Canadian Tax Highlights

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Third-Party Privilege

A lawyer often relies on the cloak of solicitor-client privilege to protect communications with and files of third-party advisers retained by him or her in the course of providing advice to his or her client. *Welton Parent* (2006 FC 67) warns that if a third-party adviser does not act as a conduit or channel of communications between solicitor and client, legal advice privilege protects the adviser's communications only if the adviser performs a function that is "essential" to the existence or operation of the solicitor-client relationship. The facts of *Welton Parent* form a pattern that is undoubtedly familiar to practitioners who retain experts in the course of preparing legal advice. The case provides little analytical guidance on why the facts failed the essential-function test, but the FC clearly states that simply seeking the views or expertise of a third-party expert when providing advice to clients does not, on its own, suffice to extend privilege.

Each of the two types of privilege—litigation privilege and legal advice privilege (solicitor-client privilege)—has a different underlying rationale and scope. The legal advice privilege covers confidential communications between solicitor and client, whether or not litigation is contemplated. The litigation privilege applies only in the context of litigation; it extends even to communications of a non-confidential nature between solicitor and client and includes materials of a non-communicative nature. The litigation privilege facilitates a process (the adversarial trial process), and legal advice privilege protects a relationship (the confidential relationship between solicitor and client).

On the facts, the CRA was auditing some Canadian employers who had claimed expenses for salaries and wages paid as contributions to alleged offshore health and welfare trusts for the employees' benefit. The CRA said that the plans did not qualify as health and welfare trusts under the criteria in *Interpretation Bulletin* IT-85R2, "Health and Welfare Trusts for Employees," July 31, 1986, and plan contributions were not deductible. During the audits, the CRA came across actuarial valuations prepared by an actuarial firm that indicated that other unnamed employers had established and contributed to similar plans. Those unnamed employers had retained lawyers to provide legal advice with respect to the plans, and the lawyers had retained Welton Parent.

The CRA issued a requirement on Welton Parent pursuant to subsections 231.2(1) and (3) to produce information and documents relating to one or more unnamed persons, for the purpose, inter alia, of obtaining the names of the unidentified employers who had established such plans. Welton Parent contacted the lawyers, who on instructions from their clients (the unnamed employers) brought a motion through Welton Parent challenging the order. Welton Parent challenged the requirement on several grounds, including that of solicitor-client privilege.

The court concluded that the names themselves were protected by legal advice privilege, but the information and documents targeted generally by the requirement were another matter. The court reviewed the jurisprudence on legal advice privilege and third-party advisers. The Exchequer Court in *Susan Hosiery* ([1969] 2 Ex. CR 27) confirmed that privilege should attach when a third party is used as a representative for the purpose of placing a situation before a lawyer to obtain legal advice, or when communications are received by such a representative from a lawyer whose advice has been sought. Although the decision was often couched in terms of whether the third party acts as an agent of either the solicitor or client, the Ontario Court of Appeal in *Chrusz* (1999 CanLII 7320) said that agency should not be pivotal to legal advice privilege. *Chrusz* said that if the third party cannot be described as a channel of communication between solicitor and client, then privilege hinges on the "true nature of the function that the third party was retained to perform": if it is "essential to the existence or operation of the client-solicitor relationship, then privilege should cover any communications which are in furtherance of that function."

The FC in *Welton Parent* concluded that Welton Parent's file—including its reports, notes, drafts, and communications with the unnamed taxpayers' lawyers—did not fall within the class of legal advice privilege "simply because these lawyers used [Welton Parent's] views to provide legal advice to their client." The court did not set out its analysis of how the *Susan Hosiery* and *Chrusz* principles applied to the facts of *Welton Parent*. It is clear from the

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facts that Welton Parent did not act as a conduit between solicitor and client or as a representative of either, but the FC did not say how one is to determine when such a third-party adviser is retained for a function essential to the solicitor-client relationship. Unfortunately, the fact pattern is strikingly similar to the circumstances in which, as a matter of course, many practitioners retain third parties in the course of advising their clients. *Welton Parent* offers a clear statement of the relevant principles, but it is left to future cases to clarify their scope.

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GAAR on CGE Monetization

In *Desmarais* (2006 TCC 44), the taxpayer entered into a series of transactions as part of a capital gains exemption (CGE) monetization strategy. The TCC found that GAAR applied: using the tax attributes of one corporation to withdraw funds from another constituted a misuse or abuse of the Act, and in particular of section 84.1.

The taxpayer, Mr. D, owned 15 percent of A Co's shares; 85 percent were owned by six shareholders at arm's length with Mr. D. Mr. D's shares' ACB and PUC were nominal, and their FMV was about $120,000. Mr. D and his brother owned B Co 50-50; Mr. D's ACB and PUC were nominal. A Co had no surpluses available for distribution and had significant debt. B Co had surpluses available for distribution.

Mr. D incorporated Holdco and transferred to it 9.8 percent of his A Co shares, electing under subsection 85(1) at $120,000 and taking back Holdco's class A preferred shares with high legal PUC. Mr. D realized a capital gain of $120,000 and claimed the CGE. Immediately after the transfer, Holdco and A Co were not connected because Holdco owned less than 10 percent of A Co and together with Mr. D did not control A Co. Thus, section 84.1 did not reduce the tax PUC of the Holdco class A preferreds, and under subsection 85(2.1) the PUC can be as high as the elected amount of $120,000. Mr. D's tax PUC and ACB of the Holdco class A preferreds was $120,000. As part of the reorganization, Mr. D also transferred his shares of B Co to Holdco for Holdco class B preferreds, electing a transfer price of $210,000 and triggering a capital gain sheltered by his CGE. Section 84.1 reduced the legal PUC of Holdco class B preferreds to the B Co shares' PUC, a nominal amount. B Co then paid dividends of $600,000 to Holdco, which redeemed its class A preferreds for $120,000. Because Mr. D's ACB and PUC on the class A preferreds was $120,000, he suffered no tax consequences.

The TCC agreed that GAAR applied. The court focused primarily on the three requirements that must be met if GAAR is to apply, which is the first of the seven steps set out in the SCC's *Canada Trustco* decision:

1) **Tax benefit?** The TCC concluded that a tax benefit arose from the series of transactions.

2) **Avoidance transaction?** The TCC acknowledged Mr. D's business purposes, such as his desire to pool all his investments in one entity and to make his own investment decisions separately from his brother. However, the TCC decided that the transfer to Holdco of only 9.8 percent of A Co was an avoidance transaction: it could not "reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit."

3) **Abusive tax avoidance?** The TCC concluded that the series of transactions constituted abusive tax avoidance because it could not be reasonably concluded that a tax benefit was consistent with the object, spirit, or purpose of the provision that the taxpayer relied on. If Mr. D had transferred only his B Co shares to Holdco, he would have received shares with low PUC because section 84.1 applied, and on a future distribution of B Co's surpluses through Holdco he would have received a taxable deemed dividend instead of a tax-free return of PUC. On the other hand, if the funds used to redeem Mr. D's class A Holdco preferreds had come from A Co, the TCC seemed to be of the view that neither section 84.1 nor GAAR would have applied and that the surpluses arising from A Co could have been distributed to Mr. D. The TCC decided that Mr. D's drawdown of the PUC of the Holdco class A preferreds received for the A Co shares achieved a tax-free distribution of B Co's surpluses through Holdco—a distribution that, if done directly, would have been prevented by section 84.1—constituted a blatant abuse for two reasons: (1) A Co may not be able to pay significant dividends to its shareholders for many years because of its requirement to reduce its debts. The immediate redemption of Mr. D's class A preferreds using B Co's funds allowed him to avoid taxes that would have been payable had he received a direct contribution of B Co's surplus. Although an eventual distribution through Holdco to Mr. D of A Co's funds after the class A preferreds' redemption would trigger tax to him, the immediate tax-free class A preferreds' redemption still promised to achieve a tax deferral. A "tax benefit" as defined in section 245 includes a tax deferral. (2) A Co's distribution of surpluses to its shareholders was not a certainty. For example, A Co might have become bankrupt before it was in a position to pay dividends, transforming the tax deferral into tax avoidance.

At first glance, *Desmarais* seems to be at odds with the decision in *Evans* (2005 TCC 684). In that case, the TCC found in favour of a taxpayer who used a partnership in his CGE monetization planning: each section relied on was said to have been used for its intended purpose and according to its design, and therefore there was no abuse of the Act.

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Bonus from Goodwill Proceeds

A recent advance tax ruling (2005-0163741R3) allowed a Canadian-controlled private corporation (CCPC) a deduction for bonuses paid to several shareholder-managers even though a portion of the underlying income came from the sale of its goodwill and other business assets rather than from the company's regular business activities.

The CRA's longstanding position is generally not to challenge the reasonableness of a salary or bonus paid to a CCPC's Canadian-resident shareholder-manager if he or she is active in the operating business and the remuneration is paid out of income from the CCPC's normal business activities. The CCPC may deduct the salary or bonus to reduce its income to the threshold for the small business tax rate; on several occasions the CRA has confirmed this general policy on bonusing down to the small business threshold.

In the ruling, three holdcos—A Co, B Co, and C Co—owned equal numbers of Opco shares. Each holdco was owned in turn by Mr. A, Mr. B, or Mr. C and a corresponding spousal trust. Mr. A, Mr. B, and Mr. C and their spouses (the shareholder-managers) were all Opco directors and were therefore responsible for the strategic direction of the company. Mr. A, Mr. B, and Mr. C managed Opco's day-to-day activities.

Opco had a history and general practice of paying bonuses to its shareholders in years when its taxable income exceeded the small business threshold. During the current year, Opco sold its goodwill and other business assets to an arm's-length purchaser for significant proceeds. The current year's assets, salaries, and bonuses were already higher than in prior years because the company retired bank financing whose loan covenants had restricted the remuneration payable to the shareholder-managers. Opco proposed to pay bonuses to the six shareholder-managers to compensate them for their contribution to the successful management of Opco and to distribute to them the proceeds from the sale of the business assets in a tax-effective manner.

The CRA ruled that paragraph 18(1)(a), section 67, and subsection 78(4) did not prohibit Opco from deducting the amount of the bonuses. This ruling accords with previous rulings (see 2004-0092931R3 and 2005-0146031R3). However, the ruling seems to contradict the CRA's statement at the Canadian Tax Foundation's 2003 annual conference round table that its administrative policy of not challenging the deductibility of bonuses to shareholder-managers does not apply to bonuses paid as part of the sale of the payer corporation's business assets.

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Capital Gains 2003

Statistics on personal income for the 2003 tax year are now available on the CRA's Web site (http://www.cra-arc.gc.ca/agency/stats/gb03/pst/final/tabhtml-e.html). Table 9 therein provides information on the 1.2 million income tax returns reporting capital gains or losses, and on the $9.7 billion in taxable gains shown on those returns.

The table below shows that the average gain (before the inclusion rate is applied) amounted to $24,620 in 2003 and represented 72.2 percent of the average income reported by all 23.1 million returns. By income class, however, the importance of capital gains varied. In the "loss or nil" category, individuals were able to realize on average $35,324 of capital gains tax-free because they were offset by losses in other income categories and yielded no tax payable. The average gain dropped to only $5,893 for those with incomes between $1 and $20,000, representing 56.9 percent of the average income in this income class. While the average gain increased as incomes rose, gains declined as a percentage of all income, falling to a low of 19.6 percent of average income in the income range $60,000 to $80,000, for which the average gain amounted to $13,434.

Taxpayers who had incomes over $100,000 and reported gains saw high average gains that represented a significant portion of total income; in many cases, the gains pushed taxpayers into higher income ranges. Because the main tables on the CRA's Web site do not break out the income range $150,000 to $250,000, the percentage of average income for that range has been used here for both of the income classes (shown separately in table 9).

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Capital Gains, 2003 Tax Year

	Average total capital gain	
Income class ($)	Amount ($)	As percentage of average income
Loss or nil	35,324	–221.7
1-20,000	5,893	56.9
20,000-40,000	8,739	29.8
40,000-60,000	11,055	22.7
60,000-80,000	13,434	19.6
80,000-100,000	19,205	21.7
100,000-150,000	34,037	28.8
150,000-200,000	56,725	34.3
200,000-250,000	77,688	34.3
Over 250,000	213,269	37.3
Average	24,620	72.2

AULC and NSULC Update

In 2005, Alberta amended the Alberta Business Corporations Act to allow the incorporation or continuance in Alberta of an Alberta unlimited liability corporation (AULC). Thus, as of May 17, 2005, Alberta became the second of only two provinces—the first was Nova Scotia—that allow for the incorporation of an unlimited liability corporation (ULC). Alberta has recently responded to concerns regarding the unlimited nature of a shareholder's liability for an AULC's debts. Nova Scotia has proposed amendments to the Nova Scotia Companies Act (NSCA) to streamline procedures. Each province is now attempting to make its ULC legislation as attractive as possible.

The main advantage of an NSULC or an AULC is that Canada and the United States treat ULCs differently for tax purposes. Canada treats NSULCs and AULCs as corporations because, like limited liability corporations, they are incorporated under Nova Scotia or Alberta legislation: they are not flowthrough entities, and they are subject to Canadian federal and provincial corporate income tax. In the United States, NSULCs and AULCs may elect to be treated as flowthrough entities. From January 1, 1997, US "check-the-box" regulations provided for two types of entities: per se corporations and eligible entities. Per se corporations, which are treated as corporations for US tax purposes, include all corporations under Canadian federal and provincial law except NSULCs and AULCs, which are treated as eligible entities because their members' liability is unlimited. As eligible entities, NSULCs and AULCs may be classified for US tax purposes as flowthrough entities—as branches if there is only one shareholder, and otherwise as partnerships.

AULCs. Shortly after enactment, concerns arose that an AULC shareholder's unlimited liability was greater than an NSULC shareholder's. To address this problem, a further amendment came into force on December 1, 2005. In addition to any immunity under the Limitations Act, under ABCA section 15.2(2) a former AULC shareholder is not liable for the AULC's debts if it ceased to be a shareholder at least two years prior to the bringing of an action to enforce a claim. By comparison, an NSULC's winding up or bankruptcy crystallizes liability. An NSULC's liquidators may require the NSULC's current members to contribute to payments for the company's debts and the costs of winding up; past members must also contribute unless their membership ceased at least one year before the winding up commenced. Furthermore, a former AULC shareholder is now not liable for an AULC's liabilities that arose after it ceased to be a shareholder. The NSCA contains a similar rule. No change was made to the rule that if an AULC becomes a limited liability corporation, its shareholders continue to be responsible for its liabilities that existed when it was an AULC; the NSCA contains a similar rule.

NSULC. A limited company may be converted to a ULC either by amalgamation or by plan of arrangement. The plan of arrangement is not a straightforward process; thus, amalgamation, though itself not a simple process, is the more commonly used method. The NSCA requires court approval for an amalgamation and for reductions of capital. To simplify the amalgamation process and preserve Nova Scotia's status as the jurisdiction of choice for ULCs, a discussion paper prepared by Services Nova Scotia and Municipal Relations explores the NSCA amendment proposals. In addition to the current amalgamation procedure, it is proposed that an amalgamation also be allowed (1) with the approval by a shareholders' special resolution of each company involved, or by a directors' resolution in the case of related companies, and (2) with the filing of an amalgamation agreement accompanied by the memorandum and articles of association of the proposed amalco and the filing of a statutory declaration by an officer or director of each company indicating (a) that it will be able to meet a solvency test on amalgamation and (b) that either an amalgamation will not prejudice creditors or creditors have been notified of the proposed amalgamation and have not objected. Proposals also simplify the methods for creating an NSULC: (1) an existing Nova Scotia limited company may convert to an NSULC by changing its memorandum of association through a unanimous shareholders' resolution; (2) an extrajurisdictional company may elect to become an NSULC upon continuance; and (3) an existing Nova Scotia limited company may re-register as an NSULC. The discussion paper recommends reducing both the $6,000 charge for an NSULC's incorporation—especially if the charge for incorporation of a ULC is lower in other jurisdictions (the

Current AULC and NSULC Differences

	AULC	NSULC
Limited liability	From date that is two years after ceasing to be a shareholder	On date one year following windup
Canadian director required?	Yes	No
Conversion to ULC	Continuance	Continuance or amalgamation
Corporate incest	Up to a maximum of 30 days	Permitted
PUC reduction	By special resolution	By shareholder or court approval
Amalgamation	Shareholder approval required; short-form and long-form	Shareholder and court approval required; long-form only
Name requirements	Include "ULC"	"Company"
Fees	Initial fee $100; no annual fee	Initial fee $6,000; $2,000 annually

charge is $100 in Alberta)—and the $2,000 annual registration fee (there is no annual fee in Alberta).

Another proposal replaces the requirement for court approval to reduce the capital of a Nova Scotia corporation (including an NSULC) with reductions by either special resolution or court order. For a reduction by special resolution, the corporation must first meet reasonable financial tests; otherwise, creditors are protected by having shareholders assume any consequent liability.

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SIB and Partnership

Subsection 125(7) defines a specified investment business (SIB) as, generally, a business whose principal purpose is to derive income from property, including interest, dividends, rents, and royalties. However, two important exceptions are made: a corporation does not carry on a SIB if it (1) employs in the business throughout the year more than five full-time employees, or (2) could have reasonably been expected to require more than five full-time employees except that an associated corporation provided managerial, administerial, financial, maintenance, or other similar services to the corporation in the year. On the facts given in document no. 2005-0120751E5, the CRA says that the latter exception is met if the services are provided by a partnership whose corporate partner is associated with the particular corporation.

A Co is a Canadian-controlled private corporation (CCPC) with fewer than five full-time employees; its only activity is carrying on a business whose principal purpose is to derive income from property. A Co is associated with B Co, a CCPC and general partner in a limited partnership whose limited partner, C Co, is also a CCPC. None of the partnership's employees are shareholders in A Co, B Co, or C Co. In the course of carrying on its active business, the partnership provides administrative services to A Co; the facts assume that in the absence of those services by the partnership, A Co could reasonably be expected to require more than five full-time employees.

In the CRA's view, the partners, B Co and C Co, carry on the partnership business; thus, B Co provides administrative services to A Co in the course of carrying on the partnership's active business. The CRA pointed to the FCA's decision in *Robinson et al.* (98 DTC 6065), which said that "all of the partners of a limited partnership carry on the business of the partnership." Because A Co could reasonably be expected to require more than five full-time employees if those services had not been provided, the CRA said that the exception to the SIB definition was met and A Co did not carry on a SIB.

The CRA's comments have important implications when determining whether a CCPC's income is eligible for the small business deduction and whether its shares will qualify for the capital gains exemption for qualifying small business corporation shares. Although the particular facts involved a limited partnership, the CRA's comments should apply equally to a general partnership.

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Treaties and Transparencies

Recent changes in bilateral tax treaties between the United States and its treaty partners may signal what is in store for changes under the Canada-US treaty. Since the United States codified rules denying treaty benefits for payments through hybrid entities, it has been seeking to update its treaties accordingly; Canada may be one of the few major US treaty partners whose treaty is yet to be updated. Canada may also want to update the treaty to reflect the 1999 OECD report, *The Application of the OECD Model Tax Convention to Partnerships*. It is widely speculated that a protocol dealing with these and other issues could be signed at any time.

The Canada-US treaty is silent on whether a partner is entitled to treaty benefits on income or gain from a partnership, but the CRA generally extends treaty benefits to a partner on its share based on the partner's residence status. Consistent with both the US and OECD model treaties, it is anticipated that Canada-US treaty benefits will be extended to a non-hybrid partnership by deeming it to be a resident of a contracting state to the extent that its income is subject to tax in that state as the income of a resident (the partner or the partnership). Such a test is similar to one in the Canada-US treaty for trusts, and it should apply whether the entity is receiving US- or Canadian-source income.

Two key proposed changes to the US-Spain treaty regarding income or gain flowing through a hybrid entity are representative of changes to other US treaties. The definition of "person" is clarified by including an LLC or other entity, wherever organized, that for US federal tax purposes is treated as a partnership or is disregarded as an entity. Furthermore, consistent with the "subject to tax" test on income that flows through a partnership, estate, or trust, income that flows through an LLC or other entity defined as a person is treated as income derived by a US resident to the extent that it is subject to tax as income of a US resident. If similar changes are made to the Canada-US treaty, it is widely anticipated that Canada will extend treaty benefits to passthrough LLCs (treated as partnerships or disregarded entities) in respect of Canadian-source income or gains to the extent that the LLC has US-resident owners. For example, if 50 percent of the LLC's income was allocated to US-resident owners, Canadian treaty benefits would apply to half of the LLC's Canadian-source income or gain. It is not yet clear whether a passthrough LLC is entitled to access the lower 5 percent withholding on direct dividends: is the requisite 10 percent owner-resident an LLC member or the LLC itself? If it is the latter, is the passthrough LLC viewed as a company?

It is also likely that Canada will extend treaty benefits to a foreign person such as a Cayman corporation that has US-resident owners and is treated as a passthrough entity for US tax purposes. Canada may seek to limit treaty benefits to foreign hybrid entities in jurisdictions with which Canada has a comprehensive exchange-of-information agreement. Canada will probably extend treaty benefits to a US grantor trust (a trust whose US-resident grantor is liable to tax on the trust income and is not a trust beneficiary). Canada is expected to deny treaty benefits to a Canadian-formed partnership receiving Canadian-source income that has elected under the US entity classification rules to be taxed as a corporation; the Canadian-source income is not taxed at the partnership or partner level, so the partnership is not a passthrough entity for its US-resident partners. The CRA recognizes entitlement to benefits under the current treaty for these reverse hybrid entities. The CRA is expected to confirm its longstanding position of extending treaty benefits to US S corporations. Procedurally, it is anticipated that the LLC or other entity will provide the Canadian withholding agent with information on the entity's classification and owners for US tax purposes.

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SR & ED and Outsourcing

A company may hire non-full-time personnel through specialized placement agencies or outsource certain functions to third parties in order to acquire personnel with certain skill sets, either part-time or for a particular project. Such arrangements are common in the information technology sector and in firms that undertake large engineering projects. At a conference on SR & ED organized by the Association de planification fiscale et financière (APFF) in Montreal on March 16, 2006, CRA representatives set out the CRA's administrative policy on SR & ED and contracts with placement agencies and similar organizations. Understanding the CRA's policy is crucial to assessing the potential impact on a particular SR & ED claim and the need to develop different strategies related to outsourced personnel.

Can a company that uses placement agency workers in its SR & ED projects include the costs of these employees in its SR & ED claims? The answer is complex and depends on the facts—for example, whether the taxpayer uses the traditional or the proxy method of claiming overheads. If the taxpayer uses the traditional method, then the cost of personnel hired through placement agencies and performing qualifying SR & ED activities can be claimed either as expenditures that are all or substantially all attributable to SR & ED or as overhead. Under the proxy method, only a limited number of expenditure types can be claimed. Contracts for SR & ED can be claimed, but contracts for services cannot; the CRA says that a standard contract between a taxpayer and a placement agency is not for SR & ED but for the supply of services, and it is therefore not claimable. However, it is CRA administrative policy to look at the amount of time spent on SR & ED by each contracted individual, and the CRA is prepared to allow payments to a third party for an individual who provides services and all or substantially all of whose time is spent in qualifying SR & ED activities during the fiscal year. CRA policy interprets "all or substantially all" as meaning more than 90 percent of the time, although there are court cases that set a lower threshold.

The CRA provided two examples at the APFF conference. In one case, a placement agency provided 25 individuals who spent all or substantially all of their time on SR & ED; all the costs were treated as a contract for SR & ED. In another example, a taxpayer using the proxy method outsourced IT work to a consulting firm. The contract was for 50 named individuals. The 30 individuals who spent all or substantially all of their time on SR & ED generated eligible costs. The other 20 individuals spent 60 percent of their time on SR & ED; their costs were not considered eligible as SR & ED under the proxy method, although the costs that related to 60 percent of their time were eligible if overheads were claimed using the traditional method.

The CRA announcement provides three important lessons: (1) Although the legislation is intended to provide incentives to Canadian taxpayers to perform SR & ED, it is not enough that the work undertaken by the individual is eligible: the contractual agreement related to the individual must fit within the parameters of the legislation. (2) A taxpayer's choice of method to claim overheads may be crucial. (3) If the taxpayer uses the proxy method to claim overheads, it is important to ensure that SR & ED contracts are worded properly to show that taxpayers are contracting for SR & ED and not for services.

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California LLC Fee Unconstitutional

A California court in *Northwest Energetic Services LLC v. Franchise Tax Board* (no. CGC 05-437721 (Superior Court, San Francisco County, March 3, 2006)) held that the state's limited liability company (LLC) annual fee violates the US constitution's commerce and due process clauses. The decision may generate refunds of LLC fees paid by out-of-state LLCs, including Canadian-owned LLCs.

The LLC fee, imposed by California Revenue and Tax Code section 17942, applies to an LLC that does business in California or is registered with the California Secretary of State whether or not it actually does business in the state. The LLC fee is based on the LLC's total income: the minimum annual fee is US$800 and the maximum fee is US$11,790 (for an LLC with total income of US$5 million or more).

Northwest Energetic Services LLC, an explosives distributor, had business locations in Washington and Oregon and was registered to do business with the California Secretary of State, but it had no other California activities. Northwest Energetic paid the LLC fee and sued for a refund. At trial, the San Francisco Superior Court said that the LLC fee violated the due process and commerce clauses because it was not fairly apportioned to California: Northwest Energetic had no California activities. The court reasoned that a multistate LLC would face multiple taxation if every state imposed a similar fee on an LLC's total income. The decision is non-precedential, so it only binds the California Franchise Tax Board and State Board of Equalization with regard to Northwest Energetic; California may appeal, and at this time it need not refund LLC fees to other taxpayers.

LLCs should continue to pay current LLC fees, but they may consider filing protective refund claims for open tax years under California's four-year statute of limitations for refunds. In light of the *Northwest* decision, California tax authorities recently outlined protective-claim filing procedures for taxpayers who had previously paid LLC fees.

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Corporate Inversions Update

The US corporate inversion tax rules enacted in 2004 affect a wide range of cross-border transactions, including Canadian income fund offerings coupled with acquisitions of US target companies, and transfers by Canadians of certain US-situs property to Canadian holdcos to avoid US estate tax. Three recent proposals clarify and modify these rules. (1) Temporary regulations issued December 27, 2005, effective March 4, 2003, clarify some important aspects of these new rules, particularly with respect to affiliate-owned stock, and they also provide a warning with respect to exchangeable share transactions. (2) Forthcoming additional regulations will clarify the "substantial business activities" exception and the application of the inversion rules to foreign partnerships. (3) Proposed legislation both tightens the inversion rules and provides relief to Canadian acquisitions of certain non-publicly traded US companies.

A corporate inversion may occur when a Canadian or other non-US entity acquires substantially all the equity interests or assets of a US corporation or partnership, and thereafter the target's former equity holders own at least 60 percent of the non-US acquiror's stock. (If they hold 80 percent or more, the non-US acquiror is treated as a domestic corporation.) The inversion rules do not apply if the non-US acquiror conducts substantial business activities in its home country. In determining whether the post-acquisition level of ownership is met, stock held by members of the expanded affiliated group (EAG) that includes the non-US acquiror and stock of the non-US acquiror sold in a public offering related to the acquisition is excluded. The latter exclusion is particularly important in structuring Canadian income fund offerings involving acquisitions of US targets.

1) New temporary regs primarily address stock held by members of the EAG, which is made up of the non-US acquiror and all companies connected to it by a chain of greater than 50 percent ownership. The regs seek to prevent the abuse of the affiliate-owned stock rule through the use of "hook stock" (stock of the non-US acquiror held by an entity in which it holds at least 50 percent of the stock, directly or indirectly): affiliate-owned stock is completely excluded from the fraction that determines the stock ownership percentage.

The regs also clarify that some legitimate internal group restructurings are outside the scope of the inversion rules—namely, certain transactions occurring as part of an internal group restructuring involving a US entity, and certain business acquisitions between unrelated parties where the former shareholders or partners of the US entity have a minority interest in the acquired properties after the acquisition. The preamble to the regs also hints at future guidance on at least eight additional inversion issues, and warns that the IRS may use its authority to issue anti-abuse regulations to address structures that it considers potentially abusive, including structures involving the use of exchangeable shares and intermediaries.

2) More recently, an IRS official, speaking at a Federal Bar Association meeting in Washington, acknowledged the broad authority to issue regs conferred by the statute, and indicated that forthcoming regulations will address how to determine whether an affiliated group has "substantial business activities" in its home country. It was suggested that the test may be modelled on the limitation-on-benefits article in many modern US tax treaties, such as that with the Netherlands. The official also indicated that new regs will prevent attempts to avoid the inversion rules by using a foreign partnership as the non-US acquiror: some taxpayers say that the rules' reference to "foreign entities" does not cover foreign partnerships, which are not taxable entities.

3) Legislation introduced in the US Senate in November 2005 proposed significant amendments to the inversion rules and is currently before the House and Senate conference committee. The proposals (a) make the rules retroactive to transactions completed after March 20, 2002 (currently March 4, 2003); (b) lower the threshold for inversions from 60 to 50 percent; (c) increase the potential accuracy-related and gross-valuation misstatement penalties for taxpayers related to the US target; (d) eliminate the generally applicable debt-equity threshold in applying the interest-stripping rules to taxpayers related to the US target; and (e) lower the threshold for excess interest expense from 50 to 25 percent. These changes may cast the net wider to catch more acquisitions of US companies by foreign entities. However, the proposal also excludes the acquisition of a US company if none of its stock was publicly traded at any time during the four years ending on the acquisition date—a welcome change for Canadian income fund offerings involving acquisitions of US companies.

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Computer Software Services

British Columbia's February 21, 2006 budget announced that effective after budget day, computer software services were exempt from the 7 percent social services tax. Previously, software services such as installing, re-installing, configuring, eradicating viruses, repairing, restoring, or providing other corrective action were subject to tax, as set out in Ministry of Small Business and Revenue *Bulletin* SST 040, "Computer Hardware, Software and Related Services." The bulletin is being revised to reflect this change.

The new exemption is intended to enhance competitiveness by reducing servicing costs, thereby encouraging business and home computer users to properly maintain their computer systems for efficient and secure computing. The exemption relieves small businesses that perform computer services from the difficult task of determining whether the tax applies. Under the previous system, not all services to software were taxable, and some services—such as certain custom modifications to software—qualified for exemption. Tax still applies to services for which the purchase price became payable or was paid before the effective date. The change does not affect the purchase of software, which remains fully taxable unless it qualifies as custom or custom-modified software. Services to computer hardware also remain subject to tax.

Ontario continues to tax computer program services, although it has recently taken some cautious steps to alleviate the burden the tax imposes on businesses and consumers. On April 1, 2006, Ontario launched a pilot project for small businesses with total annual sales of under $400,000, the Simplified Calculation of Retail Sales Tax for Computer Program Services. Under the pilot project, registered businesses may apply a reduced 6 percent rate to all the computer program services included in a sale of both taxable and non-taxable computer program services. The normal 8 percent rate, not the reduced rate, applies to a sale that includes only taxable computer program services. The new British Columbia exemption approach goes much further to enhance competitiveness and alleviate the administrative burden on small businesses.

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Control Further Dissected

The recent *Sedona Networks* decision (2006 TCC 80) dealt with the "hypothetical shareholder" rule in the definition of a Canadian-controlled private corporation (CCPC) in subsection 125(7). The TCC negotiated through these complex and sometimes confusing provisions and upheld the minister's denial of the taxpayer's claim for refundable investment tax credits because the taxpayer was not a CCPC throughout the year.

Sedona had two "groups" of shareholders, each with nearly half the shares: a group of Canadian residents who were not public corporations or controlled by public corporations, and a group (the disqualifying shareholders) that included non-residents, public corporations, and corporations controlled by non-resident and public corporations. Was Sedona a CCPC throughout its 1999 taxation year? Key to determining whether Sedona was controlled by non-residents and public corporations was the ownership of some of Sedona's voting preferred shares by a wholly owned subsidiary (X Co) of a publicly listed financial institution (Pubco)—a disqualifying shareholder—and an agreement concerning the ability to vote those shares. Also at issue were certain options to acquire Sedona shares and the relevance of a shareholders' agreement.

A corporation is generally a CCPC unless it is listed on a prescribed stock exchange or controlled by disqualifying shareholders. For this purpose, paragraph 125(7)(b)—enacted to overcome the result in *Silicon Graphics* (2002 DTC 7112 (FCA))—requires the hypothetical aggregation

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of all disqualifying shareholders into a single person to determine control. These shareholders may or may not in fact act together to control, or indeed have any relationship whatsoever.

De jure control. The courts have repeatedly accepted the *Buckerfield's* (64 DTC 5301 (Ex. Ct.)) "de jure" approach to determining control, an approach implicitly validated by Parliament with the addition of the de facto control rule in subsection 256(5.1) for association purposes. The language in the CCPC definition does not use the phrase "controlled directly or indirectly in any manner whatever" (the language used in subsection 256(5.1)), and thus the de facto approach to control was not applicable. X Co, a disqualifying shareholder, had agreed to cede the power to vote its Sedona shares to a third-party investment manager (Manageco), which held the shares as part of a technology portfolio. The taxpayer argued that the agreement was a unanimous shareholders' agreement (USA) that stripped the rights of the X Co board of directors to vote X Co's Sedona shares, thus removing de facto its voting power over the shares. That power was to be exercised by Manageco, which was neither public nor non-resident. The court easily dismissed the agreement as irrelevant, citing *Duha Printers* (98 DTC 6334 (SCC)) and clarifying *Alroy* (76 DTC 6220 (FCTD)). The agreement was a private agreement between a shareholder and a third party, and thus had no relevance in determining control of Sedona. The agreement between X Co and Manageco was not a constating document or a USA of the Sedona shareholder for the purposes of the Canada Business Corporations Act (CBCA), because it did not remove the powers of X Co's directors to manage X Co; it merely ceded to a third party the right to deal with certain X Co investments. The management agreement might be relevant for determining de facto control but not for the purpose of determining de jure control. The general test for de jure control was enunciated by Jackett P in *Buckerfield's*: does the majority shareholder enjoy "effective control" over the "affairs and fortunes" of the corporation as manifested in the "ownership of such a number of shares as carries with it the right to a majority of the votes in the election of the Board of Directors"? In *Duha Printers*, the SCC said that the determination of "effective control" includes consideration of any specific or unique limitations on either the majority shareholder's power to control the election of the board or the board's power to manage the business and affairs of the company as manifested in its constating documents or a USA.

Options. The court concluded that it need not decide whether certain options were granted to a non-resident shareholder in 1999. Paragraph 251(5)(b) provides that an option holder is "deemed to have the same position in relation to the control . . . as if the person owned the shares," but it does not confer ownership of shares on the particular shareholder. Ownership is required for the purpose of the CCPC definition. In contrast, the de facto control test for association deems such ownership. Thus, even if the non-resident owned the options, he did not own the shares, and the shares under option could not be counted as a disqualifying shareholding. This is a fine hair, correctly split, that may augur a legislative amendment.

USA? Under a voting agreement, all of Sedona's shareholders had apparently agreed to vote their shares to elect an equal number of resident and non-resident directors. The taxpayer argued that this agreement resulted in the disqualifying shareholders' not having the right to control the board of directors. The TCC quickly concluded that even if all shareholders had entered into such an agreement, it was not a USA as defined in the CBCA because it did not restrict the power of the directors to manage Sedona's business. The TCC said that agreeing to vote for a particular set or group of directors was not the same as restricting the power of directors to manage the corporation.

The SCC in *Duha Printers* said that a USA for CBCA purposes can be taken into account in determining corporate control. The CBCA has specific USA requirements; other statutes governing corporations in Canada may have different requirements. A subsequent article will explore USA provisions in various corporate statutes in Canada.

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Foreign Tax News

China

On March 16, 2006, a tax authorities' notice clarified the meaning of "business" and "preparatory or auxiliary" in the PE article of China's treaties, in line with the OECD model treaty commentary.

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