Canadian Tax Highlights

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Fairness Request Rehearing

The FCA recently found in the taxpayer's favour in *Lanno* (2005 FCA 153), allowing his application for judicial review of the CRA's refusal to grant relief under the fairness provisions for a late-filed notice of objection. The FCA overturned the FCTD's decision, found that the CRA's denial of the relief was not reasonable, and ordered that the fairness application be referred to a different CRA decision maker for reconsideration.

The fairness provisions in subsection 152(4.2) allow an individual to ask the CRA to accept a late-filed return for a taxation year or reassess a return (for tax, interest, or penalties) beyond the normal reassessment period to provide for an income tax refund or reduce an amount payable. *Information Circular* 75-7R3, paragraph 4, states that a reassessment to create a refund ordinarily is made on receipt of a written request by the taxpayer, even if a notice of objection has not been filed within the prescribed time, so long as certain conditions are met, such as a finding that the application is not based solely on another taxpayer's successful appeal to the courts.

The taxpayer was one of many investors in a real estate project in respect of which he claimed losses in his 1993-95 tax returns. In 1997, the CRA disallowed those losses, saying that he had no reasonable expectation of profit (REOP). The taxpayer had intended to file notices of objection, but he thought that the accounting firm that represented the investors in the real estate project had filed the notices on his behalf; in February 2002, he learned that the objections had not been filed. In December 2002, the accounting firm applied on his behalf for fairness relief, but the application was denied in May 2003 on the ground that it was based solely on a successful appeal to the courts by another taxpayer: in May 2002, the SCC in *Stewart* ([2002] 2 SCR 645) had held that the REOP test should not determine whether a taxpayer's activities were a source of income for the purposes of section 9. The accounting firm requested a review of the CRA's May 2003 decision. This second-level fairness request was denied in July 2003 on the basis that no circumstances beyond the accounting firm's control had prevented it from filing an objection on the taxpayer's behalf: the CRA cannot assume responsibility for errors or omissions made by a taxpayer's representative.

The taxpayer requested reconsideration of this second-level fairness response, but was informed in November 2003 that the decision remained unchanged. The CRA refused to change its decision because (1) the fairness provisions are discretionary and cannot be used to extend the time limit to file an objection; (2) there were no circumstances beyond the taxpayer's control that prevented the timely filing of an objection; and (3) there was no evidence of error or delay by the CRA. The taxpayer's application for judicial review of the CRA's July 2003 decision was dismissed; the lower court concluded that the refusal was not "patently unreasonable." However, the FCA concluded that the standard of review for a fairness application should be the less deferential standard of "reasonableness," based on its decision in *Hillier* ([2001] 3 CTC 157). The FCA made three observations on the reasons given by the CRA for denying the fairness application. (1) It was incorrect to say that the fairness provisions cannot be used to extend the time limits for filing a notice of objection. Paragraph 4 of IC 75-7R3 says, "A reassessment to create a refund ordinarily will be made upon receipt of a written request by the taxpayer, *even if a notice of objection has not been filed within the prescribed time*" (emphasis added by the court). (2) The CRA misapprehended the facts when it stated that a refund could not be granted "based solely upon a successful appeal to the Courts by a taxpayer" (in this case, *Stewart*). The evidence showed that the taxpayer's fairness application was based on a number of misunderstandings between him and the accounting firm that led to the late filing of the objections. (3) The CRA failed to address whether there was any reason to treat the taxpayer differently from three other individuals in the same position who had obtained relief; the CRA thus failed to take into account a relevant consideration. On the basis of those observations, the FCA said that the CRA's denial of the application was not reasonable.

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Voluntary Disclosure Review

The FCTD decision in *Karia* (2005 FC 639) serves notice to the CRA that the court will supervise the CRA's conduct of its voluntary disclosure program (VDP) via judicial review proceedings. Specifically, the court confirmed that if the CRA suggests, on a "no names" disclosure, that the VDP is available, it may not later renege without opening itself up to judicial scrutiny.

The applicant and his related corporation sought judicial review to set aside a CRA decision to disallow him the benefit of the VDP for both GST and income tax purposes. Before the VDP began in mid-2003, the Peel Regional Police executed search warrants on the applicant to investigate a "minor fraud." On that same day, the CRA's Special Investigations (SI) division requested copies of the tax returns for study; the following day, the police formally referred some information to SI. A month later, the applicant's lawyer spoke with the CRA (and then confirmed in writing) on a "no names" basis to request an opinion on whether the applicant qualified under the VDP. The lawyer said that the non-compliance involved the non-reporting of credit card receipts and of interest earned offshore. The lawyer also said that an unnamed police force had charged the client with a minor fraud; an investigating officer had mentioned that the CRA might be notified of the failure to report income, but to the best of the applicant's knowledge this had not been done to date. The CRA answered on October 21, four days after the lawyer's letter was written, saying that the "disclosure would be valid as presented," subject to differences in material facts that might be uncovered by an investigation. In a letter of January 19, 2004, the lawyer then disclosed the applicant's identity. On February 18, 2004, the CRA said that the VDP was not available because the disclosure was not voluntary; rather, it had been based on the applicant's knowledge of the CRA's current enforcement activities. A requested administrative review of the decision confirmed that finding on August 19, 2004. The CRA said that the police investigator's statement that he might contact the CRA fell under the category of an authority with which the CRA had an information exchange agreement.

The FCTD decided in the applicant's favour: the CRA led the applicant into relying to his detriment on its initially favourable opinion regarding the VDP's availability; the information first presented on a "no names basis" when that opinion was requested did not differ materially from what was later disclosed in detail. The elements required for a promissory estoppel existed, and the appropriate standard of review for interpreting the language of the underlying VDP *Information Circular* 00-1R was "reasonableness simpliciter," based on a mixed question of fact and law.

Significantly, the court found nothing on record that indicated that the applicant knew of any information-sharing agreement with the Peel Regional Police; the CRA subsequently admitted that no written agreement existed and that only an informal cooperative arrangement was in place. In the court's view, the CRA was asserting that the applicant "ought to have known" about the likelihood of the information sharing, a requirement not explicit in the IC; if the CRA wished to take that position, it should modify the IC's language. The CRA's decision was set aside and the matter was sent back to the minister to be assessed in accordance with the VDP.

It will be interesting to see whether *Karia* is further appealed, because the comments on promissory estoppel contrast with jurisprudence that suggests that there is no estoppel against the Crown. For example, in *Federico* (2005 TCC 323), the taxpayer attempted to suggest that incorrect advice from the CRA estopped it from assessing for uncollected GST. The taxpayer had failed to register for the GST on the basis of information received from the CRA. The TCC quickly decided that the tax was collectible notwithstanding the wrong advice, and the taxpayer was liable; the SCC decision in *Inland Industries* ([1974] SCR 54) was cited for the proposition that when the "law is clear [it] governs; wrong advice by Revenue Canada officials or anyone else cannot act as a form of estoppel."

Nonetheless, *Karia* does establish that the CRA's changes of heart on voluntary disclosures will be closely scrutinized by the courts, especially when a taxpayer has been encouraged to disclose information in the belief that relief will be forthcoming. That, after all, is the purpose of the VDP: to encourage the correction of deliberate non-reporting, etc. by the offer of the exercise of ministerial discretion to waive interest and penalties.

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Issue Raised on GST Appeal

The Excise Tax Act has rules similar to the large-corporation disclosure requirements for income tax objections. (The income tax rules were considered by the FCA in *Potash Corporation of Saskatchewan* (2004 DTC 6002).) For GST purposes, a notice of objection to a GST assessment filed by a specified person must reasonably describe each issue to be decided, set out the relief sought (in monetary terms), and provide relevant facts and reasons. Most listed financial institutions and persons that exceed the $6 million taxable supply threshold in certain periods relating to the underlying assessment are covered and can raise an issue in an objection to a reassessment or in an appeal to the TCC only if the issue was raised in the original objection. The FCA has now held in *Telus Communications* (2005 FCA 159) that the concept of "pleading over" cannot override the explicit statutory rules on GST objection disclosure.

The reassessment was confirmed and Telus appealed to the TCC, raising the same issues as it had in the objections. The notice of appeal did not refer to the due diligence defence to the penalty. Telus later filed an amended notice of appeal, in which it raised that defence. The Crown filed a reply to the re-amended notice of appeal and responded to the issue of due diligence. The Crown then brought a motion to strike the due diligence argument on the basis that Telus as a specified person was precluded from raising a new issue. The TCC rejected the challenge and stated that the Crown had joined issue on the question of penalties in the reply to the notice of appeal and could thus not argue that the impugned paragraphs constituted an abuse of process.

The FCA reversed the TCC, saying that in an appeal by a specified person the TCC has no jurisdiction to deal with an issue that was not properly raised during the objection phase: Telus never raised the due diligence issue during the objection process. The request to vacate "associated interest and penalties" in the objection to the reassessment did not refer to the application of the due diligence defence but rather to the automatic adjustment of a penalty that occurs when an objection is successful and the overall tax liability is reduced. The FCA also rejected Telus's arguments that challenged the basis on which the Crown brought its motion.

The decision in *Telus* illustrates the importance of carefully drafting GST objections for specified persons that are subject to the objection disclosure rules. Failure to raise and quantify an issue and provide supporting facts and reasons at the initial objection stage will result in a loss of the ability to argue the issue at trial. In *Telus*, the restriction on the due diligence issue was clear: the question was never raised at the objection stage. The application of the rules will be more difficult in circumstances where the Crown asserts that an appellant failed to "reasonably describe" an issue or provide sufficient facts and reasons, although as a matter of practice in most cases the Crown may limit its challenges to situations in which issues were not raised.

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GST Rebate: Not Small Change

Part of the new federal financial assistance to local governments is the rebate of the 42.86 percent of GST or HST paid by them; the amount represents the balance of tax that was paid but not rebated under the GST as introduced. Local governments, certain organizations deemed to be local (such as transit authorities and public libraries), and certain agencies that deliver municipal services (such as non-profit housing corporations and cooperatives) all qualify for the additional payments.

GST/HST Rebates to Local Governments, February-December 2004

	thousands of dollars
Newfoundland and Labrador	2,937
Prince Edward Island	878
Nova Scotia	8,724
New Brunswick	5,132
Quebec	69,704
Ontario	173,289
Manitoba	9,147
Saskatchewan	7,655
Alberta	46,143
British Columbia	46,327
Yukon	400
Northwest Territories	1,604
Nunavut	810
Total	372,750

The CRA recently released details of the first rebate of the remaining portion of GST paid by local authorities. The figures do not include all amounts due to the local level, because there is a four-year window in which to submit claims. From February 1 to December 31, 2004, the CRA paid out $373 million; the provincial distribution is summarized in the table above. Full details are available on the CRA's Web site at http://www.cra-arc.gc.ca/municipalitiesreport/.

In negotiations leading up to the new arrangement, the importance of this measure to the main cities was emphasized, but the detailed tables on the Web site show that even the smallest incorporated municipalities benefit. The total benefit gained by any of the large cities cannot be calculated from the information made available because the amounts paid to the specialized agencies must be aggregated with the amounts paid to the municipal corporations themselves. In Prince Edward Island, for example, Charlottetown received $182,000 directly, but total payments for all agencies within the city amounted to $509,000. Some such agencies provided services beyond city boundaries.

There are over 4,200 separate entries in the accounts presented by the CRA, which means that the document will attract few casual readers. A brief review of the payments to major urban areas shows how important the additional relief will be to the efficient functioning of local governments.

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Contingent or Not?

In *General Motors* (2004 FCA 370), the FCA waded into the murky waters of contingent liabilities and upheld the TCC decision (2003 TCC 815) that denied a deduction for accruals by GM under a memorandum of understanding

attached to its collective bargaining agreement with the Canadian Auto Workers Union (CAW). The FCA said that the accruals did not give rise to an absolute, non-contingent liability. Leave to appeal to the SCC has been denied.

The memorandum of understanding required that GM accrue $2 per overtime hour exceeding a specified number to the unfortunately named "special Canadian contingency fund" (SCCF). The accruals were to be used for specified employee and union-related programs, "and then only if needed," or for other initiatives to be subsequently negotiated by the CAW and GM. In all cases, any unused amounts were carried over into the next new collective agreement. In 1995, GM accrued and deducted (but was denied by the CRA) $13.8 million; an equivalent amount was paid out by GM, pursuant to the memorandum of understanding, between January 1996 and January 1999.

The TCC concluded that there was no identifiable creditor who could make a legally enforceable claim against the taxpayer for the amount accrued: in each case certain events must first transpire, such as the crossing of a funding threshold or the screening and acceptance of a request from the union. The FCA agreed, rejecting the taxpayer's argument that working the overtime hours triggered the liability to pay. The FCA noted that the taxpayer could have created an absolute liability by, for example, mirroring the arrangements it established in connection with other obligations to the CAW—agreeing to contribute funds to a trustee or otherwise segregate or set aside funds, an act that would have created an identifiable debt and an identifiable creditor. Comments at another point in the judgment, however, create some confusion because the FCA seemed to imply (as did the TCC) that there must be such a payment out to a trustee, etc. in order to establish the existence of an absolute liability. It is not clear whether this comment was made in the context of GM's having only accrued an amount without having a liability to pay the union, or because there were other such arrangements in place with the union.

The FCA referred to *Wawang* (2001 DTC 5212), in which the court held that an obligation is contingent if it depends upon the occurrence of an event that may not occur. Arguably, in GM the critical event giving rise to the liability was the overtime hours worked, not a future event that triggered actual payments to discharge the liability and to ascertain the specific purpose for which they were to be made. Comments in *Wawang* suggest that such considerations should not change the fundamental character of the obligation. More recently, in *McLarty* (2005 TCC 55), the TCC said that a promissory note was not a contingent liability simply because it was not known how much would be paid or when. Furthermore, the overtime hours also formed the basis for accruing earned vacation pay, for which a deduction is generally allowed irrespective of when payment actually occurs. (This point was reaffirmed by the FCA in *Fédération des caisses populaires Desjardins* (2002 DTC 7413), which also noted that a deduction in the same year provided a truer picture of profit for that year.) The FCA also said that a creditor with a legally enforceable claim could not be identified on the facts because the workforce that constituted the membership of the CAW changed periodically. It is not clear how this analysis meshes with the fact that the union agreement created an obligation that survived changes in the employee or union population; the court would not speculate on the relevance of the rights and remedies available to the CAW under the agreement.

Both the TCC and the FCA emphasized that the funds were to be expended for specified purposes "only if needed." In practical terms, there may have been little doubt that an amount equal to the accrual would be expended for employee-related programs based on historical experience (and later on hindsight). If these factors had been explored by the court, the lack of allocation to a specific project and the rolling over of unused amounts to subsequent agreements might have been seen in a different light.

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Plot To Defraud the CRA: US Crime

In *Pasquantino* (125 S. Ct. 1766, April 26, 2005), the US Supreme Court upheld the conviction of participants in a scheme to defraud Canada of alcohol import taxes and duties by smuggling liquor from the United States into Canada, despite the common-law revenue rule that bars enforcement in US courts of foreign revenue laws.

The Pasquantinos ordered liquor over the telephone in New York from discount package stores in Maryland. They employed individuals to hide liquor in their vehicles and drive across the Canada-US border; the liquor was not declared to Canadian customs officials, and Canadian import taxes were not paid. The wire fraud statute (18 USC section 1343) prohibits the use of interstate wires to effect "any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretences, representations, or promises." The object of the fraud must be "property in the victim's hands," which required proof of an excise tax liability to Canada and thus proof of applicable Canadian tax law.

The Pasquantinos contended that there was no violation because the government had no interest in enforcing Canadian tax laws. The US Supreme Court said that their offence was complete the moment they executed the

scheme inside the United States: "[I]t may seem an odd use of the Federal Government's resources to prosecute a U.S. citizen for smuggling cheap liquor into Canada. But the broad language of the wire fraud statute authorizes it to do so and no canon of statutory construction permits us to read the statute more narrowly." Canada's interest in the excise tax revenue was "property" within the statute's meaning, being a right to be paid money. The court also concluded that routinely concealing liquor and failing to declare it to Canadian customs officials was a fraudulent representation: "[T]hey represented to Canadian customs officials that their drivers had no goods to declare."

The principal issue before the court was whether a wire fraud scheme to defraud a foreign government of tax revenue was a violation within the ambit of the wire fraud law. The dissent concluded that it was not: (1) there is a presumption against the extraterritorial application of federal statutes, and the law does not suggest that Congress affirmatively intended extraterritorial application; (2) the law that expressly addresses international smuggling provides US criminal enforcement of foreign customs laws only for nations that enact reciprocal laws against smuggling into the United States, and Canada has not done so; (3) the Canada-US treaty that addresses the collection of taxes did not apply because the taxes at issue had not been finally determined and because the Pasquantinos were US citizens when the tax liability was incurred; and (4) indictment under Canadian law and extradition to Canada was an alternative to prosecution in US courts, and Canadian courts are better able to decide whether their excise laws have been violated.

The majority rejected concerns about the extraterritorial application of the wire fraud law: the Pasquantinos were convicted for conduct that occurred in the United States. The criminal conduct was not the smuggling of liquor into Canada but the use in the United States of telephone wires to execute their scheme to smuggle. The common-law revenue rule did not apply because in 1952, when the wire fraud statute was enacted, no case had clearly established that the rule barred the United States from prosecuting a fraudulent scheme to evade foreign taxes. Moreover, the plain language of the federal statute makes no exception for frauds to evade foreign taxes. Concerns about the interference of US courts in the intricacies of foreign tax policy were rejected: the prosecution was brought by the executive branch, which was responsible for US foreign policy. The court assumed that "the Executive has assessed this prosecution's impact on this Nation's relationship with Canada, and concluded that it poses little danger of causing international friction."

The court's opinion creates new opportunities for US federal prosecutors. As the dissent pointed out, wire fraud, like mail fraud, is a predicate offence under the Racketeer Influenced and Corrupt Organizations Act (RICO) and the money-laundering statute. The decision broadens the reach of those statutes and exposes certain defendants to the severe criminal penalties and forfeitures therein. Furthermore, as the dissent also pointed out, the decision may lead to more frequent and aggressive federal prosecutions for using the mails or wire communication to evade state and local taxes.

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Non-Commercial Transfer Pricing

The CRA continues to assert that the transfer-pricing rules can be used to impute interest on non-commercial loans made by Canadians to or for the benefit of non-resident relatives.

The Canadian transfer-pricing rules are based on international standards in the OECD model treaty's article 9, which applies where "conditions are made or imposed between . . . two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises." The term "enterprise" as defined in article 3 applies "to the carrying on of any business," clearly restricting the article's application to commercial activities.

The February 18, 1997 budget, which introduced the transfer-pricing rules, proposed "changes in transfer pricing procedures for multinational corporations that will improve taxpayer compliance, facilitate administration by Revenue Canada and, thus, protect the Canadian tax base," including "updating Canadian rules on transfer pricing to bring Canadian . . . practices in line with the evolving international standard. . . . These changes will preserve the fairness of Canada's tax system by ensuring that profits earned by taxpayers in connection with international transactions with non-resident related parties are properly measured and taxed in Canada." In a press release accompanying the draft legislation, the minister of finance affirmed its conformity with the OECD rules and the rules of other member states and also said that the rules reflected the CRA's "intention to devote more resources to the verification of cross-border transactions by multinational enterprises." Comments in *Hansard* by the parliamentary secretary to the minister also focused on multinational corporations. It thus appears that the policy intent behind the transfer-pricing rules is limited to commercial situations and that the rules were intended to conform to the OECD guidelines in all material respects.

Informal discussions with Finance and the CRA prior to the rules' enactment confirmed that it was not their

intention to apply the legislation to non-commercial transactions, although neither *Information Circular* 87-2R nor the legislation contains a clear and unequivocal statement that the rules are limited to commercial transactions. The words in section 247 are extremely broad; like all tax legislation, the section must be interpreted in context. Moreover, on the basis of the best information available to date, including the manner in which the rules were administered by the CRA, tax practitioners have understood that the transfer-pricing rules are not, and have not been, applied to cross-border estate-planning transactions and family loans; they have advised their clients and implemented their clients' plans accordingly. It is imperative that a self-assessment system be perceived to be fair and equitable and that it be applied consistently to all taxpayers. The application of a non-arm's-length principle to non-arm's-length estate-planning transactions is a change in policy. Many individuals residing in Canada have loaned money on an interest-free basis to or for the benefit of family members who live outside Canada. Furthermore, no legal principle requires that a loan bear interest—a fact implicit in section 17, which deems a Canadian resident to have received interest on money loaned to a non-resident in certain circumstances (not including the typical estate plan). The CRA is attempting to use a more general transfer-pricing rule (intended to apply in cross-border commercial contexts) to operate where the specific rule, section 17, does not apply.

Before the CRA changes such a significant policy, the public should be advised and be given ample time to restructure family transactions, and such a change should be prospective only. Finance has agreed that this position is reasonable. The minister of national revenue has now received a written request to consider the issue and arrive at the same conclusion.

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Provincial Corporate Rate Changes

The 2005 budgets of Manitoba, Nova Scotia, and Quebec announced changes in corporate tax rates; those in Ontario, Alberta, British Columbia, and the other provinces did not.

Manitoba. The March 8, 2005 budget reduced the provincial general corporate tax rate from 15 to 14.5 and 14 percent, effective July 1, 2006 and July 1, 2007, respectively. These reductions were in a bill (44) that received first reading in the provincial legislature on May 11, 2005. Thus, for Canadian GAAP purposes the reductions are considered substantively enacted as of that date, because the province has a majority government. For US GAAP, however, the bill must be enacted.

Nova Scotia. The April 26, 2005 budget cut Nova Scotia's large corporations tax (LCT) rates (see table 1). The bill (177) received first reading in Nova Scotia's legislature on April 28, 2005, making the changes substantively enacted for the purposes of Canadian GAAP as of that date. The bill also extends the LCT's application to June 30, 2009 from its previous expiration date of March 31, 2006.

Quebec. The April 21, 2005 budget proposed to increase Quebec's general corporation income tax rate and reduce its capital tax rate (see table 2). A related bill has not yet been introduced.

Ontario. Ontario's May 11, 2005 budget contained no corporate rate changes but announced a few targeted measures, including changes to the tax treatment of foreign corporations. Consistent with the federal and other provincial tax rules, liability for Ontario corporate tax will be based on whether the corporation is resident (rather than incorporated) inside or outside Canada, effective for tax years ending after the budget date. A bill (197) to implement the budget measures received first reading on May 11, 2005, making them substantively enacted for Canadian GAAP purposes as of that date.

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Table 1 Changes to Nova Scotia LCT Rates

	Taxable capital of less than $10 million	Taxable capital of more than $10 million
	percent	
Current	0.5	0.3
Effective July 1, 2005	0.55	0.275
Effective July 1, 2006	0.5	0.25
Effective July 1, 2007	0.45	0.225
Effective July 1, 2008	0.4	0.2

Table 2 Changes to Quebec Corporate Income and Capital Tax Rates

	General corporate income tax rate	General capital tax rate
	percent	
Current	8.9	0.60
Effective January 1, 2006	9.9	0.525
Effective January 1, 2007	9.9	0.49
Effective January 1, 2008	11.4	0.36
Effective January 1, 2009	11.9	0.29

Small Business Rates

This year's provincial and territorial budgets offered little to big businesses: only Manitoba decreased its general and M & P rates, Prince Edward Island increased its M & P rate, and Quebec plans to increase its active income rate in 2006. In 2005, all provinces and territories except Quebec offer a preferential corporate tax rate to CCPCs on the first $300,000 (or a higher threshold) of active business income. Several budgets decreased small business rates and increased upper thresholds therefor.

Table 1 shows small business rates for 2004 and 2005 in 2005 ascending order. Alberta, New Brunswick, Prince Edward Island, Saskatchewan, and Yukon CCPCs enjoy lower combined small business rates in 2005 because of lower provincial and territorial small business rates. On April 1, 2004, Alberta's small business rate fell from 4 to 3 percent. Saskatchewan and Yukon reduced their rates after 2004 from 5.5 to 5 percent and from 6 to 4 percent, respectively. On April 1, 2005, Prince Edward Island's rate decreased from 7.5 to 6.5 percent. New Brunswick's rate fell from 3 to 2.5 percent on July 1, 2004 and to 2 percent a year later. Rate changes beyond 2005 are expected in a few provinces. Beginning in 2006, Quebec offers a preferential rate of 8.5 percent for CCPCs on active business income of up to $400,000. Manitoba's small business rate further decreases from 5 to 4.5 percent after 2005 and to 4 percent after 2006. Although New Brunswick CCPCs already benefit from the lowest small business rate in Canada, their rate will further decrease from 2 to 1.5 percent on July 1, 2006 and to 1 percent on July 1, 2007. (The average provincial and territorial rate in 2005 is approximately 4.8 percent.)

Table 1 Combined CCPC Small Business Rate (December 31 Year-End)

	2004	2005
	percent	
Federal	13.12	13.12
New Brunswick	15.87	15.37
Alberta	16.37	16.12
Northwest Territories	17.12	17.12
Nunavut	17.12	17.12
Yukon	19.12	17.12
British Columbia	17.62	17.62
Manitoba	18.12	18.12
Newfoundland and Labrador	18.12	18.12
Nova Scotia	18.12	18.12
Saskatchewan	18.62	18.12
Ontario	18.62	18.62
Prince Edward Island	20.62	19.87
Quebec	22.02	22.02

Table 2 CCPC Small Business Threshold

	From	To	Effective date*
	dollars		
Federal	225,000	250,000	2004
	250,000	300,000	2005
Newfoundland and Labrador	225,000	250,000	2004
	250,000	300,000	2005
Northwest Territories	225,000	250,000	2004
	250,000	300,000	2005
Nunavut	225,000	250,000	2004
	250,000	300,000	2005
Prince Edward Island	225,000	250,000	2004
	250,000	300,000	2005
Alberta	400,000	400,000	Unchanged
British Columbia	300,000	400,000	2005
Manitoba	320,000	360,000	2004
	360,000	400,000	2005
New Brunswick	400,000	425,000	July 1, 2004
	425,000	450,000	July 1, 2005
	450,000	475,000	July 1, 2006
	475,000	500,000	July 1, 2007
Nova Scotia	225,000	250,000	2004
	250,000	300,000	2005
	300,000	350,000	April 1, 2005
	350,000	400,000	April 1, 2006
Ontario	400,000	400,000	Unchanged
Quebec	None	400,000	2006
Saskatchewan	300,000	300,000	Unchanged
Yukon	225,000	250,000	2004
	250,000	300,000	2005
	300,000	400,000	2007

* From January 1 unless otherwise specified.

All provinces and territories except Alberta, Ontario, Quebec, and Saskatchewan increased their small business thresholds in 2005. Table 2 summarizes those thresholds and increases that are effective after 2003.

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Information Technology Placement Services

Five provinces impose a retail sales tax on sales of tangible personal property and certain taxable services. Each province's legislative definition of a "taxable service" differs, but each imposes sales tax to some degree on computer-related services. Some of the provinces separately define certain computer-related services as a taxable service; others impose tax on services relating to tangible personal property, which by definition includes most computer programs. These differences make the

application of sales tax to information technology (IT) placement services somewhat uncertain, particularly because the individuals whose services are "placed" generally undertake tasks that, if examined in isolation, would be considered taxable services.

The "true nature," "primary purpose," and "root of a transaction" generally determine the manner in which a transaction is to be characterized from a sales tax perspective. In determining that true nature, etc. of a transaction, several factors are particularly relevant: (1) What is the customer's ultimate objective in acquiring the services? (2) What is the "substance and reality" of the transaction? (3) What "type of business" is the service provider engaged in? (4) Which components of a service are incidental and thus should not dictate the true characterization of the service? (5) In what manner are the services billed and, in particular, is a "single undivided consideration" charged for the services?

To date, only Ontario has published a formal policy paper on IT placement services. Ontario's *Information Notice*, "Agencies Placing Temporary IT Consultants" (October 2002) distinguishes a non-taxable placement service from a taxable computer consulting service, primarily on the basis of (1) whether the agency is "assuming responsibility for the project deliverables or the services being provided," and (2) whether the agency "may control or direct the work of the IT consultant." The four other provinces have not yet published formal written policies; however, on the basis of recent rulings received from the PST authorities in British Columbia and Saskatchewan, similar positions with respect to the non-application of sales tax to placement services have recently been adopted. For example, on March 31, 2005, the BC Consumer Taxation Branch said the following:

> When an IT placement agency provides an IT consultant to a client, and the contract is for the provision of human resources and not taxable services, no tax is payable on the value of the contract. Here, the individual IT consultant possesses a specific skill set that is sold to the client for a period of time, rather than on the basis of the sale of a specific service. In this case, the IT consultant's work is under the direction of the client, even though the consultant remains an employee of the placement agency. . . .
>
> However, when a contract between an IT placement agency and its client stipulates that taxable services will be provided, and the agency is responsible for the completion of the services being provided, tax is due on the value of the services. In this case, the IT consultant is under the direction of the agency, and the agency is providing taxable services to the client.

Although Saskatchewan has a significantly broader tax base, with "computer services" and "employment placement services" constituting a taxable service, Saskatchewan Finance may also consider the placement of IT consultants who remain independent contractors to be a non-taxable service.

Notwithstanding these recent policy positions, it is recommended that persons who receive or provide IT placement services obtain a ruling from the relevant tax authority, particularly because legislative or administrative "bundling rules" may result in a sales tax assessment for the entire amount paid for placement services even though only a portion of the activities undertaken is considered to be a taxable service.

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FA Amendments

At the IFA International Tax Seminar held on May 9, 2005, Finance official Wallace G. Conway outlined a number of potential amendments to the foreign affiliate proposals under consideration.

■ **FA liquidation and distributions.** Modifications to subsection 88(3) may make it more analogous to subsection 88(1): (1) proceeds of disposition to the disposing FA of property (excluded or not) will be ACB unless a relevant cost base election results in a gain that is treated as FAPI where the taxpayer has a 90 percent or greater FMV participating equity interest in the FA and the property is distributed in the course of a liquidation and dissolution; (2) pro rata shareholder distributions will not generate a subsection 15(1) benefit simply because they are neither a dividend nor a return of capital; (3) and as per a comfort letter, FA distributions that exceed returns of capital under paragraph 88(3)(e) will be treated as dividends subject to normal distribution rules (first out of exempt surplus, etc.).

No new effective date applies for these changes, although taxpayers may elect to have the February 2004 paragraph 88(3)(f) income treatment apply to transactions before the new announcement date. The comments did not mention any broadening of the language for the return of capital in paragraph 88(3)(e) (including transitional relief), nor did they confirm that, in contrast to a subsection 88(1) transaction, taxpayers could continue to recognize gains and losses on the disposing FA stock.

■ **FA-to-FA liquidations.** Similar modifications are being considered for paragraphs 95(2)(e) and (e.1). Moreover, Finance is also considering allowing the 90 percent threshold to be met at either the taxpayer or the FA shareholder level; eliminating the "no foreign tax recognition" requirement of paragraph 95(2)(e.1); and making the relevant cost base election available for excluded and non-excluded property (resultant gains are FAPI) where the FA is liquidated and dissolved and the shareholder is a specified purchaser. No change in the effective date is contemplated.

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■ **FA mergers.** Finance is considering eliminating the "no foreign tax recognition" and the 90 percent specified entitlement percentage requirements. The relevant cost base election may be available for excluded and non-excluded property, but any gain will be FAPI. No change in the effective date is contemplated.

■ **Gains and losses on debt settlement.** Paragraph 95(2)(i) may be amended to remove the proposed restrictive requirement that subsection 39(2) apply; to include gains and losses on income or capital account; and to apply to refinancings and partnerships. No change in the effective date is contemplated.

■ **Compliance on subsection 93(1) election.** Concerns over the compliance burden of proportionally adjusting all surplus balances on a subsection 93(1) election may be relieved by allowing taxpayers to apply the surplus grinds and the corresponding ACB adjustments to a smaller group of FAs that form part of a consolidated group. The gain on the share must be less than the consolidated attributed net surplus in respect of the share of the consolidated group of FAs. The whole dividend paid on the share must not exceed the amount by which the consolidated exempt surplus exceeds the consolidated taxable deficit of the consolidated group. No entity in the consolidated group can have a deficit from a previous subsection 93(1) election. The total amount of the subsection 93(1) dividend must be paid out of consolidated surplus, and the amount of that dividend cannot be greater than the consolidated exempt surplus (net of deficit) of the smaller group of FAs. No change in the effective date is contemplated.

■ **Foreign exchange.** Subsections 93(2)-(2.3) may be modified to correct an anomaly in the formula to take into account gains of previous years and partial hedges and debt and equity refinancings. Subparagraph 95(2)(a)(vi), which gives active business income treatment to income or loss from a currency hedge over a paragraph 95(2)(a) income or loss amount, may be amended to clarify its application to a currency hedge over an expense included in computing such an amount. Similarly, the definition of excluded property, which includes a currency hedge over a receivable that produces such an amount (or would if it gave rise to income) or a receivable from a sale of excluded property, may be extended to a currency hedge over an amount payable incurred to acquire or to refinance such an amount. It appears that the "reduction of risk" requirement for these provisions will be defined by reference to the FA's calculating currency: risk may be reduced by hedging into the calculating currency but not out of it and into, for example, the Canadian dollar. No change in the effective date is contemplated.

■ **ACB adjustments for the surplus balance adjustments on a subsection 93(1) election.** Subsections 92(1.2) to (1.4) may be extended to apply to non-excluded property and in computing FAPI. No change in the effective date is contemplated.

If an FA receives a loan from another FA to which the interest income is clause 95(2)(a)(ii)(D) income, the FA must grind its and its sub's surplus (including taxable surplus) balances for the interest expense (regulations 5907(2.8)-(2.83)). The ACB adjustment rules may be extended to such surplus adjustments as they apply to a subsection 93(1) dividend; both surplus and accompanying ACB adjustments will be effective for taxation years ending after February 27, 2004.

■ **Post-acquisition dividends.** Consideration is being given to fixing the anomalies in the definition of a CFA and the paragraph 88(1)(d.4) bump rule for post-acquisition dividends.

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Foreign Tax News

Israel

Tax changes intended to both help the poor and spur economic growth decrease individual rates from 49 to 44 percent and corporate rates from 34 to 25 percent by 2010, and reduce VAT from 17 to 16 percent by 2007. Capital gains reform reduces tax on dividends from 20 to 15 percent and increases tax on capital gains and real and nominal interest by 5 percentage points. An income tax credit is available to persons re-entering the workforce, and subsidies for the elderly and disabled increase.

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