CANADIAN TAX *Highlights*

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Privilege: Limited Waiver

Until the recent Ontario Superior Court of Justice decision in *Philip Services* (2005 CanLII 30328) it was not clear whether in Ontario the provision of privileged documents to a corporation's auditors constituted a general waiver of the privilege. Two prior cases came to different conclusions.

In *Cineplex Odeon* ((1994) 114 DLR (4th) 141), the Ontario Court (General Division) concluded that privilege was lost when privileged documents were provided to the corporate auditor: the taxpayer must therefore provide those documents to the CRA. Two years later, the FCTD came to the opposite conclusion in *Interprovincial Pipe Line* (1995 CanLII 3542) and denied the CRA access to the documents. The court distinguished *Cineplex*, in which the taxpayer expressly limited its waiver of privilege by stating that it was providing documents to its auditors for the purposes of the audit only. *Philip* answers two questions left by *Interprovincial*. At least in Ontario, it is now clear that providing privileged documents to one's auditors in compliance with a statutory audit obligation is not a general waiver of the related privilege. Whether or not the limitation is expressly made, the limitation applies as against any third party seeking disclosure, including the CRA.

Philip Services launched a public offering in 1997. Prior to filing its prospectus with the OSC, Philip learned that one of its executives had embezzled company funds. On the basis of legal opinions it obtained, it did not disclose that fact in the prospectus. At a January 1998 audit committee meeting, the chair directed Philip to provide copies of the legal opinions to the auditors and the committee. Philip complied. Two months after the public offering, Philip's shares dropped dramatically; the shares were delisted and Philip sought bankruptcy protection. In May 1998, the OSC began investigating the prospectus disclosure's adequacy and demanded that Philip and its auditors produce the legal opinions. The auditors complied, but Philip challenged the auditors' disclosure, claiming solicitor-client privilege.

The OSC argued, primarily on the basis of *Cineplex*, that Philip had completely waived its privilege by voluntarily giving the legal opinions to its auditors: privilege was also waived for two of the legal opinions obtained from the auditors when the OSC included excerpts in its statement of allegations against Philip. Alternatively, the OSC said that if limited waiver existed it must be express. Furthermore, the OSC said that it would be against public policy to allow a company to claim privilege on information or documents provided to its auditors, who could then not disclose any wrongdoing or fraud disclosed therein.

A number of SCC decisions established a "minimal interference" rule that directed a restrictive interpretation of any legal authority to interfere with privilege. The court held that the legal opinions were provided to the auditors in that capacity and for the purposes of the audit only; it would be contrary to the jurisprudence to extend that disclosure to the world. The court dismissed the OSC's public policy argument: the principle of limited waiver in no way precludes auditors from disclosing privileged information or documents that they are required to disclose in fulfilling their audit role. But the auditors were precluded from disclosing such information or documents outside those parameters as they did in *Philip*. Limited waiver need not be expressly asserted when privileged documents are provided to one's auditors: "[E]ven if the statute [imposing the audit obligation on the company] did not exist, the fundamental importance of solicitor-client privilege would dictate the narrow waiver rather than the broad." The court agreed with Philip that its auditors had no authority to waive privilege in respect of the legal opinion: "[P]rivilege can only be waived by the party (client) owning it or his agent, not by strangers." Philip could not be blamed for unauthorized disclosures by its auditors, and the auditors' mere possession of the legal opinions did not constitute waiver; for the same reasons, privilege was not waived on the two legal opinions excerpted in the OSC's statement of allegations.

In the result, the court held that giving the legal opinions to Philip's auditors did not constitute an unlimited waiver of the related privilege. Thus, the OSC could neither use nor rely upon those opinions in the course of investigating Philip, even though the contents of the documents had been disclosed by the auditors.

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In This Issue

Rectification Petition Notice

Rectification orders are usually sought ex parte in a provincial superior court, but provincial court rules require that notice of the proceedings be given to any person whose interest may be affected by the rectification order. When is the CRA such a person, and what is the CRA's interest? Lack of notice may be sufficient grounds for having an ex parte order set aside.

Practical considerations may dictate that a taxpayer give the CRA notice of a rectification application—for example, if the CRA's cooperation is required to reassess for prior years; if commercial reasons require the CRA's assurance that it will not later apply to set aside the order; if the error in documents turns up in the course of a CRA audit; or if the CRA has already issued an adverse ruling in respect of a transaction. Arguably, however, the need to involve the CRA does not necessarily mean that its interest may be affected by the order.

In 2001, the CRA said that it would proceed to contest the resulting order in provincial court if it was not given notice of a rectification application, implying that the CRA considered itself to be a person with an interest that would be affected by any tax-related rectification order. The CRA did not identify the nature of that interest. Recently, the CRA retracted that policy and said that it will challenge orders only in situations that it believes are abusive. The CRA thus accepts that it will not always receive notice of rectification applications, but it did not clarify whether it still believes that it has an interest in such proceedings and should therefore receive notice. The courts have reached different conclusions on whether an application could proceed ex parte.

■ In *Razzaq Holdings* (2000 BCSC 1829), a section 85 rollover was improperly implemented; the directors passed a resolution to transfer shares that were not outstanding at the time. A petition was brought for a rectification order pursuant to section 206 of the British Columbia Company Act and the equitable jurisdiction of the court. Section 206 provided that where errors or omissions cause, inter alia, a breach of the act's provisions, the BC Supreme Court may make a rectification order, but must consider its effect on, inter alia, creditors. The court concluded that the CRA was not a creditor as a result of the improperly implemented rollover and thus its interests need not be considered. Section 203 allowed the application to be made ex parte unless the court directed that notice be given: presumably the court did not consider the CRA to be a person with an interest that may be affected because it allowed the hearing to proceed ex parte.

■ In *Prospera Credit Union* (2002 BCSC 1806), in an amalgamation structured to produce significant tax savings, the transfer of property to a subsidiary was not carried out as intended, and thus the tax saving was jeopardized. Section 107 of the Credit Union Incorporation Act provides that where errors or omissions may cause, inter alia, a default in compliance with the credit union's constitution, the BC Supreme Court may make a rectification order to correct the problem. Section 203 of the British Columbia Company Act, incorporated by reference, directed that notice of the application need be given only if the court so directed. Counsel made submissions to assure the court that there was no one whose interest might be affected by the order, pointing out that the CRA was not a creditor and would not become a creditor if the petition was denied. If the petition was granted, the CRA's "interest [would] not be affected other than losing an unexpected windfall." The court allowed the hearing to proceed ex parte.

■ In *Snow White Productions* (2004 BCSC 604), a rectification order was sought after a CRA ruling that a production was not eligible to qualify for federal and provincial tax credits. The taxpayer gave notice to the CRA. In obiter, the court made the very broad statement that notice to the CRA was appropriate because the taxpayer sought to rectify a transaction designed to either avoid tax or access tax incentives.

■ In *Columbia North Realty* (2005 NSSC 212), the petitioner sought to rectify its share register, articles, and directors' resolutions in order to return paid-up capital to a shareholder. The court directed that the CRA be given notice because the effect of the rectification order would be to reduce tax in prior years. That conclusion was based on what appears to be a misreading of *Dale* ([1997] 3 FC 235 (FCA)).

> The order sought affects the tax payable . . . in previous years. An order of this Court would be binding on all, including the Minister of National Revenue, unless appealed. It is appropriate the Minister be given notice of the application in order to have an opportunity to make submissions to the Court. As Robertson, J.A. stated in *Dale v. R.* at p. 259:
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> > It seems only logical that a court would decline the invitation to grant a retroactive order which has the clear legal effect of rewriting fiscal history . . .

In fact, that passage in *Dale* was responding to the CRA's concerns about the abuse of the doctrine of rectification; the court was pointing out that a court hearing an application for rectification is quite capable of recognizing whether the petitioner is attempting to abuse the doctrine by claiming to have had an original intention that he did not in fact have. The court was not suggesting that the CRA must be given notice of a rectification application.

The cases do not expressly analyze when the CRA has an "interest that may be affected." *Razzaq* and *Prospera* impliedly reach the conclusion that unless the CRA is a creditor of the taxpayer seeking the rectification order, the CRA does not have an interest that is affected. Obiter comments in *Snow White* suggest that the CRA has an interest whenever the taxpayer is trying to minimize tax payable, and *Columbia North* said that the CRA should be given notice when an order would reduce tax in prior years.

If one disregards the obiter comments in *Snow White*, these cases can perhaps be reconciled on the basis that when the CRA is a current creditor or will become a debtor of the taxpayer if a rectification order is granted, the CRA has an interest that may be affected by the order and should receive notice. Such a conclusion would be consistent with findings by superior courts that an individual has standing to apply to set aside or vary an ex parte order when his or her legal rights or interest in property are affected. "A tribunal which is by law invested with power to affect the property of one of Her Majesty's subjects, is bound to give such subject an opportunity of being heard before it proceeds" (*Vancouver Tax Sale* (1901) 9 BCR 572).

The court in *Ivandaeva Total Image* (2003 CanLII 43168 (Ont. CA)) held that a person may apply to set aside or vary an ex parte order if the order "directly affects the rights of [that person] in respect to [its] proprietary or economic interests." Similarly, the court in *1224948 Ontario Ltd.* ([1999] OJ 753) found that a person is affected by an ex parte order "if his or her legal rights are interfered with or rendered uncertain by the existence of a judgment or order obtained without notice."

Furthermore, a court may bypass the question of whether a person's interest is affected by setting aside an ex parte order on its own motion because there is evidence that the order was obtained by non-disclosure or fraud.

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EC Cross-Border Loss Relief

On December 13, 2005, the European Court of Justice (ECJ) released its decision in *Marks & Spencer* ([2005] EUECJ C-446/03). The ECJ said that cross-border loss relief in an affiliated group of EU companies should be allowed, but only if the loss subsidiary has exhausted all possibilities in its country of residence for using the losses.

Marks & Spencer, the UK parent of a retail business conglomerate operating throughout Europe, had Belgian, French, and German subsidiaries with substantial trading losses that were claimed for UK group relief purposes against the UK consolidated group's profits. The UK tax authorities said that there was no offset for losses incurred by non-UK-resident subsidiaries that had never traded in the United Kingdom. The Special Commissioners dismissed an appeal; a further appeal to the UK High Court of Justice was stayed, and specific questions were referred to the ECJ. The ECJ was asked to determine whether the UK group loss consolidation regime was compatible with the "freedom of establishment" principle in the EC treaty.

The ECJ indicated that the UK group loss consolidation regime provided a tax advantage for the companies concerned, but access was denied to subsidiaries that were incorporated in other EU countries and that did not conduct UK trading activities. The regime restricts freedom of establishment: it results in the different tax treatment for losses incurred by a UK-resident subsidiary. Such a restriction is permissible only if it (1) pursues a legitimate objective compatible with the EC Treaty, (2) is justified by imperative reasons in the public interest, and (3) does not go beyond what is necessary to obtain that objective. The court concluded that the restriction satisfied the first two criteria, but was potentially too broad. Cross-border group loss relief claims should be allowed if two conditions are satisfied: (1) the non-resident subsidiary has exhausted all possibilities available in its country of residence to have the losses taken into account (if necessary by transferring the losses to a third party or by offsetting the losses against profits made by the subsidiary in previous periods); and (2) there is no possibility of the subsidiary's losses being taken into account in its country of residence for future periods, either by the subsidiary itself or by a third party, in particular where the subsidiary has been sold to that third party.

Whether the Marks & Spencer group can claim cross-border group relief must be decided by the UK courts on the principles set out in the ECJ decision. The ECJ did not specifically refer to other cross-border group relief or loss relief situations, but similar principles should apply. Practically speaking, it may be difficult to determine in any situation whether there is any possibility of using the losses in the subsidiary's country of residence. Further clarification may be required. As a result of the ECJ decision, companies will need to assess the viability of claims already made and whether to pursue new claims; the ECJ decision will likely limit the claims that will ultimately succeed.

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International Tax Comparisons

The OECD's annual publication, *Revenue Statistics*, shows little change in Canada's tax burden in relation to the other 30 OECD members. Provisional 2004 data indicate that Canada's ratio of tax collections to GDP, 33.0 percent,

Total Tax Revenue as a Percentage of Gross Domestic Product, 2002 to 2004

	2002	2003	Provisional 2004
France	43.4	43.4	43.7
Italy	42.5	43.1	42.2
United Kingdom	35.6	35.6	36.1
Germany	35.4	35.5	34.6
Canada	34.0	33.8	33.0
United States	26.3	25.6	25.4
Japan	25.8	25.3	na
G7 average (estimated)	34.7	34.6	na
OECD average	36.4	36.3	na
OECD Europe	29.1	29.3	na

na—not available

ranked 18th highest, well under Sweden's 50.7 percent (the highest). The table summarizes results for the G7 countries.

Canada's ratio declined by approximately 2.6 percentage points from 2000 to 2004, faster than the OECD average from 2000 to 2003, but was outstripped by the US ratio, which dropped more than 4 percentage points. The gap between the US and Canadian ratios remains significant, and has changed only slightly in the past 20 years. In 1985, our ratio was 32.5 percent; the comparable US figure was 25.6 percent.

These overall ratios represent a rough picture of the relative importance of the public sector in national economies, and say nothing about the burden of specific taxes. The main categories as shown in the OECD publication include personal and corporate income taxes (46.0 percent of Canadian and 43.3 percent of US tax sources), social security levies (15.4 percent of Canadian and 26.4 percent of US tax sources), taxation of goods and services (26.1 percent of Canadian and 18.2 percent of US tax sources), and taxes on property (10.0 percent of Canadian and 12.1 percent of US tax sources). Only five OECD members rely on taxes on property for 10.0 percent or more of total tax collections; the other three are Korea, Japan, and the United Kingdom.

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Partnership Income Allocated

In *West Topaz Property* (sub nom. *XCo Investments Ltd. v. The Queen*) (2005 TCC 655), the TCC dealt with a partnership of two partners that admitted an arm's-length partner with accumulated non-capital losses immediately before selling property. The new partner was allocated 80 percent of the sale-related income. The TCC reallocated the income to the original partners under subsection 103(1), saying that their predominant purpose behind the transactions was to save tax and that the income allocation was not reasonable. Bowman CJ also offered some interesting obiter comments on GAAR.

The two original partners were West Topaz (99 percent) and XCo (1 percent). The partnership owned two apartment properties. In anticipation of the sale of one property and several days before receiving the offer, the partnership placed an unregistered mortgage on the target property to reduce its net equity value by $5 million. Three days later and for $1.3 million, the partnership admitted a new partner, Woodwards, a retailer with substantial non-capital losses. Woodwards' participation was limited to the target apartments, and it had an 80 percent interest in the partnership. (West Topaz and XCo were reduced to 19.8 and 0.2 percent, respectively.) The partners were to share in the proceeds of the apartments' sale in proportion to their interests. Woodwards could withdraw within a period of 180 days and receive a return of its capital contribution and its share of operating income if it withdrew after the partnership's year-end following the sale. At its April 30, 1993 year-end, the partnership allocated to Woodwards $5.8 million income related to the apartments. Woodwards had delivered its withdrawal notice shortly after joining the partnership in March 1992, and it actually withdrew in May 1993.

On assessment, the CRA reduced the partnership's allocation of income to Woodwards to zero and reallocated all the income to the two original partners. Although the CRA had apparently conceded after assessment that Woodwards was a partner, the TCC said that the legal relations created by the taxpayer's documents were not shams and were genuine and legally effective. The TCC said that an analysis of the transactions must begin by asking what the situation would have been if Woodwards had never been involved. The $5 million mortgage was apparently required to assure Woodwards' participation; without the mortgage and Woodwards, there would have been a straightforward sale for $11 million and an allocation of the profit to the original partners proportionate to their partnership interests.

Woodwards paid $1.3 million for its partnership interest and received cash of $1.8 million, the difference being its profits for the use of its tax losses. From the standpoint of the original partners, the predominant purpose of the transactions was to save tax: they paid $500,000 to save tax on about $5.8 million on the sale. The TCC said, "The motivation is obvious. I have been unable to identify any other commercial or non-tax purpose." In contrast, Woodwards had no tax motivation—it had no tax to pay and none to save; the transactions were purely a business proposition. Woodwards' contribution was brief and, for all practical purposes, risk-free—a transaction that the TCC concluded fell squarely within subsection 103(1). Under that rule, if the principal motivation for an allocation of partnership profit may be reasonably considered to be the reduction or postponement of tax, the share of each partner's partnership income is the amount that is reasonable having regard to all the circumstances. A reasonable allocation to Woodwards was the amount it actually received—$500,000—an amount more in keeping with the true economic reality of the arrangement. As a result, the TCC ordered the CRA to reassess on the basis that the amount reallocated under subsection 103(1) to the taxpayers be reduced by $500,000, the amount reasonably allocable to Woodwards.

On the GAAR issue, the TCC agreed with the CRA that section 245 should apply only if its first two arguments failed (that no partnership existed and that section 103 applied) because section 245 is a provision of last resort. Subsection 103(1) dealt with the alleged tax avoidance; as a specific provision, it prevailed over the general section 245 rule. Although GAAR did not apply, the TCC made two observations applicable to section 245 and possibly to section 103. "Reasonable" is a relative term that depends on all the circumstances, but its determination is clearly not a discretionary act on the minister's part "either in the decision to apply it or in the determination of its consequences." The court is thus not fettered by the rules for reviewing a discretionary act. Furthermore, "anti-avoidance sections such as 103 and 245 are not intended as a means of punishment for offending the Minister's olfactory sense . . . where a specific anti-avoidance section covers a transaction but . . . in the Minister's view [its] remedy [is not] sufficient, section 245 is not there to permit the Minister to top up the remedy that [he] believes to be inadequate."

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US-Sales LLC

A Canadian company selling into the US market may find that its customers prefer to do business with a US entity. An LLC may be a preferable vehicle to the traditional subsidiary for both US federal and state tax purposes.

A Canco that sells goods to US customers and has no US PE can make sales in Canada, or in the United States through independent agents acting in the ordinary course of business or through employees with no authority to conclude contracts in Canco's name. If a US subsidiary's business is effectively conducted by Canco, it is likely to have a PE in and be taxable in Canada; to avoid double taxation, it must obtain a foreign tax credit on its US return for the Canadian tax. Without a US PE, the subsidiary's ability to generate exempt surplus may be impaired (regulation 5906(1)(a)). If Canco sets up a wholly owned US limited liability company (USLLC) to purchase the goods from Canco and sell them to US customers, USLLC is a disregarded entity for US federal income tax purposes: all of USLLC's income is considered earned by Canco, which is treaty-relieved from US tax on business profits not attributable to a US PE. For Canadian tax purposes, USLLC is likely a Canadian resident under the common law and taxable in Canada on worldwide income, a result similar to the income's being taxed in Canco.

The US state tax analysis is more complex. Under Public Law 86-272, states cannot impose income tax on an out-of-state entity engaged in interstate commerce if its activities in the state consist only of solicitation of orders for sales of tangible property, the orders are sent outside the state for acceptance, and any accepted orders are shipped from outside the state. The majority of states mirror the federal treatment of wholly owned LLCs as disregarded entities for income tax purposes. USLLC's sales are considered made by Canco and are thus foreign, not interstate, commerce and are generally ineligible for the protection of PL 86-272. However, 25 states have adopted a position of the Multistate Tax Commission and agreed to apply PL 86-272 to foreign commerce. For sales to other states, Canco must examine the nexus rules of each state to determine whether state income tax applies. Even if nexus exists, Canco may be effectively treaty-exempt from state income tax, if the state's computation of income starts with federal taxable income and does not add back treaty-exempt income. In the few states that treat wholly owned LLCs as separate taxable entities, USLLC's sales should be interstate commerce and protected from state income tax under PL 86-272.

PL 86-272 does not shield against the obligation imposed on vendors by most states to collect and remit sales taxes. The majority of states treat a wholly owned LLC as a separate taxable entity for sales tax purposes, and thus nexus for sales tax purposes is determined at the USLLC level. In those states, USLLC's sales to a US customer should be interstate commerce protected by the commerce clause of the US constitution. The US Supreme Court has interpreted that clause as prohibiting states from requiring out-of-state vendors to collect sales taxes, as long as they have no physical presence in the state (*Quill Corp. v. North Dakota*, 504 US 298 (1992)).

In the few states that disregard USLLC for sales tax purposes, nexus is determined at the Canco level; Canco's sales are foreign rather than interstate commerce and are ineligible for the commerce clause's protection. Canco must look to the constitution's due process clause for relief from the requirement to collect sales taxes. *Quill* established such a low threshold for nexus that an out-of-state vendor that purposefully avails itself of the benefits of a market in a state generally has a sufficient link to justify taxation under the due process clause, regardless of whether it has any physical presence in the state. If this threshold is met, and the state disregards USLLC for sales tax purposes, Canco must likely collect and remit sales taxes.

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Final and Temporary PFIC Regs

On December 8, 2005, the IRS issued final (TD 9231), temporary (TD 9232), and proposed (REG-133446-03) regulations providing guidance for taxpayers that continue to be subject to the passive foreign investment company (PFIC) excess distribution regime of Code section 1291 because the foreign corporation in which they own stock used to be a PFIC under section 1297(a) or (e). The regs provide elections to purge the PFIC taint and are effective for tax years beginning after December 8, 2005; taxpayers may elect to apply the final regs to a prior taxable year if the limitation period for assessment has not expired. The text of the temporary regs also serves as the text of the proposed regs.

■ **Final regs purge taint of former PFIC.** A foreign corporation is a PFIC if it satisfies an income test (at least 75 percent of the taxable year's gross income is passive income, such as dividends and interest) or an asset test (of its assets held during the year, at least 50 percent—which, depending on the circumstances, is based on FMV or adjusted basis—produce passive income).

A US person who has not made a QEF election is not taxed currently on a PFIC's income but is taxed on certain excess distributions received, including (1) gains on the sale or deemed disposition of PFIC stock, and (2) actual PFIC distributions received in the tax year exceeding 125 percent of the average actual distributions received in the preceding three years. An excess distribution is allocated rateably to each day in the US person's holding period. Amounts allocated to the current year and any pre-PFIC holding period are taxed currently as ordinary income; other amounts allocated to the PFIC period are subject to tax at the highest ordinary income tax rate, plus an interest charge to reflect the tax deferral. A timely QEF election avoids the excess distribution regime, and the US person is taxed currently on the PFIC income.

The new final regs allow specific relief elections for certain US persons who have not made QEF elections but continue to be subject to the PFIC excess distribution regime even though the foreign corporation no longer satisfies the PFIC income and asset tests. With minor changes, the final rules adopt temporary regs that were issued in 1988, were amended in 1998, and expired on January 2, 2001.

If at any time during a shareholder's holding period, a foreign corporation was a PFIC (but not a QEF), the stock retains its character as PFIC stock, even if the corporation ceases to be a PFIC under the income and asset tests, unless the shareholder elects to purge the PFIC taint under rules similar to the QEF rules (Code section 1298(b)(1)). After so electing, the taxpayer shareholder is treated as having sold its stock in the foreign corporation on the termination date, the last day of the corporation's last tax year during which it was a PFIC. After the election, the stock is not PFIC stock.

The final regs describe the time and manner of the deemed-sale election. Under the prior temporary regs, the shareholder could elect by filing an amended return for the tax year that included the termination date; the final regs allow an election without the filing of an amended return if an election can be filed by the due date of the shareholder's original return for that tax year. The election is made on form 8621 ("Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund") and is filed with the shareholder's return for the election year. If the election year is closed, the PFIC taint cannot be purged under the final regs, but the new temporary regulations may provide relief via a late purging election, with the IRS's consent.

■ **Temporary regs purge taint of Code section 1297(e) PFIC.** The new temporary regs allow a shareholder of a foreign corporation to make a deemed-sale (or deemed-dividend) election when Code section 1297(e) applies. Under that rule, a foreign corporation generally is not a PFIC vis-à-vis a shareholder if it is a CFC and, during the post-1997 holding period, the shareholder owned at least 10 percent of the corporation (a Code section 1297(e) PFIC). Under the temporary regs, such shareholders and shareholders of former PFICs may, with the IRS's consent, make late deemed-sale purging elections, which in some respects differ from QEF elections. The gain on a QEF-election deemed sale is taxed as an excess distribution received by the shareholder on the qualification date, defined as the first day of the PFIC's first taxable year as a QEF. Under the temporary regs, the deemed excess distribution is received on the CFC qualification date, which is the first day the PFIC becomes a CFC. The term "post-1986 earnings and profits" under the QEF regs means certain undistributed earnings and profits as of the day before the qualification date. The temporary regs define the term in relation to the day before the CFC qualification date, which, unlike the QEF qualification date, may be other than the first day of the taxable year.

The deemed-sale election must be made by filing form 8621 in the shareholder's original return for the tax year that includes the CFC qualification date, or in an amended return for that year that is filed within three years of the original due date. The gain is reported as an excess distribution, and tax and interest must be paid with the return.

The temporary regs address the "once a PFIC, always a PFIC" taint by providing that shareholders of a former Code section 1297(e) PFIC—and a former PFIC for which the election year is closed—may make a late deemed-sale election to purify the stock with the IRS's consent in certain circumstances. The taxpayer must enter into a closing agreement to eliminate any prejudice to the US government's interests as a consequence of the taxpayer's inability to file an amended return and must also complete and file form 8621-A ("Return by a Shareholder Making Certain Late Elections to End Treatment as a Passive Foreign Investment Company"), released by the IRS in December 2005.

It is not unusual for a Canadian corporation to inadvertently become a PFIC with respect to US shareholders by, for example, selling significant assets or raising capital through a public or private offering in a taxable year. Once the corporation becomes a PFIC, it remains a PFIC until the taint is purged by a QEF or deemed-sale election. These new regulations may provide some relief to US investors by allowing late elections. The excess distribution regime is extraordinarily harsh, and a purging election should always be considered for US investors in PFICs or former PFICs that failed to make a QEF election.

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CGE Monetization Not GAARed

The TCC GAAR decision in *Evans* (2005 TCC 684) is one of its first since the SCC decisions in *Kaulius* (2005 SCC 55) and *Canada Trustco* (2005 SCC 54). As part of a capital gains exemption (CGE) monetization strategy, the taxpayer in *Evans* entered into a series of transactions with a partnership (of which his wife and children were partners) and his professional corporation. The TCC said that the CRA had not adequately identified a misuse or abuse of the Act; each section the taxpayer relied on was used for its intended purpose, and thus there was no abuse of the Act. The TCC relied heavily on the principles set out by the SCC in *Kaulius* and *Canada Trustco* for applying GAAR, particularly the seven-step approach in *Canada Trustco*.

Since 1978 Dr. E, a dentist, operated his dental hygiene business through a wholly owned professional corporation (Doctorco), which was a CCPC and a qualified small business corporation for the purposes of the CGE. Dr. E was Doctorco's sole director and owned all its outstanding class A shares. In November 1996, Mrs. E and the three children formed a limited partnership under a written agreement. Mrs. E was the general partner and was entitled to a 1 percent interest of partnership income. As limited partners, the children were each entitled to a 33 percent interest. On December 2, 1996, Doctorco paid Dr. E a stock dividend of class B shares, with a declared amount of $100: the class B shares thus had an ACB and PUC of $100. The shares were entitled to receive dividends at the discretion of the director (Dr. E) and were redeemable and retractable for $487,000. On December 3, 1996, Dr. E sold his class B shares to the partnership for $487,000, via a promissory note with annual interest at 5 percent (the CRA's then prescribed rate) and thus triggered a capital gain of $486,900 ($487,000 less $100). Dr. E eliminated the related tax liability by claiming a capital gains deduction. From then and into 1999, Doctorco paid about $267,000 by way of dividends on and redemptions of the class B shares to the partnership, which used the funds to make principal and interest payments on the note to Dr. E. Mrs. E and the children reported annually their proportionate shares of the partnership net income (actual and deemed dividend income less interest expense on the note). Dr. E reported annually the interest income on the note.

The CRA argued that the whole series of transactions was a surplus strip that misused certain provisions and abused the Act as a whole. Under GAAR, the CRA recharacterized as dividends the $267,000 of principal and interest payments to Dr. E (including interest income that he had already reported) from the partnership.

The TCC said that the CRA had not met its burden to show that the "object, spirit and purpose of the various provisions relied on have been defeated or frustrated" before GAAR could apply. Treating the transactions as abusive would destroy certainty, predictability, and fairness in the application of tax legislation, and would frustrate Parliament's intention that taxpayers "take full advantage of the provisions of the Act that confer benefits." The TCC focused primarily on the three prerequisites to establishing the application of GAAR, which is the first of the seven steps set out in *Canada Trustco* by the SCC.

Tax benefit. The TCC quickly concluded that a tax benefit arose from the series of transactions: if Dr. E had simply received a $267,000 dividend from Doctorco, he would have paid tax on it, but no tax was paid under the arrangement.

Avoidance transaction. The series is an avoidance transaction if it could "reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit." The TCC did not decide the matter but assumed that the arrangement was an avoidance transaction.

Abusive tax avoidance. The series of transactions constitutes abusive tax avoidance if it cannot be reasonably concluded that a tax benefit would be consistent with the object, spirit, or purpose of the provisions relied on. The court must determine whether the series would result directly or indirectly in a misuse of the provisions of the Act or an abuse of the Act read as a whole. The TCC said that the arrangement was not abusive tax avoidance because the provisions of the Act were used "for the very purpose for which they are in the Act" and "their object and spirit is to permit people to do exactly what was done here." There cannot be an abuse of the Act's provisions when each section operates exactly as intended.

> The only basis upon which I could uphold the Minister's application of section 245 would be to find that there is some overarching principle of Canadian tax law that requires that corporate distributions to shareholders must be taxed as dividends, and where they are not the Minister is permitted to ignore half a dozen specific sections of the Act. This is precisely what the Supreme Court of Canada has said we cannot do.

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Canadian Income Deposit Securities

Canadians saw several public offerings of income deposit securities (IDSs) in 2004 and 2005, including New Flyer Industries Inc., Hot Stuff Foods Corporation, Tube City IMS Ltd., and Mini-Skool Early Learning Centres Ltd. Not all the deals have closed, but IDSs (also known as income participating securities) from Canadian issuers are now an accepted vehicle for tax-efficient acquisitions by a Canadian issuer of a US business.

The Canadian structure evolved from US IDSs Volume Services and B & G Foods, both issued by a USco, consisting of a subordinated note and a share of USco, and listed on the stock exchange. The deduction of interest paid on the debt reduced the taxable income of the operation entity. Unfortunately, the US market for IDSs did not develop, partly because the high-yield market in the United States, unlike that in Canada, is well developed.

The Canadian IDS is similar. A Canco issues an IDS unit of common shares and subordinated notes. Canco may invest in a US limited liability company (LLC) or a US C corp. Canco may own the membership interest in a US LLC that operates the business or is a partner in a US partnership owned directly or indirectly by the business's current owners. Alternatively, Canco acquires the shares of a US C corp, which forms an Alberta or Nova Scotia unlimited liability corporation (ULC). The public acquires a subordinated note of the ULC and common shares of Canco that form the IDS. The ULC invests in US C corp preferred shares.

The two alternatives exist because the interest expense must be deductible against the income of the US operating entity. If the US business is operated as an LLC or as a partnership, Canco can deduct the interest expense on its subordinated notes issued as part of the IDS on both its US and Canadian tax returns. However, if the US corporation is a C corp, then Canco does not file a US tax return and thus the public must invest in subordinated notes of a ULC owned by the US C corp. For US tax purposes, the ULC is disregarded and the interest expense on the notes is considered to be incurred and deductible by the US C corp. An IDS's components can be separated by its holder or automatically on a repurchase, redemption, or maturity of the subordinated notes, or on the issuer's change of control. Separately acquired components can form an IDS.

Canadian tax. The IDS's common shares and debt are treated as separate properties, and the price is allocated reasonably between them on the basis of FMV. On a disposition, the proceeds must be allocated and the holder will realize a capital gain or loss. The separation by a holder of an IDS into its components is not a disposition, nor is a combination into an IDS.

The US corporation (LLC or C corp) is a controlled foreign affiliate; dividends paid to Canco are included in income and deductible if paid out of the exempt surplus (generally, active business earnings earned in the treaty jurisdiction). Other dividends are paid out of pre-acquisition surplus; they are deductible in computing Canco's taxable income and reduce the US company shares' cost base. FAPI from non-active business income or passive income is included in Canco's income whether or not it is distributed and the shares' cost base is increased. Any US withholding tax on a dividend out of the US corporation (generally 5 percent from a C corp) cannot generate a foreign tax credit in Canada.

A ULC can deduct reasonable interest paid by it on the notes; any resulting non-capital loss can be carried back for 3 and forward for 10 taxation years against income, including taxable capital gains.

US tax. A non-US investor's acquisition of an IDS should be an acquisition of both common shares and subordinated notes. It is unclear whether the acquisition may be treated as the acquisition of an equity interest, allowing the note to be treated as equity; in that case, the interest is not deductible and US withholding tax applies to the payments as US-source dividends to the extent of the accumulated earnings and profits. Interest exceeding a reasonable rate is not deductible.

The IDS purchase price is allocated between the share and the note. The IRS may assert that the note's FMV is less than its stated principal and that the note was issued with an original issue discount (OID). A non-US holder owning less than 10 percent of the Canco shares benefits from the portfolio interest withholding tax exemption for any OID; otherwise, 30 percent US withholding tax applies (treaty-reduced to 10 percent for a Canadian holder). Penalties apply for failing to properly report OID.

Whether debt is treated as equity depends on a variety of factors. If the terms and conditions of the debt—including principal amount, term, interest rate, issue price, and covenants—are commercially reasonable and similar to terms that an unrelated knowledgeable non-shareholder would negotiate, the note is more likely to be debt. The issuer must demonstrate an ability to carry the debt and to refinance it on maturity. Debt treatment is also indicated if the ratio of debt to equity is commercially reasonable and the notes and shares may be separated and dealt with separately; there must be a reasonable possibility that the notes will be separated. If the IRS recharacterizes the IDS into a single debt instrument, the other US contingent payments debt instrument rules apply and create additional accrued interest income not eligible for the portfolio interest exemption.

The separation of the IDS into a share and note by a non-US holder or a combination into an IDS does not give rise to a gain or loss. The portfolio interest exemption to avoid US withholding tax on the interest also avoids US federal estate tax, on the grounds that the interest is not effectively connected with a US trade or business conducted by the holder, provided that the non-US holder owns less than 10 percent of the voting shares. Each non-US holder must complete form W-8BEN and must not be a controlled foreign corporation related to the payer corporation through stock ownership.

If a non-US holder owns 10 percent or more of the voting shares, 30 percent US withholding tax applies (10 percent for a Canadian holder). If a non-US holder engages in a US trade or business to which the interest on the debt is effectively connected, US withholding tax does not apply, but the interest income is reported on the US tax return.

Dividends paid by a C corp to the Canadian issuer out of accumulated earnings or profits are subject to US withholding tax at a 5 percent treaty-reduced rate. A foreign exchange gain or loss may arise on the payment of principal or interest on the notes, which are denominated in Canadian currency, because the functional currency for US tax purposes is US dollars.

The US inversion rules do not apply because the historic shareholders and management do not acquire any Canco shares. They may hold shares in the US company that will be redeemed.

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Dividends: Personal Tax Decrease

On November 23, 2005, Finance announced a reduction in personal income taxes on certain dividends paid after 2005. The federal government's concerns over the taxation of income trusts and other flowthrough entities instigated the change, which seeks to reduce the aggregate tax paid on dividends from Canadian corporations to approximately the level paid on distributions from income trusts. Draft legislation was not released. Taxpayers should stay tuned for any changes; it is uncertain whether and when the change will crystallize into law.

The tax reduction applies to dividends paid after 2005 by public corporations and other corporations that are not Canadian-controlled private corporations (CCPCs), that are resident in Canada, and that are subject to the federal general corporate income tax rate (22.12 percent in 2006). The reduction also applies to dividends paid by CCPCs out of non-investment income subject to the general federal corporate income tax rate—that is, active business income (ABI) over the $300,000 threshold. Thus the top federal personal income tax rate on qualifying dividends drops from 19.58 percent in 2005 to 14.5 percent in 2006, when it equals the current rate on capital gains. The reduction for qualifying dividends involves increasing the dividend gross-up (from 25 to 45 percent of dividends received) and the federal dividend tax credit (from 13.33 to 19 percent of grossed-up dividends).

The announcement notes that income subject to the general corporate tax rate is taxed in 2005 at a combined corporate and top personal tax rate of 54 percent after being distributed as dividends: by 2010, the rate drops to 46 percent if plans to reduce the federal general corporate rate to 19 percent are passed. The 46 percent rate equals the current rate on fully taxable distributions from an income trust. Thus, until 2010, the combined corporate and personal tax burden exceeds 46 percent; for example, in 2006 the combined tax rate is approximately 49 percent. Moreover, the government's objective of equalizing the taxation of qualifying dividends and income trust distributions is met only if the provinces and territories follow the federal lead and similarly reduce their personal income taxes on dividends; illustrations accompanying the federal government's announcement assume that they will. (Quebec announced on December 19, 2005 that, without further details, it will not commit to the change.)

The changes do not eliminate the tax deferral advantage of income trusts for pension plans, registered retirement savings plans, and other tax-deferred plans. Dividends received by a tax-deferred plan are generally paid out of income that has been subject to corporate tax, but a

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distribution from an income trust to a tax-deferred plan is not taxed until the plan makes distributions to its beneficiaries. In September 2005, the federal government announced that advance tax rulings respecting flowthrough entities (including income trusts) were postponed pending consultations on this issue. The November 23, 2005 announcement states that this moratorium has been lifted.

A CCPC must determine whether the dividends it pays are derived from investment income, ABI taxed at the small business rate, or income subject to the general corporate rate. New tracking and ordering rules will add complexity for CCPCs. It is not clear whether the tax reduction applies to dividends paid out of pre-2006 income that was taxed at the general corporate rate. Shareholder-managers of CCPCs should re-evaluate their strategy for receiving salary versus dividends after 2005: the lower tax rate on dividends paid out of income subject to the general corporate rate means that shareholder-managers may now prefer to receive distributions of that income as dividends.

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FOREIGN TAX NEWS

Australia

In December 2005, the Australian Tax Office (ATO) released guidance on the application of the GAAR, which will generally not apply to business and investment income splitting through spousal partnerships and family companies. The ATO also outlines how it will refocus its test case program around the alienation of personal services income.

Belgium

A proposed VAT GAAR allows recharacterization of any contract or series thereof, retroactive to November 1, 2005.

United Kingdom

The December 5, 2005 pre-budget report introduces several new measures to counter tax fraud and avoidance, effective April 2006. The 2004 anti-avoidance rules are extended to include avoidance risks for all income, corporation, and capital gains taxation. Businesses must report in-house tax schemes within 30 days of implementation. Effective immediately, the availability of capital losses is limited to those from genuine commercial transactions; taxpayers are deemed to receive commercial interest rates on cash deposits; tax benefits from the transfer of rights to intangible assets within a company group are limited; and UK-resident individuals cannot use offshore companies or trusts to avoid tax. UK domestic VAT enforcement will be strengthened.

Aruba

Tax changes not yet gazetted include amendments to Aruba exempt companies (AECs); new check-the-box rules for fiscal transparency of new AECs and public limited liability companies (grandfathering applies to other AECs and other offshore companies); changes to the free zone legislation; and a new list of eligible activities under the imputation payment system, effective after 2005.

Ireland

The 2006 budget of December 7, 2005 proposed changes generally effective after 2005, such as restrictions on relief for interest paid in certain related-company transactions (effective immediately); increases to thresholds for income tax brackets, employee and individual tax credits, and personal allowances; and an increase in the VAT registration threshold for small businesses.

Spain

Plans were announced to cut corporate income tax rates from 35 to 30 percent (general) and from 30 to 25 percent (small and medium-sized companies).

Sweden

The 2006 budget, now approved, includes changes to corporate and personal income taxation, effective after 2005.

Taiwan

An alternative minimum tax is expected to apply to individuals and enterprises after 2005.

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