CANADIAN TAX *Highlights*

Editor: Vivien Morgan, LL.B.

Volume 14, Number 2, February 2006

CRA on Aggressive Planning

The CRA is implementing several initiatives that may subject aggressive tax planning to increased scrutiny. According to its 2005-2006 to 2007-2008 Corporate Business Plan (available at www.cra-arc.gc.ca/agency/business_plans), tax integrity is the CRA's strategic priority and will be achieved by greater focus on four areas, of which aggressive tax planning heads the list. An official with the International Tax Directorate confirmed that centres of expertise, the Joint International Tax Shelter Information Centre (JITSIC), a Canada-US memorandum of understanding, and a CRA review of novel tax-planning disclosure form part of this larger strategy. The 2005 federal budget also announced an annual $30 million resource allocation to enhance CRA audit and collection activities related to international tax evasion and aggressive international tax planning.

■ On August 9, 2005, the minister announced the creation of 11 centres of expertise across Canada, following a 2005 federal budget proposal to enhance CRA compliance activities. The centres bring together audit professionals from international tax, special audits, and tax avoidance to develop new ways to track and combat aggressive tax planning, the use of international tax shelters, and the abuse of tax havens. A CRA representative confirmed that these centres are currently operational in Tax Services Offices in London, Laval, Halifax, Saint John, Montreal, Toronto West, Ottawa, Winnipeg, Calgary, Vancouver, and Burnaby.

■ On April 23, 2004, Canada, Australia, the United States, and the United Kingdom signed a memorandum of understanding (MOU) to establish JITSIC in Washington, DC in order to increase collaboration and coordinate information on abusive tax transactions or arrangements. JITSIC will enable the participants to share expertise, best practices, and experience in the field of tax administration; to exchange information about specific abusive transactions and their promoters and investors within the framework of bilateral treaties; and to carry out enforcement activities against abusive tax transactions more effectively and efficiently. JITSIC also aims, inter alia, to develop identification techniques, identify trends and patterns, gain knowledge of cross-border promotion techniques, and increase public awareness of risks. The first initiatives include targeting the ways in which financial products are used in abusive tax schemes by corporations and individuals to reduce their tax liabilities, and identifying promoters that develop and market those products. The task force will help create an Internet portal to keep an online tally of tax-avoidance schemes and shell companies.

■ A Canada-US competent authority MOU was executed on June 3, 2005. Participants in the Canadian Tax Foundation's 2005 CRA round table commented that the next steps to implementation include appointing representatives; setting agenda priorities, such as binding procedure; setting guidelines to resolve cases on topics such as arm's-length compensation, integration of businesses, non-routine intangibles, and the existence of permanent establishments; addressing transitional issues; and executing and releasing various MOUs. On December 8, 2005, the two competent authorities signed an MOU agreeing to principles, guidelines, and procedures to resolve disagreements referred to them under the mutual agreement procedure article of the Canada-US treaty.

■ The round table participants also discussed the CRA's intention to review novel tax-planning disclosure. Processes will be developed to require businesses to disclose novel tax plans or arrangements so that the CRA can identify offensive transactions and alert potential users to the related CRA position. The CRA is currently reviewing comparable US, UK, and Australian systems.

Louis J. Provenzano and Sheryl Mapa
PricewaterhouseCoopers LLP, Toronto

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Indirect Use of Funds: Paragraph 20(1)(e)

A recent technical interpretation (TI 2005-0151211I7, October 19, 2005) seems to indicate that the CRA will not extend the "indirect use of funds" test to the deduction of financing costs under paragraphs 20(1)(e), (d), (e.1), and (f), even though jurisprudence applies the test to similar wording in paragraph 20(1)(c) for the deduction of interest.

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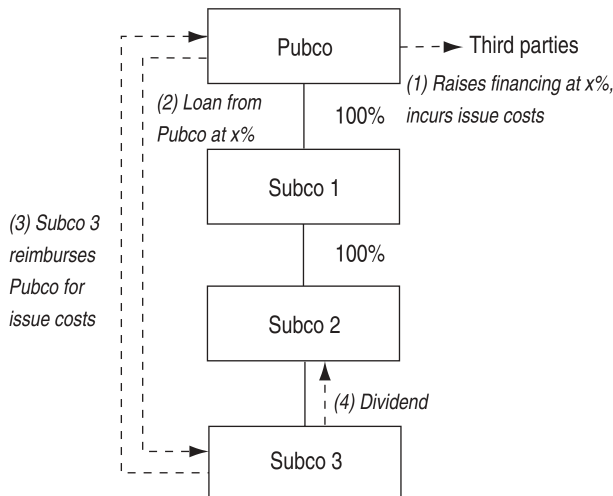

A public corporation (Pubco) sits at the top of three tiers of wholly owned subsidiaries, Subcos 1, 2, and 3; all are Canadian residents, and Subcos 1 and 3 have significant taxable income. Pubco issued interest-bearing debentures to arm's-length parties and incurred issue costs. Pubco on-lent the borrowed money at the same interest rate to Subco 3, which used the funds to pay a dividend to Subco 2. Subco 3 reimbursed Pubco for its issue costs and deducted them under paragraph 20(1)(e).

Paragraph 20(1)(e) provides that otherwise nondeductible financing expenses (such as the cost of issuing debentures) incurred by a taxpayer "in the course of borrowing money used for the purpose of earning income from a business or property" are generally deductible over five years. IT-341R3, "Expenses of Issuing or Selling Shares, Units in a Trust, Interests in a Partnership or Syndicate and Expenses of Borrowing Money," says that the paragraph 20(1)(e) deduction is restricted to the particular taxpayer who enters into the qualifying transaction described therein. For example, a parent company cannot use paragraph 20(1)(e) to deduct the expenses it pays on behalf of its subsidiary in connection with the subsidiary's issuance of shares. However, if the funds are raised by the parent and on-lent to the subsidiary, which reimburses the parent for such expenses that are reasonable in the circumstances, the subsidiary may deduct the expenses.

In the TI, the CRA says that because Subco 3 commits to reimburse Pubco its issue costs to ensure that Pubco lends to Subco 3, Subco 3 is not precluded from deducting its debt financing costs under paragraph 20(1)(e) because Subco 3 incurred that financing expense in the course of borrowing money. However, Subco 3 must still satisfy all the other requirements under paragraph 20(1)(e) to deduct its debt financing costs. Subparagraph 20(1)(e)(ii) has a use test: money borrowed by the taxpayer must be "used by the taxpayer for the purpose of earning income from a business or property." The CRA says that Subco 3 used the money to pay dividends to its parent, Subco 2, and it would thus be difficult to convince a court that Subco 3 used borrowed money for an income-earning purpose. Regardless of whether Pubco acted as Subco 3's agent in borrowing the money, the CRA's view is that the payment of dividends by a subsidiary to a parent is not made for the purpose of earning income from a business or property.

The CRA noted that cases such as *Trans-Prairie Pipelines* (70 DTC 6351 (Ex. Ct.)) and *Penn Ventilator* (2002 DTC 1498 (TCC)) apply an indirect-use test in limited circumstances to paragraph 20(1)(c) dealing with the deductibility of interest. However, no jurisprudence extends an indirect-use test to paragraph 20(1)(e), 20(1)(d) (compound interest), 20(1)(e.1) (annual fees related to borrowings), or 20(1)(f) (discounts on certain obligations).

The CRA was also asked whether Subco 3 could deduct under paragraph 20(1)(e.1) part of the amount paid to Pubco in the course of Subco 3's borrowing from Pubco. That rule deals with annual fees such as standby charges, guarantee fees, and other similar financing costs that are payable by a taxpayer in the course of borrowing money for the purpose of earning income from a business or property. The CRA's analysis was similar to its analysis for paragraph 20(1)(e) and the related-use test, with an additional concern about Subco's not being able to demonstrate that the amount it wanted to deduct was related "solely to the year" as required under the rule.

Paul Hickey
KPMG LLP, Toronto

New Meaning of Cost

The November 17, 2005 notice of ways and means motion included new section 143.3, a proposal in direct response to the TCC decision in *Alcatel* ([2005] 2 CTC 2001). *Alcatel* held that SR & ED expenditures include taxable employee stock option benefits—the excess of the shares' FMV at issuance over the exercise price. Finance believed that the amount of expenditures should not include such benefits, just as section 7 prohibits an employer's current deduction. However, the proposal goes well beyond the perceived mischief in *Alcatel*, and taxpayers face uncertainty and potential adverse implications until Finance clarifies its position with respect to section 143.3's application.

New section 143.3 grinds down the cost of property or an expense for tax purposes if (1) the expenditure arose from the granting of a stock option or the issuance of a share, and (2) the share's FMV at issuance exceeds the amount added to the PUC on account of the exercise price paid under the option or the amount of the consideration received for the issuance, as the case may be. Section 143.3 applies for the

purposes of computing a taxpayer's income, taxable income and tax—for example, in the case of a capital gain or loss.

The new rule does not specify its interaction with sections 51, 84.1, 85, 85.1, 86, and 212.1, inter alia. A literal reading might suggest that new section 143.3 applies in addition to these provisions and results in ACB grinds. Assume that property is transferred under section 85 at an elected amount less than its FMV. The prerequisites for section 143.3's operation are met because the issued shares' FMV exceeds their PUC; the property's ACB may not be fixed at a section-85-determined amount, but it may be reduced by a section 143.3 grind. Subsection 143.3(5) may prevent this adverse result, but the scope of that rule's application is certainly not clear. Another example arises in the context of a section 212.1 transaction. Assume that low-PUC shares are taken back or that there is a PUC grind under section 212.1. New section 143.3 grinds the ACB of the subject shares to the purchaser corporation down to the issued shares' PUC, even though the wording of section 212.1 does not provide for such a grind, but only for a deemed dividend or a PUC grind of the issued shares. These results are apparently unintended and anomalous; from informal discussions with Finance, it seems likely that section 143.3, which is proposed to take effect for transactions that occurred on or after November 17, 2005, will be modified.

The new rule is also of concern in the foreign affiliate (FA) context. If a Canadian corporate taxpayer transfers one FA to another FA, subsection 85.1(3) may provide a rollover of ACB. However, the purchasing FA may not be able to issue full PUC shares—either, for example, because foreign corporate law prevents it or because higher foreign franchise or capital duty charges act as a practical impediment—and then section 143.3 may grind the ACB established under subsection 85.1(3). Also, a question remains of how to compute an FA's capital gains and losses and property income. Paragraphs 95(2)(f) and (f.1) provide that for such computations the FA is regarded as a Canadian resident; absent an amendment to section 143.3, all FAPI computations must reflect its impact. Assume that an FA transfers non-excluded property to another FA for shares of less than full PUC in a paragraph 95(2)(c) transaction. If the non-excluded property is then sold to another person in a taxable transaction, the FAPI is computed by reference to the paragraph-95(2)(c)-determined ACB as reduced by a section 143.3 grind.

Paul L. Barnicke
PricewaterhouseCoopers LLP, Toronto

Sharing Taxes

Provincial personal income taxes are no longer expressed as a percentage of federal taxes, but the relationship between collections by each level remains relatively unchanged. Data from Statistics Canada's provincial economic accounts show that in 2003, the latest year available, federal collections accounted for about 62.8 percent of all income taxes.

Personal Income Tax, 2003

	Federal collections as percentage of total collections	Personal income tax as percentage of personal income	
		Federal	Provincial
NL	57.7	7.8	5.7
PE	60.2	7.7	5.1
NS	59.2	8.5	5.9
NB	61.7	8.2	5.1
QC	48.7	7.7	8.1
ON	67.5	10.5	5.1
MB	59.6	8.5	5.7
SK	63.8	8.7	5.0
AB	70.2	10.8	4.6
BC	69.0	9.3	4.2
All Canada*	62.8	9.5	5.6

* Including the territories.

The table shows that the percentage of personal income taxes paid to the federal government varied from a high of 70.2 percent in Alberta to a low of 48.7 percent in Quebec. The Quebec figure is low partly because of the additional tax points—16.5 percent of federal tax—granted to the province as compensation for opting out of shared-cost programs in the 1960s; the provincial rate has been raised to capture the additional tax room.

The table also illustrates the differences between federal and provincial tax incidence. Federal taxes were the highest in Ontario and Alberta, amounting to over 10 percent of personal income as defined for national accounts purposes, well over the levels in the Atlantic provinces. Provincial taxes, on the other hand, were lowest—5 percent or less—in Ontario and Alberta, where low-income tax relief has been more extensive. Excluding Quebec, provincial taxes were highest in Atlantic Canada. Because Quebec's system is unique, it is useful to calculate the averages for the other nine provinces and the territories, where federal income taxes averaged 10.0 percent of personal income and the comparable provincial taxes averaged 4.9 percent in 2003.

David B. Perry
Canadian Tax Foundation, Toronto

ITCs for GST Paid on IPOs

An important TCC decision, *A & W Trade Marks* (2005 TCC 493), further clarifies that expenses incurred on initial public offerings (IPOs) may be fully creditable by way of

input tax credit (ITC), and it continues to challenge the CRA's traditional views on the availability of ITCs for corporate treasury expenses.

A & W Trade Marks was in the business of licensing the A & W fast-food franchise trademarks to various parties. A & W established a revenue royalties income fund to allow public investment in its debt and equity securities, and it conducted an IPO that raised $83.4 million. Most of the funds were used to purchase additional trademarks from a related company that were licensed back to the vendor, much like a sale-leaseback transaction. A & W claimed ITCs of about $77,700 for GST paid on IPO expenses, such as payments to law firms, to RBC Capital Markets, and to a printing company. The minister denied the claim. The TCC was asked whether the goods and services at issue were "acquired" by A & W in the course of its "commercial activities" so as to generate ITCs under subsection 169(1) of the Excise Tax Act (ETA).

The TCC first addressed the relationship between A & W and the fund, which was a separate entity for GST purposes if it was a trust. The TCC assumed that the fund did not pay A & W any consideration for the IPO expenses; that A & W reflected those expenses on its financial statements; and that A & W did not receive any significant interest, dividends, or fees for financial services. The TCC then considered the subsection 169(1) requirements for ITCs. That rule required A & W to have (1) acquired or imported the goods or services (2) for use in its commercial activities and (3) paid the GST. The third test was not in issue. On the basis of the evidence, the jurisprudence, and the overall scheme of the ETA, the TCC concluded that A & W had "acquired" the goods or services, but it did not provide much reasoning to support its conclusion. The TCC also concluded, on the basis of the testimony of A & W's senior officers, that the goods and services were acquired to allow A & W to raise money to carry on its commercial activities; in the court's view, the second test was thus satisfied and the court allowed the appeal with costs.

For GST purposes, the link between a business's commercial activities and its treasury operations—which permit the raising of sufficient capital to enable the business to carry on its commercial activities—has often been nebulous. Most businesses want to take the position that their treasury operations are directly linked to their commercial activities, making GST ITCs always available for treasury operations. The CRA, however, has tended to be more circumspect. For example, the CRA accepts that GST ITCs are available for certain costs related to the undertaking of corporate obligations under corporate or securities law, such as the production and distribution of circulars for shareholders, valuation reports, and fairness opinions, and the attendant legal, accounting, printing, and mailing costs. (See Headquarters Letter no. 11585-12 (December 13, 2000).) However, the CRA traditionally refused ITCs for costs related to IPOs, takeover bids, etc.

The TCC decision in *BJ Services* ([2002] GSTC 124) forced the CRA to revisit its position on ITCs and hostile takeover bids. Now it appears that *A & W* will force further changes on the IPO front. These decisions are part of a trend that continues to explore the boundaries between eligible and ineligible treasury expenses and to enhance the scope of eligible expenses. *A & W* may also be the latest signal that the TCC is prepared to take a commonsense approach to these questions—asking, for example, whether the business is commercial or exempt in nature—rather than the more esoteric approach that some say is mandated by provisions such as ETA section 141.01. However, it is unfortunate that the court in *A & W* did not provide a more detailed analysis of the meaning of the word "acquire"; on the facts, the fund was the potential beneficiary of the expenses if it was a trust and thus a separate person for GST purposes. Perhaps the definition of "recipient" in subsection 123(1) may have resolved any potential issues in A & W's favour.

Robert G. Kreklewetz and Simon Thang
Millar Kreklewetz LLP, Toronto

ASR Gain or Pain

Public corporations often engage in stock buyback programs to boost their earnings per share for the stock still outstanding. A new US variation, known as the accelerated share repurchase (ASR) program, often costs a corporation more than expected and may carry adverse income tax consequences to the corporation that buys back its shares. The accounting disclosure for ASRs has been the subject of recent criticism, and a study is under current review by US accounting regulatory bodies.

In a normal stock buyback, the company announces its plan to purchase a certain number of shares and buys back the shares in the open market over time. In an ASR, the corporation buys back all of the shares to be repurchased at once from an investment bank, which typically borrows the stock from its institutional investors. Accounting rules allow the company to immediately reduce its shares outstanding, thereby immediately resulting in improved earnings. The investment bank must cover its short position for the stock it has borrowed. If the share price of the stock subject to the ASR rises (the result expected by the corporation), the corporation must compensate the investment bank for the loss it experienced on its short position. Gains are afforded similar treatment: the corporation wins if the stock price drops below

a benchmark price because the bank must make a payment to the corporation. The settlement contract is part of a complex forward exchange contract and typically is based on the stock's average price over a buyback period. Under many derivative contracts, gains and losses are normally marked to market each quarter; any gain or loss is recorded in the income statement. In contrast, any gain or loss under an ASR derivative contract is not recorded through the income statement but rather is reflected as an equity transaction or through the corporation's retained earnings. Accordingly, the gains and losses relating to the derivative contract with the bank are not part of the all-important income statement; rather, their effect, like that of a dividend payment, is limited to quarterly cash earnings per share (EPS). The liability or asset over the quarter is reflected on the balance sheet.

There are no Canadian accounting rules specific to ASR transactions. Although the *CICA Handbook* has general rules in sections 3240 and 3500 for share buybacks and EPS, respectively, it is probable that Canadian reporting entities will end up adopting the US accounting treatment with respect to gains and losses on the derivative.

Although ASRs have been around for a number of years, they seem to have recently gained popularity in the United States. Critics view these transactions as gimmicks designed to extract accounting benefits associated with the immediate reduction in the number of shares outstanding. Although a related note in the financial statements is required, the outstanding derivative contract is a ticking time bomb that could result in a significant cash liability. Any compensating payment losses are not deductible by the corporation for Canadian income tax purposes either as a loss or as a financing cost because the transaction relates to the repurchase of the corporation's own shares. It is difficult to argue that the derivative contract is an adventure in the nature of trade in an effort to bolster a position that any loss is deductible, because the corporation can earn a profit on the derivative only if the stock falls, and that result is at odds with the original purpose of the share buyback. It will be interesting to see how the rules evolve and whether Canadian corporations will adopt ASRs for their stock repurchase programs.

John Jakolev and Graham Turner
Jet Capital Services Limited, Toronto

Asset Protection Planning

The potential liability of directors, the scarcity of adequate insurance coverage against professional malpractice and product liability, and the increased default rate of companies and income trusts may all combine to make asset protection planning or creditor proofing—the protection of assets from creditors—a necessity for professionals, trustees, directors, and shareholders. For example, creditors may be affected by the transfer of assets within a corporate group or between family members. Each situation will require its own tailored solution, but the tools are similar.

■ An individual's personal liability on a bank loan, lease, or other obligation should be limited: liability for the repayment of loans should be several rather than joint and several; an individual should be a limited and not a general partner; and loans should be non-recourse.

An individual who lends funds to a private company, including the loanback of bonuses, should secure the loan when it is made.

■ Real estate or business assets should be acquired by a sister corporation to an opco; asset segregation at the outset prevents creditors' attacks against subsequent transfers and conveyances. A sister corporation holding real estate used in a business creates a barrier against an opco's creditors. Real estate currently owned by an opco can be rolled to a sister corporation using the butterfly exemption in paragraph 55(3)(b). A portion of the opco's shares with an FMV equal to the net FMV of the target assets is rolled to a holdco for common shares. The opco transfers the real estate to the holdco for preference shares retractable for the property's FMV net of any mortgage assumed. The opco purchases for cancellation its common shares from the holdco for the retraction amount of the preferreds, and the holdco redeems the preferreds. The opco pays FMV rent to the holdco. If the companies are associated, the rent is deemed active business income (ABI). Otherwise, the rent is derived from a specified investment business or is income from property and increases the holdco's refundable dividend tax on hand; the latter is usually preferable if the opco's ABI exceeds $300,000 a year, because the effective corporate tax rate is lower after taxable dividends are paid.

Leasehold improvements may still be borne by the opco. Under the terms of a "4 + 1" lease, for example, the opco can write off leasehold improvements over a period of six years (considering the effect of the half-year rule) rather than capitalizing leasehold improvements as part of the cost of the building. Segregating assets in sister corporations also presents an estate-planning advantage because different family members may hold various ownership interests in the different corporations.

■ Using a holdco to own an opco's shares—either from the outset or by rolling the shares into a holdco later—can yield income-splitting advantages if low-income adult family members subscribe for holdco common shares. The opco's annual after-tax profits can be distributed as

a tax-free intercorporate dividend to the holdco, removing the opco's surplus and thereby limiting its exposure to creditors. The holdco can make secured loans back to the opco if necessary. However, an individual no longer owns the opco shares and cannot claim a capital gain exemption unless the holdco itself qualifies as a small business corporation (by investing at least 90 percent of its assets in unincorporated businesses or in operating corporations carrying on an active business in Canada) and the individual can later sell the holdco shares. The CGE may be crystallized when the opco is rolled to the holdco. Alternatively, the holdco's shares in the opco may be converted under section 86 into fixed-value preference shares entitled to a non-cumulative dividend at a rate approximating the opco's annual after-tax profits. The individuals subscribe for common shares at a nominal price. This structure should not adversely affect the opco's value if it is based on a multiple-of-earnings approach.

Assets held by an individual potentially exposed to creditors' claims may be rolled over to a holdco for preference non-voting shares. Growth in the assets is protected in common shares issued to other family members who are not so exposed. No tax saving or deferral is achieved for capital gains unless the family members who own participating shares are in lower tax brackets. It may be more costly to flow investment income through a holdco to a shareholder in the top marginal tax bracket than to have the individual own the investments personally. However, for an individual who may be exposed to creditors' claims, a shareholders' agreement entered into after the shares or assets are rolled to a holdco may restrict the redemption or purchase for cancellation of shares without the shareholders' unanimous consent.

■ In provinces where limited liability partnerships (LLPs) are permitted, partners not involved in a file that is the subject of litigation are not personally liable. However, work in progress, receivables, undrawn profits, capital accounts, and practice assets are exposed to claims of creditors. Management companies or partnerships may be used to segregate practice assets such as furniture, fixtures, computers, and supplies from practice creditors. The lease for premises may be held in a separate corporation with no or only limited guarantees by partners. The partnership may restrict its borrowing practices and require several rather than joint and several liability. Capital accounts may be refinanced and converted to secured loans, subordinate to any bank loan.

■ A bare trustee corporation may hold title to real estate. The bare trustee corporation enters into a declaration of trust before or when the property is acquired, acknowledging that it has no beneficial interest in the property, which it holds merely for the benefit of and subject to the instructions of the beneficial owner. The beneficial owner's liability arguably is restricted to directly signed contracts and guaranteed debts; alternatively, it is arguable that there is no privity of contract between the beneficial owner and third-party potential plaintiffs. IT-216 ("Corporation Holding Property as Agent for Shareholder" (archived)) acknowledges the use of a bare trustee corporation, which is regarded as the beneficial owner's agent and not as the beneficial owner itself for tax purposes; the corporation need not file a trust return.

Jack Bernstein and Harry Fogul
Aird & Berlis LLP, Toronto

Trust or Partnership: US Ruling

In TAM 200512020 (August 20, 2005; 2005 TNT 58-12), the IRS explores whether a trust formed by a taxpayer (probably a bank or an insurance company) was to be treated as a trust or a partnership for all US federal tax purposes.

On the facts, a taxpayer purchased a block of income-paying equity securities. The taxpayer contributed these securities to a newly formed trust in return for two types of trust certificates—income certificates (IOCs, representing the right to all income payments on the underlying securities before the trust's termination) and termination certificates (POCs, representing the right to the underlying securities at the trust's termination). The taxpayer arranged with a promoter to sell the POCs (it retained the IOCs). The taxpayer claimed that its business purpose was to achieve intermediate-term cash flow while adding negative duration to the taxpayer's asset portfolio in order to manage duration mismatches between assets and liabilities. The taxpayer and an affiliate of the promoter also simultaneously entered into a termination agreement: if an underlying security was redeemed by its issuer before the trust's termination, the taxpayer would be paid an amount equal to a portion of the redemption proceeds based on a sliding scale. The promoter's offering materials indicated that it was going to retain some POCs in order to hedge its obligation to the taxpayer under the termination agreement.

The IRS concluded that the termination agreement was an integral part of the entire transaction: the rights and obligations thereby created are relevant in determining the rights and obligations attached to the ownership of the IOCs and the POCs. The operation of the termination agreement divides up the early payment rights relating to the underlying securities between the taxpayer (the IOC holder) and the promoter and others (the POC holders): an early call is thus prevented from rendering the IOCs

worthless. The taxpayer readily admitted that it would not have entered into the transactions, as structured and priced, without the termination agreement.

The US entity classification regulations—the so-called check-the-box rules—differentiate true trusts (IRC reg. sec. 301.7701-4) from business entities. An investment trust that has two or more classes of ownership interests is normally classified as a business entity (a partnership or a corporation for taxation purposes) unless, among other things, the trust is formed to facilitate direct investment in the assets of the trust, such as the purchase of a fractional interest in a fixed portfolio of securities. The taxpayer contended that the trust should be a trust for taxation purposes: the multiple interests merely segregated income rights (the IOCs) from corpus rights (the POCs) in a portfolio. The IRS disagreed and concluded that the certificates varied significantly from what would be a direct investment in a trust's assets. The POC holders have no initial income rights whatsoever; they look to future appreciation (if any) for a return on their investment. The IOC holders give up most of the appreciation rights, except in the event of an early redemption of an underlying security (for example, proceeds in liquidation of an issuer prior to the trust's termination). Further, the termination agreement afforded the IOC holders risk protection that otherwise would not have been present. As a result, the trust was classified as a business entity under IRC reg. sec. 301.7701-2, leading to the finding that the trust was to be taxed as a partnership pursuant to the default classification rules of IRC reg. sec. 301.7701-3. The taxpayer's preferred classification as a trust was not available because true trusts are mutually exclusive from business entities for US tax purposes. Successful planning to establish trust status in this case would require making further economic concessions in the structuring of the deal.

Steve Jackson
Ernst & Young LLP, Toronto

Final US Regs: Foreign Mergers

The IRS has adopted final regs (TD 9242, 2006-7 IRB 422) governing the type of transaction necessary to establish tax-free reorganizations under Code section 368. In particular, tax-free statutory mergers or consolidations can now be effected under foreign law and can involve foreign entities. The new regs also provide clarification and, in some cases, greater flexibility in structuring cross-border transactions.

Code section 368 contains provisions for corporations to engage in tax-free reorganizations, including a statutory merger or consolidation (type A merger or reorganization) under section 368(a)(1)(A). Temporary (TD 9038, 2003-1 CB 524) and proposed (REG-126485-01, 2003-1 CB 542) regs issued in 2003 revised the definition of a statutory merger or consolidation, generally providing that such a transaction is effected under the laws of the United States, a state, or the District of Columbia if, as a result of the operation of such laws, all of a target corporation's assets and liabilities are acquired by the acquiring corporation, and the target's separate legal existence ceases for all purposes. Proposed regs issued on January 5, 2005 revised the type A reorganization definition to include transactions effected pursuant to foreign law and transactions involving entities organized under foreign law. Changes were also proposed to the section 367(a) and (b) regs to, inter alia, account for type A reorgs involving one or more foreign entities. After receiving comments on the 2005 proposals, the IRS adopted them as final on January 23, 2006 with certain technical changes, generally effective for transactions occurring on or after that date. This change will be welcome in the many situations in which it would be beneficial for a merger involving a Canadian corporation to qualify as a type A merger. Previously, a cross-border transaction generally qualified as a type A merger only if the transaction involved the foreign acquisition of a US company—for example, if a Canadian acquiror formed a US acquisition sub that then merged with the US company.

The final regs also provide some guidance and clarification related to section 367 regs as they apply to foreign reorganizations. For example, the regs clarify that section 367(a) does not apply to any section 354 exchange of stock or securities of a domestic or foreign corporation under a section 368(a)(1) asset reorganization, unless the exchange is considered an indirect stock transfer under the section 367 regs. A US person recognizes gain under section 367(a) on an exchange of property with a foreign corporation as described in section 351, 354, 356, or 361, unless an exception applies. The former section 367 regs say that the rule does not apply to a section 354 (or 356) exchange in which a US person transfers stock of a domestic or foreign corporation "for stock of a foreign corporation" in an asset reorganization described in section 368(a)(1) that is not treated as an indirect stock transfer. Commentators pointed out that in certain triangular asset reorganizations in which a US person transfers stock of a foreign acquired corporation to a foreign aquiring corporation in a section 354 (or section 356) exchange, but receives stock of the domestic parent of the foreign acquiring corporation, the transfer by the US person might be subject to section 367(a), because the US person does not receive "stock of a foreign corporation." The IRS and Treasury said that this result was not intended, and the final regs clarify the rule by removing the requirement

that the transfer must be made "for stock of a foreign corporation."

The final regs also permit the non-recognition of gain in exchanges under section 354 by a US person of securities of a foreign corporation in a transaction described in section 368(a)(1)(E) (a type E reorganization) or of securities of a domestic or foreign corporation pursuant to an asset reorganization described in section 368(a)(1). Before the 2005 proposed regulations were introduced, commentators noted that the exception in the regs to the application of section 367(a) applied to exchanges of stock only and not to exchanges of securities, in type E reorganizations and certain asset reorganizations. Notice 2005-6, issued concurrently with the 2005 proposed regs (2002-5 IRB 448), indicated the IRS's intention to except exchanges of both stock and securities, and that change has materialized in the final regs.

The regs also amend the indirect stock transfer rules: an exchange by a US person of stock or securities of an acquired corporation for stock or securities of the corporation that controls the acquiring corporation in a triangular B reorganization (section 368(a)(1)(B)) is treated as an indirect transfer of the target's stock or securities subject to the rules of section 367(a). The prospective effective date of this amendment is not intended to raise any inference that the current law is different.

For certain triangular B reorganizations, the final regs provide that a disposition of stock of the foreign acquiring corporation is not an event triggering a gain recognition agreement. Under current regs, in a triangular B reorganization, if a US person exchanges stock of an acquired corporation for voting stock of a foreign corporation that controls the acquiring corporation, the US person is treated as making an indirect transfer of the acquired corporation's stock to the foreign controlling corporation in a transfer subject to section 367(a), but not if the acquiring corporation is foreign and the controlling corporation is domestic. Commentators have suggested that a gain recognition agreement should not be triggered when a domestic controlling corporation disposes of the foreign acquiring corporation's stock because any built-in gain in the stock of the acquired corporation is reflected in the stock of the foreign acquiring corporation held by the domestic controlling corporation under Treas. reg section 1.358-6(c)(3). The final regulations provide that the disposition of the foreign acquiring corporation's stock is not a triggering event in certain cases; for instance, the gain recognition agreement terminates if the domestic controlling corporation disposes of such stock in a taxable exchange.

Marla Waiss
Hodgson Russ LLP, Buffalo

RRSP Loss Reimbursed

A recent advance tax ruling (ATR 2005-0118591R3) concerning a settlement payment by an employer to a former employee's RRSP said that the payment was neither included in the former employee's income nor considered a premium or gift to the RRSP. The payment represents a "replenishment" for losses sustained in the employee's RRSP while it was managed by the employer.

Ms. A, an employee of Canco, contributed to several investment accounts managed by Canco, which offered its employees a group retirement savings plan featuring the matching by Canco of certain employee contributions. When the value of Ms. A's investment accounts with Canco began to decline significantly and continued to do so over several years, she discovered that, contrary to her instructions, Canco had invested her funds in a high-risk portfolio. Canco terminated Ms. A's employment without prior notice and advised her that for "business reasons a decision had been made to make some organizational changes." Ms. A retained a lawyer to negotiate a settlement with Canco regarding her termination and the losses in her investment accounts. Canco eventually offered to "recontribute" to Ms. A's RRSP an amount equal to its total contributions previously made under the group retirement savings plan. On the facts in the ATR, Ms. A proposed to accept Canco's settlement offer; Canco would make a payment to the RRSP trustee, and Ms. A would release her claims against Canco in return for this partial replenishment of her RRSP's value. In regard to the "replenishment payment," the CRA says that so long as Ms. A does not claim a deduction under subsection 146(5) for the payment, no amount is included in her income under section 3, 5, 6, or 146. Further, the payment is not considered to be a premium or gift for the purposes of subsection 204.2(1.2).

Auto benefits on lease versus purchase. At the CRA and Finance round table at the 2005 annual conference of the Association de planification fiscale et financière, panellists asked whether Finance intends to correct an apparent anomaly in the automobile standby charge: a higher taxable benefit is attributed to an employee who drives an employer-purchased car rather than an employer-leased car. (The following is based on an unofficial translation and interpretation of the proceedings.)

For an employer-owned vehicle, the employee's standby charge is 2 percent of the original cost of the car for each month that it is available to the employee. For an employer-leased vehicle, the standby charge is two-thirds of the monthly leasing costs. The standby charge is intended to represent the benefit enjoyed by the employee from possession of the vehicle; the benefit is calculated essentially from two components—depreciation and the cost of

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Published monthly

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
ISSN 1496-4422 (Online)

the vehicle's financing. The standby charge formulas, which have not been adjusted since they were established in 1981, were intended to equate employer-purchased and employer-leased vehicles.

The round table question posits an example based on actual leasing costs in 2005 for a vehicle costing $55,000. The annual employee standby charge benefit (assuming a 48-month lease) is about $6,600. For an identical vehicle purchased by the employer (and financed at current interest rates), the annual employee standby charge benefit is about $13,300, roughly double the leased-vehicle taxable benefit. For vehicles costing between $26,000 and $77,000, the taxable standby charge benefit for an employer-purchased vehicle is roughly double that of an identical vehicle that is leased.

This anomaly seems to occur because the standby charge for a leased vehicle is two-thirds of the monthly lease cost, a formula that automatically takes into account any changes in the cost of the vehicle and related financing costs that are inherent in and either raise or lower the lease payment, but the formula for an employer-purchased vehicle does not. The "2 percent of cost" factor was established in 1981, when interest rates were much higher than they are today, and that rate now overstates the financing cost component of an employer-owned vehicle. The question says that the leasing cost formula seems to fairly accurately reflect the amount of the actual benefit to an employee from the use of the car (based on an assumed 67 percent employee personal-use portion). Thus, it is suggested that the formulas could be put on an equal footing again if the 2 percent factor for employer-owned vehicles was reduced. Finance says that it appreciates the comments and will consider them along with other interested parties' views in an upcoming review of automobile measures.

Wayne Tunney
KPMG LLP, Montreal

Foreign Tax News

United Kingdom

Effective January 20, 2006, Her Majesty's Revenue and Customs announced the repeal of section 730(3) of the Income and Corporation Taxes Act in order to end a dividend-stripping tax-avoidance scheme that artificially generated losses through the buying and selling of the right to dividends on shares before the dividends were received or the shares sold.

Norway

After 2005, an exit tax applies on capital gains on shares, replacing rules that taxed capital gains on shares (and some other instruments) in Norwegian companies realized within five years after the taxpayer's emigration year. Tax treaties based on the OECD model challenged the old rules, which implied that the state of source had relinquished its taxing rights for capital gains on shares.

Treaties

On December 14, 2005, **Austria** and **Latvia** signed their first income and capital tax treaty, which generally follows the OECD model. The text is in Latvian, German, and English, but the English prevails in case of divergence. Withholding rates are generally 10 percent, with reduced 5 percent rates for dividends whose beneficial owner is a company holding 25 percent or more of the payer's capital and for royalties for the use of industrial, commercial, and scientific equipment.

Belgium and **Taiwan**'s first treaty and protocol, signed October 13, 2004, entered into force on December 14, 2005, and is generally effective after 2005. **Italy** ratified its first income and capital tax treaty and protocol with **Congo (Rep.)**, signed on October 15, 2003. Japanese Finance officials said that **France** and **Japan** will begin official talks in Paris on January 25, 2006 to revise their 1995 income tax treaty; the objective is to encourage more bilateral investment by lowering withholding tax rates. On January 13, 2006, **India** and **Italy** signed a protocol to amend their 1993 treaty to reduce withholding tax rates to 10 percent for dividends, interest, and royalties.

Maria Mavroyannis
Canadian Tax Foundation, Toronto

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