CANADIAN TAX *Highlights*

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UK: Corporate Residence

A Canadian multinational's tax-risk management involves monitoring the residence of foreign corporate group members. Such taxpayers will be interested in the recent UK Court of Appeal (Civil Division) decision in *Wood & Anor. v. Holden* ([2006] EWCA Civ 26), which upheld the High Court decision that a board of directors did not forfeit central management and control by virtue of its relative lack of activity. It is not yet known whether Her Majesty's Revenue and Customs (HMRC) will seek leave to appeal the decision.

A Netherlands-incorporated corporation (E) participated in a complex set of transactions that culminated in the realization of a significant gain upon the disposition to a third party of an indirect shareholding in a corporation successfully carrying on business in the United Kingdom. HMRC assessed capital gains tax on Mr. Wood and his wife, saying that E was a UK resident at critical times during the transactions. The Special Commissioners confirmed the assessment, concluding that the taxpayers failed to establish that E was not a UK resident for tax purposes. The commissioners relied on the principle articulated in *DeBeers* ([1906] AC 455 (HL)) that a corporation's residence is not determined by its place of incorporation, but by the place where its central management and control actually abides, meaning where the effective decisions are made by those charged with the governance of the corporation, usually the board of directors. Parts of the commissioners' decision seemed to imply that if E did not engage in a certain level of activity, the managing director (an international financial institution, ABN) had nothing to manage, and thus the taxpayer had failed to establish that the central management and control of E was not in the United Kingdom at the relevant time. Furthermore, the commissioners were of the opinion that there was "no real consideration" given by ABN to certain transactions entered into by E: E simply fell in with the wishes of Mr. Wood and his advisers. "[T]he mere physical acts of signing resolutions or documents [do not] suffice for actual management. . . . What is needed is an effective decision as to whether . . . the resolution should be passed. . . . [They] must be informed decisions."

On appeal, the High Court found that the commissioners either did not apply the correct test of residence to the facts or applied it incorrectly. The High Court differentiated between the exercise of management and control and the ablility to influence its exercise: if a parent company tells a foreign subsidiary's board of directors what it wishes them to do without otherwise usurping the powers of the local board, the local board retains management and control of the subsidiary.

In a decision unanimous in its result, the Court of Appeal upheld the High Court decision. The majority refused to accept that a low level of activity in E negated the decisions made by the managing directors: management and control was not rerouted just because the governing body had nothing to do but approve and follow the advice of others with little or no independent analysis. The majority also said that a managing director's decisions are effective even though the director might have looked for additional information in reaching such decisions or even if the director might have been in breach of duty in not looking further into the matter. On the facts, the decisions taken were no less effective just because ABN might have arrived at a different decision after further consideration.

As a matter of fact the commissioners found that there was "nothing surprising in the fact that [E's] directors accepted the agreement," a finding that the majority in the Court of Appeal said made explicit a conclusion that E's managing director "did sign and execute the documents . . . and so must, in fact, have decided to do so."

One of the three judges agreed but issued a separate opinion. "AA Trust [as the director of E] might have had every incentive to carry it out; but it had the right to refuse if it wished, and had the power to do so."

The Court of Appeal's decision in *Wood & Anor. v. Holden* should provide some clarity on the application of *DeBeers* in determining corporate tax residence in the United Kingdom and other Commonwealth jurisdictions. However, if the tax-effectiveness of a corporate group is dependent on the residence of one or more members,

In This Issue

UK: Corporate Residence 1
SBD for Professional Corporations 2
GST on Flip by Newco 2
Education Tax Credits 3
New Government's First Budget 3
Attribution Not GAARed 4
Global Strategies for Tax Disputes 5
Pre-Incorporation Expenses 7
R & D: Global Changes 7
US State Tax: Asset Purchases 8
When Creditor Proofing Fails 8
Foreign Tax News 9

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care must be taken to ensure that that place of residence is continuously maintained.

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SBD for Professional Corporations

Two recent advance rulings (2005-0130131R3 and 2004-0104681R3) conclude that a professional corporation created by a partner to provide professional services to the partnership is eligible for the full small business deduction. On the facts of each ruling, the partnership carries on a professional services business. Professional partnership members who are considering incorporating their practices in a professional corporation to provide services to the partnership may find the ruling informative. The structure also gives each partner the flexibility to be remunerated directly from the partnership and/or through the corporation.

In the two rulings, one or more partners each incorporates a company to provide professional services to the partnership. In the 2005 ruling, the fees paid by the partnership to each company are negotiated case by case at FMV; in the 2004 ruling, the compensation is initially a fixed fee not exceeding FMV. The 2005 ruling also explains that each company may provide services to other persons and is not prohibited from competing with the partnership; the 2004 ruling is silent on these issues. In both rulings, each incorporating partner is allocated his or her share of partnership income (reduced for amounts paid to his or her professional corporation).

In both instances, the proposed transactions are intended to allow the partners to benefit from provincial amendments that permit certain professionals to incorporate and to enhance the partnership's ability to retain current and recruit additional professionals. The transactions also provide each incorporating partner more control over (1) participation in the partnership practice through the management of personal practice preferences; (2) expenditures that may not be in the interest of the other partners; and (3) personal estate and financial planning.

Both rulings confirm that income derived by each professional company from charges to the partnership is income from an "active business carried on by a corporation," fully eligible for the small business deduction. According to the CRA, the charges are not "specified partnership income," presumably because the corporations are not partners of the partnership. The 2005 ruling also states that the business activities of each company do not constitute a "personal services business"; the 2004 ruling does not comment on the matter, but it may be a foregone conclusion in light of the ruling that the income is active business income.

Both rulings also conclude that the fees payable by the partnership to the companies are deductible by all the partners in calculating their respective share of partnership income. Assurance is also given that certain anti-avoidance rules do not apply: subsections 56(2), 56(4), and 246(1) do not render the companies' incomes taxable to the partners; subsection 103(1) does not adjust the allocation of partnership income among the partners; and GAAR does not apply. The 2004 ruling confirms that the proposed transactions do not trigger a disposition of all or part of an interest in the partnership by any of the partners, nor do they create non-arm's-length relationships between the partners. In both rulings, the CRA was unable to rule on the application of the anti-avoidance provision in subsection 256(2.1), which determination is made annually and may change over time.

In both cases, the partners' having bona fide non-tax reasons for incorporation was a significant factor in attaining a favourable ruling. It is interesting that only the 2004 ruling states explicitly that the potential for income tax savings was not a reason for the proposed incorporation of a professional corporation.

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GST on Flip by Newco

For GST purposes, is a newco engaged in a "commercial activity" when it purchases and resells assets in the context of an internal reorganization? If the answer is yes, then GST is generally payable on the sale, and a related input tax credit (ITC) can be claimed to recover the GST paid on the acquisition. (Alternatively, the newco may be eligible to make a section 167 election to eliminate the GST's application.) If the newco is not engaged in a commercial activity, then its sale of the assets is not subject to GST and the newco cannot register for the GST or claim ITCs to recover the GST otherwise payable on the assets acquired by it. The TCC in *Aviva* (2006 TCC 57) recently held that flipping assets was not a commercial activity for GST purposes.

Aviva acquired trademarks from a vendor that had bought them from an affiliate on the same day. Aviva was engaged in making exempt supplies of financial services; any GST payable on the trademarks was unrecoverable through the ITC mechanism. The TCC allowed Aviva's rebate claim

for tax paid in error, concluding that the corporation that sold the trademarks to Aviva was not engaged in any commercial activity and thus that the supply of trademarks to Aviva was not a taxable supply that attracted GST.

For GST purposes, a taxable supply is defined as a supply made in the course of a commercial activity; a commercial activity is defined to include a business carried on by a person, an adventure or concern in the nature of trade, and a non-exempt supply of real property. The TCC said that the flipping of assets was not an adventure or concern in the nature of trade, because the purchase and sale of the trademarks had no element of speculation and no characteristics of a trading transaction: the court was not convinced that the phrase should have different meanings for GST and income tax purposes. A business, the court said, requires more activity than a single isolated transaction and because the vendor of the trademarks did not carry on any other commercial activity to which the asset flip was connected, there was no basis to treat the sale as a taxable supply.

Aviva serves as a warning about the use of a newco in corporate reorganizations. Fortunately for the vendor of the trademarks, the assessment period related to the recovery of GST payable on its acquisition of the trademarks has now lapsed. In a reorganization involving a newco, the sale of real property (and perhaps only such a sale) generally constitutes a commercial activity. For other assets, a newco may be well advised to use them in a commercial activity for at least some time following their acquisition to support an ITC claim or to avoid the potential application of the change-of-use rules otherwise associated with making a section 167 election.

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Education Tax Credits

The latest information on the CRA Web site ("Income Statistics") shows that in 2002, 2.7 million of the 22.5 million tax returns filed claimed either the credit for tuition fees or the credit for attendance at post-secondary educational institutions. The table shows that the majority of those credits were claimed by individuals with low incomes.

Of the 2.1 million claiming the credit for tuition fees in 2002, 51 percent paid no tax, and 60 percent had assessed income of less than $20,000. Almost 1.5 million returns claimed the education credit for their own attendance (most of whom would also be claiming the tuition fee credit); 67 percent were non-taxable, and 79 percent had incomes below $20,000. A further 607,000 returns contained either tuition or education credits transferred from children. Only 3 percent of these returns were non-taxable, and nearly 51 percent had incomes ranging from $20,000 to $60,000.

Percentage Distribution of Tax Returns Claiming Tuition or Education Credits, 2002 Tax Year

	Claiming on own behalf		Credits transferred from children	
Income	Taxable	Non-taxable	Taxable	Non-taxable
	percent			
Under $20,000	24.6	96.9	5.2	74.1
$20,000 to $40,000	39.8	2.8	25.0	20.3
$40,000 to $60,000	20.5	0.2	26.4	3.0
$60,000 to $100,000	12.3	0.1	30.0	1.6
Over $100,000	2.8	0.1	13.4	1.0

If the entire $11 billion claimed was needed to eliminate or reduce tax, the 16 percent federal credit would have amounted to $1.7 billion, with approximately $1 billion flowing from the complementary provincial credits.

The concentration of returns claiming the credits in the low-income ranges indicates that the credits have been targeted to post-secondary students. Statistics Canada data indicate that full-time university undergraduate enrolment in the 2002-3 school year was 676,000, and part-time enrolment was slightly over 135,000. Since this enrolment represents less than one-half of all those claiming credits, the credits claimed on behalf of students at non-university post-secondary educational institutions must account for most of the difference.

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New Government's First Budget

Prime Minister Stephen Harper's new federal government has not yet revealed the timing and content of its first federal budget, except by referring to it as a "spring" budget. Parliament will come into session on April 3, 2006. To anticipate potential tax changes, this article summarizes the Conservatives' tax policy election promises from its campaign platform document and its position on the former government's tax policy announcements that were not passed into law before the January 23, 2006 election. Because the Conservative government holds a minority of seats, it may not be able to fulfill all these promises.

■ **GST.** The Conservatives promised a GST reduction from 7 percent to 6 percent immediately and to 5 percent over five years.

■ **General corporate rate and surtax.** The Conservative fiscal plan document promised to reintroduce the

Liberals' November 2005 economic statement tax relief proposal to reduce corporate tax to 19 percent from 21 percent by 2010 and eliminate the 4 percent surtax by January 1, 2008.

■ **LCT.** An election promise calls for the revival of the Liberal's November 2005 economic statement promise to eliminate the federal LCT after 2005 (two years earlier than scheduled).

■ **Small business, employers' child care, and apprenticeship.** Other election promises include a reduction in the federal small business tax rate for eligible CCPCs to 11 percent from 12 percent over five years; an increase in the small business tax rate threshold to $400,000 from $300,000; a new tax credit for employers of up to $10,000 for each new child-care space created for employees or for the wider community in collaboration with not-for-profit organizations; and a new employer tax credit for 10 percent of wages paid to eligible apprentices for two years, up to $2,000 per apprentice per year.

■ **Personal tax.** Although no official announcement has been made, the media have reported that the Conservative party has said that it will enact, for 2005 only, a November 2005 economic statement promise to decrease the lowest personal income tax rate to 15 percent from 16 percent after 2004. Similarly, the party has indicated to the media that it will enact the economic statement promise to increase the basic personal credit by $500 and the spousal or partner credit by $425 for 2005, but it will not enact further increases promised for 2006. The author is not aware of any official pronouncement on the matter. The CRA's payroll tables now in use for 2006 show the reduced 15 percent tax rate and assume the 2006 credit increases.

■ **Dividends and income trusts.** Campaign promises were made to enact the Liberals' dividend tax credit changes announced in November 2005 that lower the personal tax rate on dividends paid by public companies and CCPCs out of income subject to the high corporate tax rate. The Conservatives also announced that they will not introduce any new taxes on income trusts.

■ **Donations.** The Conservatives promised to eliminate capital gains tax on donations of listed stocks to charities, a promise expected to apply to all taxpayers.

■ **Other personal tax measures.** The campaign also promised to eliminate capital gains tax for an individual who on an asset's sale **reinvests the proceeds** within six months; to increase the maximum **pension income** eligible for the federal credit to $2,000 from $1,000 immediately, and to $2,500 over the next five years; to introduce a non-refundable 16 percent federal credit for the cost of **public transit travel** on buses, light rail, and subways, transferable to parents of dependent children (receipts must be kept on file); to extend the $500,000 capital gains exemption to fishers and provide tax-free transfers of **fishing assets** within families; to introduce a **child-care allowance** of $1,200 per year for each child under age six, starting in 2006, taxed in the hands of the lower-income spouse (with no clawback from middle-income families); to introduce a federal credit of up to $500 per child under age 16 for the cost of registration in eligible **physical fitness** organizations; to introduce a tax credit of $500 for all students in trades, technical schools, or universities for the cost of **textbooks**, transferable to their parents; to increase the tax exemption for student **scholarship or bursary income** to $10,000 from $3,000; to provide $1,000 **apprenticeship grants** for two years for apprentices in approved programs; and to provide tax deductions for up to $500 for **tools** purchased by employees as a condition of their employment.

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Attribution Not GAARed

The TCC recently found in *Overs* (2006 TCC 26) that GAAR did not apply to deny the taxpayer's claim to deduct carrying charges and interest expenses incurred on a loan made by a bank to the taxpayer's spouse. The three prerequisites to GAAR's application as set out in the SCC *Canada Trustco* decision (2005 SCC 54) were not met. *Overs* highlights that before the transaction can be seen as abusive so that it attracts GAAR, the CRA must establish that an avoidance transaction frustrates or defeats the purposes for which the Act confers a tax benefit.

By September 20, 1998, the taxpayer (Mr. T) owed his wholly owned corporation (Canco) $2.3 million. If Mr. T repaid the shareholder loan by September 30, 1999, it would not be included in his 1998 income under subsection 15(2). On September 28, 1999, Mrs. T accepted an offer from a bank to establish a credit facility for her for $2.3 million; Mr. T agreed to sell her some of his Canco common shares for $2.3 million; and Canco provided a guarantee to the bank for Mrs. T's liability and a security agreement, for which Mrs. T agreed in writing to pay Canco an annual fee of $11,500. The following day, Mrs. T borrowed $2.3 million from the bank and signed a promissory note therefor; Mrs. T paid $2.3 million by cheque to Mr. T, who transferred some of his Canco common shares to her and used the cheque's proceeds to repay the shareholder loan. In his 1999 income tax return, Mr. T deferred any capital gain on the transfer of the common shares to Mrs. T by not electing out of the rollover. In computing his income for 1999 and 2000, Mr. T deducted $49,000 and $164,000, respectively, for interest and guarantee fees paid by Mrs. T for the bank loans and

attributed to Mr. T under the income attribution rules. The CRA denied these deductions.

Mr. T argued that the deductions were deductible losses from the Canco shares transferred to Mrs. T; the losses were attributed to Mr. T under subsection 74.1(1), which deems any income or loss realized by a spouse from a property transferred to him or her to be the transferor spouse's income or loss. The CRA argued that Mr. T received three tax benefits: (1) the shareholder loan was not included in his income; (2) he deferred a tax liability by not electing out of a rollover on the disposition of his shares; and (3) deductions for Mrs. T's interest and carrying charges were attributed to him, and he used the borrowing to repay his shareholder loan. The TCC followed the three-step analysis in *Canada Trustco*.

1) Is there a tax benefit? The taxpayer claimed a deduction against taxable income and thus "may have obtained a tax benefit."

2) Are the transactions undertaken primarily to obtain a tax benefit? Mr. T adhered to subsection 15(2) by repaying his shareholder loan within the year, and thus the loan was not included in computing his income: this transaction was not an avoidance transaction, and GAAR did not apply. The TCC noted that the plain intention of subsection 73(1) is to facilitate the interspousal transfer of property, and Mr. T followed the rules to facilitate the transfer of the common shares to his wife: the transaction was thus not an avoidance transaction and GAAR did not apply. Regarding subsection 74.1(1), the TCC said that the plain meaning applied and the loss on the transaction was attributed to Mr. T. Mr. T followed the rules and was thus entitled to claim the loss; this was not an avoidance transaction, and GAAR did not apply.

3) Is the avoidance transaction abusive? The TCC said that none of the transactions were avoidance transactions, and thus it was not necessary to deal with the third test; but in the event that the court was not correct in its determination, it considered the third test. In analyzing the meaning of the words "abusive tax avoidance," the TCC said that comments in *Canada Trustco* were useful:

> The GAAR was enacted as a provision of last resort in order to address abusive tax avoidance, it was not intended to introduce uncertainty in tax planning. . . .
>
> Parliament sought to address abusive tax avoidance while preserving consistency, predictability and fairness in tax law and the GAAR can only be applied to deny a tax benefit when the abusive nature of the transaction is clear. . . . Unless the Minister can establish that the avoidance transaction frustrates or defeats the purpose for which the tax benefit was intended to be conferred, it is not abusive.

On the basis of its understanding of the evidence and GAAR, the TCC did not believe that any of the transactions could be considered to be abusive tax-avoidance transactions, and thus GAAR did not apply.

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Global Strategies for Tax Disputes

Tax administrators around the world are routinely challenged by the effects of the globalization of business operations, such as the centralization of functions and risks by multinational corporations (MNCs). Tax administrators need to develop means to manage their increasingly demanding workload in order to fulfil their treaty obligations to avoid double taxation.

Functions and risks transferred. In order to lower the overall cost of operations, an MNC typically transfers the performance of functions (and often the assumption of risks) out of many different countries into a low-cost jurisdiction, frequently centralizing them in one location. Although many if not most such transfers represent legitimate business restructurings, often significant tax savings arise that commonly precipitate major tax controversies over potential goodwill exit tax imposed by the affected high-tax countries and the consequent sharp decline in corporate tax revenues. Numerous tax issues also commonly arise under the new business arrangement between the principal operating in the low-tax, low-cost jurisdiction and the affiliates in the higher-tax jurisdictions—for example, whether the principal has a permanent establishment (PE) in one or more affiliate jurisdictions; the amount of profits to be attributed to the PE(s); the appropriate markups for various services performed cross-border; whether intangibles are developed locally in any affiliate jurisdictions; and the extent to which the economic behaviour of the parties is consistent with the underlying documentation. Several OECD working parties are revising OECD model treaty commentary rules that define when a PE exists and the extent of profits attributable to the PE. Publicly circulated drafts, although intended to clarify, have caused considerable controversy in the business community, especially among US MNCs, because of a perception that they expand source-based taxation and will likely increase double taxation.

The value of the functions and risks transferred can also elicit controversy between the tax authorities in the affected countries; some of the more critical issues include the following.

1) Are the distributors in the affiliate countries true strip-risk distributors, or do they perform more extensive entrepreneurial functions?

2) If contract manufacturing is performed, did the pre-restructuring manufacturing function generate local manu-

facturing intangibles that must be compensated? A continued sharp rise in investments by MNCs in countries with key markets will intensify the focus on whether local intangibles have been developed, especially if an MNC's market share in a particular category rises and its profit margin per unit sale increases. The deduction of local marketing-related costs is often a factor in this analysis. Whether locally developed intangibles exist is in issue in several US mutual agreement procedure (MAP) cases involving foreign-initiated adjustments and is a major area of dispute in the pending *Glaxo* litigation.

3) Does the low-tax-jurisdiction principal deliver premium or high-priced services that are embedded with intangibles? The United States and many other developed and less developed nations are focusing on the transfer-pricing implications of the heavy cross-border traffic in clerical, administrative, and support services that is primarily intended to reduce the MNC's overall cost structure. The propriety and extent of any markup will remain controversial until the United States, the OECD, and other stakeholders align their treatment of administrative services. Moreover, controversy—as reflected in both the number of cases and the quantum of adjustments—over the pricing of premium-valued services and the presence of embedded intangibles is likely to increase. The IRS has committed to issuing new regulations on intercompany services by the end of the current business-plan year, and the OECD working party continues to seek consensus among member countries.

4) A lack of clarity and agreement is heightening tensions over the apportionment of savings from performing functions, typically manufacturing, in low-cost locations. In a series of cases the IRS sought unsuccessfully to shift significant cost savings to the United States; its position is currently in flux. Other countries have adopted various positions, including theoretical residual profit splits and more pragmatic revenue-driven methods. No single approach is uniformly taken in developed or less developed nations.

5) The continued increase in tax dispute complexity and quantum makes it imperative that tax administrators agree on the parameters for comparable transactions. For example, the geographical criteria for comparables are not established: must the comparable occur in the country where the adjustment is proposed, or are regional or global comparables allowed? Limitations on public disclosure of financial data may render it extremely difficult to rely on local comparables; whether secret comparables should be allowed remains controversial.

Dispute resolution strategies. Globalization will continue to heighten the need for effective dispute resolution strategies. Governments will strive to balance the need to protect their corporate tax base and the need to adhere to their tax treaty obligations to reduce or eliminate double taxation. Arriving at a conceptual agreement on the standards for tax disputes is essential. If the expectations for the global economy are to be met, effective dispute resolution strategies must be implemented in order to minimize the possibility of double taxation and avoid the slower economic growth that ultimately could impede corporate tax collections. The author, the most recent US competent authority, offers the following thoughts on dispute resolution strategies.

■ Given the magnitude and complexity of the challenges, tax administrators must agree on the appropriate standards for resolving cross-border tax disputes or be frustrated in their attempts to reach a settlement; even when identical standards are applied, countries cannot always reach a settlement. The taxpayer ultimately bears the brunt of such a failure in the form of double taxation. The recently executed Canada-US memorandum of understanding (MOU) concerning factual disputes, for example, recognizes the need for a new dispute resolution tool: if the two MAP organizations cannot agree on a case's underlying facts, the case is referred to the respective appellate functions for resolution.

■ Tax administrations need additional resources. All tax administrations have various tools to resolve tax disputes, ranging from administrative appeals to APAs and MAP proceedings on cross-border transactions; litigation is the final resort. In order to ensure effective dispute resolution, tax administrators must have adequate resources to manage an increasing inventory of cases, including adequate training for personnel to develop technical expertise and negotiating skills. Many countries assign myriad functions to the same personnel and provide minimal support. The demographics in many developed countries suggest that the next generation of tax administrators must be prepared to take the reins soon. It is increasingly clear that transfer pricing is likely to remain the key focus of cross-border tax controversies, and an APA is key to a country's success in managing the issues. The APA program has proved valuable in resolving complex cases with large amounts in controversy, and it is also an instructional tool for tax administrators on the intricacies of cross-border transfer pricing. Recently the State Administration of Taxation in the People's Republic of China issued a circular announcing procedures to be followed in its APA program; negotiation of bilateral APAs is intended to be centralized in the National Office.

■ Mandatory binding arbitration should be a standard feature of bilateral tax treaties to ensure the successful management of complex big-ticket cross-border tax disputes. Binding arbitration will be essential to resolve cases if the issue of intangibles embedded in transferred functions and risks becomes more prominent, as the author predicts. Binding arbitration prevents double taxa-

tion by imposing a time limit on competent authority personnel to reach an agreement on a case before their participation terminates, a pressure that will resolve cases and result in more reasonable audit examination practices. The US Treasury recently announced proposals for binding arbitration in treaty negotiations with two of its leading treaty partners. Canada recently reversed itself and expressed support for binding arbitration during a recent OECD working party meeting. Most importantly, an OECD draft recommendation released for public comment proposes to amend the OECD model treaty to provide binding arbitration.

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Pre-Incorporation Expenses

A recent ruling (2005-0159391E5) deals with activities that occur and expenses that are incurred before incorporation. The ruling also addresses the question whether there is an absolute time limit for a business conversion (from a partnership or sole proprietorship) or a new business incorporation for the purpose of determining whether pre-incorporation expenses are considered to have been incurred by the newco.

The CRA says that it is a question of fact whether business activities that occur before incorporation are considered the newco's activities; the conditions for the deductibility of such expenses are as set out in *Interpretation Bulletin* IT-454 ("Business Transactions Prior to Incorporation," August 11, 1980). The IT acknowledges that expenses are often incurred in contemplation of the newco's incorporation. Whether such expenses are considered to have been incurred by the newco—which does not exist at law until its articles are issued by the relevant government department—is one issue, but it is clear that the pre-incorporation expenses must have been in contemplation of the newco's formation. The CRA's administrative position (set out in paragraph 2 of the IT) is that most corporate statutes—including the CBCA and those in Alberta and Ontario—provide that a corporation that comes into existence may adopt a written contract made in its name or on its behalf before it comes into existence. The relevant statute may provide time limits for this relief, but if the applicable conditions are met the deductibility for tax purposes of expenses incurred is not an issue.

For jurisdictions that do not have such enabling legislation, the CRA normally accepts the accounting for pre-incorporation expenses by a newco if (1) the facts clearly indicate that it was the parties' intention that the business should be carried on by a corporation; (2) the time between the commencement or purchase date and the incorporation is relatively short and any delay is not due to an action taken by the parties involved; (3) the persons authorizing the transactions and the newco do not dispute who will account for the transactions; (4) the effect on the combined tax liabilities of the parties involved is negligible; and (5) the newco adopts any written contract made in its name or on its behalf before its incorporation in respect of the pre-incorporation expenses for which it is accounting.

The IT goes on to explain that if a proprietor or partnership incorporates an existing business, the CRA will not accept any pre-incorporation expenses as the newco's; such expenses of similar parties will be accepted as a newco's if they incorporate a newly acquired business.

Whether the time limit for business activity between the date of the decision to incorporate and the actual date of incorporation has been met so that the expenses can be accounted for by the newco can be determined only after all the facts are known. There is no absolute time limit.

Taxpayers that carry on business in jurisdictions without enabling corporate legislation should be cautioned that the CRA does not automatically accept pre-incorporation transactions as being a newco's transactions.

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R & D: Global Changes

Belgium's new refundable tax credit, effective in 2006, was tailored to trigger favourable accounting treatment. Non-refundable incentives are treated for accounting purposes as a below-the-line credit, which does not stimulate increased R & D spending because most companies measure earnings before interest and taxes (EBIT); in contrast, refundable credits reduce costs to which they relate and therefore increase EBIT. This new incentive is intended to enhance the position of Belgium-based R & D centres in international comparisons.

Effective after 2005, **France** enhanced its corporate R & D incentive program by increasing the base incentive to 10 percent from 5 percent of qualifying expenditures and by reducing the incremental incentive to 40 percent from 45 percent. The maximum claim rose from €8 million to €10 million, which is either creditable or, with certain restrictions, refundable.

Bucking the trend to introduce or enhance R & D incentives, **Spain** proposed a five-year phase-out of its R & D incentive program as part of an overall proposed corporate tax rate reduction to 30 percent from 35 percent.

The **United States**' R & D credit expired at the end of 2005; proposed legislation extends the credit for one year, and President Bush intends to make the credit permanent,

rationalize it, and improve its effectiveness. The current credit is difficult to work with and provides only limited benefits to many taxpayers. Temporary R & D incentives are a drawback to companies that consider the benefits of the credit in their investment decision-making process.

Poland introduced a new R & D regime, **Portugal** reintroduced incentives, and the **United Kingdom** proposed changes to make its incentives more effective. Both **China** and **South Africa** announced the introduction of R & D regimes that provide a 150 percent deduction for R & D expenditures.

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US State Tax: Asset Purchases

The two primary US state tax issues that come into play when one is purchasing all, or substantially all, the assets of a US business are the imposition of sales and use tax and successor liability. Because the rules in the United States differ greatly from those in Canada, a Canadian purchaser of a US business must exercise due diligence to identify and prevent state tax exposure.

Sales and use taxes. Many states provide an exemption that could exclude the transfer of a business's assets from sales or use tax; a purchaser should determine whether an exemption is available and applicable. Generally, assets not normally sold by the seller in its regular business are exempt under a casual (or occasional) sale exemption. In most states, inventory is exempt as a sale intended for resale, where appropriately documented. Rules and regulations vary, and each state should be reviewed independently. For example, California generally imposes sales or use tax on the transfer of business assets if the seller is required to hold a California seller's permit. Texas generally does not impose sales or use tax on the transfer of business assets if the purchaser acquires the entire operating assets of a business or an identifiable segment of the seller's business. In Washington, sales tax is not imposed on the casual or isolated sale of tangible personal property sold by a person who is not engaged in the business of selling such assets; however, a use tax is generally imposed on the purchaser if the assets are for use in Washington.

Most states require a vendor to collect sales tax on the transfer of tangible personal property. Use tax is imposed on a purchaser for the use, storage, and consumption of tangible personal property within a state. Use tax is a complementary tax, meaning that it is imposed only if sales tax has not been properly paid, and it is generally imposed on the same base and at the same rate as sales tax. Thus, as noted above, the seller of business assets may not be required to collect sales tax from the purchaser, but the purchaser may be held liable for use tax.

Successor liability. Generally, when a retailer ceases to do business, most states require the filing of final tax returns and the payment of tax due. In the case of returns for trustee tax (sales and employment tax), if final returns are not filed or the tax goes unpaid, the obligation to remit the tax can fall on the purchaser of the business's assets. If the purchasing corporation does not satisfy the outstanding liability, most states can hold personally liable the individual responsible for filing these tax returns (a corporate officer). Most states do provide certain guidelines to prevent the passthrough of the seller's state trustee tax liabilities, such as filing for a state's tax clearance certificate, but a state may require the purchaser to actually remit these taxes on the seller's behalf.

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When Creditor Proofing Fails

If a tax-motivated transaction such as an estate freeze or a butterfly is detrimental to the rights of creditors, it may in some cases be set aside as a settlement or a reviewable transaction under the Bankruptcy and Insolvency Act (BIA) or provincial fraudulent conveyances or assignments and preferences legislation.

Settlements. A settlement is usually a transfer of property for inadequate consideration with the intent that the property be retained in its original form. In a gift, the donee is generally free to retain or dispose of the property. If the settlor becomes bankrupt within one year of the settlement, it is not necessary to prove that he was unable to pay his debts without the settled property; if bankruptcy occurs within five years, the settlement is voidable if the settlor could not so meet his debts. Debts may include contingent liabilities under a guarantee, depending on whether the guaranteed loan was in default at the time of settlement and whether other assets were available to satisfy debts. If a settlement is voided, the property is deemed to be the bankrupt's. Proof of fraudulent intent on the part of the transferor or the transferee is not required, but the exemption for a bona fide purchase for valuable consideration is not available if the transferee knew of the transferor's financial problems and the transferor's intent is established. A transfer of a residence to a spouse for natural love and affection or as part of an estate plan is a settlement even if no thought has been given to creditors. If a person was the registered owner of property that was being held on resulting trust for a family member (that is, if the family member contributed to the price), the transfer to the beneficial owner will not be

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viewed as a settlement. A shareholders' agreement entered into shortly before bankruptcy that provides for the buyout of an insolvent shareholder at a discount is a settlement.

Reviewable transactions. A court may review a transaction made within one year of bankruptcy by the bankrupt (whether or not insolvent) and set it aside if the price was conspicuously greater or less than FMV. A new rule dealing with under-value transfers will provide that in an arm's-length transfer, the recipient is liable for the shortfall in consideration given or received by the debtor relative to FMV of the property or services if (1) the transaction took place within one year of the date of bankruptcy, and (2) the debtor was insolvent or was rendered insolvent by the transaction and the debtor intended to defeat the interest of creditors. In a non-arm's-length transfer, the other party is liable for the shortfall if (1) the transaction took place within one year of the date of bankruptcy, or (2) the transaction took place within five years before the date of bankruptcy and the debtor was insolvent at the time or was rendered insolvent by the transaction or the debtor intended to defeat the interests of creditors.

Fraudulent conveyances. A fraudulent conveyance of real or personal property is made with the intent to defeat, hinder, delay, or defraud creditors and is voidable. The "badges of fraud" include situations where (1) the grantor is in a precarious financial situation; (2) the transaction occurs between near relatives; (3) the property is shown as the grantor's after conveyance; (4) the grantor preserves an interest in the property; (5) the transaction denudes the grantor of property otherwise available to creditors or delays or defeats creditors; (6) the grantee knows that the property is worth substantially more than he or she must pay; (7) the transaction is done in secret; (8) consideration is inadequate or absent; (9) unusual haste is made in closing; and (10) there is no immediate or early change of possession.

If there was no consideration and the effect of the transaction is to defeat, hinder, delay, or defraud creditors, the court can infer fraudulent intent whether or not the grantee had notice or knowledge thereof. However, even if the requisite intent exists, a transaction is not void if it was made for good consideration (excluding natural love and affection) and in good faith to a person who at that time had no notice or knowledge of the grantor's intent. The transferor need not be insolvent at the time of transfer; the court will examine the financial position of the transferor and determine whether the transfer was to related parties for inadequate consideration and whether it removed all property otherwise available to creditors.

Assignments and preferences. Every conveyance of property made by an insolvent person with intent to defeat, hinder, or delay creditors is void against the injured creditors, except a bona fide conveyance in consideration of a present actual bona fide payment in money. Furthermore, every conveyance of property by an insolvent person to a creditor with the intent to give such creditor an unjust preference over other creditors is void against them. In contrast to fraudulent conveyances, at the time of transfer the transferor must be insolvent or unable to pay his debts in full or know he is on the brink of insolvency. If an individual has advanced unsecured sums to a spouse, the taking back of security after the spouse encounters financial difficulty may be a preference.

Under the BIA, a fraudulent disposition, concealment, or removal of property can attract a fine of $5,000, imprisonment up to one year on summary conviction, or both, or a fine of $10,000, imprisonment up to three years on conviction on indictment, or both. The Criminal Code provides that a transfer or concealment of property with intent to defraud creditors is an indictable offence subject to a penalty and imprisonment not exceeding two years.

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Foreign Tax News

Treaties

On February 2, 2006, a new **UK-Japan** treaty was signed. The new treaty (which replaces the 1969 treaty) improves benefits for investors, particularly UK companies investing in Japan, and restricts treaty relief via a comprehensive limitation-on-benefits article similar to that found in recent US tax treaties. The **United States** is starting treaty negotiations with Bulgaria; negotiations are in process with Canada, Chile, Germany, Hungary, Iceland, Korea, and Norway, and are substantially complete with Denmark and Finland. Informal exploratory discussions are under way with several Asian countries. **Luxembourg** and **Latvia** ratified a first income and capital tax treaty and protocol on February 16, 2006, as did **Luxembourg** and **Lithuania**.

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