

■ An excise tax applies to purchases of certain telecommunication services, effective after 2005. Providers of such services are subject to a gross receipts tax.

■ Newly introduced economic development incentives may be affected by the Sixth Circuit Court of Appeals decision in *Cuno v. DaimlerChrysler* (September 2, 2004), which found Ohio tax incentives to be unconstitutional. Kentucky is within the Sixth Circuit's jurisdiction. (See "Ohio ITC Unconstitutional," *Canadian Tax Highlights*, February 2005.)

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EHT Update, Part 2

Recent refinements to the Employer Health Tax Act simplify procedures for making instalments, increase penalties on late-filed returns, clarify that taxable benefits are subject to EHT, and clarify the imposition of EHT with respect to employees who work at an Ontario PE. (See "EHT Update," *Canadian Tax Highlights*, September 2004, for a discussion of the first two changes.)

Regarding taxable benefits, the amendments mirror Ontario Finance's position in *EHT Information Bulletin* 2-96 (January 2004) and generally ensure that all employee income under sections 5 to 7 of the federal Income Tax Act is subject to EHT. These amounts include automobile benefits; interest benefits on low-interest employee loans; employee group term life insurance premiums; stock option benefits; and employer contributions to employee profit-sharing plans, employee trusts, or RRSPs.

The amendment that clarifies the EHT's application to employees who work at an Ontario PE is a response to the Ontario Superior Court of Justice (OSCJ) decision in *Toronto Blue Jays* (docket no. 03-CV-248830CM3, April 27, 2004), which excluded from the EHT base those salaries paid to employees who worked outside Ontario at games played by Ontario sports teams. The decision was recently overturned by the Ontario Court of Appeal (docket no. C41861, February 15, 2005). The taxpayers operated three professional sports teams: the Blue Jays, the Maple Leafs, and the Raptors. The taxpayers' head offices were in Ontario and their employees were paid from Ontario, except for the Florida-based employees of the Blue Jays. The teams played about half of their games at non-Ontario locations, where they were provided with a designated space, including a dressing room, coaches' room, and training room. The taxpayers' witness stated that a team's rights to a designated space resembled the rights of an individual in possession of a hotel room. The OSCJ said that the designated spaces at away games were fixed places of business, and thus PEs; however, bats, balls, sticks, pucks, uniforms, and training and medical equipment used by the teams at non-Ontario locations were not substantial machinery and equipment that elevated those locations to PEs. An SCC decision was cited as authority that "substantial" referred to size, not number. The Ontario Court of Appeal reversed on the first point: the away-game venues were not the taxpayers' PEs: the taxpayers had no element of ownership, management, or authority in the designated spaces at the away games, and their connection to and control of the designated spaces was insufficient for these venues to be considered fixed places of business. The court agreed that the machinery and equipment were not substantial.

The EHT amendments, retroactive to January 1, 1990, clarify that if an employee reports to work at an employer's Ontario and non-Ontario PEs during the year, all of his or her remuneration is subject to EHT. The changes' reach could thus extend far beyond the targeted *Toronto Blue Jays* scenario. An exception applies for employees who work at a non-Ontario PE for all or substantially all of the year.

The decision is a relief to non-Ontario teams that visit and play at sports stadiums in Ontario and that might otherwise have been subject to EHT. Because the EHT PE definition parallels the income tax definition, the decision may also have implications for income tax purposes. (The treaty definition may differ.)

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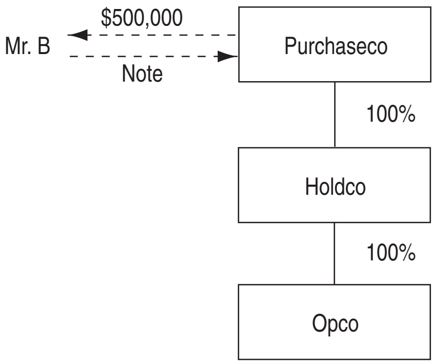
Arm's Length: Section 84.1

The TCC recently held in *Brouillette* (2005 TCC 203; judgment available in French only) that section 84.1 (which deems amounts to be dividends, not proceeds of disposition) and section 245 (GAAR) did not apply in what appears to be an obviously arm's-length sale of the shares of a business.

Mr. B and Mr. R each owned half of Opco, which operated an auto dealership. Mr. R wished to retire and sell his interest. To acquire the interest, Mr. B and Purchaseco, owned by two individuals unrelated to him (the two purchasers), formed a Holdco, whose shareholders were Mr. B (51 percent) and Purchaseco (49 percent). In June 1995, Holdco used the proceeds of a loan from Opco and cash proceeds from Purchaseco's share subscription to purchase Mr. R's interest in Opco for $500,000. Next, as arranged, Mr. B rolled over his Opco common shares for $500,000 of non-voting and non-participating preferred Holdco shares with nominal paid-up capital. Holdco was then Opco's sole shareholder.

In October 1995, Mr. B sold his 500,000 Holdco preferreds to Purchaseco for a $500,000 non-interest-bearing demand note with a minimum annual payment of $50,000 (as Opco's cash flow permitted) and the balance payable October 1, 2000. In a unanimous shareholders' agreement of November 1995, Holdco's shareholders (Mr. B and Purchaseco) agreed that Purchaseco would not receive any dividends from Holdco while the promissory note remained outstanding and would use all amounts received from Holdco to satisfy the note. In June 1997, Purchaseco exercised a right of prepayment and paid Mr. B $300,000 in final satisfaction of the note.



The CRA said that Mr. B was not dealing at arm's length with Purchaseco; section 84.1 applied, and the proceeds of the sale of shares received by Mr. B triggered an immediate deemed dividend, not proceeds of disposition giving rise to a capital gain. The CRA further contended that GAAR applied. The CRA argued that Mr. B and Purchaseco were acting in concert in this transaction because only one entity was responsible for negotiating the transactions and the parties were economically dependent and acted without separate interests. The unanimous Holdco shareholders' agreement of November 1995 gave Mr. B full control over Purchaseco's revenues from Holdco and indirect control of the use of any surplus generated by Opco. The CRA also said that Mr. B's sale of his 500,000 preferred shares to Purchaseco had no commercial legitimacy, and the demand note only served to create an artificial situation. In the CRA's view, Mr. B exercised control in fact over the entire transaction. The CRA also claimed that GAAR applied because these were avoidance transactions without a real business purpose.

Mr. B said that he and the purchasers had different economic interests and that the transaction was entered into strictly for the purchase and sale of his remaining half-interest in Opco. Mr. B was not a shareholder of Purchaseco, nor did he have de jure or de facto control of it. The transaction was structured to minimize tax, but that did not mean that the parties were acting in concert.

The TCC said that section 84.1 did not apply: Mr. B and Purchaseco were dealing at arm's length because their interests were distinct. The purchasers were interested in acquiring a new business without the presence of the old shareholders, a scenario anticipated from the outset. One shareholder (Mr. R) retired immediately; under the terms of the demand note, Mr. B was to leave within five years and in fact left within two years. The parties' use of the same accounting firm for the tax-planning advice did not mean that they were acting in concert: the clients, not the advisers, made final decisions and clearly acted with their own benefit in mind. Nor did Mr. B control Purchaseco: the requirement that Purchaseco satisfy the shareholders' purchase price before obtaining dividends on Opco's profits was designed to protect the vendor and did not cause control of Purchaseco to pass to Mr. B.

These findings precluded the application of GAAR: "This brings an end to the judicial debate. To decide that section 245 should apply would be making the law. [The CRA] indicated that the Act does not tolerate corporate surplus stripping. Thus it would have been necessary for [the CRA] to indicate which section . . . could apply besides section 84.1" (unofficial translation). Even if it were possible to apply section 245, the TCC said that the objective of the transactions was essentially business or commercial. The financial advisers helped the parties to complete these transactions in the most tax-efficient way. Because the parties acted with separate and distinct commercial interests, subsection 245(3) rendered GAAR inapplicable.

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Naming Rights: Still a Gift

A recent advance ruling (2005-0110701R3) says that a donation gifting program to a university by an individual's private corporation and a private foundation (the donors) that is subject to certain conditions, including naming rights for the individual, constitutes a charitable gift for income tax purposes.

In the ruling, a Canadian-resident individual (Mr. T) is the controlling shareholder of a private Canco. Mr. T wishes to enter into an agreement with Canco, a private foundation, and a university under which Canco and/or Mr. T will make a series of charitable donations to the university. The donation program is intended to enable the university to create and fund scholarships for students entering or enrolled in a particular faculty; Mr. T wishes the faculty to be renamed after him and another individual. In the unlikely event that the university does not keep its part of the bargain, it must repay the donation plus interest to the foundation, which will expend the amounts on charitable gifts to qualified donees in that year or the next. Otherwise, the gift is irrevocable to Mr. T, Canco, and any related persons. Mr. T, Canco, and the foundation agree not to participate actively in, or be employed in, the day-to-day operations of the university or the faculty. The donation's purpose is to support and encourage the particular faculty.

Mr. T asked the CRA to confirm whether the donation constituted a gift for income tax purposes; whether subsection 15(1) applied to include the amount of Canco's donation in his income as a shareholder benefit; and whether the amount of the advantage from the naming rights is nil for the purpose of proposed subsection 248(31). In general, a gift is a voluntary transfer of property owned by a donor to a donee, in return for which no benefit flows to the donor. Proposed subsection 248(30) defines the eligible amount of a gift as the amount by which the FMV of the property given exceeds the amount of the advantage from the gift. That advantage is described in proposed subsection 248(31) as, in general, the total value of all property, services, compensation, or other benefits to which the donor is entitled as partial consideration for, or in gratitude for, the gift. The advantage may be contingent or receivable in the future, whether to the donor or to a non-arm's-length person, and need not be receivable from the charity.

The CRA ruled that subsection 15(1) did not apply to include the corporate donation in Mr. T's income. For a previous ruling, the CRA's valuation section advised that if there is no prospective economic benefit associated with the naming rights—naming faculty, scholarships, or chairs after the shareholder in this case—no value is assigned them. In the absence of such a benefit, the amount of the advantage under proposed subsection 248(31) is nil. This position is consistent with previous rulings that conditions attached to a gift do not alone negate the gift.

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OECD Model on PEs

The 2003 and 2005 updates to article 5 of the OECD model treaty revised the PE commentary on fixed place of business and agency and added new guidelines for electronic commerce. The threshold for the existence of a PE has been lowered, exposing to tax previously treaty-protected business profits. The CRA generally follows the OECD commentary except where Canada has specifically entered a reservation, an approach generally accepted by Canadian courts.

■ In *Dudney* (2000 DTC 6169 (FCA)), a US-resident independent contractor successfully argued that he had no fixed place of business in Canada, although he spent 300 days in Canada in 1994 working for one client. He did not have an exclusive office, he did not have control over the premises where he worked, he could not carry on other business at the premises, and he had restricted use of the telephone and restricted access to the building. The court concluded that Dudney did not carry on "his" business at the client's premises; the CRA follows *Dudney* if a taxpayer does not have sufficient physical control of the space to carry on his business there. The amended OECD commentary appears to mandate a different conclusion: a place of business may exist even if the occupant has no formal right to use the premises. For example, a PE is established by the presence of a painter in the office building of his main client, for three days a week for more than two years, to perform the most important function of his business (painting). Revised technical notes will clarify the CRA's position on *Dudney*.

■ A business maintained for less than six months is presumed to lack the permanency required for a PE. A temporary interruption in activities does not terminate a PE. A place of business that exists for a short time may be a PE if by virtue of the nature of the business its term is short.

■ If a consultant provides services to several offices of the same company under a single contract, each location is considered separately in determining whether there is the necessary geographic coherence for a single place of business. Related locations may be considered a fixed place of business. Leasing tangible or intangible property to third parties through a fixed place of business maintained by an enterprise generally renders it a PE; the maintenance of a fixed place of business, the provision of other services, or the supervision of the equipment is crucial.

■ A dependent agent (individual or corporation, employee or not) with authority to contract may create a PE. Dependence hinges on whether the person is subject to detailed instructions or comprehensive control and whether he has entrepreneurial risk. The agent need not be a resident of, or have a place of business in, the state where he acts for the enterprise. Contracts that are binding on the enterprise need not be in that enterprise's name. An enterprise's lack of active involvement in transactions may indicate a grant of authority to an agent. For example, an agent is not a PE if he only solicits and receives (but does not finalize) orders that are sent to a warehouse from which goods are delivered and that are routinely approved by the foreign office. Factors pointing to an agent's PE status include an absence of significant control; freedom to conduct business on behalf of the principal; provision of information to the principal for the purpose of ensuring the smooth running of the agreement, not for the purpose of obtaining approval; having more than one principal; bearing risk and reward through the use of entrepreneurial skills and knowledge; and performing activities in the ordinary course of the agent's business rather than activities that fall economically within the enterprise's sphere.

The authority to conclude contracts must cover contracts relating to operations that are the proper business of the enterprise and must be habitually exercised; the extent and frequency of activity depends on the nature of the contracts and the principal's business. The authority to hire employees or to conclude contracts only for internal operations is not problematic. A person authorized to negotiate all elements and details of a contract that is binding on the enterprise may exercise this authority even if the contract is signed by another person in the state where the enterprise is situated or if the first person has not formally been given a power of representation. Mere attendance at or involvement in negotiations with a client is not sufficient to establish the exercise of authority to contract in the enterprise's name, but involvement in negotiations may be relevant in determining the exact functions that the person performed on the enterprise's behalf.

■ A parent company may have a PE in a state if its sub owns a space that is a fixed place of business where the parent carries on its own business. If the sub habitually exercises in that state an authority to conclude contracts in the parent's name, a PE may exist unless the activities are limited to excluded activities or the sub is an independent agent. The same principles apply to any company that forms part of a multinational group. (Although a sub is not automatically a PE, it may be advisable to transfer the employee to the sub's employ even temporarily.) If an employee of a company (say, the parent) is allowed to use an office in the headquarters of another company (say, a newly acquired sub) to ensure that the sub complies with its obligations under contracts with the parent, the office may be a PE of the employer if it is at the employee's disposal for a period sufficient to constitute a "fixed place of business" and the activities performed there go beyond those named in article V(6).

■ The carrying on of a group member's business in the member's own premises using the member's own personnel may provide an economic benefit to the business of another group company, but that does not mean that the other company carries on its business through a PE at that location. A company that purchases parts or services manufactured or supplied by another company in another jurisdiction does not thereby acquire a PE, even though it may benefit therefrom.

■ Criteria to determine whether the use of computer equipment in a country constitutes a PE are set out in the commentary. A Web site, which is not tangible property, is not a place of business. A server may constitute a fixed place of business if it is at the disposal of the enterprise (for example, owned or leased).

Computer equipment must be fixed to be a PE; a server must be located at a place for a sufficient period of time to be fixed. The business must be at least partly carried on through the equipment, and a PE exists without any personnel to operate the equipment. A PE is not created by preparatory or auxiliary activities such as providing a communications link, advertising goods and services, relaying information through a mirror server for security and efficiency, gathering market data for the enterprise, or supplying information. A PE exists if essential and core functions of the enterprise are carried on through the computer equipment. An ISP that hosts the Web sites of other enterprises on its own servers is generally not the PE of the other enterprises carrying on electronic commerce through Web sites operated through servers owned and operated by the ISP.

■ To attribute profits to a PE, the PE must be treated as a functionally separate enterprise and its functions, risks assumed, and assets must be examined. Transfer-pricing guidelines are then applied. The PE is notionally capitalized with sufficient capital to support its functions, and consideration is given to an appropriate arm's-length return.

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Paragraph 55(3)(a): Public Companies

In various types of corporate reorganizations, public companies commonly transfer assets within their corporate group. A tax-deferred transfer of assets down the corporate chain is usually straightforward, but if commercial and/or tax considerations preclude an amalgamation or winding up, a transfer up may prove more difficult. A transfer that satisfies paragraph 55(3)(a) may be the only tax-efficient option for a public company. Unfortunately, the CRA recently took a position that makes it difficult or impossible for a public company to rely on that rule to acquire assets from a subsidiary.

To transfer assets from a sub (Subco) to a parent public company (Pubco) under the paragraph 55(3)(a) exception, Pubco first incorporates a new wholly owned sub (Newco) and transfers to Newco shares of Subco with a value equal to that of the Subco assets to be distributed. Subco then rolls the assets to Newco in exchange for Newco shares. The cross-shareholdings are then eliminated: Newco and Subco redeem their respective shares in exchange for promissory

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notes, and paragraph 55(3)(a) applies to the deemed dividends. Pubco directly acquires the transferred assets when Newco amalgamates with, or is wound up into, Pubco.

The continuity rules in paragraphs 55(3.01)(b) and (c) that apply for the purposes of paragraph 55(3)(a) generally provide that a corporation formed on an amalgamation, or the parent following a windup, is deemed to be the same as, and a continuation of, the predecessors or the sub. Pubco seems to be a continuation of Newco for the purposes of paragraph 55(3)(a), and Pubco's shareholders (presumably "unrelated persons") seem to have "significantly increased" their direct interest in Newco. According to the CRA, percentage interests in a corporation immediately before and after the relevant transaction must be compared to determine whether there has been a significant increase. Pubco shareholders' initial 0 percent direct interest in Newco increases to 100 percent—an increase that contravenes the rules in subparagraphs 55(3)(a)(ii) and (v) and thus disqualifies the transaction under paragraph 55(3)(a).

The result is clearly anomalous and presumably unintended; several previous rulings had confirmed that paragraph 55(3)(a) applied to such transactions. (See, for example, document nos. 2000-0015783 and 2000-0049543.) But recent discussions with CRA officials indicate that those rulings were issued under a previous policy to approve such transactions case by case; in the context of a recent ruling request, the CRA indicated that it would no longer ignore the "clear" language in paragraphs 55(3.01)(b) and (c) in applying paragraph 55(3)(a) to public, or widely held, companies. According to the CRA, this change responds to transactions that abused the previous administrative practice; although the CRA agrees that transactions such as that outlined above are not abusive and should be allowed, it cannot accommodate any such transactions at this time. Consequently, a public company (or any company with "unrelated" shareholders) may be precluded from relying on the paragraph 55(3)(a) exception for such a transaction. Unless the CRA decides to return to its previous administrative practice on this issue, an amendment to subsection 55(3.01) may be required.

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Foreign Tax News

Treaties

A new treaty with **Ireland**, which was signed on October 8, 2003 and came into force on April 12, 2005, replaces the 1966 treaty. It is effective for withholding tax on amounts paid after 2005 and for other tax for taxation years beginning thereafter.

Venezuela

Investigations will determine whether foreign oil companies are evading tax: only 10 percent of such companies recently paid tax, and many may be reassessed retroactively. Years of tax breaks led to many loss claims that eliminated taxes under licence agreements with the government.

South Korea

The National Tax Service (NTS) launched an investigation of foreign funds for possible tax evasion, in an environment of tightening regulations on foreign investors and owners. The NTS said that the investigations will improve transparency. New regulations require foreign investors that acquire more than 5 percent of a Korean company to fully disclose (1) their investment capital source; (2) whether there is any intent to influence management; and (3) their legal status, their management structure, and the identity of their largest backers.

Russia

A draft law improves the special tax and customs regime in the Kaliningrad region's special economic zone (SEZ), extending its life to 25 years and exempting investment from corporate income tax for the first 6 years and reducing it by 50 percent in the next 6 years. A minimum RUB 150,000,000 must be invested in the SEZ over three years. SEZ imports are exempt from customs duties; exports are subject to all taxes and charges.

United States

Following public hearings, the IRS advises that it will consider concerns regarding advance pricing arrangements and introduce changes shortly.

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