CANADIAN TAX Highlights

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Accountants' Working Papers

Revised IC 78-10R4, "Books and Records Retention/Destruction," includes a requirement that an accountant's working papers used to determine a taxpayer's tax obligations and entitlements be available to the CRA as part of the taxpayer's books and records. New IC 05-1, "Electronic Record Keeping," was also released.

■ **Foreign-based information or documents.** The CRA may require a Canadian-resident person or a non-resident that carries on business in Canada to provide any information or documentation located outside Canada if it may be relevant to the enforcement and administration of the Act (IC 78-10R4).

■ **Electronic record keeping.** The format of electronic records must allow their processing and analysis by CRA auditors using CRA equipment and software. All books and records must be stored in a secure environment in Canada, including those of a business that operates via the Internet and is hosted on a server located abroad. Proper backup records must be maintained; the new guidance recommends ways to ensure that electronic books and records are backed up or archived adequately and to ensure that the CRA record-keeping requirements are satisfied (both ICs).

■ **Electronic business systems documentation.** A taxpayer must maintain and provide to the CRA on request documentation describing its operating and business systems, including documentation relating to system controls, Internet-based transactions, and archiving and retention procedures. The taxpayer must preserve an accurate chronological record of changes to a business system, such as software or file formatting. Documentation is required even if the electronic record-keeping function is outsourced to third parties. Methods of maintaining the integrity and security of an electronic business system are recommended. The CRA may review a taxpayer's electronic business system to understand the flow of information, to evaluate the reliability of internal controls, and to identify electronic files that will be required (IC 05-1).

■ **Failure to provide information.** The CRA may apply to a judge to order a person to provide access, assistance, information, or documents sought under section 231.1 or 231.2 (both ICs). Two recent cases seem to show the courts' willingness to uphold the CRA's broad interpretation of its powers to demand documents. (See "CRA Demand for Documents," *Canadian Tax Highlights*, August 2005.)

■ **Inspections, audits, and examinations.** Under section 231.1 of the Income Tax Act, the CRA may inspect, audit, or examine any other person's documents, property, and/or processes related to information in a taxpayer's books and records, including electronic records. A new "Keeping Records" tax guide (RC4409(E)) addresses the topics covered in both ICs and applies to all taxpayers that collect or pay income taxes, GST/HST, excise taxes, and payroll taxes.

■ **New centres of expertise on aggressive international tax planning.** The CRA has created 11 centres of expertise across Canada to address "aggressive international tax planning" at tax services offices in London, Laval, Halifax, Saint John, Montreal, Toronto West, Ottawa, Winnipeg, Calgary, Vancouver, and Burnaby. A CRA news release dated August 9, 2005 says that these centres will bring together auditors from International Tax, Special Audits, and Tax Avoidance and will "develop new ways to track and combat aggressive tax planning and the use of international tax shelters." This program draws on $30 million in additional annual funding announced in the 2005 federal budget to enhance CRA compliance activities.

What the CRA considers to be aggressive international tax planning was not detailed, but materials presented at the August 9 news conference seem to indicate a focus on tax havens. The CRA recognizes legitimate uses for tax havens such as estate planning, asset protection, and benefiting from reduced regulatory regimes, but it becomes concerned when tax havens are used to hide the ownership and control of assets, to abuse the intent of the law through tax avoidance, or to facilitate tax evasion.

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GST/HST: Procurement Cards

After years of consultation with procurement card providers and users, the CRA released Notice 199, "Procurement Cards—Documentary Requirements for Claiming Input Tax Credits." The new policy addresses registrants who use procurement cards and do not receive sufficient documentation to adequately support GST/HST input tax credit (ITC) claims.

A procurement card program is intended to enhance purchasing efficiency and thus reduce costs for persons who must otherwise process volumes of documentation related to purchasing transactions. Most organizations have developed internal policies and procedures that require the retention of receipts for purchases made; thus, they obtain appropriate documentation to support ITC claims. However, collecting such documentation obviates many benefits of a procurement card program. Other organizations merely retain credit card sales drafts, which typically lack sufficient information for GST/HST recovery, and are at risk of being denied ITCs. In the new policy, the minister has exercised his power to exempt certain registrants from the normal ITC documentary requirements. The policy's stated purpose is to allow eligible registrants to claim ITCs for purchases made using procurement cards. ITC claims are based on tax estimated at the rate of 7/107 (GST) or 15/115 (HST) of total purchases appearing on the card issuers' report, to the extent of ratios calculated in accordance with the new audit policy. The ratios are valid for five years.

Only registrants whose activities are at least substantially all commercial—a defined term—are eligible. Many non-profit organizations and provincial gaming authorities do not qualify. The policy is also restricted to purchases under $1,000. Organizations whose applications are approved may welcome the demise of the threat to ITC claims, but the application process is onerous. Registrants must meet 18 qualifying conditions, such as the supply of a statistically valid sample of purchases for four full months of transactions and appropriate documentation of the selected samples. The registrant's external auditor must confirm in writing that its internal controls for procurement card purchases are reliable. The four months' purchases sample must be selected and verified by an external auditor or by a person at a senior level who is appointed by the registrant and who is qualified to perform statistical sampling.

A number of uncertainties remain. The CRA may be inundated with applications that will take years to process. The cumbersome requirements may discourage many from applying. To date, the ITC claims of procurement card users have received little attention. Should that change, even approved registrants may be exposed for prior periods. It is not clear whether Revenue Quebec will adopt the same application process for QST purposes.

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Assumption as Co-Obligor Not Boot

A recent CRA advance ruling (2005-0119481R3) confirms a previous ruling (2003-0054013) and accepts that a party's assumption of a debt as co-obligor is not considered "boot" for the purposes of the elected amount limits in paragraph 85(1)(b) of the Income Tax Act if the original debtor effectively retains the primary obligation to pay the debt.

Parentco controls Holdco, Opco's sole shareholder, and each of the parties is a taxable Canadian corporation. Parentco and Opco have formed a general Canadian partnership (POP), and Parentco wishes to roll substantially all its business assets to POP under subsections 97(2) and 85(1) and then transfer some of its POP units to Holdco. Holdco will transfer those units to Opco, which can shelter POP income with non-capital losses. The transfer of substantially all of Parentco's assets is restricted by covenants in its debt obligations, which require another person to assume Parentco's obligations to prevent an event of default; for this and other commercial reasons, Parentco wishes to remain the primary debtor under its existing debt structure and not transfer it to POP. Thus, POP assumes—as co-obligor and on a joint and several basis with Parentco—various commitments (the assumed liabilities), and Parentco is not discharged from any of its obligations thereunder. Parentco rolls substantially all its operating assets to POP and jointly elects with Opco. As consideration, POP assumes Parentco's non-assumed liabilities and issues partnership units, but the assumed liabilities are expressly said not to be received as consideration for the transfer. Parentco indemnifies POP for any loss suffered because of Parentco's default on the assumed liabilities and agrees to act as primary obligor in respect of all payments thereon to be funded with its POP distributions. POP can recover amounts it pays on the assumed liabilities by setoff against amounts it owes to Parentco. Parentco rolls some of its POP units to Holdco, which rolls them to Opco. POP income is allocated to Parentco and Opco.

The CRA has confirmed that paragraph 85(1)(b) does not deem the agreed amounts on the transfer of Parentco's operating assets to POP to be other than the amounts actually agreed on by Parentco and Opco, which amounts did not include any FMV for the assumed liabilities. Those liabilities are thus not boot in respect of the assets transferred; the CRA apparently assumes that Parentco received nothing from POP and that the FMV of the assumption as co-obligor is nominal. Parentco remains

the primary obligor and must compensate POP for any liability arising therefrom. However, it is not inconceivable that the assumption's FMV is not nominal. For example, if POP suffers a loss and Parentco defaults on the assumed liabilities, POP is liable for the obligations and there are no distributions to Parentco to offset payments thereon. Parentco is in default and may not be able to comply with its indemnity agreement. In the 2003 ruling, by contrast, a parent transferred property to its wholly owned sub for shares, debt, and an assumption of liabilities. The sub, as in the 2005 ruling, assumed as co-obligor various liabilities not included as consideration under the asset transfer, and no consideration was given for the sub's assumption as co-obligor. However, the sub's right to set off any liability under its assumption was tied to a debt owed by it to the parent, and thus the sub assumed less economic risk because it had additional security. In the 2005 ruling, POP's right to setoff depends entirely on its income.

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INCOME FUNDS: NOT ALWAYS A WASH

In its 2004 budget, the federal government made it clear that it was content to leave income trusts unchanged for individuals: the conversion of mature corporations to income trusts eliminates corporate income tax, but payouts of profits from the trusts are subject to personal income tax in the investors' hands. Because the payouts are bigger and no dividend tax credit applies, the additional income tax revenue offsets the corporate income tax lost, preserving the federal revenue base. But the same does not hold for individual provinces.

Percentage Distribution by Province, 2002

	Personal taxable income	Corporate income before taxes
Newfoundland and Labrador	1.2	3.1
Prince Edward Island	0.3	0.3
Nova Scotia	2.6	2.0
New Brunswick	1.9	1.4
Quebec	22.0	16.5
Ontario	42.3	38.9
Manitoba	3.1	2.4
Saskatchewan	2.6	3.8
Alberta	11.4	22.5
British Columbia	12.3	8.3
Total	100.0	100.0

Saskatchewan's 2005 budget documents pointed out that income trusts reduce the province's net tax revenue. The table shows that in 2002 Saskatchewan's share of corporate profits before taxes was higher than its share of taxable personal income. Thus, if payouts from Saskatchewan income trusts were distributed across the country as personal income, a portion of the offsetting increase in personal income tax (noted by the federal government) would not generate tax in Saskatchewan, but would fall into the tax net of other provinces.

The table shows that Newfoundland and Labrador and Alberta also have a larger share of corporate profits than personal income. The remaining provinces have a larger share of personal income than corporate profits: those provinces would gain from the conversion of corporations to income trusts. In effect, the reduction in corporate income taxes in the three provinces would lead to an increase in personal income taxable in the other provinces. The Saskatchewan budget went on to explore the fact that income trusts do not pay capital taxes, leading to a further reduction in the province's tax collections.

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HEADHUNTER COSTS REDUCE STOCK OPTION BENEFIT

In *Morin* (2005 TCC 324), a taxpayer-employee paid fees to a third-party executive recruiter for assistance in obtaining an employment package, including employee stock options. The TCC allowed a deduction for the fees as part of the cost of acquiring shares under an employee stock option arrangement, reducing his benefit therefrom under subsection 7(1) of the Income Tax Act.

In 1999, Mr. M entered into an agreement with a headhunter (HHco) to help him find employment with a company in the high-tech industry that would offer an employee stock option benefit plan. For any option or similar compensation from any resulting job placement, Mr. M agreed to pay HHco 100 percent of the first $100,000 of benefits received and 33 percent of the second $100,000. With HHco's assistance, Mr. M accepted a job that included an employee stock option plan. In 2000 and 2001, Mr. M exercised options and paid HHco $83,000 and $51,000, respectively. In those years, Mr. M reported employment income that included stock option benefits of $192,000 and $117,000, respectively, and deducted the amounts paid to HHco as "acquisition cost for [the employer's] share options" from such benefits reported by the employer.

The CRA denied the deductions, saying that the amounts were not paid to acquire the stock options; they were

payments for employment consulting and counselling services. The CRA also argued that subparagraph 7(1)(a)(iii) covers only amounts paid to the employer (the "particular qualifying person") to acquire the stock options, and therefore amounts paid to HHco were not deductible. Mr. M countered that the agreement was made to obtain advice from HHco on how to secure employment with a stock option package; amounts paid to it thus qualified as "any amount paid" by the taxpayer to acquire such options and should offset the benefit under subparagraph 7(1)(a)(iii). If it was intended to limit offsets to amounts paid to the employer, the rule would specifically say so, as does subparagraph 7(1)(a)(ii). The TCC said that subparagraph 7(1)(a)(iii) allows the amounts paid to HHco—payments required for Mr. M to acquire the stock options—as deductions in determining Mr. M's employee stock option benefit. Because no payee for the amounts paid in acquiring the stock options was specified, the TCC interpreted the rule broadly so that it included any expense paid for the purpose of obtaining such options. The amounts paid to HHco were directly related to the acquisition of the stock options by Mr. M, albeit in an unorthodox arrangement; the payments were thus deductible.

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Capital Tax Decline: Part 2

The last few years have seen a trend toward reducing the general capital tax burden, but compliance issues remain. ("Capital Taxes on the Decline," *Canadian Tax Highlights*, August 2005 summarizes rates, exemptions, and changes since 2003.)

The federal large corporations tax (LCT) exemption increased from $10 million to $50 million for taxation years ending after 2003, yielding up to $70,000 in LCT savings for small to mid-sized corporations in 2005. The 0.225 percent general capital tax rate is eliminated over five years. However, a CCPC must still calculate its taxable capital and LCT using the pre-2004 rate (0.225 percent) and exemption ($10 million) to test for a small business deduction (SBD) clawback; the SBD limit is also calculated using the notional LCT for the associated group, and that LCT is not reduced by the corporation's surtax liability or carryforwards. The clawback reduces the SBD on a straightline basis for corporations with more than $10 million taxable paid-up capital employed in Canada in the preceding year on an associated basis; the SBD is eliminated at a $15 million threshold. The SBD of a corporation whose associated group has $15 million taxable capital in a taxation year is eliminated in the following year, although the corporation pays no LCT. The two-pronged calculation can create administrative headaches for corporations, tax preparers, and tax assessors, particularly if the associated group includes several corporations.

The clawback also applies to SBDs in all provinces and territories except Ontario. The Ontario SBD is clawed back when the associated group's aggregate taxable income exceeds $400,000, and it is eliminated at $1,128,519. Thus, planned decreases to Ontario's capital tax rates and increases to its exemption do not affect the calculation of its SBD clawback. The elimination of Ontario's capital tax will be a relief to large associated corporate groups with Ontario PEs that have had the difficult task of allocating the capital tax deduction within a group. (See "Ontario Cap Tax Election," *Canadian Tax Highlights*, June 2003, for more details.)

For a corporation with a Manitoba PE, for taxation years beginning after January 1, 2004, the capital tax exemption is replaced with a $5 million deduction shared by its associated group of corporations with Manitoba PEs. In contrast to Ontario, but similar to the federal rules, the group can choose which members benefit from all or part of the deduction.

Quebec announced a preferential rate of 8.5 percent for CCPCs on up to $400,000 of active business income after 2005, adding compliance complexity for small businesses in that province. Paralleling the federal SBD, Quebec's CCPC rate is reduced on a straightline basis when associated taxable capital exceeds $10 million.

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Cross-Border Income Securities

Income trusts have become popular with US companies that make Canadian public offerings. New variations may be more attractive to Canadian investors.

The traditional income fund structure is generally a trust, structured as a flowthrough entity for US tax purposes, that holds the debt and equity of an operating business and provides a steady investment return to unitholders in the form of dividends and interest. Such structures have been used to fund the acquisition of US-based operating businesses in the last couple of years. Income participating securities (IPSs) in Canada or income deposit securities (IDSs) in the United States are essentially that same structure, but without the trust: instead of holding trust units, the investor directly holds Canco's underlying debt and equity in one security, the IPS. The following overview of some US tax issues focuses on IPSs but is also relevant to income funds and their unitholders.

Debt versus equity. It is critical that the IRS respect the IPS's debt component and not recharacterize it as

equity. If the debt is not respected, the interest paid from the US Opco to the IPS holders is not exempt from US withholding tax under the portfolio interest exemption, and a 15 percent withholding tax generally applies to the amounts as US-source dividends. Furthermore, US-source interest paid on corporate debt is deductible from the US Opco's taxable income, but dividends are not. The classification of a corporate security as debt rather than equity is a question of fact, but numerous factors are well-accepted indicators of debt. Although the IRS has not yet examined an IPS or IDS structure in which a company's debt and equity are clipped, it recently examined the debt-versus-equity issue in connection with the increasingly popular US hybrid securities. Revenue ruling 2003-97 blessed the use of Merrill Lynch's "feline PRIDE" products, which are investment units comprising a three-year forward contract to buy the corporation's stock and a five-year note; each unit is referred to as a single purchase-contract/note unit. The unit's note portion is pledged to secure the holder's obligation to pay the settlement price under the purchase contract, but the holder has the legal right to separate the note from the unit by putting up new collateral for the purchase contract; the facts in the ruling state that the holder is thus not under economic compulsion to keep the unit components together. The issuer also promises to remarket the notes at specified intervals; the issuer's agent sells the note on the public market, so that the proceeds of the remarketing (not the note itself) are used to satisfy the holder's obligation under the purchase contract. The facts in the ruling assume that remarketing is "substantially certain" to succeed.

The IRS ruled that the note and the purchase contract were separable instruments when issued, so that the interest accruing on the unit's note was deductible under Code section 163(a), and the deduction was not disallowed under the interest-stripping rules. The IRS identified four critical characteristics that led to the note's being treated as debt for federal income tax purposes: (1) the holder has an unrestricted legal right to separate the unit into its purchase contract and note components and was not economically compelled to keep the unit together; (2) the purchase contract terminates on the issuer's bankruptcy, when the note is released to the holder, a creditor in bankruptcy; (3) the note remains outstanding for a significant period after the remarketing, and on the maturity date the issuer must pay the note's principal amount; and (4) a remarketing of the note is substantially certain to succeed.

New US inversion legislation. The increasing use of Canadian income fund and IPS structures to acquire and invest in US Opcos mandates a focus on the corporate inversion rules enacted as part of the American Jobs Creation Act in October 2004, retroactive to transactions occurring after March 4, 2003. The rules target certain transactions in which a non-US corporation acquires "substantially all" the assets of a US corporation or partnership whose former equity owners receive a certain percentage interest in the acquiror. In determining that percentage ownership, securities are disregarded if they are issued in a public offering of the non-US entity (in the context of income funds and IPSs, to partially fund the acquisition of the US operating business).

The IRS has yet to issue regulations on the rules' interpretation, including what is meant by the acquisition of "substantially all" the assets. For example, if a new income fund is the top tier in a structure involving a Canadian Holdco and a wholly owned US Opco, were substantially all of the US Opco's assets acquired by a foreign entity, triggering the inversion rules? Moreover, if the US Opco's existing owners exchange their interests for fund units or IPSs in conjunction with the issuer's Canadian public offering, are they deemed to own 100 percent of the foreign entity after the offering for purposes of the inversion rules?

The tax consequences of the inversion rules turn on whether the US entity's former equity holders hold between 60 and 80 percent or over 80 percent of the new foreign parent. If the over-80-percent threshold is met, the foreign acquiror is treated as a US corporation for all US federal tax purposes, including taxability on its worldwide income and classification of its equity as US-situs assets for US estate tax.

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The Algebra of Tax Settlements

One of the more difficult decisions facing in-house tax professionals is whether to settle or pursue a tax dispute, and, if so, on what terms. Many different factors, financial and otherwise, go into the decision-making process. Most tax professionals generally have a good grasp of the factors pertinent to their particular business, including the effect on the financial statements—such as whether a sufficient reserve was booked for the tax dispute—and whether key executives have the fortitude and time to engage in a prolonged battle with the CRA. However, it is more difficult to evaluate issues such as the impact on ongoing relationships with the CRA and the setting of a precedent for future taxation-year filings. Moreover, in developing a breakeven financial analysis, many tax professionals do not properly measure the odds of success necessary to justify pursuit of a tax dispute. A simple algebraic formula demonstrates that any such analysis must incorporate the cost of losing. (A slightly more complex formula is used by US trial attorneys to help calculate how much their corporate defendant clients should pay to settle with US regulators or class-action plaintiffs.)

Measuring legal and other costs is typically a first step. Tax litigation counsel will normally give an estimate, or at least a range, of the likely costs of litigation, which usually includes all lawyers' time plus expert witnesses' fees. These costs must be compared to all or a portion of the disputed tax likely to be won. The next step is to calculate the odds of success.

Assume that the tax in dispute is $10 million. Counsel estimates that the maximum cost of litigation after tax is $487,500 (a pre-tax estimate of $750,000, because most litigation costs are deductible under paragraph 60(o) of the Income Tax Act). The CRA proposes a settlement of $7.2 million after tax. Most practitioners will assume that as long as the odds of winning are approximately 18 percent, the costs of litigation are covered by the excess of the anticipated gain from 100 percent success at litigation over the offered settlement (($10 million – $7.2 million) × 18% = $504,000). However, it is incorrect to simply compare the cost of litigation with the upside of winning the dispute, because such an analysis does not properly factor in the cost associated with losing. It is key to determine a breakeven proposition that establishes the point when the amount of the anticipated settlement equals the expected outcome of the litigation. This breakeven equation can be expressed as follows:

$$\text{Settlement amount} = \text{Litigation and other costs} + \text{expected outcome}$$

The expected outcome is the product of the chance of failure and the tax in dispute. Assuming the same numbers as above, the breakeven equation is as follows:

$$\$7,200,000 = \$487,500 + (\$10,000,000 \times X),$$

where X is the chance of failure. Solving for X,

$$X = 0.6712.$$

Absent non-tax factors, the taxpayer should litigate if the chance of winning is one-third or better—not 18 percent or better, which is the figure arrived at using only an upside approach. The breakeven method above is limited because it does not work for all possible tax disputes and outcomes. It is least useful in solving tax disputes that are all or nothing—for example, when the issue is whether a particular item is deductible and there is no possibility of settlement. However, if there is a possibility of settlement or if the tax dispute involves valuation issues in which there is a range of possible outcomes, the breakeven method provides a useful analytical tool to assist in-house tax professionals in deciding whether it makes sense to refuse a particular CRA-proposed settlement and proceed to litigation.

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FIE Proposals: July 2005

On July 18, 2005, Finance released revised proposals for the taxation of non-resident trusts and foreign investment entities (FIEs) and other technical amendments. Finance anticipates that Parliament will table a final version in the fall; it accepted comments until September 15, 2005.

There are no fundamental changes to the FIE framework from the October 30, 2003 notice of ways and means motion. Many of the revisions are technical, and are intended to correct inconsistencies or anomalies; many issues from the CBA-CICA Joint Committee submission of April 2004 are addressed. The rules continue to apply to years beginning after 2002, but some new aspects apply from the July 18, 2005 announcement date.

Some more significant technical changes include a broadening of double tax relief. The relief formula now applies to all three regimes (prescribed rate, mark-to-market, and accrual) and seeks to eliminate double taxation if income of a non-resident entity to which any of the regimes applied in calculating the income in the year or a preceding year becomes payable to the holder. In addition, an interest in a discretionary trust is not usually considered a participating interest in a FIE; this change addresses concerns regarding such a trust settled by a non-resident for the benefit of Canadian-resident beneficiaries (a so-called granny trust). The definition of "exempt interest" is modified so that a share in a Canco that can be exchanged for an exempt interest in a non-resident entity should not be subject to the FIE rules. Moreover, for taxation years beginning after July 18, 2005, in applying the asset test in paragraph (b) of the FIE definition, intellectual property is considered investment property unless it is used or held principally in a non-investment business by the entity or a related entity.

The retroactive denial of rollover treatment for FIEs continues to apply for taxation years beginning after 2002; Finance refused to introduce relief for taxpayers that transferred FIE interests before the denial was announced on October 30, 2003. Nor is relief given for interest and penalties on unpaid taxes to taxpayers who filed 2003 and 2004 returns based on the current section 94.1. Taxpayers who amend such returns must rely on the CRA's discretion: the CRA has indicated informally that it will not assess interest and penalty on the amount owed under the new rules if amended returns are filed shortly after enactment and if the taxpayer asks for a waiver of interest and penalty, presumably under the fairness package. Apparently the CRA has now indicated that it is reviewing the issue and prefers to address it when the legislation is introduced in the House of Commons.

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GST Health-Care Services Rebate

Public interest in private health-care options was rekindled by the SCC in *Chaoulli v. Quebec (Attorney General)* (2005 SCC 35): a slim majority held that Quebec's ban on private health insurance for services covered by the public system violated the Quebec Charter of Human Rights and Freedoms owing to prejudice from delays. Amid the ensuing debate, the enhanced public-service-body GST rebate announced in the 2005 federal budget was finalized; the rebate should encourage the establishment of more patient-care facilities and services. New CRA GST/HST *Policy Statement* P-245, dated August 17, 2005, offers welcome guidance on which services qualify for the enhanced rebate; it will defuse concerns about whether the specified activities satisfy the requirements.

Section 259 of the Excise Tax Act allowed a hospital authority (an organization designated by the minister for the operation of a public hospital) to claim an 83 percent rebate of GST paid on its purchases for use in the operation of a public hospital to provide patient care. Unrebated GST would otherwise be a hard cost, because ITCs are not available for such tax-exempt supplies of goods and services. The budget extended that enhanced rebate to increase relief available from at best 50 percent for eligible charities and non-profit organizations that provide qualifying health-care services or facilities. P-245 provides guidance on which expenses incurred in a public hospital's operation qualify for the rebate, but the comments will also interest other eligible health-care service providers.

P-245 clarifies that hospital authorities apportioning their expenses for the rebate may consider not only purchases such as medications, equipment, meals, and supplies used directly in patient care, but also related expenses, including the acquisition of teaching services in the hospital; the provision of student residences; pastoral care; toys and play activities; research performed for their own use (including sponsored research, collaborations with non-profit or commercial entities, and clinical trials); fundraising activities for their own use; medical libraries; housekeeping and record keeping; and maintenance, custodial, security, staffing, and human resources services. Other specified activities fall outside the new rebate, such as the operation of a long-term care facility (assisting in daily living for those who cannot live independently in the community) and other income-generating activities that utilize the hospital's excess capacity, such as applied research on behalf of a pharmaceutical company not related to patient care; daycare, catering, laundry, fitness, or recreational services not related to patient care; leasing of retail or banquet rooms; and sales of medical supplies not related to patient care. Also not eligible are community outreach services, including activities such as travellers' health services and inoculation, prenatal classes, counselling for eating disorders and nutrition, the teaching of parenting skills, addiction counselling, immunization programs, and poison information hotlines.

An increase in the rebate for health-care service providers may positively affect the economic feasibility of their facilities and may nudge Canadians closer to a private health-care system model. The rebate also applies to the federal component of HST, which combines the GST and the participating provinces' tax. Other rebates may be available to some organizations engaged in activities that do not qualify for the 83 percent rebate. And hospital authorities that are GST registrants engaged in commercial activities other than the provision of health care still benefit from full GST ITCs.

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CRA Attack on US Companies

The CRA is verifying whether tax returns have been filed by US companies that provide services in Canada through an employee. If no tax return was filed, the CRA is assessing an annual penalty of up to $2,500 and requiring withholding on a portion of the salary paid to the employee, as it would for any other employee in Canada.

A non-resident is taxable in Canada if it carries on a business here, which under the common law may involve, inter alia, the place where purchases are made or services are provided or the place where transactions are solicited. Section 253 of the Income Tax Act also captures certain non-residents who solicit orders or offer anything for sale in Canada. The CRA says that a business is carried on in a place where services are rendered. Although a US resident carrying on business in Canada may not need to pay Canadian tax thereon under the Canada-US treaty because it has no Canadian PE, the treaty does not relieve the requirement to withhold tax from payments made in respect of services rendered in Canada.

Regulation 105 requires every person that pays to a non-resident a fee, commission, or other amount in respect of services rendered in Canada to deduct or withhold 15 percent of the payment; an additional 9 percent withholding is required under the Quebec Taxation Act for services rendered in Quebec. Although it is difficult to obtain, a waiver may be granted (IC 75-6R.) A Canadian payer who does not withhold is subject to penalties. A USco should receive a refund if it files a Canadian tax return and can establish that it has no Canadian PE. A non-resident corporation claiming treaty protection should complete a non-resident T2 return and send it to the International Tax Services office in Ottawa. Failure to file

T2 schedule 91 to claim a treaty exemption results in a penalty of $100 per day up to $2,500.

Paragraph 153(1)(a) and regulation 102 provide that remuneration (including salaries, wages, bonuses, and commissions) paid to non-resident employees who provide services in Canada in respect of an office or employment in Canada is subject to the same withholding, remitting, and reporting obligations that apply to Canadian-resident employees: deductions are made at source based on graduated rates and must be remitted on an accelerated basis, depending upon the employer's source deduction history. The obligation extends to a non-resident that employs resident or non-resident employees for services performed in Canada: the employer must withhold and remit withholding tax, Canada pension plan (CPP) contributions, and employment insurance (EI) premiums for each employee unless a waiver of withholding tax has been issued and/or an exemption has been provided for CPP based on a reciprocal agreement on social security between Canada and the employee's home country. The employer must prepare and file a T4 information return (T4 slips and summary form) reporting all amounts paid to its employees even if it has a withholding waiver from the CRA. Any employer that fails to deduct and remit is liable for the whole amount plus interest and penalties. The withholding is not a final tax to the employee; it is payment on account of his or her part I tax liability to Canada that is assessed when a return is filed. A non-resident employee must normally file a Canadian income tax return to calculate his or her tax liability or obtain a refund and generally reports only the Canadian-source employment income.

Many US corporations have not filed a Canadian tax return or withheld tax on wages paid to US employees who performed services in Canada because they assumed that not having a Canadian PE eliminated their Canadian tax obligations. US corporations should ensure that they have complied with their obligations to file a Canadian tax return and to withhold tax from employee remuneration.

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Dual-Resident USco: No US FTCs

ILM 200532044 continues the IRS assault on dual-resident corporations.

Revenue ruling 2004-76 provided tie-breaking rules for a non-US corporation that was resident in two countries, establishing the US tax treaty (if any) under which the taxpayer could claim benefits. (See "IRS: Treaty Benefits," *Canadian Tax Highlights*, January 2005.) Then TAM 200509023 denied treaty benefits to a taxpayer that remained a USco and was included in its US parent's consolidated US federal income tax return for years after it was continued into a foreign country and treated as a corporation under the foreign country's laws. (See "Continued USco: No Treaty Benefits," *Canadian Tax Highlights*, May 2005.) Now, the IRS says that a USco that is a dual resident because its place of management is in a foreign country must first exhaust all practical remedies to resolve the residency question before it can claim federal tax credits on its US tax return.

On the legal memorandum's facts, a USco was incorporated in the United States. As part of a cross-border sale-leaseback transaction, USco deposited funds at interest in a foreign country. In order to improve yield, USco undertook a financing transaction whereby it became a subsidiary of a newly formed country X corporation, which then issued to investors hybrid instruments that country X treated as equity for tax purposes. USco and its parent obtained a ruling that allowed them to file a consolidated income tax return in country X, so that any country X tax paid by USco on the interest on its deposit became imputation tax credits passed out to the investors.

The country X parent was a disregarded entity for US tax purposes; thus, USco remained a member of the US consolidated group. In order to obtain country X consolidation, USco moved its place of management to country X; as part of the country X ruling process, USco agreed not to be considered a non-resident of country X under any tax treaty. The residency article of the treaty between country X and the United States provides that if a corporation has dual residence, the competent authorities will attempt to mutually agree on which of the countries is the sole country of residence; if they cannot agree, the corporation is not accorded any residence status and is not eligible for treaty benefits.

Under Code section 901 and related regulations, USco may claim credit against its US taxes for any foreign income tax that was a compulsory payment. The IRS said that the tax paid to country X on the interest income was not compulsory: USco chose to subject itself to double taxation by becoming a dual resident and then proactively chose not to seek the potential relief available. Thus, unless and until USco exhausts its practical remedies, including a competent authority request, the foreign tax it paid to country X was not compulsory and is thus not creditable against USco's US taxes.

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Charitable Split Receipts et al.

On July 18, 2005, Finance released draft legislation supporting December 2002 split receipt proposals that

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were relieving in nature and also December 2003 changes that added complexity because they were designed to prevent the use of charitable gifts in tax shelter vehicles.

Split receipting. Historically, the CRA affirmed the common-law rule that a transfer of property is not a gift unless it is voluntary and made for no consideration. The split-receipting rules in subsections 248(30) to (41) generally apply to gifts made after December 20, 2002, but some modifications apply from a later announcement date. A charity must issue a receipt for a gift's eligible amount, defined as the gift's FMV less the advantage received by the donor. The advantage is the total value of all property, services, compensation, or other benefits to which the donor or someone with whom the donor does not deal at arm's length is entitled as a result of the gift. The definition is very broadly drafted and includes not only consideration, but also something received in "gratitude" or otherwise related to the gift. The FMV of the property transferred is the ACB of the donor who acquired the property within the last 3 years, or the last 10 years if it is reasonable to conclude that one of the acquisition's main reasons was to make a gift to charity. This rule takes aim at the art flip tax shelters: an investor purchases art at (usually) a low price despite the intended use of a significantly greater FMV in a charity's receipt. The deemed FMV in such cases is now the cost. Exceptions are made for ecological gifts, gifts of inventory, real property situate in Canada, cultural property, and shares of a corporation issued to the donor as part of certain reorganizations.

Anti-avoidance rules prevent pre-donation transactions from avoiding the rules. The donor's cost is looked through to a purchase from an arm's-length party. Transactions are also transparent if the charity purchased the newly acquired property before the gift was made. Finance and the CRA are intent on eliminating serious perceived abuses of the charitable giving rules.

The July release significantly clarifies the responsibilities of a charity that issues a receipt for gifts in excess of $5,000 made after 2005. The charity must inquire into the existence of circumstances that would result in the reporting of an eligible amount less than the property's FMV. The explanatory notes suggest that a charity should inquire about the amount of any advantage (including any limited-recourse debt) received in connection with the gift; whether the donor acquired the property in the context of a tax shelter transaction; whether the property was acquired in the last three years and, if so, its ACB; and, if the property was acquired in the last 10 years with a main purpose of giving the property to charity, the donor's cost. Responsibility for making these audit-type inquiries is thus placed with the charity, which must show that it has taken steps to make such reasonable inquiries before issuing such a receipt. Furthermore, if the donor did not disclose to the charity information that would be relevant to the calculation of the gift's eligible amount, the amount is nil regardless of the amount shown on the official receipt. This rule also applies to gifts made after 2005.

Other amendments. (1) The term "municipality and other government body" is clarified to include a public body performing a function of government; both are qualified donees for the purposes of the Act. Thus, native bands qualify as municipalities despite TCC and Quebec court decisions to the contrary. (2) A significant gift from a donor to an arm's-length charitable organization or public foundation does not result in its redesignation as a private foundation. (3) A new rule codifies CRA policy that a charitable foundation cannot gift amounts to non-qualified donee organizations even if the foundation has otherwise met its disbursement quota and the gift was made to further its charitable objects.

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Foreign Tax News

Netherlands

A protocol to the Netherlands-US treaty that entered into force January 1, 2005 included a rule respecting income received through a hybrid entity. Dutch Finance published a decree to clarify the rule; the decree entered into force on July 6, 2005 and applies to dividends distributed or paid in a financial year starting after 2005. The protocol said that the 25 percent Dutch withholding tax applies to dividends paid by a Dutch BV to a hybrid treated as a corporation for US tax purposes and a partnership for Dutch tax purposes. The decree provides that in similar situations and under certain conditions the Dutch underminister of finance may allow treaty benefits such as reduced withholding.

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