CANADIAN TAX Highlights

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CRA-IRS Mutual Agreement Procedure

On June 3, 2005, US and Canadian competent authorities signed a memorandum of understanding to establish principles and guidelines to improve the performance and efficiency of the mutual agreement procedure (MAP), in accordance with the terms set out in the Canada-US treaty. The memorandum of understanding is a positive development that should enhance the MAP and increase taxpayer confidence in its efficacy.

The MAP is a dispute resolution mechanism used in cases of double taxation or taxation contrary to the treaty. A taxpayer normally files a MAP request with both the Canadian and the US competent authorities, requesting that they resolve the issue in a timely manner. As CRA and IRS auditors have become more sophisticated and more aggressive in recent years, the number of cases requiring resolution under the MAP has increased substantially, the issues have become more complex, and the competent authorities have often become mired in prolonged or unsuccessful negotiations. Therefore, the CRA and the IRS have actively pursued negotiations to improve the MAP. The June 3, 2005 memorandum of understanding is the result.

The memorandum of understanding states that the competent authorities are committed to the principle that resolution should be possible in all cases of double taxation and taxation contrary to the treaty; they agree to follow certain principles and guidelines in seeking to resolve a particular case:

1) *Principled, reasonable, and consistent positions.* Positions taken in each case by the competent authorities should be well documented, have merit, and follow the principles of consistency and reciprocity.

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2) *Agreement on the facts.* The competent authorities recognize the importance of reaching agreement on the facts when negotiating MAP cases: they will accept a transaction as structured by the taxpayer and consider disregarding or restructuring it only in exceptional cases. If the competent authorities cannot agree on the underlying facts and circumstances of a particular MAP case within six months after negotiations commence, they will refer the case to a joint panel made up of tax administration officials chosen by the CRA assistant commissioner of appeals and the IRS chief of appeals. The agreed facts bind the competent authorities.

3) *Means of resolving cases.* Both the CRA and the IRS acknowledge that substantive differences on issues may complicate negotiations, even if the underlying facts and circumstances are agreed on. If a MAP request is not resolved within two years from its date of acceptance, the director general, International Tax Directorate (CRA) and the director-international, LMSB (IRS) agree to meet (or, when appropriate, agree to have their subordinates meet) to resolve the case.

To resolve substantive issues, the competent authorities also agree to follow the OECD's "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations." However, the competent authorities have identified a number of issues that have resulted, or could result, in a failure to resolve cases of double taxation or taxation contrary to the treaty, including (1) the determination of an arm's-length compensation for consignment manufacturing operations; (2) whether a business is so integrated that a profit-split method is appropriate and, if so, the relative value of contributions made by related parties toward the generation of profit; (3) the presence of non-routine intangible assets and their arm's-length value; (4) the existence of a PE and the profit attributable to it; (5) whether a transaction is properly characterized as a service or a licence of intangibles; (6) the amount of compensation, if any, for either the closure or the relocation of a business and the allocation of associated closing costs; and (7) appropriate relief when the laws of the source country and the laws of the residence country conflict. The competent authorities expressed commitment to reach an agreement establishing guidelines to resolve such cases and those involving other issues that have delayed negotiations. Both the CRA and the IRS recognize that they may be required to call on additional resources to assist in developing these guidelines.

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US Partnership Withholding Regs

On May 13, 2005, the IRS issued final and temporary regs (TD 9200, 2005-23 IRB 1158) regarding a US partnership's obligation to withhold tax under Code section 1446 on effectively connected income allocable to a foreign partner, applicable to partnership taxable years beginning after May 18, 2005 (or beginning after December 31, 2004 if the partnership so elects). The new regs finalize regulations proposed on September 3, 2003 and are intended to simplify the withholding.

Generally, a foreign person engaged in a US trade or business is subject to US tax on effectively connected income. A US partnership with effectively connected taxable income (ECTI) that is allocable to a foreign partner under section 704 (relating to a partner's distributive share of partnership income) must pay a withholding tax at the highest tax rate applicable to such a foreign partner: 35 percent for both corporations and individuals. The tax paid on its behalf by the partnership is generally creditable by the foreign partner.

The new regs include guidance on (1) the determination of the domestic or foreign status of partners, (2) tiered partnership structures, (3) the calculation of the withholding tax, and (4) the application of interest, penalties, and additions to the tax on a withholding agent's failure to comply.

A partnership must only withhold on a foreign partner's ECTI share and therefore must determine whether the partner is US or foreign. Prior to the new regs, the process to certify foreign status was not consistent with the withholding rules applicable to foreign persons for passive income under sections 1441 and 1442. Under the final regs, a US partnership may accept any form that constitutes acceptable documentation of US or foreign status for the purposes of section 1441, including forms W-9, W-8BEN, W-8IMY, W-8ECI, and W-8EXP, and any substitute therefor that is consistent with the section 1441 regulations. However, two notable differences exist: for section 1446, a US grantor trust with a foreign grantor is treated as a foreign partner, not a US partner, and a foreign simple trust is treated as an entity, not a flowthrough entity. Thus, a US grantor trust and a foreign simple trust may need to provide different documentation for section 1446 and sections 1441 and 1442.

The final regs generally require a partnership to look through any of its partners that is a foreign partnership if that foreign partnership has provided appropriate documentation, such as form W-8IMY, and documentation establishing the status of its partners. If an upper-tier foreign partnership provides a form W-9 on behalf of one of its (US) partners to a lower-tier US partnership but fails to adequately document the status of its other partners, the lower-tier partnership must look through the upper-tier partnership to the extent of the US partner's interest and not withhold section 1446 tax on that partner's allocable share.

The final regs also provide guidance in calculating the section 1446 tax. In determining the highest rate of applicable tax, the regs allow a US partnership to consider the relevant type of income or gain allocable to a foreign partner. Thus, a partnership may apply a reduced 15 percent rate of tax to effectively connect income consisting of long-term capital gain allocable to a non-corporate partner, but only if the partner has adequately documented its status to the partnership.

In addition, the temporary regs generally allow a US partnership to consider a foreign partner's deductions and losses that are reasonably expected to be available to reduce the partner's US income tax liability on its allocable share of US business income or gain from the partnership in the taxable year. The new temporary regs allow certain foreign partners to certify that they have deductions and losses to reduce their tax liability on their allocable share of the partnership's effectively connected income. However, the partnership may be liable for the tax if the partner's certification proves incorrect.

The final regs also clarify the rules relating to the imposition of additional tax, interest, and penalties for a partnership's underpayment of a section 1446 instalment tax under sections 6655, 6601, and 6651. A partnership is now responsible for additions to tax, interest, and penalties on its failure to make instalments even when it is deemed to have paid all section 1446 tax due as of the close of its taxable year with respect to a foreign partner who fully paid its US income tax.

The new regs offer welcome guidance for many Canadian investors in US partnerships and limited liability companies. Canadian individual partners may now benefit from the lower capital gain rate (15 percent) when the section 1446 tax is computed. Further over-withholding relief is gained because Canadian partners may take into account certain deductions and losses outside the partnership to reduce the required withholding.

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IC on Reg 105 Withholding

On February 23, 2005, the CRA released IC 75-6R2, "Required Withholding from Amounts Paid to Non-Residents Providing Services in Canada." As a followup, at a CRA and Professionals Consultation Group seminar held in Toronto on June 15, 2005, the CRA presented a paper of 20 questions and answers setting out its views on when withholding taxes apply and on the process that taxpayers should follow in applying for waivers.

The paper provides guidance and detailed examples of how regulation 105 withholding tax applies to various situations, touching on topics such as withholding tax on bundled services, determining whether services are rendered in Canada, apportioning services provided inside and outside Canada, the treatment of directors' fees, subcontractor issues, and regulation 102 and 105 waivers.

Questions 17-20 deal with permanent establishment issues, including the factors the CRA considers when determining whether a non-resident service provider has a Canadian PE. The CRA said that a PE is defined as "a fixed place of business, through which the business of an enterprise is wholly or partly carried on" and that three tests must be met: (1) there must be a place of business, (2) the place of business must be fixed, and (3) the business of the non-resident must be wholly or partly carried on through the fixed place of business. The CRA added that it refers to the OECD commentary when determining whether a PE exists in Canada. In response to a question about the effect on PE issues of the recently revised commentary to the OECD model treaty, the CRA said that it will provide comments after it has fully considered the commentary.

In *Dudney* ([2000] 2 CTC 56), the FCA held that the premises of a US-resident consultant's Canadian client did not constitute a fixed base regularly available to him during the time he worked there; article XIV of the Canada-US treaty would have allowed Canada to tax him on independent personal services if he had had such a fixed base. The FCA said that a particular location is a "fixed base regularly available" to a person who provides independent personal services only if that person's business is being carried on there. The FCA considered the actual use made of the premises alleged to be the Canadian fixed base, whether and by what legal right the person exercised or could exercise control over those premises, and the degree to which the premises were objectively identified with the person's business.

In the paper, the CRA said that the PE definition carries the same meaning for both an individual and a corporate non-resident service provider. If the factual situation of a corporate non-resident service provider differs from that in *Dudney*, factors other than those listed there may be more relevant. The CRA cautioned that if a situation differs on its facts from *Dudney*, a taxpayer should ensure that none of the three tests in the PE definition are met, in order to avoid having a PE in Canada. The CRA emphasized that taxpayers should not rely too heavily on *Dudney*.

A CRA official also said that there have been inconsistent assessments across the country relating to PE issues. The official said that the CRA expects to release a technical news document in September 2005 that will include a discussion of "physical control" because there is confusion about what constitutes control, especially in the services industry.

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Provincial Budgets, 2005

As provincial finance ministers and treasurers prepared their 2005 budgets, they faced an unusually high level of uncertainty. Not only were economic forecasts unclear about the direction of regional and national economies in the next year, but a number of federal policy initiatives also had to be factored into fiscal forecasts. Most budgets tended to be pessimistic about the bottom line for 2005-6.

The table shows that 7 of the 13 provincial and territorial governments predict a surplus for the 2005-6 fiscal year, the same number as last year. Only 5 of the 13 expect a better result for the year ahead than the preliminary results for 2004-5. In aggregate, the budgets show a decline from a surplus of $2.8 billion in the past year to a deficit of $1.8 billion in the forecast year, reflecting projected increases of 2.4 percent in revenue and 4.8 percent in spending. However, the aggregate change can be explained by the change in Alberta's approach. Wary of basing its fiscal policy on the volatile revenue from oil and gas production, the province deliberately uses a cautious forecast. Last year, oil and gas revenue pushed the provincial surplus to $4.3 billion; for 2005-6, the budget predicts a surplus of only $1.5 billion.

The federal government enriched its transfers under the Canada health transfer plan and increased the equalization payments to Newfoundland and Labrador and Nova Scotia. Full details on the transfer of a portion of the federal gas tax for local transportation had not been announced when the provincial budgets were set, and agreements to implement the federal child-care strategy had not been finalized; therefore, provincial budgets were not able to reflect the last two programs.

Provincial Governments' Reported Surplus or Deficit

	2005-6	2004-5
	$ millions	
Newfoundland and Labrador	–62.0	21.3
Prince Edward Island	–10.0	–24.7
Nova Scotia	–320.5	–321.0
New Brunswick	4.0	53.1
Quebec	–267.0	–221.0
Ontario	–2,796.0	–2,993.0
Manitoba	3.0	314.0
Saskatchewan	0.1	289.8
Alberta	1,520.0	4,314.0
British Columbia	220.0	1,440.0
Yukon	29.1	27.3
Northwest Territories	–95.3	–51.2
Nunavut	3.7	–8.4

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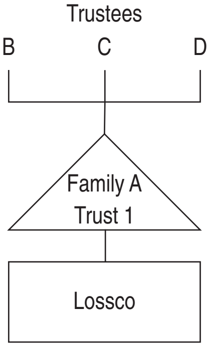
CHANGE OF TRUSTEE AND CONTROL

Is control of a corporation acquired when a trustee of a family trust holding its shares is replaced? In a recent technical interpretation (2004-0087761E5), the CRA said that a change in any of the trustees resulted in a new group controlling the corporation and, subject to the exceptions in paragraph 256(7)(a), an acquisition of control of the corporation. Thereafter, any of the corporation's losses incurred before the acquisition of control either expire or are restricted. This view seems contrary to the CRA's previously published administrative position.



In situation 1 described in the TI, Lossco, a CCPC, has non-capital and capital losses. Lossco's sole shareholder is a discretionary trust for family A's members (trust 1), which has three trustees (B, C, and D) who are unrelated to each other and to family A. A simple majority of the trustees makes the trust's decisions. The TI asks the following questions: (1) If any trustee resigns and is replaced by another who is also unrelated to family A, is control of Lossco thus acquired? (2) If two trustees resign and are replaced by others who are also unrelated to family A, is control of Lossco thus acquired? (3) If trustee B is related to family A and does not resign, is control of Lossco acquired by a change in one or both of the unrelated trustees?

The CRA says that when a trust is a shareholder, case law examines the trustees in assessing corporate control because the trust is not a legal entity; it is a relationship between the trustees and the beneficiaries. When a trust has multiple trustees, it is a question of fact which trustee or group thereof controls the corporation; but in the absence of contrary evidence, the CRA presumes that all the trustees constitute a group that controls. Thus, in situation 1, the CRA says that a change in any trustee results in a new group controlling Lossco and, subject to paragraph 256(7)(a), an acquisition of Lossco's control. (Paragraph 256(7)(a) says that control of a corporation is deemed not acquired by a person who acquires its shares when the acquiror is related to the person from whom he or she acquired the shares, or the acquiror is related to the corporation immediately before the acquisition.) Therefore, inter alia, Lossco's non-capital losses can only be carried forward against income from the same or similar businesses, and Lossco's net capital losses expire. The TI's conclusion seems to contradict the administrative position in *Interpretation Bulletin* IT-302R3 regarding losses and acquisition of control: "For purposes of paragraph 256(7)(a), where the executor, administrator or trustee is replaced as a result of that person's death or inability to fulfil his or her functions, *the control of the corporation will be regarded as remaining unchanged*" (emphasis added).

The TI also describes situation 2, involving family A's trust 1 and another family A trust (trust 2), which owns a Profitco. The trustees of trust 2 are B, C, and E. Lossco and Profitco amalgamate to form Amalco, and trust 2 receives the majority of the voting shares of Amalco. After the amalgamation, the CRA says, subparagraph 256(7)(b)(ii) (which deals with the acquisition of control of two or more corporations in an amalgamation) applies to deem an acquisition of control because the amalgamation results in control of Amalco being acquired by a group of persons (B, C, and E), a group clearly different from the group (B, C, and D) that controlled Lossco immediately before the amalgamation. Non-capital losses thus carry forward only against income from the same or similar businesses, and net capital losses expire.

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HABITUAL ABODE IN TAX TREATIES

When an individual is a resident of both Canada and another country, the tiebreaker rules in the applicable tax treaty determine which residence prevails for Canadian income tax purposes. In the vast majority of cases, the first or second tiebreaker applies: the location of the individual's permanent home or the centre of personal and economic interests. The recent TCC decision in *Allchin* (2005 TCC 476) was based on the third tiebreaker rule—the location of the individual's habitual abode—and the court chose not to use the OECD commentary as a guide.

Allchin was a Canadian citizen who held a green card to work as a registered nurse in the United States. Almost all of her personal connections (such as her family, her doctor, and her dentist) were in Canada; almost all of her economic activities (such as her work and her membership in a professional organization) were in the United States. The TCC said that she was a dual resident and that her country of residence would be decided by the tiebreaker rules in the Canada-US treaty. The court also said that she had a permanent home in both countries or neither country (following the treaty's wording) and a centre of vital interests in both countries. In considering the taxpayer's "habitual abode," the court acknowledged the OECD commentary's highly persuasive value but said that it was "not useful" in determining the meaning of the term "habitual abode" under the Canada-US treaty because its ordering of the tiebreaker rules differed from the model treaty's. Under the Canada-US treaty, if the individual has a permanent home in both states or in neither state, the tiebreaker is the individual's centre of vital interests; if the centre of vital interests cannot be determined, the tiebreaker is the individual's habitual abode. The model treaty follows the same order if the individual has a permanent home in both states; but if he or she has a permanent home in neither state, the tiebreaker is the location of the habitual abode, not the centre of vital interests.

Unfortunately, the TCC did not elaborate on why this distinction should preclude the use of the OECD commentary as an interpretive aid. Given the object and purpose of tax treaties, the courts have interpreted treaties liberally rather than strictly and literally, generally making extensive use of the OECD model treaty and related commentary. The purpose of the tiebreaker rules is to spare individuals double taxation and to mitigate the administrative complexities of filing returns in two jurisdictions. It is not clear why a minor difference in the tiebreakers' ordering outweighed the judicial mandate to interpret tax treaties liberally and ousted the OECD commentary from its role as a relevant and useful interpretive tool. Moreover, the effect of any difference in ordering should be limited to cases where the tiebreaker ordering actually differs: that is, when the individual has a permanent home in neither state, not when there is a permanent home in both states. Perhaps the decision in *Allchin* to disregard the OECD commentary can be rationalized as hinging on the finding of fact that the taxpayer had a permanent home in both countries or in neither country.

To determine the meaning of "habitual abode," the TCC cited the *New Shorter Oxford English Dictionary* definition of "abode" as, inter alia, "a habitual residence," and of "habitual" as "[o]f the nature of habits fixed by habit; constantly repeated or continued . . . Given to a specified habit; that habitually does or is what is denoted by the noun . . . usual, constant, continual." The court summarily concluded that the taxpayer's habitual abode was clearly in the United States; its conclusion was based on a combination of the evidence describing the nature of her "lifestyle and activities" there and the fact that in each year she spent about 265 days there and only 100 days in Canada.

Although the matter is not clear, the TCC appeared to examine the taxpayer's "lifestyle and activities" to assess her usual, constant, and continual habits, even though those factors were already taken into account for the "centre of vital interests" tiebreaker and were found inconclusive. The OECD commentary on habitual abode calls for a "comparison" of the length of stays in each country over a period sufficiently long to allow an assessment of whether the residence in each is habitual and to determine the intervals at which the stays occur: the country where the individual "stays more frequently" in such a period "tips the balance." Regard is given to all stays at any place in a country, not just at the permanent home. Some commentators suggest, without elaboration, that an individual's habitual abode is where the individual "normally" lives. A test based on a sufficiently long period, as required by the OECD commentary, seems reasonable to determine whether an individual "normally" lives in a country to which he or she frequently, regularly, and continually returns and in which he or she spends considerable time. More than a simple computation of the days spent in each country is required, but factors already considered in the first two steps of the tiebreaker rules and found inconclusive are not included.

As a practical matter, globalization and rising levels of cross-border employment may increase the difficulty in determining an individual's centre of vital interests and render "habitual abode" the predominant tiebreaker rule in determining residency. Unlike the Canada-US treaty, most of Canada's treaty tiebreaker rules are in the same order as they are in the OECD model treaty; thus, the OECD commentary will be highly persuasive in their interpretation. The "habitual abode" tiebreaker will break the tie in favour of the country to which the individual frequently returned at regular and continual intervals and in which he or she spent considerable time. Moreover, despite the minor difference in the ordering of the Canada-US treaty tiebreaker rules, there is a strong argument that the OECD commentary should be used to interpret the meaning of "habitual abode," especially if on the facts the individual has a permanent home in both countries.

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Alberta ULCs

On May 17, 2005, Alberta's Business Corporations Amendment Act was proclaimed in force, including new part 2.1 and a series of consequential amendments that provide for the incorporation or continuance in Alberta of an Alberta unlimited liability corporation (AULC) under the Alberta Business Corporations Act (ABCA).

An AULC's shareholders have unlimited liability for any liability, act, or default of the corporation. The scope of the liability is intended to satisfy the general requirement of the US income tax regulations test that excludes a

Canadian company or corporation from classification as a per se corporation if it is "a company or corporation all of whose owners have unlimited liability pursuant to federal or provincial law." An entity that escapes per se corporation classification may be able to use the US check-the-box rules and be classified as a disregarded entity for US tax purposes.

In contrast to the requirement under section 135 of the Nova Scotia Companies Act, there is no one-year lookback period to determine the former shareholders who must contribute on dissolution of an AULC, and there is no express statement that the shareholder is liable to contribute only an amount sufficient to allow the AULC to pay its debts and liabilities. The ABCA approach differs partly because the AULC, unlike an NSULC, is not specifically authorized by the US regulations.

New part 2.1 provides that an AULC's articles must expressly state its unlimited liability and that the corporation's name must end with either "ULC" or the words "Unlimited Liability Corporation." Other rules are designed to expressly warn shareholders of their joint and several unlimited liability and to empower the registrar of corporations to compel disclosure of the names of unlisted shareholders. Changes between AULC status (or the extraprovincial equivalent) and the usual limited corporate form may be accomplished via amalgamation, continuance, or the filing of articles of amendment. A shift to AULC status from limited liability status subjects the shareholders to liability for all of the obligations of the body corporate then in existence (and whenever incurred) at and from the time of the change. In contrast, a shift from AULC or equivalent extraprovincial body corporate status under part 2.1 provides the shareholders with limited liability protection that is prospective only; the liability of the shareholders at the time of the change is not limited in respect of the corporation's pre-existing obligations. If the shareholders of an extraprovincial corporation have unlimited liability for the entity's obligations, that corporation is expressly permitted to continue in Alberta as an AULC, and on continuance, the shareholders' unlimited liability for all the extraprovincial corporation's obligations lives on. However, because an AULC's unlimited liability rules differ from an NSULC's, there is some concern that Nova Scotia may resist the continuance of an NSULC as an AULC.

Because an AULC is defined as a special form of corporation, with few exceptions outside the special rules of part 2.1, the ABCA applies to an AULC exactly as it applies to all other Alberta corporations. Consequently, AULCs and other Alberta corporations all enjoy the same advantages that are inherent in a modern business corporations regime, including the amendment of articles, amalgamation, and certain dissolutions, all of which may occur without court supervision. AULCs also benefit from other changes in the amending legislation, such as the reduction of the ABCA's Canadian-residency requirement for directors to one-quarter—the standard under the Canada Business Corporations Act—and several amendments specifically targeted toward improving the ABCA's business efficacy. The Alberta Corporate Registry is now accepting AULCs for registration; to date, no additional tariff has been set over and above the regular $100 incorporation fee for an Alberta corporation.

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ULC: Alberta or Nova Scotia?

The recently enacted part 2.1 of the Alberta Business Corporations Act (ABCA) provides for the formation of an unlimited liability corporation (AULC). Nova Scotia ULCs (NSULCs) have been used extensively by both US and Canadian corporations for inbound and outbound investments. Tax practitioners should consider the pros and cons of using an AULC and whether existing ULCs formed under the Nova Scotia Companies Act (NSCA) should migrate to Alberta.

For almost a century, ULCs were a historical anomaly, the remnant of a failed experiment in Victorian corporate law. Because the shareholders of a ULC have unlimited liability, the ULC was regarded as a business vehicle inferior to a corporation, which protected shareholders from legal liability. In Canada, only Nova Scotia's corporate statute was old enough to retain ULC provisions; the NSCA is based on the UK Companies Act, modified for concepts in modern US business corporation statutes.

Previously under US tax rules, an entity was classified as a partnership and not a corporation if it lacked at least two of four corporate characteristics: (1) limited liability, (2) continuity of life, (3) free transferability, and (4) centralized management. Eventually, some bright tax practitioner realized that an NSULC was an entity that, for US tax purposes, could conveniently fail the test for corporate treatment and be classified as a partnership, a flowthrough vehicle. This hybrid tax treatment made the NSULC the preferred investment vehicle for many US corporations that intended to make inbound investments into Canada with significant startup tax costs or to acquire a Canadian company. Deductions such as tax depreciation and interest expense flow through the NSULC and can be deducted on the US consolidated return. The utility of an NSULC as a disregarded entity was codified and further enhanced with the introduction of the simplified US check-the-box rules, which generally enabled US taxpayers to choose whether a particular entity retained corporate status or had flowthrough status for tax purposes. Canadian corporations also used ULCs and the check-the-box legislation to (among other things) create double-dip structures. We understand that AULCs will also be treated as disregarded entities for US tax purposes. Some key aspects of Alberta's and Nova Scotia's ULC legislation are compared below.

■ The ABCA allows any corporation to be continued into Alberta as an AULC. All property of the continued corporation becomes property of the AULC, and the former entity is treated as having been formed under the ABCA. It is not possible to continue a corporation formed elsewhere into Nova Scotia directly as an NSULC, although this can be done indirectly by continuing an ordinary corporation into Nova Scotia and then amalgamating with a "shell" NSULC. An amalgamation in Nova Scotia requires a 75 percent positive vote of each class of shares followed by court approval. Similar approval is required if a company chooses to reduce its share capital. The ABCA procedures for amalgamations are streamlined in that they do not require court approval and may be short-form or long-form amalgamations. Short-form procedures require only board approval; long-form amalgamations require the approval by vote of 66 2/3 percent of the shareholders but no court approval. Similar approval is required for share capital reductions.

■ Under the NSCA ULC provisions, because contributed surplus cannot be created, neither can high-low shares; many corporate reorganizations and tax-driven transactions are thus, at best, time-consuming. In certain circumstances, these transactions are possible under the ABCA.

■ An ABCA corporation may hold shares in itself (without cancellation) and permit subsidiaries to acquire its shares for a maximum of 30 days, a concession that facilitates reorganizations. Unlike a company formed in Nova Scotia, an ABCA company may give financial assistance to any person for any purpose without regard to a solvency test.

■ Dividends of a Nova Scotia company must be declared and paid out of its profits. Shares of a company may not be redeemed or purchased without meeting a solvency test, and shareholders must approve a company's purchase or other acquisition of its own non-redeemable shares. An ABCA corporation has more latitude to acquire its own shares and declare dividends: it may do so without approvals, provided that it has reasonable grounds to believe that solvency tests are met.

■ The Nova Scotia legislation retains a significant advantage over the ABCA: directors need not be resident Canadians. The ABCA requires that at least one-quarter of directors be resident Canadians.

■ There may be a degree of comfort in dealing with the NSCA because taxpayers and their counsel are familiar with it; the ABCA ULC rules, by contrast, were only recently enacted. Moreover, Nova Scotia may decide to update the NSCA to include some of the favourable changes set forth in the ABCA. It will be interesting to see whether the gap between the fees to incorporate will shrink as each province competes for business relating to the incorporation or formation of a ULC.

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"Carrying On Business" for Non-Resident Lessors

In a welcome move, the CRA's Excise and GST/HST Rulings Directorate is improving the transparency of its administration of part IX of the Excise Tax Act through the regular release of GST policy statements. *GST/HST Policy Statement* P-051R2, "Carrying On Business in Canada," dated April 29, 2005, and a recently released draft GST policy statement entitled "Agreements and Novation" (CRA *Notice* 201, June 27, 2005) are of interest to non-resident leasing companies.

P-051R2 takes the position that for the purposes of determining whether a non-resident is carrying on business in Canada, the location where sales contracts are concluded cedes primary importance to a variety of factors, including the place of delivery, the place of payment, and the location of the assets or inventory. By means of a number of examples, the CRA indicates that for GST purposes a non-resident lessor of tangible personal property carries on business in Canada (and generally must register for GST) if its presence in Canada is limited to (1) taking delivery of property that it purchases in Canada and (2) leasing that property in Canada. This same position was stated unequivocally at the March 3, 2005 GST Round Table meeting of the Canadian Bar Association:

> [T]he CRA's position is that where delivery of the tangible personal property to the lessor and the lessee both occur in Canada, the non-resident lessor will be considered to be carrying on business in Canada for GST/HST purposes. Therefore . . . a non-resident lessor will be considered to be carrying on business for GST/HST purposes where the leased property is drop-shipped to the Canadian lessee in Canada by the Canadian that supplies the property to the lessor in Canada.

P-051R2 reaches a similar conclusion on a sale-leaseback arrangement involving the purchase and leaseback of a conveyance situated in Canada (example no. 1). Conversely, if the leased property is delivered to the lessee at a location outside Canada, then the CRA does not view the lessor as carrying on business in Canada solely because the lessee subsequently uses the property in Canada. In such situations, the supply of the leased property is deemed (under the "once-and-for-all" test provided for in ETA paragraph 136.1(1)(d)) made outside Canada if "possession or use of the property is given or made available outside

Canada" to the lessee and reliance on the special non-resident place-of-supply rules is not necessary.

Given the CRA's new policy on carrying on business, the determination whether an agreement has been novated or has only been modified can become significant from a GST perspective. For example, if a new lease agreement is created through novation, the lessor is likely to be carrying on business in Canada if the leased property is situated in Canada at the time. The draft policy statement on novation does not contain any examples involving leases, but it states that in "circumstances where no new party is introduced, the obligation to be performed by either party to the novation contract must be significantly different to require altering the original agreement," such as "varying the form, terms and conditions of an agreement to such an extent that a fresh undertaking is being concluded and agreed upon between the same parties." Some additional guidance on leases and novation was provided in *Technical Information Bulletin* B-066 and *GST Policy Statement* P-020, "Grandfathered Leases."

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Small Business Software Services

The 2005 Ontario budget briefly referred to a pilot project to simplify the PST rules for software services supplied by small businesses. The key working assumptions are still under development, but the project is likely to be welcomed by IT practitioners, who have long argued that the software rules are too complex for all businesses.

The need to properly classify, and then segregate, services in a bundled contract as either taxable (for example, installation, configuration, and upgrades) or non-taxable (for example, training, planning, and advisory services) often creates undue complexity and strains the resources of a small business. The pilot project offers a simplified method of tax calculation to certain participants, but the required qualifications are still under review. It has been suggested that certain GST concepts be mirrored. For example, a business that generates certain revenue up to $200,000 in a particular period can elect to simplify its GST accounting and use the so-called quick method. There is some logic in creating symmetry by aligning PST simplification with the existing GST program, which has the same objectives.

Under the simplified PST rules, qualifying small businesses, with the purchaser's agreement, may elect to apply less than the regular 8 percent rate of tax to the sale of bundled computer services, regardless of the mix of taxable and non-taxable components. The rate, as yet undetermined, will render the change revenue-neutral.

It is likely that the parameters and layout of the proposed measures will be fleshed out over the summer; final rules are expected to be issued early in 2006. If the final rules are perceived as beneficial to industry, it will be interesting to see whether the ministry can be convinced to expand their application to larger businesses, or whether other provincial jurisdictions will follow suit. The ministry is to be commended for continuing to review the existing rules, keeping an open mind, and considering options to achieve a greater degree of simplification.

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R & D Advantage Waning?

Canada has long been recognized as having one of the most generous and stable R & D regimes in the world, but many countries—including Australia, France, Ireland, Hungary, Poland, Portugal, and the United Kingdom—have either introduced or increased R & D incentives over the last few years. More than 30 countries now have R&D incentives. Has Canada lost its edge?

In order to evaluate incentives, several factors must be considered: (1) What is the effective after-tax rate of the federal credit? (2) Are local or regional incentives available? (3) Is the system volume-based or incremental? (4) Is the credit refundable? (5) Must the work be performed within territorial restrictions? (6) What types of expenditures qualify? (7) What types of activities qualify? (8) How is the program administered? (9) What is the cost of compliance? Canada continues to receive high marks in general, but is falling behind in refundability and territorial restrictions.

The federal Canadian incentive is refundable within limits for CCPCs; some provincial incentives, such as Quebec's, are refundable without restriction even if a corporation generates losses. In contrast, a loss corporation in Austria may surrender its R & D incentives for an 8 percent refund; a loss corporation in France may receive a refund of the R & D incentives up to €8 million. In the United Kingdom, a small or medium-sized enterprise (SME) may earn credits at a higher rate than a large corporation and can surrender the credits for cash at a slightly discounted rate. The UK definition of an SME does not contain the ownership restrictions that exist in Canada, and the UK tests for qualification as an SME (such as turnover and total assets) are much less restrictive than the Canadian tests. In practice, many corporations in a loss position fail to file R & D claims because of a combination of the lack of federal refundability in Canada (other than for CCPCs) and the 18-month filing requirement, thus denying themselves the benefits of the program.

The Canadian program requires that all work be performed in Canada. Jurisdictions such as Austria, France,

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Hungary, Ireland, Japan, and Spain have less restrictive requirements. Do Canadian territorial restrictions hinder international R & D projects? Competition to attract and retain R & D jobs around the world is clearly intensifying; it may be time for Canada to revisit some aspects of its incentive program in order to retain its position as one of the most attractive R & D regimes in the world.

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APAs for Small Business

The CRA recently implemented a small business advance pricing agreement (APA) program (IC 94-4R, Special Release, March 18, 2005) in response to requests from small businesses.

The Competent Authority Services Division of the CRA will consider taxpayers' requests for a small business APA if two conditions are met: (1) the taxpayer's gross revenue in the immediately preceding taxation year was less than $50 million or the proposed covered transaction is a non-arm's-length transaction of less than $10 million (or expected to be less); and (2) the proposed covered transaction is non-arm's-length and involves either the purchase or sale of tangible goods (not bundled with non-routine intangibles) or the provision or receipt of routine services. The gross revenue and transaction thresholds are based on the taxpayer's reported prices for the immediately preceding taxation year (not those prices ultimately determined to be at arm's length). A taxpayer may request that the APA cover multiple transactions of dissimilar products or services if the threshold is met for each transaction.

The new APA program differs in several respects from the traditional APA program introduced in 1993. The taxpayer may request only a unilateral APA; thus, a site visit and travel for competent authority negotiations are not required. The taxpayer cannot request a rollback of the results to prior taxation years, and only a functional analysis is required, not an economic analysis typical of the traditional program. Existing transfer-pricing documentation containing a complete and accurate functional analysis for the proposed transactions meets the functional analysis criterion if it contains the records or documents enumerated under paragraph 247(4)(a), other than "data and methods considered." The functional analysis should include an organization structure depicting the transaction flows and entities involved; the transaction's terms and conditions; the functions performed, the property used or contributed, and the risks assumed by the entities involved; transaction assumptions, strategies, and policies; detailed financial data for the three latest fiscal years for the relevant entities; a business history; the names of direct competitors; industry background information (including critical success factors); and a description of transactions with unrelated parties that may be potentially considered comparable. (The CRA also possesses so-called secret comparables.) These information requirements are similar to those in the OECD transfer-pricing guidelines for multinational enterprises. With the taxpayer's functional analysis in hand—and an economic analysis if it so chooses—the CRA will perform an economic analysis on which it will determine an arm's-length price for the transactions "based on the most reliable data available." A draft copy of the CRA analysis is given to the taxpayer for possible discussion, but not negotiation.

The CRA will charge a fixed non-refundable administrative fee of $5,000, payable when the taxpayer makes its official small business request. The annual compliance report required under the traditional APA need not be filed, only an annual statement that the critical assumptions have been reviewed for the APA year and have not been breached.

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Foreign Tax News

Commonwealth of Independent States

Azerbaijan, Armenia, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Uzbekistan, and Ukraine signed an agreement to cooperate in the prevention, discovery, and investigation of tax crimes by analyzing the problem in different regions, harmonizing tax treaty legislation, designing joint programs to combat tax crimes, and coordinating treaty implementation measures. Compliance measures include information exchange; responses to requests for investigations; the involvement of competent authorities in training, research, and coordinating of investigations; and exchanging experience, research, and recommendations.

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