Canadian Tax Highlights

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CRA Round Table

At the Canadian Tax Foundation's annual conference on September 27, 2005, three CRA officials (Marc Vanasse, Arlene White, and Theresa Murphy) responded to a number of questions on international matters.

■ **DRUPA.** When asked to review a complex series of transactions, the CRA revisited whether a partnership formed under the Delaware Revised Uniform Partnership Act (DRUPA) with its separate legal entity feature should be treated for Canadian tax purposes as a partnership or as a corporation. The CRA's review is now complete. Provided that the partnership carries on a business with a view to profit, the CRA will continue to view a DRUPA-formed partnership as a partnership. A limited partnership formed under the Delaware Revised Uniform Limited Partnership Act (DRUPLA) is also a partnership for tax purposes.

■ **GAAR.** A number of international tax issues—some old, some new—are under review for GAAR purposes. These include (1) certain international financing arrangements used to create or import interest expenses (presumably including tower financing structures used to refinance an existing borrowing of a US subsidiary); (2) avoidance of subsection 85.1(4) on disposition of foreign affiliate shares; (3) Barbados spousal trust arrangements (presumably involving a Barbados tax resident spousal trust claiming treaty exemption on a capital gain); (4) Canadian estate freezes that shift future growth to offshore trusts with Canadian beneficiaries (presumably a reference to the time when a non-resident settlor could establish an offshore trust with resident beneficiaries and freeze property); (5) treaty issues including treaty shopping; and (6) surplus stripping, domestic and non-resident.

■ **Compliance.** The CRA noted three compliance concerns: (1) transfer pricing and residency concerns raised by the shifting of the international portion of a business to related entities in a lower-tax jurisdiction; (2) concerns over sale price, value of royalties, and the residence of a related corporation when intangible assets are transferred to a related tax haven corporation; and (3) improper foreign tax credits.

■ **Disclosure of taxpayer information.** The CRA noted that Canada signed the OECD Convention on Mutual Administration Assistance in Tax Matters on April 28, 2004. Proposed subparagraph 241(4)(e)(xii) in the July 2005 technical amendments gives the CRA authority to share taxpayer information pursuant to a tax treaty or a listed international agreement, which includes the OECD agreement. In commenting on the implications of this sharing of information, the CRA noted that Canada has not agreed to assist other countries in collecting taxes; the agreement covers GST and excise taxes, which are not covered under bilateral treaties, and the OECD agreement does not override treaties.

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In This Issue

Lumber Dispute Shakes NAFTA

Although the importance of softwood lumber as a trade issue should not be understated, its long-term significance is more likely to be measured by its impact on Canada-US trade relations, especially the integrity of the North American free trade agreement (NAFTA).

The influential US lumber industry lies at the heart of the dispute and alleges that Canada is subsidizing its own lumber industry by allowing it to export to the United States at below-market prices. The subsidy in this context is said to arise because most Canadian timber land is Crown-owned and cutting rights are allegedly offered below market; in the United States, timber is largely found on privately held land, and market prices prevail for cutting rights. Canada maintains that no subsidizing occurs and that price discrepancies are due to competitive advantages in supply, cutting, and milling. At the US lumber industry's urging, the US Commerce Department is continually at odds with Canada on the issue.

The dispute has festered since the 1800s, but in the latest of a series of disputes spanning the last two decades, US duties were imposed on Canadian softwood in 2002 (coinciding with the end of the 1996 softwood lumber agreement). Those duties are now over $5 billion; unless Canada prevails, the duties will likely be redistributed to the US lumber industry under the controversial US

Byrd Amendment. The World Trade Organization (WTO) has ruled that this redistribution is inconsistent with international trade obligations, a ruling that allows offended nations to institute retaliatory trade measures.

In an effort to trump the US decision to impose duties, Canada argued before the NAFTA dispute settlement panel that all the lumber duties should be returned to Canada because there was no threat to the US lumber industry to justify them. A review of the favourable decision that Canada received from the panel was sought by the United States under NAFTA's extraordinary challenge procedures, but was unsuccessful in August 2005. Unfortunately, even this final review has not resolved matters because its interpretation is now the subject of disagreement. Moreover, a subsequent interim WTO finding seems to suggest that the Unites States' imposition of the duties did not violate international law.

Canada is now appealing the interpretive issue in the NAFTA decision to the US Court of International Trade, and the US lumber industry is following through on threats to challenge the legality of the entire NAFTA chapter 19 dispute settlement process under the US constitution. Several Canadian companies are also challenging the US government under chapter 11 of NAFTA, which involves dispute settlement in relation to foreign-owned investments that are treated less favourably than domestic ones.

Canada has been quietly considering an export tax on softwood lumber. An export tax would still result in high export prices for Canadian lumber, but at least it would allow Canada, not the United States, to collect the duties. The idea of an export tax is not new: it was also proposed when the Softwood Lumber Agreement wound down, and again more recently in the context of oil exports to the United States. On the other hand, the United States is now raising the possibility of removing the duties on softwood and other construction materials (such as Mexican cement) in the aftermath of Hurricane Katrina in order to assist in the rebuilding of its southern coastline.

There are clear political overtones to both the Canadian and the US positions. There are also jurisdictional issues: the integrity of chapter 19 of NAFTA dealing with trade disputes in matters involving tariffs and duties is now being tested as chapter 19 faces competing processes in the WTO and in domestic legal standards such as the Canadian and US constitutions. The NAFTA decisions are supposed to be binding; the WTO makes only recommendations, but they are nonetheless usually implemented to ward off retaliatory tariffs. The challenge under the US constitution, and ultimately before the US Supreme Court, is potentially much more troubling. NAFTA panels generally represent members chosen by all three NAFTA countries. In contrast, the involvement of a purely US domestic judiciary enhances the likelihood of a real political element in the decision-making process; given the changing reality of the US Supreme Court bench, the likelihood of Canadian success is less predictable.

Resolving the softwood dispute is undeniably significant to Canada's softwood producers, but the industry's volume is minuscule in comparison with aggregate trade flows with the United States in other sectors. Continued success for the economy as a whole requires the maintenance of good US trade relations—a compelling reason for not allowing the softwood dispute to manoeuvre Canada into bad trade decisions. Time will tell whether the Canadian export tax or the US rapprochement will come to fruition, but the benefits of the export tax are dubious because it only appeases US interests, penalizes the Canadian industry, and seems to prove the ineffectiveness of the NAFTA dispute settlement mechanisms. The future of NAFTA may rest in the balance.

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US-Mexico: Transparencies

The United States and Mexico have agreed on when treaty benefits extend to a fiscally transparent entity formed under the laws of either country. The new competent authority mutual agreement also clarifies the procedure for claiming benefits from Mexico. The agreement is effective with respect to Mexican-source payments to the extent that the Mexican limitation period therefor has not expired; thus, there may be an opportunity to claim refunds.

The Mexico-US treaty, like other treaties, is based on the fundamental principle that benefits enure to persons resident in one or both countries. A contracting state must be satisfied that the recipient is a person and, if so, a resident. The relevant definitions are conceptually different from domestic rules. The definition of "person" is generally not an issue because typically it is broad: like the Canada-US treaty definition, the Mexico-US treaty definition of "person" includes a partnership and an association. The definition of "resident" is potentially problematic in its application to fiscally transparent entities and hybrids: a resident is any person who under the laws of the state is liable to pay tax by reason of domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature. The Canada-US treaty similarly includes in the definition a person who is liable to tax by reason of domicile, residence, etc. A fiscally transparent entity such as a US limited liability company (LLC) is a partnership in the United States and is not liable to US tax at the entity level; the issue thus arises whether US persons who are LLC members are entitled to treaty benefits. The Canada-US treaty does not resolve the issue, and the CRA says that the LLC is not entitled to treaty benefits.

The new Mexico-US agreement provides that for the purposes of residence determinations, a partnership, estate, or trust is a resident of a contracting state only to the extent that the income it derives is subject to tax in that state as the income of a resident, either in the hands of the partnership, estate, or trust or in the hands of its partners or beneficiaries. The Mexican and US competent authorities agree that income from sources within one of the contracting states that is received by an entity that is treated as fiscally transparent under the laws of either state is treated as income derived by a resident of the other contracting state to the extent that such income is subject to tax as income of such a resident.

The agreement provides an example. A US resident who is a member of a US LLC treated for US federal tax purposes as a partnership is afforded treaty benefits on her share of income derived from Mexico through the LLC. Similar rules apply to a US-resident shareholder of a US subchapter S corporation, an LLC that is disregarded as an entity separate from its owner, and a US grantor trust. If a US resident derives income from a fiscally transparent entity that was created under and is subject to the laws of a third jurisdiction, Mexico will apply the agreement if the third jurisdiction has an in-force, effective, and comprehensive exchange-of-information agreement with Mexico, as Canada does. If, for example, a US subchapter S corporation owned an interest in a Canadian partnership with Mexican-source income, it appears that a US citizen-shareholder of the S corp is entitled to treaty benefits with respect to such income. It appears that the same result follows if the Canadian entity is an NSULC, an entity that is fiscally transparent for US federal tax purposes but not for Canadian tax purposes.

Mexican law does not currently provide for fiscally transparent entities. If that law changes, it is intended that income received thereby will be treated as income derived by a Mexican resident to the extent that the income is subject to tax as income of a Mexican resident.

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Canada: G7 Fiscal Star

The annual edition of the Department of Finance's Fiscal Reference Tables (http://www.fin.gc.ca/frt/2005/frt05_e.pdf) provides a useful summary of government finance, revenue, expenditures, and debt for all three levels of government in Canada. The tables also provide information on our fiscal performance in relation to the other members of the Group of Seven (G7) countries. Again in 2004, Canada enjoyed greater fiscal stability than other G7 members.

Government Income and Outlays as a Percentage of GDP, 2004, for G7 Member Countries

	Revenue	Spending	Surplus or deficit
Canada	40.7	39.4	1.3
United States	31.7	36.0	−4.3
Japan	31.2	37.3	−6.1
United Kingdom	40.7	44.1	−3.4
Germany	44.0	47.7	−3.6
France	50.7	54.4	−3.7
Italy	45.5	48.6	−3.1
G7 average	36.3	40.4	−4.1

The table above shows that Canada was the only G7 country to record a surplus on the operations of all levels of government—our eighth consecutive surplus. In 2004, the surplus was equivalent to 1.3 percent of gross domestic product (GDP). Italy showed the next best performance with a deficit equal to 3.1 percent of GDP. Canada also displayed the greatest improvement over the past decade. In 1994, Canada's deficit represented 6.7 percent of GDP, 8.0 percentage points worse than in 2004. The next largest improvement occurred in Italy, where the balance improved by 6.2 percentage points, still not enough to enable the country to show a surplus in 2004.

The favourable Canadian performance emerged because of drastically reduced spending relative to GDP. From 1994 to 2004, public sector spending dropped from 49.7 to 39.4 percent of GDP; in contrast, all forms of revenue dropped only 2.3 percentage points, from 43.0 to 40.7 percent of GDP. For the G7 countries as a whole, the unweighted average of government revenues dropped from 37.2 to 36.3 percent of GDP over the decade; spending dropped slightly more, from 41.8 percent of GDP in 1994 to 40.4 percent in 2004, a significantly smaller decline than in Canada.

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ABCA Amendments

Amendments to the Alberta Business Corporations Act (ABCA), proclaimed in force on May 17, 2005, introduce a regime under new part 2.1 for the incorporation or continuance in Alberta of an unlimited liability corporation (AULC). Other changes are also significant in the planning or implementation of corporate reorganizations or transactions with tax considerations.

Alberta consulted on the proposed amendments for at least 10 years; the process gained momentum after the

Canada Business Corporations Act (CBCA) was amended in November 2001. The new ABCA conforms to the CBCA in several respects: one-quarter of directors must be Canadian residents; the definition of a distributing corporation under the ABCA is now co-extensive with the Alberta Securities Act definition of "reporting issuer"; and series shares may be designated in the articles that create the series, without requiring a filing of articles of amendment. The ABCA goes further, however, and addresses other issues for reorganizational or tax-planning transactions.

■ **Prohibited shareholdings.** The 2001 CBCA amendments pried open the prohibition on corporate incest to permit cross-shareholdings in a very narrow set of circumstances involving an international transaction. The new ABCA permits any corporate incest however caused, so long as the cross-shareholding is eliminated within 30 days (section 32).

■ **Financial capacity tests clarified.** The CBCA amendments addressed the accounting treatment of redeemable preferred shares. Upon a redemption or an alternative acquisition of shares, the realizable value of the corporation's assets must exceed its liabilities plus the amount required to redeem shares with equivalent or prior entitlement to a return of capital, to the extent that the amount was not included in liabilities. The ABCA clarifies that a corporation's liabilities do not include the stated capital attributable to any class of shares, or the amount payable on a share's redemption or liquidation, for the purposes of the financial capacity tests respecting alternative acquisitions of a corporation's issued shares; redemption of shares; a reduction of stated capital; the payment of dividends; a statutory declaration required in conjunction with an amalgamation; or payments to a dissenting shareholder. The clarification ensures the maintenance of a clear corporate-law distinction between the entitlements of shareholders and the corporation's obligations to creditors for the purposes of these financial capacity tests (sections 35, 36, 38, 43, 185, and 191).

■ **Dissolution by directors or shareholders in special cases.** For windups to which the federal income tax subsection 88(1) applies, in some jurisdictions the parent simply agrees with the subsidiary that all its assets are to be transferred to the parent and the parent assumes all its liabilities; short-form dissolution rules then effect the subsidiary's immediate dissolution. There was concern that the ABCA did not authorize this practice unless, along with the assumption of liabilities, all parties to which the wound-up corporation owed obligations granted releases. However, because a dissolution into a solvent parent corporation functions as an amalgamation equivalent, the new amendments permit certain dissolutions if the parent assumes all the subsidiary's liabilities. Consistent with federal tax law, the new ABCA rule applies only if the Canadian parent holds at least 90 percent of the subsidiary's issued shares. An officer of the parent must also provide a statutory declaration affirming the parent's assumption of the subsidiary's liabilities (section 211).

■ **Stock splits.** The new ABCA permits a directors' resolution to authorize a stock split as an alternative to a split achieved by the filing of articles of amendment. If more than one class of shares is outstanding, the holders of each class, voting separately as a class, must approve the split by special resolution; otherwise, the shareholders need only be notified of the changes within 60 days (section 27.1).

■ **Stock dividends.** To quell the debate over whether CBCA-type statutes permit the issuance of high-low stock dividends, the requirement that the directors add the "declared amount of the dividend" to the stated capital account has been removed. The new ABCA clarifies that "the directors may add all or part of the value of [the stock dividend] to the stated capital account" (section 44).

■ **Going-private and squeeze-out transactions.** The new ABCA does not follow new CBCA sections 193 and 194, which are new authority for such transactions.

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CRA To Follow Kruco

The CRA recently announced a new administrative policy on the calculation of safe income and provided more guidance on determining whether a non-resident service provider has a permanent establishment (PE) in Canada for the purposes of Canada's tax treaties.

Safe income. *Income Tax Technical News* (ITTN) no. 33 (September 16, 2005) announced that the CRA has reversed its previous position and will now follow the approach in *Kruco* (2003 FCA 284) in calculating a corporation's "income earned or realized" (safe income) for the purposes of the subsection 55(2) anti-avoidance rule. Subsection 55(2) is intended to prevent a corporation from reducing a capital gain by receiving a tax-free intercorporate dividend before disposing of shares of a related corporation; a dividend out of safe income is not recharacterized as a capital gain. The FCA in *Kruco* held that safe income is not reduced for investment tax credits (ITCs) under subsection 55(2) and paragraph 55(2)(c). The CRA's administrative policy was that the reduction in capital cost allowance claims and the direct income inclusion attributable to ITCs created phantom income for tax purposes that was not supported by cash inflow and thus should not be included in safe income.

The CRA says that the FCA in *Kruco* indicated that safe income generally includes only amounts that are included in net income for tax purposes or specific adjustments in paragraph 55(5)(b) or (c); a deduction from net income for tax purposes reduces safe income. Otherwise, safe income is generally reduced only by those cash outflows that occur after the determination of net income but before the particular dividend is paid (such as taxes and dividends) to the extent that such disbursements reduce the income to which the capital gain may be attributable. If the corporation owns shares of a foreign affiliate, the CRA still follows the FCA decision in *Brelco Drilling* that exempt deficits of some affiliates should be netted against the exempt surpluses of other affiliates in computing a Canadian corporate taxpayer's safe income ([1999] 3 CTC 95).

Although *Kruco* was decided in the taxpayer's favour, the CRA recognizes that some taxpayers may be adversely affected by its change in administrative policy. Thus, for taxable dividends received before 2007, the recipient may determine safe income on hand attributable to the particular share in accordance with either the CRA's historical positions set out in various publications and technical interpretations or the FCA's approach in *Kruco*. A taxpayer who chooses the CRA's published guidelines must accept them in their entirety; one cannot cherry-pick only the advantageous adjustments. For any taxable dividend received after 2006, the safe income is determined according to *Kruco*.

PE for non-resident service provider. ITTN no. 33 also provides more guidance for determining whether a non-resident service provider has a PE in Canada for the purposes of Canada's tax treaties. The CRA released the guidance in response to questions about the application of the *Dudney* decision ([2000] 2 CTC 56 (FCA)). The FCA held that the premises of a US-resident consultant's Canadian client did not constitute a fixed base for the consultant during the time he was working there; he was thus not liable for Canadian tax on the work he did at his Canadian client's premises. The FCA considered the following factors: (1) the actual use of the premises alleged to be the person's fixed base; (2) whether and by what legal right the person exercised or could exercise control over the premises; and (3) the degree to which the premises were objectively identified with the person's business.

The CRA clarifies that the PE analysis should not stop simply because of a conclusion that there is no legal control: that factor was only one of the three listed in *Dudney*, and the list was not intended to be exhaustive. Therefore, having a legal right to exercise control over a place of business is not a prerequisite to establishing a Canadian PE but is only one of several factors. The CRA notes that it was important to the FCA that the taxpayer did not carry on all aspects of his business at his Canadian premises. However, Canada's treaties define a PE as a fixed place of business through which an enterprise's business is wholly or partly carried on; thus, the CRA says that a Canadian PE may exist even if a non-resident does not carry on all aspects of his business in Canada.

The CRA points out that the PE definitions in provincial tax legislation differ from those in Canada's tax treaties. Thus, jurisprudence related to the one may not apply to the other, although it may be persuasive, depending on the similarity between provincial legislation and the treaty and the interpretive principles that apply to each.

The CRA says that when considering whether a Canadian PE exists it examines the specific facts in light of the particular words of a treaty, the jurisprudence, and the OECD model commentary. The commentary says that under the PE definition there must be a place of business, the place of business must be fixed, and the non-resident must carry on his business wholly or partly through the fixed place of business. The CRA says that these three conditions form an appropriate framework for a PE analysis, and any factor relevant to a PE determination must centre on one of these conditions. ITTN no. 33 provides several examples of factors that may be relevant in determining whether these three conditions are met.

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Planning Errors Stand

The TCC was unable to correct harsh results that arose from individuals' flawed tax planning in two cases that illustrate the importance of careful business and estate tax planning to encompass all possible outcomes of transactions.

In *Toews* (2005 TCC 597), the taxpayer, a beneficiary of a discretionary trust, made direct interest-free loans to the trust's wholly owned subsidiaries (Holdco and Opco). Opco became bankrupt and the loans were not repaid. The taxpayer was one of four trustees, and he could not compel trust distributions to him without the consent of two other trustees. The TCC said that there was insufficient nexus between the taxpayer and Holdco's and Opco's profits. Thus, the loans were not made for the purposes of gaining or producing income as subparagraph 40(2)(g)(ii) requires, and a $160,000 business investment loss deduction for the interest-free loans was denied.

The taxpayer (Mr. T) relied on the principle established by the FCA in *Byram* ([1999] 2 CTC 149), which did not involve an intermediary trust. The taxpayer in that case successfully argued that direct and indirect interest-free loans to an Opco and a Holdco, respectively, satisfied the requirement of subparagraph 40(2)(g)(ii). The FCA recognized that the loans need not be interest-bearing to meet the income test: the taxpayer could expect to receive dividend income (either directly from Opco or indirectly from Holdco) if Opco's business was successful. For the loans to be made for the purpose of gaining or producing income, there need only be linkage between the income and the taxpayer. Mr. T argued that a similar nexus existed in *Toews*: Mr. T was a beneficiary of a family trust that wholly owned Holdco, which in turn owned Opco. Opco dividends would be paid to Holdco and then distributed to the trust. As a trust beneficiary, Mr. T could reasonably anticipate receiving trust income distributions.

The TCC refused to apply the *Byram* principle because there was insufficient nexus between Mr. T and Opco: the nexus between Opco and the trust stopped short of Mr. T because Opco profits might never accrue to his benefit. The trust terms allowed the trustees to pay part or all of the trust income to any beneficiary to the exclusion of all others. Because Mr. T was only one of four trustees and only one of four beneficiaries and could not secure a trust distribution without the votes of two other trustees, he may have had some expectation of receiving some Opco profits, but he certainly had no right to them under the existing structure. The TCC was sympathetic to Mr. T's situation: choosing a corporate structure that apparently focused more on the consequences of Opco's success than its possible failure ultimately deprived him of the opportunity to salvage at least a tax deduction from this business failure.

In *DePedrina* (2005 TCC 590), the taxpayer (Mr. D) was surprised when he was assessed a capital gain from the disposition of real estate: a substantial portion of the gain had accrued before he took possession of the property in 1997, although his parents had granted him a remainder interest in the property in 1978. Although the TCC was sympathetic, it said that Parliament specifically contemplated this result in section 43.1.

In 1978, without informing their children, Mr. D's parents signed and registered a deed for the five-acre property on which they resided, transferring the remainder interest in the property to Mr. D, his brother, and their wives (the children) and reserving a life interest in the property. On the death of the surviving parent in 1997, the life interest expired and the children acquired full ownership rights. In 1998, they sold the property for $1.8 million.

Subsection 43.1(1) deemed the parents to have disposed of the life interest in the real property in 1978 and immediately reacquired it for proceeds equal to its then FMV. The actual disposition of the remainder and a deemed disposition of the life interest combined to effect a disposition of all the parents' interests in the property in 1978, and any gain then accrued should have been realized in their income. When the life interest later expired on the mother's death, it was deemed disposed of by her for proceeds equal to her ACB. Thus, any gain that accrued between the 1978 disposition of the remainder and the expiration of the life interest in 1997—a period when the children held only a remainder interest—was not recognized by the mother or her estate, but rather was deferred until the children sold the property in 1998.

The CRA argued that the tax consequences should accord with section 43.1: as the current owner, Mr. D should be taxed on the gain that accrued since he acquired the remainder interest in 1978—comprising, presumably, most of the $400,000 capital gain assessed to each of him and his wife using the remainder interest's value in 1978 as his ACB on the ultimate sale in 1998. Mr. D appealed primarily on the grounds of fairness, saying that he should not be taxed on the amount of the gain that accrued before 1997 because he could not fully exercise ownership rights over the property until then. Mr. D also pointed out that the result was particularly harsh because the parents could not claim the principal-residence exemption on the gain or on the portion thereof attributable to the part of the property used as their principal residence.

The TCC said again that it cannot overrule assessments that properly apply the tax legislation, even if the results are harsh. The particular tax consequences were clearly contemplated by Parliament when section 43.1 was enacted. Thus, as long as the deed signed by the parents was legally effective, the CRA's assessments could not be overturned.

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Williams: Beneficially Yours

The tax treatment of business trusts has recently been the subject of much commentary in the press. Surprisingly, after 500 years of trust law and more than 50 years of Canadian tax rules dealing specifically with trusts, the dividing lines between the taxation of trusts and the taxation of beneficiaries is still not clear. The recent *Williams* case (2005 TCC 558) exemplifies this complexity.

The facts and issues are simple, but the law is not. The controversy hinged on an interpretation of the trust agreement. Mr. W transferred several properties, including shares of a private company, to a trust of which he was, at least at first blush, the sole beneficiary. He was also one of three trustees. In form, the trust was a protective trust: the trust property was placed out of the settlor's control, but it is not clear why, because any protection against creditors was ineffective. The transferred shares had a nominal ACB and an FMV of $2.5 million. Mr. W was reassessed on the basis that he had realized a capital gain on the disposition of his shares into the trust. The issue was whether there had been a disposition, which by definition excludes "any transfer of property by virtue of which there is a change in the legal ownership of the property without any change in the beneficial ownership thereof."

The trust agreement seems to have been of the do-it-yourself variety; it was likely based on another trust agreement more properly drafted for a trust established for a family. Mr. W was the only named beneficiary of the trust, and the trustees were to manage the trust property and pay him at their discretion any income or capital, at any time, but the trust property was to be distributed to Mr. W before the trust's 21st anniversary. A number of provisions appeared to be inconsistent with Mr. W's status as the sole beneficiary. For example, there was a preferred beneficiary clause, a no-vesting clause, and a no-reversion clause. The first clause was unnecessary, the second clause included an error, and the third clause was nonsensical in the context of a sole beneficiary. There was also a clause allowing the trust to be amended, albeit with the taxpayer's consent. Counsel for the Crown argued that this last clause allowed for the possibility of the addition of other beneficiaries.

The TCC carefully examined the inconsistencies and concluded, on balance, that Mr. W was the "beneficial owner" of the trust property, and hence there had been no disposition. The court noted that the exact nature of a beneficiary's interest in a trust had long been the subject of academic debate, but concluded that a resolution of the debate was not necessary for the decision in this case. However, as an initial proposition the court said that "it makes some sense to consider that property always has a beneficial owner": a recent article cited in support said that "the beneficiaries of a trust are, after all, the quintessential 'beneficial owners.'" The court also noted that the term "beneficial ownership" can have different meanings depending on the context, and it was careful to distinguish between "ownership," which appeared to be the basis of the Crown's position, and "beneficial ownership," which was in issue. Here the trust property was maintained for Mr. W's sole benefit: no one else could benefit, and the trustees were obliged to manage the property in his best interest. How could anyone other than Mr. W have beneficial ownership?

Crown counsel pointed out that the taxpayer had seemingly avoided tax on the transfer of the property and had also avoided attribution under subsection 75(2), because of the no-reversion clause. Some confusion is apparent in a footnote on this point: the court said that it did not agree that the taxpayer had avoided subsection 75(2), perhaps implying that there had been a disposition. Perhaps the court meant that it did not agree or disagree that the provision applied, because on balance it seems clear that no disposition occurred in the first place. Attribution was unnecessary because Mr. W's ties with the property were never severed.

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Section 116 Certificates

On the actual or deemed disposition, directly or indirectly, of real estate by a non-resident, a section 116 certificate may be required.

A deemed disposition includes a seizure by a creditor; a gift or bequest; a corporate reorganization, merger, or liquidation; and a redemption or purchase for cancellation of shares. A non-resident is taxable on the disposition of taxable Canadian property (TCP), including Canadian-situs real estate, or indirect holdings such as an interest in a partnership or shares in a private non-resident corporation whose property aggregated more than 50 percent Canadian-situs realty at any time in the previous 60 months. If such a private company goes public via a share-for-share exchange or a merger or amalgamation, the TCP status of its shares flows through. (No similar rule applies on a tax-deferred reorganization of capital.) Shares of a listed non-Canadian public company that meets the "more than 50 percent real estate" test are also TCP if the non-resident shareholder alone or with non-arm's-length parties owned at least 25 percent of any class of shares.

Canada's treaties generally do not exempt capital gains realized on Canadian real estate directly or via a disposition of shares of a private corporation whose value is derived primarily from Canadian real estate. The Canada-UK treaty exempts a shareholder that owns less than 10 percent of such shares. The Canada-US treaty alone exempts a gain realized by a US resident on the disposition of shares of a non-Canco that derives its value principally from Canadian realty. The US treaty exemption does not apply to a US limited liability company (LLC) unless it elects to be treated, for domestic purposes, as a corporation; the CRA takes the position that an LLC is not a resident under the treaty because it is not liable to taxation. Certain treaties exempt gains on shares in publicly traded companies whose value is derived principally from immovable property: Algeria, Austria, Belgium, Bulgaria, Croatia, Estonia, Germany, Hungary, Iceland, Ireland, Italy, Kazakhstan, Kuwait, Kyrgyzstan, Latvia, Lebanon, Lithuania, Luxembourg, Mexico, Netherlands, Slovenia, South Africa, Sweden, Switzerland, Tanzania, Ukraine, United Kingdom, Uzbekistan, and Venezuela.

Section 116 requires a vendor who is or will be a non-resident at the time of disposition to apply for a clearance certificate either before or within 10 days after a disposition of taxable Canadian property other than excluded property, even if a treaty exemption applies; failure to comply or the making of false representations exposes the vendor to prosecution. Practical enforcement problems exist if shares of a non-Canadian resident corporation are sold by one non-resident to another. No clearance certificate is required for shares listed on a prescribed stock exchange, and thus there is no section 116 reporting if a treaty applies, although a tax return should be filed to claim the treaty exemption.

A certificate's issue may take six weeks or longer. The CRA provides comfort letters if a certificate of compliance cannot be issued before a transaction closes: the purchaser must withhold 25 percent of the purchase price and may wait for the certificate to be issued without being liable for penalties or interest. A non-resident would-be vendor of TCP shares must complete form T2062 and provide information such as the name and address of both vendor and purchaser, a description of the property, the estimated or actual proceeds, and the TCP's tax cost. Any treaty relief is claimed on the application, and proof of residency is required. If a foreign partnership owns TCP shares, one notice of disposition is filed for all partners, including names, addresses, and tax identification numbers of non-resident partners and payment of the tax or security therefor.

On a sale of shares, 25 percent of the gross gain must be paid or provided as tax or security with the application; expenses are deducted only on the tax return, and a refund may be available. Form T2064 is the clearance certificate for a proposed disposition; form T2068 is used for an actual disposition. The certificate sets out a certificate limit, based on the reported proceeds; a second certificate may be required if the purchaser changes, if the price increases, or if the tax cost is lower. Additional tax must be paid before a certificate of compliance is issued. The purchaser must make a reasonable inquiry as to whether the vendor is a non-resident; Canadian sale agreements for shares of Canadian private companies or Canadian real estate contain a boilerplate warranty that the vendor will not be a non-resident at closing. If a vendor indicates non-resident status, the purchaser must require a section 116 clearance certificate with a certificate limit not less than the purchase price in order to be relieved of liability.

If a treaty exemption is claimed, the certificate's issuance is discretionary; it may not be issued if there are concerns about abusive planning—for example, when Canadian residents own shares of a non-resident company or the beneficial owners cannot be identified because a widely held partnership owns the shares. If there is no certificate, or if the certificate amount is less than the purchase price, the purchaser must withhold and remit 25 percent of the gross proceeds within 30 days after the month-end. Late payment triggers a penalty, and failure to withhold renders the purchaser liable for 25 percent of the gross proceeds plus interest and a penalty of 10 percent of the amount required. The purchaser may be liable for 50 percent of the gross proceeds if there is a direct sale of real property inventory and no clearance certificate is obtained, and for 50 percent of the excess proceeds over the certificate amount. The exercise of a warrant to acquire shares of a private corporation resident in Canada or the grant by a non-resident of an option or call to acquire such shares or real property in Canada is a disposition of TCP, and a clearance certificate is required. However, the warrant's issuer is not a purchaser for these purposes and is not liable if a certificate is not obtained (TI 2005-0111741E5).

In the case of Quebec realty, section 1094 of the Taxation Act (Quebec) imposes a similar certificate procedure. The vendor must pay a Quebec tax equal to 12 percent of the gain, and in the absence of a certificate the purchaser must withhold 12 percent of the proceeds. There are some differences: a non-resident corporation must obtain a certificate on the disposition of taxable Quebec property, but a non-resident individual needs a certificate only on a sale of Quebec-situs realty, not for the disposition of resident or foreign company shares. A certificate is also required for all deemed dispositions, including those that arise on death.

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Provincial R & D Credits

Corporations may claim R & D tax credits in eight provinces and one territory. In Newfoundland and Labrador, Quebec, and the Yukon, individuals may also claim the credits. R & D tax credits may be applied against provincial or territorial income tax. In Ontario and Quebec, the tax credit may also be used to offset capital taxes. Provincial and territorial tax credits are considered to be government assistance for federal tax purposes, and therefore they reduce expenditures that are eligible for the federal R & D deduction and federal investment tax credits. The table summarizes 2005 provincial and territorial R & D tax credits.

Recent changes generally enhanced R & D credits. British Columbia's R & D tax credit was scheduled to expire on August 31, 2004, but was extended five years to August 31, 2009. Manitoba increased its R & D tax credit on March 9, 2005 from 15 to 20 percent and, applicable to 2004 and later taxation years, extended the R & D credit carryforward from 7 to 10 years. (Tax credits incurred before then continue to expire after 7 years.) A

Quebec budget proposal increased its R & D wage tax credit from 35 to 37.5 percent for R & D expenditures by certain Canadian-controlled corporations incurred after April 21, 2005; draft legislation has not yet been released. The rate remains 17.5 percent for all other taxpayers.

<table>
<tr><th colspan="2"></th><th>Rate (%)</th><th>Refundable?</th><th>Carry-back period (years)</th><th>Carry-forward period (years)</th></tr>
<tr><td colspan="2">AB</td><td colspan="4">No R & D incentives</td></tr>
<tr><td rowspan="2">BC</td><td>Qualifying CCPCs</td><td rowspan="2">10</td><td>Yes</td><td>na</td><td>na</td></tr>
<tr><td>Other corporations</td><td rowspan="2">No</td><td rowspan="2">3</td><td rowspan="2">10</td></tr>
<tr><td colspan="2">MB</td><td>20</td></tr>
<tr><td colspan="2">NB</td><td rowspan="3">15</td><td rowspan="3">Yes</td><td rowspan="3">na</td><td rowspan="3">na</td></tr>
<tr><td colspan="2">NL</td></tr>
<tr><td colspan="2">NS</td></tr>
<tr><td colspan="2">NT</td><td colspan="4" rowspan="2">No R & D incentives</td></tr>
<tr><td colspan="2">NU</td></tr>
<tr><td rowspan="2">ON</td><td>Innovation tax credit</td><td>10</td><td rowspan="2">Yes</td><td rowspan="2">na</td><td rowspan="2">na</td></tr>
<tr><td>Business research tax credit</td><td>20</td></tr>
<tr><td colspan="2">PE</td><td colspan="4">No R & D incentives</td></tr>
<tr><td rowspan="2">QC</td><td>R & D wage tax credit</td><td>17.5 or 37.5</td><td rowspan="2">Yes</td><td rowspan="2">na</td><td rowspan="2">na</td></tr>
<tr><td>University research, public research centre, research consortium, and pre-competitive research tax credits</td><td>35</td></tr>
<tr><td colspan="2">SK</td><td>15</td><td>No</td><td>3</td><td>10</td></tr>
<tr><td colspan="2">YT</td><td>15</td><td>Yes</td><td>na</td><td>na</td></tr>
</table>

Notes: na—not applicable. **British Columbia**'s refundable R & D tax credit is limited to 10 percent of the lesser of (1) eligible R & D expenditures and (2) the federal R & D expenditure limit ($2 million or less). **Ontario** corporations that on an associated basis have taxable income under $300,000 and taxable capital under $25 million may claim the innovation tax credit on up to $2 million of expenditures; a partial credit is available if taxable income falls between $300,000 and $500,000 or taxable capital falls between $25 million and $50 million. One hundred percent of current expenditures and 40 percent of capital expenditures are eligible. The business research institute tax credit is 20 percent of qualifying payments (up to $20 million annually on an associated basis) to Ontario eligible research institutes. **Quebec**: Canadian-controlled corporations with less than $25 million in assets are eligible for an R & D wage tax credit of 37.5 percent on up to $2 million of R & D wages on an associated basis; if the corporation has assets between $25 million and $50 million, the rate is gradually reduced to 17.5 percent, which is the rate for all other taxpayers. Credit eligibility also extends to 50 percent of payments to unrelated subcontractors. Quebec allows a 35 percent credit for 80 percent of payments to certain eligible entities (such as universities and public research centres). **Yukon**'s R & D tax credit is 20 percent on R & D expenditures made to the Yukon College. All thresholds are in respect of the previous year, on a worldwide associated basis.

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Readers are invited to submit ideas or written material to *Canadian Tax Highlights*. Please write to Vivien Morgan in care of the Canadian Tax Foundation.

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Foreign Tax News

Russia

The tax service issued Order SAE-3-26/439 of September 8, 2005, vitiating a January 30, 1996 letter, and approved the procedure confirming permanent-resident status in Russia for individuals (Russian and foreign), Russian legal entities, and international organizations, for the purposes of Russian income tax treaties.

France

Details of the individual tax reform were released on September 13. Beginning next year, the number of individual income tax rates is reduced from six to four, and the top rate is cut from 48 to 40 percent. A 60 percent ceiling is introduced on an individual's total income tax.

Australia

Proposed legislation of September 14, 2005 significantly limits corporate loss carryforwards in order to prevent loss trading. Current tax law does not impose a time limit on carryforwards.

Netherlands

On August 12, 2005, the Supreme Court ruled that a US-citizen Netherlands resident cannot deduct from taxable income any US tax owed after applying a foreign tax credit in the United States.

European Court of Justice

On September 15, 2005, the European Court of Justice held that when a cruise ship travelling from one EU port to another stops at a non-EU port, it is a stop in a third territory under article 8(1)(c) of the Sixth VAT Directive. The EU VAT regime does not apply to shipboard sales made during the stop: *Antje Kohler v. Finanzamt Dusseldorf-Nord* (C-58/04).

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