CANADIAN TAX Highlights

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US Estate Tax: Strangi Upheld

Changes in the CRA's administrative position on the application of shareholder benefit rules to single-purpose corporations (SPCs) led to their abandonment in favour of partnerships as the preferred vehicle through which to own US vacation properties and avoid US estate tax, especially if trusts were not viable alternatives. These structures include partnerships that check the box to be treated as corporations for US tax purposes. (Such elections may occur near or after the death of the Canadian owner and have a retroactive [pre-death] effect.) However, the Fifth Circuit's recent affirmation of the US Tax Court's decision in *Estate of Albert Strangi* (85 TCM 1331) signals a continuing risk that the IRS may in certain situations subject the property to US estate tax at the death of its Canadian owner and user. *Strangi* may also support any attempt by the IRS to look through certain Canadian holdcos that are used to own US stock and securities and other US-situs non-personal-use property.

Non-US-citizen Canadians are subject to US estate tax only on US-situs assets, including US real property; tangible personal property located in the United States; and stock in US corporations and debts of US persons or entities (except, for example, portfolio debt obligations). US-situs assets that are owned at death either outright or through certain trusts and partnerships are generally included in the estate tax base, but stock in a non-US corporation that owns US-situs assets is not (subject to any lookthrough). The IRS has long maintained that it routinely and successfully looks through certain non-US holding companies (such as a Canadian SPC) that are used to own US vacation properties; however, until 2002 (when *Strangi* was first decided) the only corroborative cases and rulings were those in which corporate formalities had not been followed or the corporation was purely a nominee title holder.

In *Strangi*, the decedent and a corporation owned generally by him and his children formed a limited partnership about two months before his death. The corporate general partner contributed 1 percent of the partnership capital; the decedent, a limited partner, contributed 99 percent, including a personal residence in which he continued to reside. Two distributions were made to the decedent to meet his expenses; proportional distributions were made to the general partner. Rentals for the residence were accrued but not paid until more than two years after the decedent's death. The partnership made distributions to the estate to pay funeral expenses, administration expenses, various debts of the decedent, a specific bequest, and estate taxes of about $3 million. The US Tax Court looked through the partnership and included the transferred property in the decedent's gross estate under Code section 2036 on the ground that the transferor retained during his lifetime a significant interest in, or control over, the property. The rule requires that after the transfer the decedent retain either "possession or enjoyment" of or the right to income from the transferred property, or "the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom." Regulations require that at the time of the transfer there be an express or implied agreement that the transferor will retain possession or enjoyment of the property. An exception to the rule exists if the transfer was a bona fide sale for adequate and full consideration in money or money's worth.

The Fifth Circuit affirmed the decision: there was no clear error in the Tax Court's findings. The decedent retained "possession or enjoyment" of the transferred residence by his continued used thereof, his receipt of partnership payments before death, and the partnership's payment of various estate debts and expenses. An agreement to retain possession or enjoyment was implied: on the creation of the partnership, the decedent retained assets barely sufficient to meet his living expenses for his minimum life expectancy of about one year (not including rent, estate administration costs, outstanding personal debts, and funeral expenses or taxes), and he received periodic payments from the partnership. The bona fide sale exception was not met even though the decedent received an equity interest in the partnership equal to the value of the property transferred in, because the transfer did not objectively serve "substantial business or other non-tax purposes." None of the purposes presented by the taxpayer, such as creating a joint investment vehicle for

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the partners and permitting centralized active management of working interests owned by the decedent, were adequate.

In light of *Strangi*'s affirmation, Canadians must continue to take care in structuring corporations or partnerships to hold US-situs property, especially personal-use property that is used rent-free by the Canadian individual transferor. A properly structured trust may be an alternative in certain circumstances: in many cases, a trust offers the dual US tax benefits of avoiding US estate tax and qualifying for the lower 15 percent US federal capital gain tax rate on future appreciation realized in a gain on the property's sale.

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Taxation of Satellites

The CRTC recently approved applications to license radio programming to be delivered by satellite to Canadian subscribers for a monthly fee. (See Broadcasting Public Notice CRTC 2005-61 and Broadcasting Decisions CRTC 2005-246 and CRTC 2005-247, all dated June 16, 2005.) Because Canada has insufficient Canadian satellite capacity to distribute these subscription radio services to Canadian subscribers, foreign satellites are authorized to do so. The application of Canadian income tax to the foreign satellite operators involves some interesting issues.

If a non-resident operator maintains facilities and equipment in Canada, such as Canadian ground stations and transmission centres, it may be easy to conclude that it attracts part I tax on its business profits. But whether the mere operation of a satellite that transmits to Canada attracts Canadian income tax is less certain. When a non-resident operates a satellite whose trajectory passes over Canada, does the satellite operate "in Canada"? How far above Canada's land mass does its taxation jurisdiction extend? Under both the federal Income Tax Act and the Income Tax Conventions Interpretation Act, the definition of "Canada" includes the "airspace" above the land mass, but that term is not defined.

In *Air Canada v. Manitoba* ([1980] 2 SCR 303), the SCC concluded that overflights by an aircraft did not create a situs for provincial taxation purposes. The Manitoba Court of Appeal ([1978] CTC 812) had refused to apply literally the legal maxim *Cujus est solum ejus est usque ad coelum et ad infernos* (the owner of land owns up to the sky and down to the depths): in an era of jet aircraft, satellites, orbital travel, and visits to the moon, that maxim is obviously no longer appropriate.

As to whether satellite operations meet the PE threshold, the OECD model treaty commentary on article 7(1) says that the model treaty need not be amended to explicitly deal with space activities: "[N]o country envisages extending its tax sovereignty to activities exercised in space or treating these as activities exercised on its territory." The commentary notes that activities conducted in space should not run any new risks of double taxation; it appears that only the satellite operator's country of residence can impose taxation on the business profits, because the mere operation of the satellite in space does not create a PE in a country.

The limits of a country's airspace are bounded by outer space, which is under development as a legal concept by the United Nations Committee for Peaceful Uses of Outer Space (see http://www.oosa.unvienna.org). A reasonable interpretation of public international law as it currently stands is that a country's sovereign airspace ends and outer space begins at about 100 kilometres above the country's territory, a distance that represents the lowest point at which a satellite could be put into orbit around the earth. Thus a country's borders may include the airspace above it, but not "outer space," a view consistent with the Manitoba Court of Appeal's decision in *Air Canada* and the OECD model treaty commentary.

Business activities that occur outside a country's sovereign airspace—in outer space—should not be considered to take place within the country. Absent other presence or activity in Canada, a non-resident's business profits attributable to satellite operations and transmissions that occur in outer space should thus be exempt from part I tax even if the non-resident resides in a non-treaty country. Furthermore, because the non-resident satellite operator is not carrying on business in Canada, it need not file a schedule 91 treaty-based return to assert that it does not have a Canadian PE. Before its business profits are subject to Canadian taxation, a non-resident satellite operator must have additional presence in Canada, such as a ground station or transmission facility. Business profits from satellite operations that are isolated in a separate legal entity from other activities required to be performed in Canada should be exempt from Canadian tax. Moreover, lease payments made by a Canadian resident to a non-resident for the lease of satellite capacity should not constitute the rental of equipment in Canada and should not attract part XIII tax under subparagraph 212(1)(d)(i).

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CRA Demand for Documents

Two recent cases seem to demonstrate the courts' preparedness to uphold the CRA's broad interpretation of its statutory powers to obtain documents and information from taxpayers in order to conduct its audit activities.

In *Saipem Luxembourg* (2005 FCA 218), the issue was whether a CRA notice of requirement demanding that the foreign taxpayer produce all its corporate records for its 1999 and 2000 taxation years was so broad as to be unreasonable and thus should be set aside. The CRA had requested extensive foreign-based information and documents to determine whether the foreign-based taxpayer had a PE in Canada, but the taxpayer was prepared to provide only the documents relevant to its Canadian operations.

Under subsection 231.6(2), the CRA may require that a non-resident person carrying on business in Canada provide "foreign-based information or documents," defined as any information or document that is available or located outside Canada that may be relevant to the administration or enforcement of the Act. A court may confirm the requirement, vary it, or set it aside if satisfied that the requirement is unreasonable.

The CRA said that it was unable to assess the taxation years in question until it could independently determine whether the taxpayer had a Canadian PE and, consequently, a Canadian tax liability. To make this determination, the CRA said that it must audit all the taxpayer's books and records. Because the CRA did not accept the taxpayer's offer to produce all documents relevant to its Canadian operations or to have the TCC decide whether it had a PE in the years in question, the taxpayer argued that the CRA's requirement was unreasonable and should be set aside.

The FCA said that the reasonableness of the CRA's determination that an audit was required was not in issue. What was in issue was the reasonableness of the notice of requirement in light of that determination to conduct an audit; the determination to conduct an audit supported the scope of the requirement served on the taxpayer and was thus not unreasonable. Because the records in question were maintained outside Canada, the CRA could do little more to gain access to them than issue a notice of requirement.

In *1144020 Ontario* (2005 FC 813), the taxpayer applied for a judicial review of the CRA's requirement that the taxpayer produce foreign and domestic documents. Here too the court found that the request for information was not unreasonable.

The taxpayer argued that (1) the requirement was unreasonable because the CRA asked for information that the taxpayer had provided on several occasions during three CRA audits; (2) most of the information sought was unrelated to the only year that remained under review, and thus the requirement letters were unrelated to the administration and enforcement of the Act; and (3) the requirement letter seeking information or documentation from an unrelated non-resident was unreasonable.

The court noted that the legislation does not specify a period within which the CRA must issue a requirement for foreign-based information or documents; nor does it specify that the requirement be issued during the course of an assessment or reassessment. A review of the relevant jurisprudence revealed the following principles relating to domestic requirements: (1) the determination of the taxpayer's tax liability is a purpose related to the administration and enforcement of the Act; (2) for a requirement to be valid, the CRA need only show that the taxpayer's records may be relevant, not that they will be relevant; and (3) the test of relevance is whether the particular record requested may be relevant in the determination of a taxpayer's tax liability, not whether it is relevant to a particular issue under audit. The FC said that since the taxpayer's tax liability was under investigation, the requirement for foreign-based information was "relevant to" the administration or enforcement of the Act, and the requirement for domestic information was "for a purpose related to" such administration or enforcement. The requirement letters were thus valid; they were not unreasonable simply because the taxpayer said that it had previously provided much of the information sought. The minister cannot know whether information that was previously provided represents all that is required or that may be relevant. Furthermore, the FC rejected the argument that a requirement that seeks foreign-based information or documents from an unrelated non-resident is unreasonable. The targeted information must be in the possession of the requirement's recipient or a related entity: it is a complete response for a taxpayer to say that it does not have the information or documents and cannot provide them because they are in an unrelated person's possession or control.

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City Tax Resource

A recent study from Statistics Canada (11-624-MIE) shows that average employment income in cities exceeds that in the rest of the country, a statistic that has implications for the possible introduction of local income taxes.

The CRA Web site contains a wealth of detail on personal income tax collections, including compilations of tax statistics by the locality shown as the return address on income tax returns. From information on the 2001 tax year, the average taxable income on returns filed from one city in each province was calculated. The table shows that average taxable income in each city exceeds the average in the rest of the province—by as much as 60 percent in the case of Winnipeg, for example.

The range of variation in city averages is as great as the variation in provincial averages. As a result, a uniform national rate of local income tax would raise 35 percent

Average Taxable Personal Income in City as a Percentage of Average in Rest of Province, 2001

City	%
St. John's, NL	150.6
Charlottetown, PEI	136.9
Halifax, NS	137.4
Saint John, NB	113.8
Montreal, PQ	109.6
Toronto, ON	131.9
Winnipeg, MB	159.5
Regina, SK	129.2
Calgary, AB	148.6
Vancouver, BC	141.3
Average, 10 cities	131.5

more revenue in Calgary than in Charlottetown. The federal equalization system is designed to shield the poorer provinces from similar disparities. If there are, as the Statistics Canada study suggests, greater variations within each province than there are among the provinces, fulfilling the need for some form of provincially funded equalization would create an additional burden on provincial resources.

The higher taxable incomes in cities provide a clear indication that cities contribute significantly to provincial and national economic prosperity, a fundamental argument in favour of local income taxes. The disparity in the tax base within provinces and across the country, however, may make it difficult to implement local income taxes without a complementary system of equalization.

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Personal Tax Roundup

Offset mechanism for interest. The CBA-CICA Joint Committee on Taxation recently made a submission to Finance concerning a proposed measure that allows an offset for interest on personal tax overpayments and underpayments in order to remove an inequity faced by individual taxpayers. The measure was announced in the February 28, 2000 federal budget but is still not enacted.

Currently, an individual is taxable on refund interest but cannot deduct arrears interest; the result is unfair if the arrears interest and the refund interest accrue over the same period, as commonly occurs when the CRA adjusts a taxpayer's returns so that income is shifted from one year to another. The 2000 federal budget measure allows an offset of the taxable amount of refund interest against any arrears interest accruing in the same period, effective for accruals after 1999. A similar measure was enacted for corporations; in a December 21, 2000 press release, Finance reconfirmed its intention to enact the proposal for individuals, but has been silent since. The Joint Committee recommends that Finance enact the measure and retain the originally announced effective date.

Compliance with proposed FIE and NRT rules. The draft amendments on foreign investment entities (FIEs) and non-resident trusts (NRTs) are set to apply from January 1, 2003 but have yet to be enacted. The CRA was recently asked what advice it could give to taxpayers who in the interim are trying to comply with the rules for reporting foreign income from investment sources.

Questions and answers from the CRA Round Table at the conference of the Society of Trust and Estate Practitioners held in Toronto on June 7, 2005, were recently released. The CRA said that Finance is not prepared to recommend a change in the proposal's effective date; it is difficult for the CRA to issue any formal guidance on how to file when the legislation is not enacted. Taxpayers can file under the existing legislation or under the proposals, and in either case they may have to file amended returns once the legislation is passed.

The CRA pointed out that the failure to accrue income as required under the proposals will trigger interest charges on the overdue tax payments, as per section 221.1 and the proposals' retroactive application. The CRA's senior management is currently reviewing a recommendation to waive interest and late-filing penalties related to FIE and NRT income under the proposals; the CRA added that it is preferable to respond to this issue when the legislation is introduced in the House of Commons. On July 18, 2005, Finance released revised draft legislation on these rules (News Release 2005-049) and said that it intends to table the proposals in Parliament in the fall.

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Convertible Hedge Plan Trimmed

The recent FCA decision in *Rezek* (2005 DTC 5373; sub nom. *Hayes*, 2003 DTC 1205 (TCC)) reversed the TCC's holding that there was no net gain or loss because the convertible hedge (short sale plus convertible security) was a single property. Relying on *Schultz* (95 DTC 5657), the FCA said that each taxpayer and his or her spouse were in partnership and, on a net basis, had minimal taxable income or loss: there was no income splitting or taxable rate differential to be exploited.

Each of the plaintiffs (who were unrelated parties with similar issues) entered into convertible hedges that shorted

common shares of a public company when his or her spouse owned another security (debt or preferred shares) that was convertible into an equal number of the common shares. Any price movement in the underlying commons created a loss or gain on the short position and a corresponding gain or loss on the convertible security. Under the tax strategy, the losing position was closed and an income loss claimed; the gain position was held, usually through a year-end, and a capital gain was claimed. In this win-win strategy, it was contemplated that the investor would win from the cash flow generated from the strategy, from the increased investment value, and from tax refunds if losses were incurred. A key component of the investment strategy was the brokers' waiver of their 50 percent margin requirement, provided that the individuals and their spouses signed customer agreements and cross-guarantees that allowed the brokers to satisfy margin requirements from either the account holder or the guarantor.

The TCC said that a business existed but was not carried on: it was an adventure in the nature of trade. The FCA concluded that there was no authority for the proposition that an adventure in the nature of trade was not a business for the purposes of the relevant Partnership Act, and that each individual and spouse were in partnership. The business commenced when the accounts and cross-guarantees were set up to start the convertible hedging business. The profit arose from the spread, dividends and interest, and tax-deductible losses (the last because spouses were involved). The TCC erroneously concluded that a convertible hedge was a "separate identifiable property" distinct from its underlying component; the TCC thus distinguished the facts from those in *Schultz*, a case that the FCA said was overwhelmingly similar and binding.

Assuming that the parties did not use the accrual basis to calculate income, dividends and interest income were taxed in the year received, and compensatory dividends, rental charges, commissions, and other fees were deductible in the year paid. Because the partnership business was convertible hedging, the transactions should be collapsed and not considered independent transactions, thereby defeating the income-splitting opportunity. The maximum gains and losses sustained were the gains and losses on the spreads. They should be recognized by the partnership when the accounts of each spouse offset each other entirely because the securities in one account matched the securities sold short in the other account—that is, the year in which the common-common position was reached.

The Canadian Bankers Association (CBA) was granted intervenor status in *Rezek*. An intervenor is a party that has no immediate stake in the case but has an interest in the case's outcome for other reasons. An intervenor must convince a judge that, in the interests of justice, the intervenor should be allowed to make legal arguments. Presumably, the CBA objected to the TCC's characterization of the convertible hedge as a "separate identifiable property"—probably because its members were engaged in similar activities, albeit in a more traditionally commercial context.

In the result, both the CBA and the CRA achieved their objectives. The FCA said that the convertible hedge consists of two (or more) properties for tax purposes, but the taxpayers were stymied by the finding that a partnership existed. It is difficult to reconcile the finding of partnership—the TCC said there was no view to profit—with cases such as *Backman* (2001 DTC 5149 (SCC)), which said that a larger profit did not support a finding of partnership and was merely window dressing.

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Substance over Form: RST on Rentals

In *Spie*, an Ontario RST case, the Ontario Superior Court of Justice dealt with the troublesome distinction between the provision of taxable personal property (TPP) and the provision of non-taxable services ([2005] OJ no. 229). It appears that the substance-over-form approach to tax interpretation is alive and well in Ontario.

On a rental of TPP in Ontario, the vendor must charge and collect sales tax from its customer based on the full fair value of the charges for the goods. (Ontario generally says that full value is the full contract price, including many incidental charges that many might view as escaping taxation.) If the equipment comes with a skilled operator, the question is whether the contract is for a taxable rental or a non-taxable service; in the latter case, the vendor is relieved from collecting any RST but must self-assess RST in respect of the TPP's cost. If the contract is viewed as a provision of non-taxable services, the total RST burden on the transaction is generally based on the vendor's cost of the equipment.

Spie Construction was engaged in pipeline construction. It acquired the services and related equipment of qualified welders by entering into separate labour and rental agreements with them. Each welder signed an "employee sign-on" form and an equipment rental agreement, disclosing information that was used by Spie's accounting personnel to track its expenses. Spie was not charged RST by the welders, but it remitted RST—apparently because, as the equipment's purchaser, it thought it was liable to pay the tax. Spie later concluded that it had erred in remitting RST and applied for a refund of about $200,000.

Ontario disagreed, saying that because Spie treated the welders as employees and had separate equipment rental agreements, Spie was not purchasing non-taxable services:

it acquired TPP, and its self-assessment was correct. Ontario has a well-established policy that the acquisition of equipment "with an operator" is really the acquisition of a non-taxable service: the supply of the TPP (the equipment) is incidental to the provision of the services. In *Spie*, however, Ontario seemed to rely on the actual agreements in place between the parties.

The court found in Spie's favour. A considerable portion of its analysis was based on the fact that the separate-agreements approach was due to union requirements. Spie was forced to adhere to the collective agreement between the Pipeline Contractors Association of Canada, of which it was a member, and the Plumbing and Pipefitting Industry of the United States and Canada, and to practices within the industry. The court said that in substance the agreements should be characterized somewhat differently. The welders were independent contractors regardless of how they were labelled for internal accounting purposes: each was hired on a project-by-project basis; the contracts were short-term; there was no guarantee that the welders would be hired for the next project; the welders were free to quit at any time; the welders owned their equipment, which was worth a substantial sum (about $75,000); the welders were responsible for the equipment's financing, repair, fuel, licensing, and insurance; the welders had discretion over the make and model of the equipment, its repair, and its maintenance; Spie told the welders what work to do but not how to do it, as long as their work was performed in a workmanlike manner; the welders supplied their own work clothing; and the welders bore the benefit or the risk of profit or loss as evidenced by their ability to negotiate performance bonuses based on timely completion or to bear the cost of transporting their equipment to the site if they failed the initial welding test or failed to remain on the project for an initial number of days.

There was no rental of the equipment because the welders brought their own equipment and maintained exclusive control over it. The welders could also part with their equipment at any time; they would not have provided equipment to Spie without their services being engaged as well; and they would not have allowed any other welder or employee of Spie to use their equipment. Thus, the essential element of exclusive possession, use, and quiet enjoyment by Spie did not exist. Spie never intended to rent equipment; it only intended to have the welding completed.

A tension appears to exist between the result in *Spie* and commentary by the SCC in cases such as *Shell* ([1999] 3 SCR 622), which suggests that a taxpayer is bound for tax purposes by the legal relationships that it chooses to create. If Spie chose to separate the services from the equipment, why should it not pay tax? The minister made this argument in *Spie*, arguing that "a taxpayer cannot structure its affairs in one manner and then argue that it is entitled to a tax benefit if it had structured its affairs in a different manner"; this is reminiscent of the maxim *Verba chartarum fortius accipiuntur contra proferentem* (essentially, "The words of written documents are construed more forcibly against the party using them"). However, the judgment in *Spie* reflected the fact that in some instances a taxpayer may simply be unable to create the legal relationships that it has documented. Thus, on the facts, Spie was incapable of creating an employment relationship with the welders or of renting their equipment. *Spie* is thus an excellent example of the substance-over-form concept in action.

Spie did not address the ultimate application of the RST to the equipment in question: it does not simply go untaxed. It is not clear whether as a result of the case the welders were left to pay tax out of pocket: they may have purchased the equipment on an exempt basis in the expectation that they could rent it to Spie. *Spie* clarifies that the initial acquisition of the equipment by the welders is in fact a taxable event, which means that the welders are likely to bear the RST burden.

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Ohio Business Activities Tax

Ohio recently enacted a sweeping tax reform package as part of its annual budget. The package includes a controversial new broad-based, low-rate commercial activity tax based on gross receipts to replace the corporate franchise tax; a new state sales tax rate of 5.5 percent; and a five-year phase-out of personal property taxes on business machinery, inventory, equipment, and furniture and fixtures.

Commercial activity tax (CAT). Of most interest to Canadian companies doing business in Ohio is the introduction of the CAT and the phase-out of the corporate franchise tax. The CAT applies to all types of businesses, including corporations, sole proprietorships, partnerships, and LLCs, whether operated in Ohio or located outside the state if the taxpayer has sufficient business contacts (nexus) with Ohio. Potentially, the CAT can apply to a Canadian company even without a physical presence in Ohio. Excluded businesses include financial institutions, dealers in intangibles, insurance companies, and some public utilities.

Businesses with taxable gross receipts of more than US $150,000 per calendar year (including sales of goods and services) are subject to the CAT on receipts after June 30, 2005, with no deduction for the cost of goods sold. Proceeds from the sale of goods are a taxable gross receipt if the goods are delivered in Ohio; sales of services yield Ohio receipts if the portion of the purchaser's benefit received from the services in Ohio exceeds the purchaser's benefit received elsewhere. Excluded receipts

include certain interest income, dividends, capital gains, wages, certain commissions, and gifts. The CAT rate for 2005 is 0.06 percent of gross receipts, increasing annually by about 20 percent until the full phase-in on April 1, 2009, when a rate of 0.26 percent applies to gross receipts exceeding US $1 million. The existing Ohio corporation franchise tax is phased out over five years, starting in 2006. During the phase-out period, taxpayers may use existing net operating loss (NOL) carryovers against corporate franchise tax, or they may elect to convert some existing NOLs to a credit that may offset the CAT beginning in 2010.

Sales tax. A temporary 1 percent increase to the 5 percent Ohio sales tax was scheduled to expire on June 30, 2005, but the new budget permanently sets the state sales tax rate at 5.5 percent.

Personal property tax. For most businesses, the tangible personal property (TPP) tax is phased out over four years starting in tax year 2005 and ending with no tax due in 2009. New manufacturing machinery and equipment first reportable on the 2006 return is not subject to the TPP tax.

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CRA Round Table: Paragraph 95(6)(b)

The CRA may seek to apply paragraph 95(6)(b) in a broad range of situations that arguably are not a concern under GAAR. (See "Paragraph 95(6)(b) Favoured?" *Canadian Tax Highlights*, October 2004.) The CRA has also argued paragraph 95(6)(b) in two recent court cases: *Univar* (not yet reported) and *Kruger* (settled). Since September 2004, the CRA has consulted with various groups about providing guidance on which kinds of structures it might seek to assess under paragraph 95(6)(b). At the IFA International Tax Seminar held in Toronto on May 9, 2005, the CRA commented on seven scenarios.

1) Branch incorporation. The CRA does not consider the incorporation of a foreign branch of a Canadian corporation (Canco) into a foreign affiliate to be caught by paragraph 95(6)(b) because the tax-avoidance purpose test is not met.

2) Foreign holdco. If a Canco inserts a foreign holding company over lower-tier foreign affiliates to mix high- and low-rate underlying foreign taxes and thus minimize Canco's tax on receipt of taxable surplus dividends, the CRA may apply paragraph 95(6)(b). In answer to a followup question, the CRA indicated that its view is not altered because the motivation behind the structuring was a reduction in foreign withholding tax.

3) Classic double dip. If interest is paid by a Canco's foreign affiliate (Foreign Opco) to another of its foreign affiliates (Finco) and the resultant income to Finco qualifies as subparagraph 95(2)(a)(ii) income, the CRA says that it will not apply paragraph 95(6)(b) if Canco borrowed funds to invest in Finco's share capital. Without commenting on the technical merits, the CRA says that it will maintain its longstanding position not to challenge such structures and will not seek a paragraph 95(6)(b) reassessment.

4) Double dip/debt importation 1. This example ends up in the classic double-dip structure, but the external debt was initially borrowed by Foreign Opco and assumed by Canco for consideration of an intercompany debt that was transferred to Finco for Finco stock. A taxpayer must have a valid non-tax reason to restructure in this manner and avoid paragraph 95(6)(b), notwithstanding that the classic double-dip structure is not caught.

5) Double dip/debt importation 2. This example is similar to the preceding one, but instead of assuming Foreign Opco's obligation, Canco borrows from a third party to acquire Foreign Opco's debt and then transfers it to Finco for Finco stock. The analysis of the previous structure applies here.

6) Tower structure 1. In this plain vanilla tower structure, Canco and CanSubco form a partnership created under US law that borrows from a third party to subscribe for stock of a Nova Scotia unlimited company. The NSULC subscribes for stock of a US limited liability company. The LLC uses the subscription proceeds to make a loan to Foreign Opco, which in turn uses the loan proceeds in its active business. If the funds were initially borrowed in Canada (through the partnership), paragraph 95(6)(b) does not apply.

7) Tower structure 2. This example is the same as the preceding one except that Canco owns only 60 percent of Foreign Opco, not 100 percent. Paragraph 95(6)(b) should not apply. Section 17 deals with the policy issue of the reduced ownership percentage.

Although some of the comments may seem surprising, it is anticipated that in its consultations with various groups the CRA will provide a more comprehensive technical analysis of the application of paragraph 95(6)(b) to these structures. Practitioners may thus gain insight into how other transactions or variations of these examples are affected by paragraph 95(6)(b).

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Capital Taxes on the Decline

Six provinces and the federal government each impose a general capital tax on any corporation (other than financial

institutions and insurance companies) that has a PE in the jurisdiction. Alberta, British Columbia, Newfoundland and Labrador, Prince Edward Island, and the territories do not levy general capital taxes. The trend in the last few years seems to be toward reducing the general capital tax burden.

Each jurisdiction calculates the tax base for capital tax differently and relieves smaller corporations from paying the tax via an exemption that must generally be shared by associated or related corporations. Allocating the exemption can be administratively difficult for large groups of corporations. Although the federal large corporations capital tax (LCT) is not deductible for corporate income tax purposes, the company's federal surtax liability reduces its current LCT liability first, and any excess reduces LCT for the previous three and the next seven years. Unused surtax credits are calculated as if the LCT rate and the capital tax threshold were 0.225 percent and $10 million, respectively. Provincial capital taxes are generally deductible, except in Alberta.

Because capital tax is based on balance sheet amounts (such as share capital and indebtedness of the company) and not on profitability, the tax has been long criticized by Canadian businesses and investors. As a result, many governments in the last few years have announced rate and exemption changes that reduce or eliminate the general capital tax burden. In particular, the federal, Nova Scotia, and Ontario governments plan to eliminate general capital taxes, and Quebec will cut its rate by over 50 percent.

Table 1 summarizes the general capital tax rate changes after 2003.

Some jurisdictions have recently increased or plan to increase exemptions as shown in table 2, further reducing a corporation's capital tax liability. For example, in 2005, the federal exemption increase saves up to $70,000 tax.

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Table 1 Changes in Capital Tax Rates After 2003

	Rate		
	From	To	Effective date
Federal	0.225	0.2	After 2003
	0.2	0.175	After 2004
	0.175	0.125	After 2005
	0.125	0.0625	After 2006
	0.0625	nil	After 2007
Manitoba			
On first $10 million taxable capital	0.3	0.3	na
On taxable capital > $10 million	0.5	0.5	na
New Brunswick	0.3	0.3	na
Nova Scotia (if taxable capital = $10 million)[1]	0.25	0.3	April 1, 2004
	0.3	0.275	July 1, 2005
	0.275	0.25	July 1, 2006
	0.25	0.225	July 1, 2007
	0.225	0.2	July 1, 2008
	0.2	nil	July 1, 2009
Ontario	0.3	0.225	After 2008
	0.225	0.15	After 2009
	0.15	0.075	After 2010
	0.075	nil	After 2011
Quebec	0.6	0.525	After 2005
	0.525	0.49	After 2006
	0.49	0.36	After 2007
	0.36	0.29	After 2008
Saskatchewan	0.6	0.6	na

[1] The rate doubles for taxable capital between $5 million and $10 million, but with the exemption the effective rate is the same. Nova Scotia's plans to eliminate its capital tax on April 1, 2006 have been deferred until July 1, 2009.

Table 2 Increases in Exemptions

	Exemption		
	From	To	Effective date
	$ millions		
Federal	10.0	50.0	After 2003[1]
Manitoba[2]	5.0	5.0	na
New Brunswick	5.0	5.0	na
Nova Scotia[3]	5.0	5.0	na
Ontario	5.0	7.5	After 2004
	7.5	10.0	After 2005
	10.0	12.5	After 2006
	12.5	15.0	After 2007
Quebec	0.6	1.0[4]	After 2004
Saskatchewan			
Basic[5]	10.0	10.0	na
Additional	5.0	7.5	After 2003
	7.5	10.0	After 2004

[1] Effective for taxation years ending after 2003. [2] Before January 2, 2004, Manitoba capital tax applied to corporations with over $5 million taxable capital and at reduced rates up to $5.015 million. For taxation years beginning after January 1, 2004, the exemption is replaced with a $5 million deduction (shared by associated corporations) and no reduced rates apply. [3] The exemption applies only if taxable capital is less than $10 million. [4] In Quebec, the exemption is reduced by $1 for every $3 of the previous year's paid-up capital (of the associated group) exceeding the exemption: a corporation with a Quebec PE and taxable capital exceeding $4 million is subject to full Quebec capital tax rates. [5] In Saskatchewan, the basic exemption applies to every corporation; the additional exemption is shared by the associated group, and its availability depends on the proportion of the company's salaries and wages paid in Saskatchewan in relation to the group's total salaries and wages paid.

EU Holdco Regimes: Update

In the expanded European Union. some member countries are competing to offer the optimal holding company regime. Several regimes impose no or minimal tax on dividends received from EU member states and from treaty countries.

Friedrich E.F. Hey of Debevoise & Plimpton LLP, Frankfurt, prepares annual comparative analyses of various EU holdco regimes. This year's analysis compares Austria, Belgium,

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Cyprus, Czech Republic, Denmark, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Norway, Poland, Portugal (both mainland SGPSs and Madeira mixed holding companies), Spain, Sweden, Switzerland, and the United Kingdom.

■ A holdco may be required to own and hold a minimum percentage of shares for a minimum ownership period before dividends received therefrom are tax-exempt. For example, Austria, Belgium, Denmark, Portugal (SGPSs), and Spain have a 12-month holding period.

■ Ideally, the holdco is not taxable on capital gains arising from the disposition of shares of its subsidiaries, which in some jurisdictions means owning a minimum percentage of voting or other shares for a minimum holding period of, say, one to three years. For example, Austria, Italy, Spain, Switzerland, and the United Kingdom require a one-year holding period.

■ Ideally, no or minimal withholding tax applies on the holdco's distributions of dividends. If the parent company is not in the European Union, the holdco's jurisdiction may have a domestic exemption from withholding tax on the payment of dividends. Cyprus and Portugal, for example, have such domestic exemptions. Switzerland does not, but dividend withholding tax may be avoided if a company formed in Cyprus owns the shares of the Swiss company; dividends to Cyprus are not subject to Swiss withholding tax, although Cyprus is not yet fully admitted to the European Union. In some countries, the domestic exemption for dividend withholding tax applies only if the parent is in a treaty jurisdiction and not a tax haven. Luxembourg imposes a withholding tax on dividends that may be avoided by a total or partial liquidation of the Luxembourg company.

■ Some EU countries have a capital infusion tax. Consolidated filing may allow the holdco to claim a subsidiary's losses. Controlled foreign corporation rules (FAPI-like rules) may affect the choice of a holdco's jurisdiction, depending on the location of investments.

■ If the holdco is capitalized with debt, thin capitalization rules may restrict the debt-to-equity ratio and the deductibility of interest. A capital infusion tax may apply only to authorized capital, so that capitalization with a large debt component may be preferable. The ability to deduct interest may be significant if the holdco would otherwise have taxable income.

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CRA on Alcatel

The CRA has issued a bulletin accepting the position in *Alcatel* (2005 TCC 149). (See "Stock Options: SR & ED Salaries," *Canadian Tax Highlights*, April 2005.) If an employee who is engaged in SR & ED exercises employee stock options, the resulting benefit can be included as an expenditure in the calculation of the corporation's investment tax credits (ITCs) under the following conditions:

■ The stock options were issued to the employee in a year in which he or she was engaged in the performance of R & D as the claimant's employee.

■ The options were received as a result of an employment relationship rather than as a shareholder.

■ All or some of the employee's salary was allowed as an SR & ED expenditure in the year in which the option was issued.

■ The employee has exercised the option or disposed of it.

■ The taxpayer filed its SR & ED claim before the 18-month deadline for the year in which the benefits were earned.

Such an employee stock option is considered an eligible expenditure for ITC purposes in the same proportion that the employee's salary was allowed as an SR & ED expenditure in the year that the options were issued. However, the benefit is not considered a qualifying expenditure for the purposes of subsection 37(1).

One key issue raised by this announcement is that of timing. The calculation of the benefit is based on factors relating to the year in which the options were issued, yet the benefit is not recognized until the year in which the option is exercised or disposed of. In many instances there can be a substantial time lag between the two events, creating an additional administrative burden for claimants.

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