CANADIAN TAX Highlights

Editor: Vivien Morgan, LL.B.

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Provincial Income Allocation

The CRA and Ontario Finance are scrutinizing provincial income allocation and, as a result, increasing the compliance burden faced by Canadian corporations. The CRA has made the review of provincial income allocation an audit priority, and it will form a working group to study the issue. In addition, any ruling request that involves loss consolidations among related parties must now analyze the provincial tax implications. The emphasis on provincial income allocation reflects a shift in the CRA's focus.

■ The CRA has undertaken an 18-month pilot project, the Provincial Income Allocation Audit Plan, to ensure that gross revenues earned by a Canadian corporation are allocated fairly among the provinces and territories. The project was motivated by the provincial income allocation concerns of the agreeing provinces (all jurisdictions except Alberta, Ontario, and Quebec) and by Ontario's concerns connected with its move toward a single federal–Ontario corporate tax system. A provincial income allocation audit plan must be completed as part of a regular CRA income tax compliance audit. The plan focuses on (1) details of corporate activities with respect to mergers, acquisitions, windups, and reorganizations, where and how the corporation conducts business, and its shareholders, related corporations, and intercompany transactions; (2) identifying permanent establishments (PEs) in each province (ensuring that no PEs are omitted and that those reported are PEs); (3) reconciling gross revenue and salaries and wages set out in a corporation's T2 schedule 5 to its accounting records; and (4) performing tests on gross revenue and on salaries and wages to ensure proper reporting, including full accounting for gross revenues earned in each province and the allocation of salaries and wages to the PE to which an employee is attached. The taxpayer may face reassessment if the provincial income allocation audit supports a reallocation of amounts reported on the taxpayer's T2 schedule 5.

■ At the Canadian Tax Foundation's 2005 annual conference, the CRA announced that it will create a working group of federal and provincial finance and revenue officials to review transactions that affect provincial tax bases. Targeted transactions include those involving loss consolidations and transfer pricing.

■ The CRA also said that ruling requests involving related-party loss consolidations must now analyze the provincial tax implications. The CRA will consult with a province if the transaction would materially affect the taxable income in an agreeing province. If the effect is not material or if the province involved is Alberta, Ontario, or Quebec, the CRA will forward a copy of the ruling to the province.

■ Ontario Finance is increasing its audit emphasis on transfer-pricing arrangements between entities in Ontario and related entities in other Canadian jurisdictions. This initiative was hinted at in Ontario's 2005 budget. It is intended to protect Ontario's corporate tax base if it adopts a single federal–Ontario corporate tax system.

These initiatives increase the compliance and tax-planning burdens faced by Canadian corporations. Canadian corporations must evaluate not only transfer-pricing arrangements with related companies outside Canada, but also those with related parties in other provinces and territories. Cancos must now review both the international and the interprovincial dealings with branches and PEs and must pay special attention to business activities that may inadvertently create a PE in a province or territory.

Louis Provenzano and Sheryl Mapa
PricewaterhouseCoopers LLP, Toronto

Streamlined US Sales Tax

Canadian companies that sell into the United States routinely face the challenge of complying with state and local sales tax laws: 45 states and over 7,000 local jurisdictions impose sales tax. The Streamlined Sales Tax Project (SSTP), which began in 2000, is the first substantial attempt to develop a uniform system of sales taxation in order to facilitate compliance and ultimately increase sales tax collections.

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The SSTP spawned the Streamlined Sales Tax Governing Board, which began operating on October 1, 2005, to administer the Streamlined Sales and Use Tax Agreement. The agreement adopts uniform definitions, tax bases, and sourcing rules, and it simplifies tax rate structures and administrative requirements. To date, 18 states have either fully or partially complied with the requirements of the agreement and thus qualify as participating board members.

This initiative is voluntary for taxpayers. Canadian companies that have not previously registered with member states for sales and use tax collection may choose to take advantage of a new centralized registration system and a one-year amnesty program for delinquent taxes.

The centralized registration system allows taxpayers to voluntarily register to collect sales tax for the 18 participating states. Registered taxpayers eventually must collect sales and use taxes for the 13 states that have fully complied with the agreement's requirements (Indiana, Iowa, Kansas, Kentucky, Michigan, Minnesota, Nebraska, New Jersey, North Carolina, North Dakota, Oklahoma, South Dakota, and West Virginia). Tax collection is currently optional for states in partial compliance (Arkansas, Ohio, Tennessee, Utah, and Wyoming). Registered taxpayers must begin collecting sales and use taxes 60 days after notice is given of the availability of at least one approved certified service provider (CSP) or certified automated system (CAS), depending on which method the taxpayer is using. CSPs are approved agents that can aid taxpayers in the collection and remittance process; CASs are approved software systems that taxpayers use to help with calculations.

A 12-month amnesty period, which expires in September 2006, is available for taxpayers who register voluntarily; the amnesty applies to uncollected or unpaid sales and use taxes in fully participating states for the period prior to registration. For a state that is in partial compliance, the amnesty clock will not begin ticking until the date on which the state becomes a fully participating board member. Taxpayers already contacted for audit do not qualify for the amnesty program.

Jeffrey Brown and Laura Naclerio
KPMG LLP, Toronto

Generally Worded Refund Claims

Taxpayers often draft a refund claim using broad general terms. The FC signalled in *Scott Paper* (2005 FC 1354) that this practice can backfire on the claimant.

Scott Paper manufactured paper products, including facial and bathroom tissues. When the FST was replaced by the GST on January 1, 1991, Scott Paper submitted a refund claim alleging an overpayment of FST on exempt sales. The total refund claim was about $2.8 million and was filed on a protective basis. In 1999, and following a substantive decision in an unrelated but precedentially binding case, the minister instituted a "desk audit" to verify Scott Paper's documentation and concluded that a significant portion of the refund claim should be disallowed. Scott Paper then asked the minister to consider a previously unclaimed refund of taxes paid in error on bathroom tissue as part of the original refund claim: the total of this new claim and the allowed amounts in the original claim still fell within the $2.8 million originally claimed.

A notice of decision allowed only $1.6 million on facial tissue, and denied the entire claim with respect to bathroom tissue: the original refund claim did not identify bathroom tissue, and the two-year time limitation for making a claim had expired. Scott Paper appealed unsuccessfully to the Canadian International Trade Tribunal (CITT) and then exercised its right to a trial de novo in the FC. The FC dismissed the appeal, finding that the general wording of the refund claim did not satisfy the statutory requirements of ETA section 68 with respect to the bathroom tissue. Like the CITT, the FC said that to meet the normal limitation periods for the filing of a refund claim, a taxpayer must reasonably indicate what it is applying for and the nature of the alleged error. The statutory two-year limitation period that was part of the refund process indicated Parliament's intention to establish a degree of certainty with regard to refund claims. Proper administration of the ETA required certainty with respect to the nature and scope of the refund claimed. If the category of products that was the subject of the claim could be left indeterminate, a statutory limitation period would be effectively defeated. Generally, the courts will strive to avoid an interpretation that defeats the purpose of a provision.

The decision echoes *W. Ralston* (2002 FCT 627), in which the FC observed that ETA section 68 "commands that the 'application' state the type of goods and the nature of the error." *Scott Paper* reiterates the lesson for all taxpayers that under modern taxing legislation a refund or rebate claim (for example, for GST, income taxes, or provincial sales taxes) requires a certain degree of specificity in outlining the reasons for the claim. The case also provides the CRA with some useful ammunition for attacking "new arguments" on rebate claims. For example, an ETA section 261 rebate claim is filed for GST paid "in error" because business assets purchased on the sale of a business were non-taxable by virtue of ETA section 167 (sale of a business). It was discovered later that ETA section 167 did not apply, but the assets were nonetheless non-taxable under ETA subsection 200(3) (exempt user to exempt user). *Scott Paper* seems to indicate that a new rebate claim must be filed, and within the proper time limits.

Robert G. Kreklewetz
Millar Kreklewetz LLP, Toronto

PROVINCIAL TAX BURDENS

Statistics Canada's recently released provincial economic accounts provide detail on the 2003 total taxes paid. Once again, of the provinces, Alberta recorded the lowest ratio of taxes to gross domestic provincial product (GDPP): 24.6 percent. Quebec still had the highest, at 38.3 percent. The three territories continue to enjoy the lowest tax ratios.

The tax-to-GDPP ratio remains the most reliable of the many methods of comparing the tax burden, because it takes into account all taxes and a number of special charges, such as motor vehicle licences, profits from the sale of alcoholic beverages, and health-care premiums. The ratio provides no information on the value received for taxes paid, and it cannot show the benefit from subsidized auto insurance or utilities, a feature of many provincial budget tax comparisons. It provides an indication of the demands made by the public sector on each provincial economy.

The table shows that for most provinces the ratios vary little from year to year, except for the two major oil-producing provinces, Alberta and Newfoundland and Labrador, where the ratios dropped by two percentage points from 2002 to 2003. British Columbia's ratio dropped from 32.2 to 31.5 percent over the same period. The ratios rose in Prince Edward Island and Quebec, but by less than 0.5 percentage points each.

Taxes as a Percentage of Gross Domestic Provincial Product, 2003

	Federal	Provincial	Local	CPP/QPP	Total
NL	11.5	11.8	1.3	2.6	27.2
PE	16.7	15.1	1.1	3.7	36.6
NS	15.2	13.4	2.8	3.1	34.5
NB	14.5	13.4	1.7	3.5	33.1
QC	14.9	17.1	3.2	3.2	38.3
ON	16.1	11.7	3.8	2.9	34.6
MB	14.1	13.2	3.1	3.2	33.6
SK	12.8	12.0	3.8	2.6	31.1
AB	13.5	7.3	1.7	2.2	24.6
BC	15.0	11.3	2.1	3.1	31.5
NT	10.2	6.1	1.0	2.0	19.3
NU	12.0	4.5	0.8	2.7	20.1
YT	13.0	5.8	1.7	3.5	24.0
National average	15.0	12.3	3.0	2.9	33.2

The table also shows the relative importance of each level of government in the tax burden. On average, federal levies were equivalent to 15.0 percent of GDPP, slightly less than the 15.3 percent represented by the combined provincial and local levels. Federal taxes in the provinces ranged from a low of 11.5 percent of GDPP in Newfoundland and Labrador to a high of 16.7 percent in Prince Edward Island.

David B. Perry
Canadian Tax Foundation, Toronto

WITHHOLDING POSITION CHANGE

A recent technical interpretation (TI 2004-0099401I7) says that the 25 percent part XIII withholding tax rate applies when a Canco pays a dividend to a non-treaty-resident trust even if its beneficiary is a treaty-country resident. Thus, the CRA's position is that there is no lookthrough of the trust to allow the lower treaty rate, a change from its prior position that the lower treaty rate applies.

A 1987 TI (97052-5) dealt with the withholding tax rate on interest and dividends paid to a Bermuda trust whose beneficiaries were residents of Canada, the United Kingdom, and the United States. The CRA said that because part XIII is silent on the beneficial ownership principle, the "obligation of the Canadian payor is merely to look to the residence of the payee," and the lower treaty rate applies. In the new TI, a corporation resident in Canada (Canco) pays a dividend to a trust resident in a non-treaty country. The trustee, located in Bermuda, pays a dividend to a trust beneficiary who is resident in the United Kingdom, a treaty country. The CRA said that the payment to the trust is a payment to an individual resident in a non-treaty country because subsection 104(2) deems a trust to be an individual. Thus, the trust does not benefit from any treaty, and the applicable withholding tax rate is 25 percent under part XIII. The CRA stressed that the previous TI does not reflect its current position, but it may "look through" a trust that may reasonably be considered to be acting as an agent for the beneficiaries, and look to the beneficiaries in determining the applicable tax treaty.

Ontario budget bill. Ontario tabled Bill 18 on November 2, 2005 to enact various measures in its May 11, 2005 budget. Several amendments are made to the Ontario Corporations Tax Act (OCTA), including the introduction of retroactive GAAR amendments, corporate tax shelter rules, and restrictions on the deductibility of charitable donations following a change of control. The bill also contains amendments to the Ontario Income Tax Act, including a phase-out of the tax credit for labour-sponsored investment fund corporations.

OCTA section 5 is amended to extend its GAAR to transactions involving the misuse or abuse of regulations made under the OCTA, a tax convention or treaty with a foreign country, and any other legislation relevant in computing tax. The amendments parallel the federal amendments from the 2004 federal budget and are deemed to have come into force on December 31, 1991.

New OCTA section 56.1 essentially adopts the corporate tax shelter rules in federal section 143.2 and subsection 237.1(1) and precludes a corporation's deduction or claim for an amount relating to a tax shelter unless the corporation files an information return regarding the tax shelter with the CRA. A corporation must also reduce the amount of any expenditure that is a tax shelter investment or that is the cost or capital cost thereof by amounts for which the corporation is not fully at risk. If a corporation files its Ontario tax returns or an Ontario notice of objection for a taxation year on the basis that the federal tax shelter rules already applied in Ontario, then these amendments apply to property acquired and outlays and expenses made or incurred after November 30, 1994. For corporations that filed such returns or objections on the basis that the federal rules did not apply in Ontario, the amendments apply prospectively.

Paul Hickey
KPMG LLP, Toronto

US Tax Panel's Simplified Plans

On October 18, 2005, the US President's Advisory Panel on Federal Tax Reform endorsed two tax reform options for recommendation to the Treasury for discussion and debate purposes. The first is a dramatically different "simplified income tax" intended to lower tax rates, simplify rules, and better target a more limited group of tax subsidies. The second is a "progressive consumption tax" with a top tax rate of 30 percent for wage income; a flat 15 percent rate on interest, dividend, and capital gain income; and a 30 percent tax on corporate cash flow. Businesses may fully expense the cost of new investments. Both plans recommend the elimination of the individual and corporate alternative minimum tax (AMT). The panel will not recommend or reject an add-on value-added tax option, but its report will include detailed background information on such a proposal. At its October 11 meeting, the panel rejected a national retail sales tax as a replacement for the current income tax.

■ **Simplified income tax.** The simplified individual income tax broadens the tax base by removing some complexity, eliminating the AMT and most tax deductions and preferences, and reducing the number of individual tax brackets from six to three (15, 25, and 30 percent). All taxpayers may claim a deduction for charitable contributions exceeding 1 percent of income; distributions from retirement savings vehicles may be donated without incurring tax. The definition of employees' taxable compensation changes significantly; employer-provided fringe benefits are taxable, but in-kind benefits provided to all employees continue to be excluded. Up to 15 percent of mortgage interest paid for a primary residence may be claimed as a home credit; maximum eligible debt equals the FHA loan allowance amount. Gains on the sale of a primary residence exceeding $600,000, indexed for inflation, are taxable at ordinary income rates. The current deduction for all state and local taxes, including property taxes, is eliminated. To encourage personal savings, a four-pronged savings package is proposed: (1) "Save at Work" accounts replace employer defined-contribution plans and simplify the non-discrimination rules to ensure that they do not favour highly compensated employees. (2) "Save for Retirement" accounts replace IRAs and deferred compensation plans. Annual contributions of up to $10,000 are allowed without income phase-outs. (3) "Save for Family" accounts replace all other tax-favoured savings vehicles in the Internal Revenue Code, such as health savings accounts, flexible savings accounts, and education accounts. Annual contributions of up to $10,000 are allowed with no income phase-outs; earnings are tax-free. (4) The refundable "savers' credit" is 25 percent of account contributions up to $2,000, phased out rateably as income rises.

Full corporate integration is envisioned. Individuals may receive US-source dividends tax-free and be taxed on only 25 percent of capital gains attributable to sales of corporate stock at ordinary rates. A "clean" tax base is used for corporate tax, eliminating most or all credits and special preferences. The corporate rate is reduced to 31.5 percent and applies to all business entities, including passthrough entities such as partnerships, S corporations, and limited liability companies. Corporate AMT is abolished. Firms with less than $10 million in annual receipts are taxed on a cash basis. Small businesses with assets less than $1 million may immediately expense all business expenditures except for land and building, obviating depreciation schedules for specific assets. Medium-sized firms with assets between $1 million and $10 million enjoy a simplified depreciation system. In order to aid compliance, small businesses with annual receipts under $1 million must set up a business bank account. Banks must provide the IRS and the taxpayer with annual information reports on all such account transactions; similarly, credit card companies must provide annual information reports summarizing credit transactions of those businesses.

In the international tax arena, a territorial tax system replaces the current worldwide system. Overseas active income is not subject to US tax and may be repatriated tax-free; the foreign tax credit regime is thus eliminated, except for overseas passive income, which remains taxable. US corporate residency is determined not by the place of incorporation but by the principal place of management.

■ **Progressive consumption tax.** The progressive consumption tax is a drastic shift from the current income-based system to a consumption tax, although it stops short of a pure consumption tax owing to concerns about the distribution of the tax burden across income groups. Individual taxable income is determined in much the same way as it is under the simplified income tax, including the treatment of home mortgages, charitable contributions, and savings vehicles. Rates are 15, 25, and 30 percent, but a flat 15 percent applies to capital income (interest, dividends, and capital gains).

All companies (other than sole proprietorships) are taxed at 30 percent on cash flow. A deduction is allowed for employee compensation. Capital investment may be immediately expensed with no deduction for interest expense. Businesses losses may be carried forward.

A host of issues are unresolved, including transition and the taxation of financial services: special rules are required because the cash flow system would result in large tax losses for financial services companies.

Steve Jackson
Ernst & Young LLP, Toronto

CCPC Bonus Down and Out?

On November 23, 2005, Finance proposed to reduce income tax rates on eligible dividends in an effort to level the playing field between corporations and income trusts. The proposed enhanced gross-up and dividend tax credit mechanism for eligible dividends will theoretically, and finally, attain tax integration, regardless of whether the investor earns income indirectly via a corporate structure or directly as an income trust unitholder. The decision to increase the dividend tax credit and to not tax income trust distributions was welcomed enthusiastically on Bay Street as the income trust sector and dividend-paying companies surged ahead. The proposal may transmogrify the structuring of owner-manager compensation.

Table 1 illustrates the federal government's intent to ensure that the overall tax burden should be the same whether a corporation earns the income and distributes the after-tax amount as dividends to the Canadian shareholder, or whether the shareholder earns the income directly as a unitholder of an income trust.

Traditionally, active business income earned by a CCPC in excess of the small business limit (currently, $300,000 federally) is bonused out to the active shareholder(s) so that the excess is not double-taxed on distribution to the shareholders as dividends. Table 2 illustrates the effect of this practice.

The backgrounder accompanying Finance's press release said that "CCPCs will be able to pay eligible dividends to the extent that their income (other than investment income) is subject to tax at the general corporate rate."

Table 1 Corporation Versus Income Trust

	Large corporations		Income
	Current	Proposed	trusts
		dollars	
A) Income	100	100	100
B) Corporate tax	(32)	(32)	0
C) Distributed to individual investor	68	68	100
D) Included in individual's income	85	99	100
E) Personal income tax (46% x D)	39	46	46
F) Dividend tax credit	(17)	(32)	—
G) Net personal income tax	22	14	46
H) Total tax paid (B + G)	54	46	46

Table 2 Bonusing Down To Avoid Double Tax

	No bonus, liquidating dividend (old rules)	Bonus out to small business limit, liquidating dividend (old rules)	No bonus, liquidating dividend (new rules)
		dollars	
Income	1,000,000	1,000,000	1,000,000
Bonus	—	(700,000)	—
Subtotal	1,000,000	300,000	1,000,000
Corporate tax on first $300,000 (assume 17%)	(51,000)	(51,000)	(51,000)
Corporate tax on balance (assume 35%)	(245,000)	—	(245,000)
Subtotal	704,000	249,000	704,000
Personal tax on ineligible dividends (assume 30%)	(211,200)	(74,700)	(74,700)
Personal tax on eligible dividends* (assume 15%)	—	—	(68,250)
Personal tax on bonus (assume 45%)	—	(315,000)	—
Add: gross amount of bonus	—	700,000	—
Overall retained cash	492,800	559,300	561,050

* An eligible dividend is a dividend of net after-tax income (provided that such income was subjected to the general corporate tax rate).

Thus, the portion of a CCPC's net income above $300,000 can be distributed as an eligible dividend. Is the traditional "bonus-down" strategy—along with its inherent complexity and uncertainty—now a thing of the past?

Attaining tax integration without declaring and paying a bonus alleviates significant tax concerns. If a bonus is found to be unreasonable and a deduction is denied under section 67 while the bonus is taxed in the recipient's hands, double taxation ensues. CRA administrative guidelines have developed over the years to deal, inter alia, with the changing decisions on the reasonableness of bonuses paid from a CCPC's income, as set out most recently in *Income Tax Technical News* no. 22 (January 11, 2002). Those guidelines include requirements that the shareholder-manager who receives the bonus be (1) a shareholder of a CCPC, (2) a Canadian resident, and (3) actively involved in the CCPC's day-to-day operations; thus, uncertainty may arise at several points. Furthermore, the courts are not bound by the CRA guidelines, and a bonus may be impugned under section 67 even if the guidelines are adhered to. The CRA may also argue that the bonus was not incurred for the purpose of earning business income and deny a deduction under paragraph 18(1)(a). The full integration promise of the newly enhanced dividend tax credit may eliminate the need for the CCPC bonus-down strategy.

Paul LeBreux
Global Tax Law Professional Corporation, Toronto

Kim Moody
RSM Richter LLP, Calgary

Small Business Software Services

On November 2, 2005, Ontario introduced legislation governing the reduced rate of Ontario retail sales tax (ORST) on computer services provided under an eligible service contract. The program was first announced in the 2005 budget and was devised to allow small businesses an alternative to segregating taxable and exempt computer services and charging tax at the regular 8 percent rate. The amendments allow such services to be invoiced for a single bundled price on which tax is charged at 6 percent.

The proposal was a step forward from the complexity of the existing computer services rules and the administrative and business difficulties faced by small vendors in attempting to comply with them. The amendments establish the lower rate, but they do not provide details of who qualifies for the new rules and on what basis. Further details will likely be released early in 2006. Options include linking eligibility to revenue thresholds, such as a maximum of $200,000 per year, a level applicable to certain small business GST initiatives. Higher revenue thresholds of up to $1 million in sales might enhance access to the program for a broader range of businesses, such as those that are in a start-up or development phase and could therefore benefit the most.

The amendments refer to a requirement that vendors must be authorized by the minister to take advantage of the program, thus granting Ontario Finance greater control over the program's scope as well as the opportunity to educate applicants on both the program requirements and the ORST's application to computer services. The amendments also require that the purchaser consent to pay tax under the special method; presumably consent must be evidenced contractually, or in a separate statement or document. The requirement for purchaser consent means that an authorized vendor cannot automatically use the lower rate on a blanket basis for all its sales, but must deal with each sale and purchaser on a contract-by-contract basis. The special method cannot apply in the absence of either vendor authorization or purchaser consent.

The method will have limited application at the outset, but the evolution of the program and its degree of acceptance by industry will be interesting. Success could potentially lead to the inclusion of computer programs in the definition of an eligible supply, and perhaps to an increase in the maximum revenue threshold for authorized vendors.

Audrey Diamant
PricewaterhouseCoopers LLP, Toronto

Partnerships and EHT

Whether a partnership is a separate person is important from a commodity tax perspective. For example, is provincial sales tax (PST) payable on the acquisition of an interest in a partnership because the partners have an undivided interest in the underlying assets of the partnership, or is the interest a chose in action much like corporate shares? Similarly, is the employer health tax (EHT) payable in respect of amounts paid to a partnership composed of individuals because the partnership is transparent and merely a contractual relationship between the partners? Subject to any relevant legislation, which may define a "person" to include a partnership, the answer to these questions generally depends on whether the aggregate or the entity theory of partnerships is applied.

The Ontario Superior Court of Justice recently considered the status of a partnership for EHT purposes in *SMI Sales Inc.* (2005 CanLII 34356). The issue was whether EHT was payable on amounts paid for management services by two corporate entities, SMI Sales Inc. and Service Mold Inc., to a partnership, Service Mold Associates. The partners were two individuals whose family directly or indirectly owned the two corporations involved. EHT was payable only if the payments were "Ontario remuneration paid by an employer"; in keeping with the definitions of "employer," "remuneration," and "employee" in section 1(1) of the EHT Act, the payment to the partnership must therefore be regarded as a payment to an individual in order to attract EHT. The court concluded that EHT was not payable on the amounts paid to the partnership, saying that a partnership is a separate legal entity distinct from its members.

> It is well decided that a partnership is a legal entity, which is separate and distinct from its constituent members and therefore is not an individual. In *Re Langille et al v. Toronto-Dominion Bank* (1982) 131 D.L.R. (3rd) 571, the Supreme Court of Canada confirmed that there is indeed a distinction between "persons" and "individuals" and that the latter concept is confined to single persons and is not therefore, a partnership or firm which [has] a separate and distinct meaning from that of "individual."

The court's reliance on *Langille* for the "well decided" principle that a partnership is a separate legal entity is apparently misplaced: the relevant legislation in *Langille* specifically defined a "person" to include a partnership. (Similarly, "person" is defined in the applicable GST and Ontario PST legislation to include a partnership.) Moreover, abundant jurisprudence adopts the aggregate theory of a partnership, which effectively looks through a partnership to the various partners. However, given the scheme of the EHT Act and, in particular, its reference in section 1(1.1) to a partnership's being an employer for the purposes of paying EHT on amounts that a partnership pays out to its employees, the court's decision appears to be correct in the result. Thus, to the extent that EHT is payable by a partnership when it pays remuneration to an employee, it follows that EHT is not payable on amounts paid to a partnership.

Brent Murray
Wilson & Partners LLP, Toronto

Estate Plan After Separation

The Ontario Superior Court of Justice (OSC) in *Gaudio* (CV-05-003040-00) recently held that the separated spouse (Mrs. G) of a deceased person (Mr. G) was entitled to the proceeds of the deceased's RRSP and life insurance policy ("the plans"), even though she had signed a separation agreement that relieved her of any entitlement to share in his estate. The court said that the boilerplate clauses in the separation agreement were not sufficient to revoke Mrs. G's designated beneficiary status under the plans, and on the facts there was insufficient evidence that Mr. G intended to revoke that designation.

Gaudio is not a tax case, but it shows that an individual should revisit and update his or her estate planning shortly after significant life changes or events. An individual who undergoes a separation or divorce should seek legal advice to include special provisions in his or her separation agreement that qualify to revoke an ex-spouse's designation as beneficiary under plans such as RRSPs and life insurance policies; he or she should also remove the ex-spouse as a designated beneficiary under any plan, if that is intended.

During their marriage, Mr. G designated Mrs. G as the plans' beneficiary. In late 2004, the couple entered into a separation agreement on amicable terms: Mrs. G contracted out of her entitlement to a share in Mr. G's estate and purported to settle all claims between them. However, her designated beneficiary status under the plans was not specifically revoked in the separation agreement, and her name was not removed as designated beneficiary in the plans. Shortly afterward, Mr. G died without a will. The two were never divorced; Mr. G had never remarried, had no children, and was survived by his mother and siblings.

The issue was whether the separation agreement effectively revoked Mrs. G as the designated beneficiary of Mr. G's RRSP and life insurance policy. The OSC said that there was no specific revocation of the plans' designated beneficiary: the separation agreement's standard boilerplate clauses pertaining to claims against the estate did not operate to revoke previously made designations. In making this determination, the OSC relied on evidence showing that there was no bitterness between the spouses before they executed the separation agreement and, apart from that agreement, there was no evidence that Mr. G intended to change the plans' designated beneficiary. Jurisprudence relied on by the estate was distinguishable because it was clear in those cases that the deceased individuals had intended that the provisions of the separation agreement operate to revoke the designated beneficiary: there was evidence of bitterness between the parties, and they subsequently divorced and remarried. Furthermore, the OSC said that it is immaterial whether Mr. G left the designations intact owing to pure error or inadvertence, because the court should not speculate as to what the deceased might have done. The general boilerplate releases in the separation agreement pertained exclusively to rights against the estate, and "monies payable under the [insurance] policy do not form part of the estate." The Succession Law Reform Act provides a similar treatment for RRSP proceeds so that they do not devolve to the estate; in support of this interpretation, the OSC cited the Ontario Court of Appeal decision in *Amherst Crane* (2004 DTC 6584), which determined that a deceased's creditors were precluded from making a claim against the RRSP proceeds paid to a beneficiary. It appears from *Gaudio* that the OSC will not find that a beneficiary designation has been revoked unless clear evidence exists that the deceased intended to revoke it.

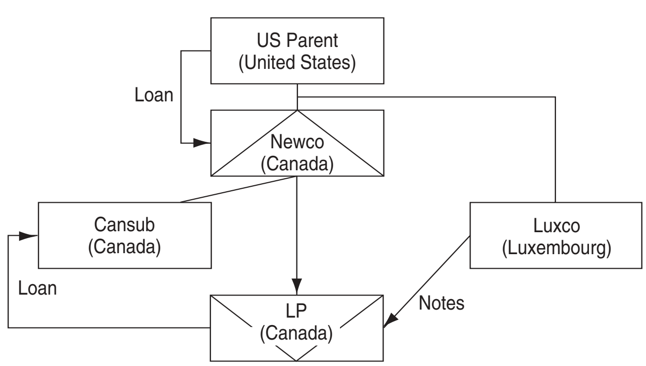
Wayne Tunney
KPMG LLP, Montreal

Thin Cap on Partnership Borrowings

A recent TI (2005-0123631R3) comments on the application of the thin capitalization rules to a Canadian partnership that borrows from a related non-resident lender. Previous TIs confirmed that subsection 18(4) does not apply to a borrowing by a partnership that has Canadian-resident partners. The CRA also said that if there is a tax motive, GAAR may apply to expose a particular transaction to the thin cap rules. The new TI takes a different approach.

On the TI's facts (illustrated in the figure below), the wholly owned Canadian sub (Canco) of US Parent had borrowed from a related Luxembourg company (Luxco) in circumstances to which the thin cap rules applied. Through a series of steps, Canco's Canadian operations had been transferred into its wholly owned sub (Cansub); Canco's shares had been transferred to a new Canadian corporation (Newco); and Canco had been wound up. The refinancing essentially involved US Parent's lending funds to Newco (in an amount subject to the thin cap limit), Newco's advancing funds as partnership capital to a partnership (LP) newly formed with Cansub, and LP's purchasing the pre-existing loans made by Luxco to Canco for cash and a note issued by LP.

Although concern existed that in arrangements like this the CRA might apply GAAR on account of subsection 18(4), the CRA's expected approach was never clear. Arguably, the CRA might apply GAAR only to the extent that a subsection 18(4) disallowance arose if the note was Newco's obligation. Although it may essentially amount to the same result (where Newco has a 99 percent interest), the CRA indicated that subsection 18(4) should apply as if each partner borrowed from Luxco its proportionate share of the note.



Also of concern is whether subsection 18(6) applies because of the back-to-back nature of the debt funding through LP to Cansub. The CRA confirmed that subsection 18(6) should not apply: LP purchased the loan to Cansub, and subsection 18(6) applies only if a loan is "made." Also arguably, subsection 18(6) should not apply even if loans were made back to back, unless the loans to LP were made on condition of an on-lending to Cansub.

Paul L. Barnicke
PricewaterhouseCoopers LLP, Toronto

SR & ED Legislative Changes

Three recent announcements affect the SR & ED program.

Finance's Economic and Fiscal Update of November 14, 2005 proposed to increase the carryforward period for investment tax credits from 10 years to 20 years, effective for taxation years ending after 2005.

The November 17, 2005 notice of ways and means motion (NWMM) contains two further changes. In *Alcatel* (2005 TCC 149), the TCC allowed the taxpayer to claim SR & ED ITCs on the amount by which the FMV of the Alcatel shares issued to its employees carrying out SR & ED exceeded the exercise price payable to the corporation. The proposal prevents a taxpayer from so increasing its SR & ED ITC claims for options issued after November 16, 2005. The NWMM's explanatory notes say that "future jurisprudence may constrain or eliminate" the ability to make such claims, perhaps signalling further court cases on the issue.

The NWMM also deals with the deadline for filing SR & ED claims. Since 1994, SR & ED claims have had to be filed within 18 months of the taxpayer's year-end in order to be valid. Over the past few years, the CRA has further increased the pressure on that deadline by tightening its administrative policy on what must be filed by the deadline before a claim is considered to be complete and therefore filed. As a consequence, some taxpayers have requested waivers of the deadline under the Income Tax Act's fairness provisions. The NWMM proposes that the minister no longer be able to waive the 18-month rule for claims filed after November 17, 2005.

Kenneth J. Murray
Deloitte & Touche LLP, Toronto

Non-Resident Sale of Canco

A non-resident who invests either directly or indirectly in a Canadian or foreign private or public company that holds Canadian real estate will have to deal with the Canadian tax consequences on a disposition of the shares.

■ **A non-resident owns Canco shares.** An actual or deemed disposition of Canco shares that are taxable

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Canadian Tax Foundation
595 Bay Street, Suite 1200
Toronto, Canada M5G 2N5
Telephone: 416-599-0283
Facsimile: 416-599-9283
Internet: http://www.ctf.ca
E-mail: vmorgan@interlog.com
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Canadian property (TCP) is taxable in Canada; both a section 116 clearance certificate (unless the shares are listed on a prescribed exchange or the shares are transferred under a will) and a Canadian tax return must be filed. A Quebec clearance certificate is required for Quebec-situs property unless the vendor is an individual. Shares are not TCP, and no clearance certificate is required if Canco is a Canadian public corporation and the shareholder (and non-arm's-length persons) owns less than 25 percent of any class, unless the non-resident previously transferred shares of a Canadian private company to Canco under section 51 (convertible shares), 85 (transfer to a Canadian corporation), 85.1 (share-for-share exchange), or 87 (amalgamation). Several treaties exempt capital gains on shares of listed companies, even if share ownership was 25 percent or more or there was a previous transfer of TCP; the exemption is claimed on a Canadian return.

Canco's liquidation triggers a deemed disposition at the FMV of the corporate assets; a deemed dividend to a shareholder equal to the distribution net of the shareholder's allocable paid-up capital is subject to 25 percent withholding tax or a reduced treaty rate. The shares are deemed disposed of at the amount distributed less the deemed dividend, and a capital gain arises if the proceeds exceed the shares' tax cost. A section 116 certificate is required. A deemed dividend also arises on a redemption or purchase for cancellation of the shares, and 25 percent withholding tax (or a reduced treaty rate) applies. A deemed disposition occurs at the amount distributed less the deemed dividend. A clearance certificate is required for non-listed shares (and a certificate is required in Quebec for property located there). A deemed disposition occurs on the shareholder's death, on a transfer from a non-resident trust to a beneficiary, on a seizure by a creditor, and on a share reorganization or merger that is not a tax-deferred transfer. No section 116 certificate is required on death, on a section 51 conversion, or on an amalgamation. The exercise of an option or warrant to acquire Canco shares is a disposition of TCP; a section 116 certificate is required, as is a return if the non-resident vendor is not an individual.

■ **A non-resident owns a Foreignco that owns Canadian real estate.** Shares of the foreign Holdco are TCP if they are not listed and, in the 60 months before disposition, (1) more than 50 percent of Holdco's property's FMV is TCP and (2) more than 50 percent of the disposed-of shares' FMV is derived from Canadian real estate. If the class of shares sold is listed, the non-resident and non-arm's-length parties must have owned at least 25 percent of the issued shares of any class in the previous 60 months (or previously transferred to Holdco TCP shares) and must meet the tests in points 1 and 2 above. There may also be treaty relief. Canada may characterize as a corporation a foreign hybrid or transparency. If the Holdco shares are TCP, the non-resident is taxable in Canada and must file a Canadian tax return. Unless the shares are listed or deemed disposed of on death, a section 116 clearance certificate (and a Quebec certificate, if applicable) is required. Practical enforcement issues arise if the shares are transferred to another non-resident.

A redemption or purchase for cancellation, a gift, or a liquidation, merger, or corporate reorganization of Holdco shares is a deemed disposition. In contrast to the treatment of Canco shares, there is a capital gain and no deemed dividend on the redemption. A foreign share-for-share exchange or a foreign merger may not be taxable under subsection 85.1(5) or 87(8) or if the merger is of a continuance type. A foreign reorganization of capital may not be taxable under section 86.

Under the Canada-US treaty, a US resident (other than an LLC that does not elect to be treated as a corporation) is not taxable in Canada on a disposition of Holdco shares; a section 116 certificate is required if the shares are not listed. For example, the treaties with Germany and Switzerland only permit Canada to tax the sale of shares of companies resident in Canada.

(Next month's issue will deal with a non-resident that owns a foreign holdco that owns a Canco.)

Jack Bernstein
Aird & Berlis LLP, Toronto

FOREIGN TAX NEWS

United States

The IRS will appeal the Tax Court's holding in *Xilinx* (125 TC no. 4 (2005)) that the IRS cannot reallocate under Code section 482 amounts related to a company's issuance of stock options to its foreign subsidiary's employees who are developing intangibles under a cost-sharing agreement.

Maria Mavroyannis
Canadian Tax Foundation, Toronto