CANADIAN TAX Highlights

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Volume 13, Number 11, November 2005

Justice: Is the CRA Its Client?

Over the years, tax practitioners and TCC judges have expressed annoyance and frustration at Justice lawyers' apparent inability or refusal to make decisions in tax appeals without obtaining "instructions" from CRA officers.

The passage of the Department of Justice Act in 1868 invested the attorney general of Canada with the authority to regulate and conduct all litigation for or against the Crown in respect of any subject within the authority or jurisdiction of Canada. In the criminal law sphere, it has always been clear that Crown attorneys, not police officers or public servants, exercise independent authority and control over prosecutions, including tax offences. This approach is consistent with the AG's historical role as the Crown's representative charged with protecting the public interest.

In the civil tax law sphere, however, the AG's counsel seem to rarely take positions in appeals that are not endorsed by the "client" at the CRA, notwithstanding expressions of opinion by members of the judiciary (since at least the early 1960s) that the considerations applicable to the conduct of Crown counsel in criminal matters should also apply if the imposition of tax is concerned. Chairman Fisher of the Tax Appeal Board said in *Nielson* (63 DTC 811, at 815) that the dictum "the Crown never loses a case and the Crown never wins a case" applies equally in civil tax cases; he also noted that the Crown must be scrupulously just in all dealings with its subjects. Teskey J of the TCC observed in *Hatton* ([2000] 1 CTC 2979, at paragraph 23) that Justice counsel, who as representatives of the AG are in charge of all litigation in Canada, do not need any authority or directions from the CRA and can exercise their discretion in tax matters: "I think there's a . . . special duty on a justice lawyer. They are in a very unique position. Yes, they are representing the government of Canada but they're also a servant of the people of Canada."

In the recent *Garber* case (2005 TCC 635), the taxpayers brought a motion for an order striking out the Crown's reply to a notice of appeal or, alternatively, for an order that assessments be vacated pursuant to subsection 171(1). The taxpayers alleged that the Crown had abused the settlement process: a settlement of civil tax appeals involving disallowed partnership losses had been reached with the CRA in 1994, but Justice later repudiated the settlement, saying it had no underlying factual basis. Bowman CJ found that the civil settlement was repudiated because prosecutors thought that its existence would jeopardize criminal proceedings against partnership promoters. Bowman CJ said that it is not clear that the courts have yet pronounced the "last word" on the subject of the minister of revenue's refusal to honour agreements his officials have made with taxpayers, noting that perhaps the taxpayers could have sought to enforce their settlement agreement in the Federal Court. He also noted that far more tax disputes are settled at the pre-assessment, objection, and appeal levels than are litigated, and in his view the system could not sustain the burden created if the Crown was able to renege on all settlements so that all tax disputes must be litigated. However, by virtue of the responsibility conferred on the AG under section 5(d) of the Department of Justice Act, he concluded that Justice has the authority to repudiate the agreement made by CRA officials:

> Department of Justice lawyers sometimes refer to the Department of National Revenue as their "client." This is a convenient shorthand turn of phrase but it is not entirely accurate, even though the relationship between the Attorney General and the various government departments in whose interests the Department of Justice acts may have some incidents that are analogous to a solicitor-client relationship.

This decision is consistent with the traditional law on the subject, and it clearly has implications for the role of Justice generally in tax law matters before the courts. The TCC's decision is likely to be appealed.

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In This Issue

CRA Special Enforcement

A CRA requirement letter to provide documents or information pursuant to subsection 231.2(1) must be for a purpose "related to the administration or enforcement" of the Act and not, for example, to further or to assist in a penal investigation (*Jarvis*, [2002] 3 SCR 757). In *Ellingson* (2005 FC 1068), the FC concluded that a requirement letter issued by an auditor employed in the CRA Special Enforcement Program (SEP) was not for a valid purpose. *Ellingson* has been appealed to the FCA.

In January 2004, Ellingson was indicted in the United States for the importation and distribution of illicit drugs and the laundering of the related proceeds. Two weeks after the grand jury indictment, two British Columbia newspapers disclosed the charges; SEP also received a Suspicious Transaction Referral form from the RCMP Proceeds of Crime Unit stating that Ellingson had made several large cash payments against two car bank loans and that, in one instance, "the money had the distinct odour of marijuana." In July 2004, a SEP auditor issued Ellingson a requirement to provide tax returns and personal detailed financial information for 1999 to 2003. Ellingson refused to answer the requirement because it was issued for the invalid purpose of furthering a criminal investigation, and he sought judicial review of its issuance. SEP is part of the CRA's Investigations Division, and its overall objective was set out in a 1992 working arrangement between the RCMP and the CRA:

> In order to address more effectively the accumulation of unreported illicit wealth amassed by Organized Crime and increase the effectiveness of criminal law enforcement and thus cause maximum disruption to Organized Crime, stem the infiltration of legitimate business by criminal elements, and reduce the activities of Organized Crime on society, [SEP] and the RCMP agree to act in concert with one another in combating Organized Crime through enforcement under the *Income Tax Act*.

The minister agreed that the arrangement was still in effect, but said that its application had significantly changed because of a 2002 CRA publication, "Operational Guidelines for SEP," which stated that SEP "has evolved . . . and its focus has shifted from a criminal to a mainly civil approach." Moreover, the minister attached significant weight to the fact that the issuing SEP auditor honestly believed and intended that the issuance was to be for tax liability purposes only.

The FC quashed the requirement, saying that the auditor had acted beyond his jurisdiction in its issuance. The arrangement was the most important evidence in determining the purpose of the requirement's issuance. The FC agreed with *Harris* (95 DTC 5653), in which the British Columbia Supreme Court said that SEP was not solely regulatory or administrative and that there was a "criminal or quasi-criminal function apparent in the procedures and methods." Under the arrangement, the CRA (via SEP) has an institutional obligation and intention to act in concert with the RCMP to investigate organized crime "for the purpose of attempting to ultimately impose penal sanction." No weight was given to the 2002 guidelines; SEP's adopting a civil approach in many cases does not "mean that the obligation and intention when first approaching a given case is not the imposition of penal sanctions." Nor was any weight given to the minister's argument that SEP is bureaucratically divided between "audit" and "investigation" functions: whether a CRA agent was a SEP auditor or an investigator was irrelevant because "the whole of the activity of the SEP is dedicated to the investigation of penal liability" and any issuance of a requirement by any SEP member is ultimately for the same purpose.

Ellingson clarifies that the issuance of a requirement letter by a SEP member is always intended for use in the investigation of penal liability and thus is not valid for income tax purposes. The court heeded *Harris* and would not follow the CRA's direction to "turn a blind eye to the close working relationship between [SEP] and the RCMP." The FC was not persuaded that SEP validly issues requirements in the course of an audit. Condoning requirements issued by SEP as part of an investigation of penal liability would compel the target to provide incriminating evidence and disregard the individual's right to silence and right to freedom from unreasonable search and seizure under the Charter of Rights and Freedoms.

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IRS: Abusive USRPI Transactions

In its continuing quest to stop tax abuse, the IRS recently issued FS-2005-16, which outlines two types of US real property transactions involving foreign (non-US) persons that the IRS views as abusive transactions designed to circumvent the US withholding tax. The two cases involve disposing of an option or a contract to acquire a US real property interest (USRPI) without remitting withholding tax, and a transfer of a USRPI by a foreign corporation to a foreign individual shareholder before it is sold to a third-party buyer. The fact sheet is intended to "remind all real estate and tax professionals of the withholding tax" applicable when a foreign person sells a USRPI. Under US tax rules, a buyer must inquire as to a seller's status as a US or foreign person, and a buyer—or anyone with control over the proceeds of sale, such as the real estate agent or the attorney who is handling the transaction—can be liable for the failure to withhold and remit the US tax.

Under FIRPTA, a foreign person (including a foreign corporation, company, partnership, trust, or individual) must pay US income tax on a gain on a USRPI's disposition. A USRPI includes many real estate interests, such as options for land, contracts to acquire land, leasehold interests, and condos and co-ops. The buyer generally must withhold and remit to the IRS 10 percent of the gross sales proceeds owing to the foreign person. The withholding is not a final liability, but it ensures that at least some tax is collected before proceeds from a USRPI disposition leave the United States' jurisdiction. The foreign seller must file a US income tax return to report the transaction and must pay any additional tax or receive a refund if the withholding exceeds the tax owing.

The first potentially abusive transaction described in the fact sheet involves options or contracts to buy real property that are sold before title to the real property is acquired. Although it may not be obvious to the parties that such an option or contract is a USRPI, the buyers must comply with the FIRPTA withholding procedures and the seller must file a US tax return and pay the related tax. The second transaction involves a seller taking advantage of the lower long-term capital gains rate for individuals (a maximum 15 percent federal rate if the property is held for more than one year) instead of the corporate capital gains rate (a maximum 35 percent federal rate). Foreign individuals often purchase US real property through a foreign corporation—historically, to avoid exposure to US estate tax (a tactic that may now prove ineffective). The fact sheet says that it is incorrect to claim that a shareholder, not the corporation, may report the gain from the sale and pay the tax. First, the foreign corporation may be treated as making a distribution to the foreign shareholder of the USRPI, a deemed sale that generates a corporate-level tax; in this case, it must withhold 35 percent (or other reduced rate) on the gain in the property. Second, the corporation may be treated as selling the USRPI directly to the third-party buyer, disregarding the transfer to the shareholder. Similarly, US corporate tax, not the lower individual capital gains tax, applies if the USRPI is owned by a US corporation unless its foreign owner can sell its stock rather than the USRPI.

No doubt the fact sheet was issued to put foreign persons on notice, but also to alert buyers and other withholding agents—especially the professionals involved in real estate transactions—to ensure that all persons involved in transfers of USRPIs by foreign persons are aware that the FIRPTA withholding tax regime has a long reach. The fact sheet also highlights that if a foreign purchaser acquires US real estate using a corporation to hold title, a much higher US income tax rate may be triggered when the property is sold, so long as the significant disparity between the individual long-term capital gains rate and the corporate tax rate continues. Foreign purchasers should consider using alternative structures to purchase US real property, such as a partnership, a trust, a tenancy in common, or individual interests, keeping in mind the possible exposure to US gift and estate tax issues as well as the income tax issues.

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Small Business Breaks

The 2005 provincial budgets confirmed that competition for the lowest tax rate is still key to provincial tax policy. Five provinces dropped their 2005 rates on the profits of qualifying Canadian-controlled private corporations (CCPCs), and New Brunswick now claims the lowest: its 2008 rate drops to 1 percent.

Table 1 shows provincial and federal rates for CCPCs in calendar years 2004 to 2008. When the effective date of change straddles the calendar year-end, the rate shown is the average of the two rates operative during the year. Only the 2004 and 2005 figures are firm; the 2006 to 2008 rates assume no change from the policy announced

Table 1 Income Tax Rates on Small Business Profits (by Calendar Year)

	2004	2005	2006	2007	2008
			percent		
NL	5	5	5	5	5
PE	7.5	6.75	6.5	6.5	6.5
NS	5	5	5	5	5
NB	3	2.25	1.75	1.25	1
QC	8.9	8.9	8.5	8.5	8.5
ON	5.5	5.5	5.5	5.5	5.5
MB	5	5	4.5	4	4
SK	5.5	5	5	5	5
AB	3.25	3	3	3	3
BC	4.5	4.5	4.5	4.5	4.5
YT	6	4	4	4	4
NT	4	4	4	4	4
NU	4	4	4	4	4
Federal	13.12	13.12	13.12	13.12	12

Table 2 Thresholds for Small Business Deduction (by Calendar Year)

	2004	2005	2006	2007	2008
			thousands of dollars		
NL	250	300	300	300	300
PE	250	300	300	300	300
NS	250	350	400	400	400
NB	425	450	475	500	500
QC	250	300	400	400	400
ON	400	400	400	400	400
MB	360	400	400	400	400
SK	300	300	300	300	300
AB	400	400	400	400	400
BC	300	400	400	400	400
YT	250	300	300	400	400
NT	250	300	300	300	300
NU	250	300	300	300	300
Federal	250	300	300	300	300

in the 2005 budgets. The federal rate drops when the surtax expires.

Table 2 shows how all jurisdictions have been raising the threshold at which CCPCs no longer qualify for the small business deduction. Again, the figures for 2004 and 2005 are firm; future budgets may raise the thresholds even further. New Brunswick has the highest threshold; it will reach $500,000 by 2007.

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Assumption as Co-Obligor: Boot After All

A recent advance ruling (2005-0119481R3) appeared similar in result to a prior ruling (2003-0054013). Both rulings dealt with whether the assumption of a debt by another as co-obligor is considered boot for the purposes of the elected amount limits in paragraph 85(1)(b) if the primary obligation to pay remains, effectively, with the original debtor. (See "Assumption as Co-Obligor Not Boot," *Canadian Tax Highlights*, September 2005.) The CRA has now clarified that such an assumption is boot.

As part of a series of transactions, Parentco sought to roll substantially all its business assets to a partnership (POP) under subsections 97(2) and 85(1). The asset transfer was restricted by covenants on various Parentco debt obligations; thus, POP assumed, as co-obligor and on a joint and several basis with Parentco, various commitments ("the co-assumed liabilities"). Parentco remained primarily liable for the co-assumed liabilities and provided an absolute indemnity to POP. The transfer agreement specified that the co-assumed liabilities were not part of the consideration from POP for the transferred assets. Parentco requested confirmation that paragraph 85(1)(b), as modified by subsection 97(2), did not adjust the agreed amounts in the election. The CRA granted the ruling.

Initially, it appeared that the CRA had taken the position that Parentco received nothing from POP in relation to the co-assumed liabilities and that the FMV of the assumption as co-obligor was nominal, a position apparently also reflected in the previous ruling. However, CRA Rulings recently clarified that it does consider such an assumption to be boot for the purposes of the elected amounts limit in paragraph 85(1)(b) even if the original debtor effectively retains the primary obligation to pay the debt. The ruling does not reflect CRA policy on the technical issue of whether the co-assumption was boot, but rather the relative dollar values at stake. There was a considerable difference between the cost amount of the assets transferred and the value of the other liabilities (not the co-assumed liabilities) that were assumed as consideration. The ruling did not confirm that the co-assumption was not consideration for the transferred assets, but it did confirm that, on the facts, the value of the co-assumption could not possibly exceed the considerable difference between the cost of the transferred assets and the value of the other liabilities assumed. Thus, the CRA ruled that paragraph 85(1)(b) did not apply to adjust the parties' agreed amounts.

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Health and Welfare Trusts

On September 12, 2005, the CBA-CICA Joint Committee on Taxation (JCT) submitted comments to the CRA on draft IT-85R3 on health and welfare trusts (HWTs). (The IT is not yet public.) The JCT's main concern is the CRA's application of the prepaid expense rule in paragraph 18(9)(a) to deny employer deductions of certain contributions to an HWT in the year they are made.

An employer may set up and administer an employee health and welfare benefit program through a trust. An HWT is not a defined term in the Act, but it is recognized by the CRA administratively. Generally, an employer's contribution to an HWT is accepted as a contribution to a "group sickness or accident insurance plan" (subparagraph 6(1)(a)(i)) and is deductible; payments from HWTs are not taxable to employees. To qualify, an HWT must be restricted to the funding of group sickness and accident insurance loans, private health services plans, group term life insurance for employees, or any combination thereof. Contributions to HWTs generally cannot exceed the current cost of providing employees' health and welfare benefits for the year; the contributions cannot be voluntary, and they must be actuarially determined. See the current IT-85R2 ("Health and Welfare Trusts for Employees," July 31, 1996) for more information on the CRA's position.

In the draft IT, the CRA says that contributions to an HWT made in an employer's taxation year are deductible only to the extent that they are made to fund benefits that may reasonably be expected to be paid out in the year, plus administrative costs. The CRA says that excess contributions are consideration for insurance for a period after the year-end, and paragraph 18(9)(a) prohibits a deduction therefor.

The JCT submits that the CRA's view reflects a misunderstanding of the nature of insurance. Insurance is an undertaking to make payments when specified events occur; the CRA's view seems to be that insurance is considered to be provided when benefits are paid. The JCT submits that the correct view is that insurance is provided for a period if an event occurring during the period gives rise to an entitlement to benefits. For insurance to be "in respect of a period" (as provided in subparagraph 18(9)(a)(iii)), insurance proceeds are payable if an insured event occurs in that period, even if particular claims are not actually paid until a later period. The timing of a payment does not alter the timing of the insurance, and the application of subparagraph 18(9)(a)(iii) is not affected by when insurance proceeds are actually paid. The JCT submission also addresses the use of the term "health and welfare trust"; tax implications to the employer (terminology, funding, actuarial reserves, and administrative costs); surplus; loss of HWT status; and miscellaneous items.

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Trust Capital Distributions

Trust administrators should bear in mind that section 116 applies when a Canadian trust distributes cash or other properties to a non-resident beneficiary in satisfaction of all or part of his or her capital interest. The trust may be liable to withhold tax on such payments, and the beneficiary may need to file a Canadian income tax return for the year to report the disposition.

When a non-resident disposes of taxable Canadian property (TCP), section 116 requires that the purchaser withhold and remit 25 percent of the sales proceeds to the CRA, unless a clearance certificate has been issued authorizing the withholding's reduction or elimination. A distribution of cash or other property payment by a Canadian-resident trust (other than a mutual fund trust) in full or partial satisfaction of a non-resident beneficiary's capital interest gives rise to a full or partial disposition thereof, and the CRA says that section 116 applies.

The trust is considered to be the purchaser and must pay the 25 percent withholding tax (subsection 116(5)). A request for a clearance certificate to reduce or eliminate withholding can be filed on behalf of the beneficiary. Because it is possible (although not usual) for a non-resident beneficiary to realize a capital gain on the disposition of part of the capital interest in a personal trust, the CRA says it is not unreasonable to require an application for a clearance certificate to reduce the withholding taxes in such cases. Form T2062, a request for a clearance certificate, must be filed with the CRA within 10 days of the capital payment. The CRA also says that the non-resident beneficiary must file a Canadian income tax return for the year to report the TCP disposition even if no capital gain arises. Although no penalties apply when no income tax is payable, the beneficiary is technically required to file a return.

Late-filing penalties apply if a taxpayer does not comply with the clearance certificate procedures. The penalty for the late filing of certificates is the greater of $100 and $25 multiplied by the number of days after the due date, to a maximum of $2,500 for each failure to comply (subsection 162(7)). If a certificate has not been obtained and the purchaser (the trust) has not remitted 25 percent of the gross proceeds, it is subject to a penalty of 10 percent of the amount that should have been remitted, plus interest compounded daily (subsection 227(9)). Legal representatives (such as trustees) who do not obtain a certificate before distributing property that they control are personally responsible for interest on any unpaid tax on the property and for the tax itself. The CRA may be prepared to grant relief in certain cases under its voluntary disclosure program or under the fairness provisions.

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CRA on Treaty PEs

ITTN no. 33 (September 16, 2005) comments on aspects of *Dudney* (2000 DTC 6169) and discusses the CRA's "permanent establishment analysis framework," making numerous references to the OECD model treaty commentary. It seems that the CRA may be moving toward a greater reliance on the OECD commentary in treaty interpretation.

Two principles raised in *Dudney* attract comment: (1) the control of space at the taxpayer's disposal, and (2) the scope of carrying on business in a particular location. ITTN no. 22 (January 11, 2002) indicated that the

CRA would "apply *Dudney* . . . where [on the facts] it can be concluded that . . . the taxpayer does not have sufficient physical control of space to be carrying on . . . business in a particular place." ITTN no. 33 now says that a PE determination should not rest solely on the issue of legal control: "[T]here are numerous factors to be considered that are outlined in the OECD Model Commentary and derived from jurisprudence. Which factors are most relevant in any particular case will be largely dependent on the nature of the taxpayer's business."

The CRA says that a PE can exist if the taxpayer carries on a limited scope of business activities at a particular location. OECD model treaty article 5(1) sets out the fundamental definition of the term "permanent establishment" to mean "a fixed place of business through which the business of an enterprise is wholly or partly carried on." ITTN no. 33 says that all aspects of the non-resident's business need not be carried on in Canada, because the fundamental definition includes the words "or partly."

As a general approach, the CRA "looks at the issue whether a PE exists in Canada by examining the specific facts of the situation in light of the particular words of a treaty, the jurisprudence, and the OECD Model Commentary." The CRA PE analysis framework refers to three conditions contained in the fundamental PE definition: there must be a place of business, it must be fixed, and the non-resident must be carrying on his business wholly or partly through this fixed place of business. The CRA provides examples of factors to consider in evaluating each condition. Instead of discussing those factors at length, however, the CRA refers the reader to specific paragraphs of the OECD commentary. (The only reservation made by Canada to model treaty article 5 is to subparagraph 2(f), dealing with mines and other sites that involve the extraction of natural resources.) It remains to be seen how much weight the courts will place on the current version of the OECD model commentary in interpreting article 5.

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RECENT SR & ED PUBLICATIONS

■ ***Application Policy* SR & ED 2000-02R, "Guidelines for Resolving Claimants' SR & ED Concerns"** (June 30, 2005). This AP revision establishes the role and responsibilities for both CRA personnel (technological and financial) and claimants, and sets out a three-step procedure for resolving concerns.

■ ***Application Policy* SR & ED 2002-02R2, "Experimental Production and Commercial Production with Experimental Development—Allowable SR & ED Expenditures"** (July 29, 2005). This revised AP sets out the methodology to distinguish experimental production (EP) and commercial production with experimental development (CP/ED) and thus isolate ineligible CP. The revision says that it only clarifies and does not change key principles in the previous AP. Notably, the revision recognizes that the sale of a production (at a profit or loss) should not be used to determine whether ED is EP or CP/ED, but is only a triggering event for further investigation to identify other technical considerations and evidence to be used in that determination.

■ **"Plastics Materials, Processing, Equipment & Tool Making Guidance Document"** (August 2005). This joint CRA/industry-sector committee paper discusses technical issues to assist plastics-sector claimants in preparing SR & ED claims. The new section deals with scale-up and related issues. (Other planned additions will deal with feasibility studies, experimental runs on commercial equipment, prototypes and pilot plants, continuous improvement, and technology transfer.) The first part of the new section deals with validation, which, in industrial settings, generally means the process of confirming, corroborating, substantiating, or checking that something is "as intended." Validation is not necessarily SR & ED: eligibility depends on why the validation is being carried out. Validation work is part of the SR & ED project if it is the final confirming experiment after a technological advancement has been attempted, but it is not SR & ED if it is carried out to confirm that a piece of purchased equipment performs as it has previously.

■ ***Application Policy* SR & ED 2005-01, "Shared-Use-Equipment"** (September 8, 2005). This AP intends to clarify the application of the rules for shared-use equipment (SUE) and prescribed depreciable property, and provides various illustrative examples. SUE is generally defined as capital property that does not meet the "all or substantially all" (90 percent) test but is used primarily (more than 50 percent) in SR & ED during its operating time. Taxpayers earn investment tax credits (ITCs) on up to 50 percent of the cost of such property; 25 percent ITCs are earned if the property meets the usage tests for SUE during the first 12 months after its acquisition, starting when the equipment is available for the taxpayer's use. ITCs on another 25 percent of cost are earned if the equipment continues to meet the usage tests throughout the 24 months after acquisition. (The cost of SUE is not included in the pool of deductible SR & ED expenditures, because it is included in the CCA calculation.)

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Owner-Manager Year-End Tips

It is time again for owner-managers to focus on year-end planning.

■ The optimal salary-dividend mix for an owner-manager and other family members will minimize overall taxes. Considerations include the owner-manager's marginal tax rate, the corporation's tax rate, provincial health and/or payroll taxes, CPP contributions, and RRSP contribution room. Salaries and bonuses are preferred if the combined federal-provincial corporate tax rate exceeds 20 percent (generally, taxable income above $300,000 for 2005). Tax is deferred if the corporation retains income when its tax rate is less than the individual's rate. The table shows the income tax deferral if ABI is retained in a corporation and not paid out as salary to the shareholder, and the tax saving (or cost) of paying out the after-tax corporate income as a dividend.

■ Owing to lower 2005 corporate income tax rates in Quebec, corporations may wish to accelerate income to 2005 by deferring discretionary deductions. Rates on ABI above $400,000 are expected to increase from 8.9 percent in 2005 to 11.9 percent by 2009.

■ Conversely, corporate taxpayers in Manitoba and British Columbia may wish to defer income to 2006 and later years by maximizing 2005 discretionary deductions to benefit from lower provincial rates after 2005.

■ Compare the provinces' taxes, tax incentives, and other costs of doing business. For example, Quebec has a new refundable tax credit for eligible salaries for major employment-generating projects in the information technology sector; British Columbia, Manitoba, Newfoundland and Labrador, Nova Scotia, Ontario, and Quebec have enhanced media tax incentives.

■ Draft rules on the deductibility of interest and other expenses, effective for tax years beginning after 2004, allow losses only if a business or property has a "reasonable expectation of profit"; disallowed losses are not carried forward. Changes to the draft are anticipated.

■ Quebec limits the deductibility of investment expenses to the investment income earned in the taxation year; the rule does not apply to expenses incurred to earn ABI or to non-personal trusts. Changes retroactive to March 30, 2004 affect the treatment of flowthrough shares and the portion of capital gains eligible for the $500,000 capital gains exemption.

For additional points, see "Owner-Manager: Year-End Tips," *Canadian Tax Highlights*, November 2004.

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Determining the Optimal Salary-Dividend Mix
(Based on a December 31, 2005 Year-End and $10,000 ABI)

	Eligible for SBD		No SBD, no M&P deduction		No SBD, M & P deduction	
	Deferral of salary: tax deferred	Dividend not salary: saving (cost)	Deferral of salary: tax deferred	Dividend not salary: saving (cost)	Deferral of salary: tax deferred	Dividend not salary: saving (cost)
			dollars			
AB	2,288	268	538	(1,061)	538	(1,061)
BC	2,608	6	884	(1,173)	884	(1,173)
MB	2,940	67	1,040	(1,166)	1,040	(1,166)
NB	3,147	(6)	1,172	(1,245)	1,172	(1,245)
NL	3,153	97	1,353	(1,031)	2,253	(467)
NS	3,013	306	1,013	(1,033)	1,013	(1,033)
ON	2,881	330	1,131	(871)	1,331	(734)
PE	2,750	189	925	(1,053)	1,135	(910)
QC	2,831	272	1,931	(333)	1,931	(333)
SK	2,588	268	488	(1,237)	1,188	(735)
NT	2,679	222	779	(1,115)	779	(1,115)
NU	2,379	(21)	679	(1,229)	679	(1,229)
YT	2,528	155	528	(1,272)	1,778	(380)

Note: The individual is assumed to be taxed at the top marginal income tax rate. Only federal and provincial income tax, the employer portion of provincial health tax, and the employee portion of payroll tax for Northwest Territories and Nunavut are considered. The SBD figures for Yukon assume that the rate on non–M & P ABI applies; if the M & P ABI rate applies, the tax deferral and tax saving are $2,678 and $262, respectively.

Fair Market Value: GST Excluded?

The FMV of a property has been defined as the amount that a willing purchaser will pay to a willing vendor for a property. It may appear self-evident that the amount should include all amounts payable, such as all taxes payable on the purchase price. To resolve any uncertainty, subsection 123(1) of the Excise Tax Act provides that the FMV of a property is determined without reference to any tax excluded by section 154. The TCC in *Sira Enterprises* (2000 CanLII 237) said that a property's FMV excluded GST/HST under section 154. Nonetheless, the CRA continues to add GST/HST to the amount otherwise determined as a property's FMV.

Numerous appeals are apparently awaiting resolution of the issue of whether an appraisal should include GST/HST. Adding GST/HST to FMV is particularly of concern where a taxpayer may be required to self-assess on commencing to rent newly constructed apartment buildings, and it is also relevant in any circumstances in which the Excise Tax Act requires a determination of an asset's FMV.

Recently, in *Pioneer Plumbing* (2005-639 (GST)I), an appeal to the TCC from an assessment including HST in the calculation of the FMV of the property, a consent judgment allowed the appeal on the basis that the HST should be excluded from the FMV. Even though the Crown appears to accept the fact that GST/HST is excluded from FMV, the CRA continues to assess otherwise. In a recent case in which the taxpayer was assessed on the basis that HST must be added to the amount otherwise determined to be the FMV, the matter was held in abeyance after an objection was filed. The CRA appeals officer advised that the disposition of the objection waited on a determination by Head Office GST/HST Rulings as to whether it is CRA policy to add GST/HST to the amount that otherwise constitutes FMV.

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Section 116: Part 2

A section 116 certificate may be required on the disposition of taxable Canadian property (TCP) shares, and a return may have to be filed to determine the final tax owing.

A gift of TCP shares is a deemed disposition at FMV and requires a clearance certificate. A sale of non-excluded TCP between related parties is deemed to generate proceeds equal to its FMV. Some deemed dispositions do not require a clearance certificate—for example, death or mortgage foreclosure (see IT-150R2, paragraphs 2 and 3, archived) and the exercise of a power of sale if the debtor is a non-resident. A seizure by a creditor of pledged shares requires a certificate.

A certificate may be required even if there is no gain when a Canco's capital is reorganized under section 86 or on a tax-deferred share-for-share exchange under subsection 85(1) or section 85.1. On a section 51 conversion pursuant to a conversion feature, there is no disposition for the non-resident. However, the CRA says that the Canco purchaser acquires shares that are TCP; the CRA will issue Canco a comfort letter stating that no withholding is required and that interest and penalties do not apply.

An amalgamation does not require a certificate; but a foreign merger does, unless it results from a tax-free reorganization in another country, generally including a merger or combination of two or more non-Canadian-resident corporations to form one non-resident corporation (subsection 87(8.1)). If the applicable corporate law provides for a continuation-type merger (see *Black and Decker*, [1975] 1 SCR 411), there is no disposition and no certificate is required (TI 2002-0169775).

A redemption or purchase for cancellation of shares in a foreign company is a disposition; if the shares are non-excluded TCP, a clearance certificate is required. A redemption or purchase for cancellation of a Canco's shares triggers a deemed dividend equal to the shares' proceeds less their paid-up capital (PUC); generally, withholding tax applies at 25 percent, or at a treaty-reduced rate of 15 percent or 5 percent if the recipient corporation holds at least 10 percent of the voting shares. However, the non-resident is deemed to dispose of the shares for proceeds less the deemed dividend; a capital gain may arise if PUC exceeds tax cost. A section 116 certificate is required.

Returns. The vendor must file a return for the taxation year of the TCP shares' disposition even if they are excluded property and no section 116 certificate was required. Any excess payment is refunded, or the security is released when all tax is paid. Expenses relating to a sale do not reduce the certificate amount but may be claimed on the tax return. A non-resident individual must file a return by April 30 of the calendar year following the disposition, unless he only had a gain from a TCP disposition; a non-resident trust must file within 90 days after the year-end; and a non-resident corporation must file within six months of its fiscal year-end, even if a certificate was obtained, on pain of penalty.

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US Tax Shelter Valuation Penalties

Treasury Circular 230, "Rules of Practice Before the IRS," was issued in revised final form on June 20, 2005. ("US Tax

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.

Published monthly

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E-mail: vmorgan@interlog.com
ISSN 1496-4422 (Online)

Opinions and Practices," *Canadian Tax Highlights*, March 2004, outlined the regulations that govern practice before the IRS and best practices relating to tax shelter opinions.)

Like the Canadian third-party civil penalties under the federal Income Tax Act and related CRA practice (*Information Circular* 01-1), the IRS sanctions can apply to business valuators as well as tax professionals and were originally inspired by tax shelter opinions and offering materials. The revised regulations are comprehensive. Regulation section 10.33 requires that if the FMV of property or the expected financial performance of an investment is relevant to the tax shelter, a practitioner may not accept an appraisal or financial projection as support for the matters claimed therein unless "(A) The appraisal or financial projection makes sense on its face; (B) The practitioner reasonably believes that the person making the appraisal or financial projection is competent to do so and is not of dubious reputation; and (C) The appraisal is based on the definition of fair market value prescribed under the relevant [US] federal tax provisions."

A practitioner who provides a tax shelter opinion analyzing the federal tax effects of a tax shelter investment must also examine the terms and conditions upon which the property was (or is to be) acquired. If the purchased property's FMV is to be established by reference to its stated purchase price, the practitioner's examination of the said terms and conditions must determine whether that price may reasonably be considered to be the FMV.

A practitioner who is associated with financial forecasts or projections relating to or based upon the tax consequences of the tax shelter offering (included in the offering materials or disseminated to potential investors other than the practitioner's clients) may rely on the opinion of another practitioner as to any or all material tax issues, provided that the former practitioner has no reason to believe that the standards vis-à-vis tax practitioners and reliance by them on other opinions are not satisfied.

The IRS Lead Development Center (LDC) is part of the IRS's Abusive Tax Avoidance Transactions unit, which accepts or rejects sanctions recommended by the IRS's National Engineering Program. That program uses specially trained IRS agents to investigate the valuator and valuation in order to provide the basis of its recommendations. The LDC may approve the penalty against the valuator; the valuator then has certain appeal rights.

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FOREIGN TAX NEWS

OECD

A status report was recently released on issues regarding the attribution of profits to a PE: (1) general issues, expected to be finalized January 2007; (2) PEs carrying on traditional banking activities, close to completion; (3) global trading of financial instruments, close to completion; and (4) PEs carrying on an insurance business, expected to be finalized by January 2007. The OECD Web site contains comments from the business community on the final chapter of the report on the attribution of profits to a PE that deals with carrying on an insurance business.

Denmark, Finland, Iceland, Norway, and Sweden

Nordisk eTax (http://www.nordisketax.net) is a new public Web site for residents of a Nordic country who have income from or assets in another Nordic country. Tax administrators collaborated on the Web site's contents to facilitate the cross-border sharing of fiscal information.

Australia

On October 2, 2005, the Australian Tax Office (ATO) released a guide dealing with the principles of and approaches to the attribution of profits to agency PEs; the guide contains examples illustrating their application to sales agencies and toll manufacturing. The guide is based on several ATO rulings and follows in part a June 2002 ATO discussion paper on profit attribution to commissionaire PEs.

France

The lower House of Parliament amended the 2006 finance bill to provide a 75 percent net wealth tax exemption on the value of nominative shares held by employees, managers, or shareholders of companies for at least six years, applicable after 2005.

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