CANADIAN TAX Highlights

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BENEFICIAL OWNERSHIP: SPECIAL-PURPOSE VEHICLES

A recent decision of the UK Court of Appeal, *Indofood International Finance* ([2006] EWCA Civ 158), concluded that an intermediary corporation that received income and made payments under back-to-back arrangements was not entitled to the benefit of treaty-reduced withholding tax rates on its income. The decision may negatively affect many common structures used for international tax planning.

In 2002, Indofood, an Indonesian company, sought to raise capital by issuing loan notes on the international market. To avoid the 20 percent withholding tax on interest payments under Indonesian domestic law that would be triggered if Indofood issued the notes itself, its wholly owned Mauritius subsidiary issued the notes. The issuer on-loaned the capital to Indofood on terms that purported to comply with the Indonesia-Mauritius tax treaty and thus reduce withholding to 10 percent. The notes were redeemable early if Indonesian law changed to increase withholding to more than the 10 percent treaty rate, unless "reasonable measures" by the issuer could avoid the effect of the change.

In June 2004, Indonesia gave notice to Mauritius to terminate the treaty, thus increasing withholding to 20 percent. The treaty terminated in January 2005. Indofood sought to redeem the notes early, citing the unavoidable rate increase caused by the treaty's termination. The trustee for the noteholders claimed that the increased rate was avoidable by using a Dutch special-purpose vehicle (SPV) (Newco) as an intermediary to access a reduced rate under the Indonesia-Netherlands treaty. The issuer would assign to Newco the benefit of the loan agreement with Indofood. Indofood (with the support of the Indonesian tax authority) claimed that the proposed SPV structure would not ensure the lower rate because Newco would not be the beneficial owner of the interest payments as required by the Dutch treaty, nor would it be a Netherlands resident under that treaty.

The UK High Court ruled in favour of the trustee and found that a restructured loan using a Dutch SPV would avoid the effects of the Mauritius treaty's termination. Newco would not be a mere nominee or agent for the issuer, despite the contractual constraints on Newco's dealing with the interest income; it was key that undistributed interest held by Newco would be available to all its creditors in the event of its insolvency. The CA reversed the High Court and held that Newco would not be the beneficial owner of the interest under the Dutch treaty. Nor, it said, was the Mauritius subsidiary the interest's beneficial owner under the existing arrangement, as yet unchallenged by the Indonesian tax authorities. This finding could have decided the case, but in his separate judgment the chancellor went on to say that the term "beneficial owner" should be given an international fiscal meaning. The OECD commentary was amended in 2003 to read as follows:

> It would be equally inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption where a resident of a Contracting State, otherwise than through an agency or nominee relationship, simply acts as a conduit for another person who in fact receives the benefit of the income concerned. For these reasons [the 1986 OECD Conduit Companies Report] concludes that a conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties.

The chancellor also quoted from an Indonesian tax circular and concluded that beneficial ownership requires "the full privilege to directly benefit from the income." On the facts, the chancellor said that Newco, in both "commercial and practical terms," was required to pay forward the interest it received and could not make the payment from any other source. Furthermore, Newco did not keep any interest rate spread: its compensation lay in handling charges and the injection of capital, although it is unclear whether this was a significant factor in the decision.

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The court did not discuss the relevance of the fact that the Dutch treaty was signed before the 2003 OECD commentary amendment (although the treaty came into force afterward) or the intended scope of the beneficial ownership concept. It is unlikely that the treaty partners expected such breadth of meaning.

All three CA judges concurred that the appeal failed on the beneficial ownership issue. But in his separate judgment, the chancellor, "for completeness," also concluded that the Dutch treaty's tiebreaker test—place of effective management—would result in the dual-resident Newco's being considered an Indonesian resident for treaty purposes. This followed because the decision-making power of Newco's board of directors would be limited, and the parent, Indofood, would make the key decisions. However, that analysis of a residency determination is inconsistent with the traditional approach and with the recent decision of the CA (not including the chancellor) in *Wood v. Holden* ([2006] EWCA Civ 26).

Indofood will not be appealed. The case has caused considerable concern internationally, particularly for taxpayers (and their advisers) who use SPV structures in countries such as Luxembourg and Ireland. At a recent Washington tax conference, the decision was the topic of discussion among Canadian, UK, US, and other tax authorities. The CRA has recently signalled aggressive assessing positions on the meaning of beneficial ownership; *Indofood* may provide more ammunition.

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QUEBEC AND TAX EVASION

Quebec's initiatives to counter tax evasion have recently been extended beyond the usual parameters. A new disclosure policy raises concerns.

In 1994, Quebec announced that it intended to tackle all forms of tax evasion, including the underground economy, and implemented various measures early in 1996. Revenue Quebec (MRQ) reached agreements that allowed access to information in the records of other public service bodies. The information is matched to identify individuals and businesses that may not be fulfilling their tax obligations, thus assisting in the selection of files for audit. For a number of years, the MRQ has been issuing press releases and using its Web site to disclose the names of individuals and businesses convicted of tax evasion. That publication provides forceful evidence of the intention to counter the underground economy and reminds taxpayers of the need for every Quebec resident to pay his or her fair share of taxes. More recently, the MRQ began to disclose information relating to search warrants, in the hope that this disclosure will deter those who might contemplate tax evasion. The MRQ also hopes that the public will actively participate in the fight against the underground economy and the consequent loss of revenue.

It goes without saying that the plan to counter all forms of tax evasion is in the public interest, ultimately for the benefit of all taxpayers, and deserving of support. However, it is debatable whether the identities of persons who are subject to search warrants but have not yet been convicted should be publicized so broadly. The information is otherwise publicly available, but without the names' disclosure on the MRQ's Web site, the publicity attached to the names would be far more limited. In the public's eye, publication on the Web site may suggest a stronger suspicion that a crime has been committed than is justified by the mere fact of a search warrant's having been issued and acted on. Deterrence may be enhanced, but the novelty of the tactic may also result in the named parties' being prejudged.

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INTER-SPOUSAL INTEREST CONVERSION: GAAR

In *Lipson* (2006 TCC 148), Bowman CJ found that GAAR applied to a series of transactions designed to convert non-deductible home mortgage interest payments into deductible interest payments. The finding against the taxpayer is surprising because the TCC found in the taxpayer's favour in *Overs* (2006 TCC 26), a very similar case.

In *Lipson*, Mr. L and his spouse agreed to purchase a personal residence for $750,000 in April 1994. In August 1994, as part of the tax plan, Ms. L borrowed $560,000 from a bank ("the share loan") and gave back an interest-bearing demand promissory note. With the loan proceeds, Ms. L purchased from Mr. L $560,000 worth of shares in a family corporation. Mr. L forwarded the funds to the trust account of the solicitor who was handling the home purchase. In September 1994, Mr. and Ms. L borrowed $560,000 from the bank ("the replacement loan") secured by a mortgage on the new home and used the funds to repay Ms. L's share loan.

Because Mr. L did not elect out of the spousal rollover on the share sale, the transfer was deemed to occur at his tax cost with no resulting gain or loss, even though Ms. L purchased the shares at FMV. Any income or loss on the shares realized by Ms. L would be attributed to Mr. L

(subsections 74.1(1) and 74.2(1)). The CRA reassessed Mr. L's 1994 to 1996 taxation years, disallowing about $105,000 in deductions for interest expenses paid on the replacement loan. Both the CRA and the taxpayer agreed that the transactions were avoidance transactions within the meaning of subsection 245(3); the only issue was whether the transactions constituted an abuse or misuse of the Act.

The TCC held that the series of transactions undertaken by Mr. L and Ms. L resulted in a misuse of paragraph 20(1)(c) and subsection 20(3). Subsection 20(3) allows a deduction for interest on money borrowed to repay money previously borrowed for commercial purposes. The TCC said that subsection 20(3) essentially serves a practical function in the commercial world by facilitating refinancing, and that the rule was abused because the share sale was a mechanism to fund the purchase of a family home. The proceeds of the share loan moved from the bank to Ms. L, then to Mr. L, and finally to the vendor of the home in a prearranged sequence, with the vendor receiving the proceeds one day after the original borrowing.

Subsection 73(1) and section 74.1 were also misused to the extent that they were used to achieve the misuse and to execute the scheme as a whole. The TCC said that none of the purposes of these provisions was fulfilled by the series of transactions. The overall purpose of the series and the use of each individual provision was to deduct interest on money used to buy a personal residence. The TCC pointed out, as recognized by the SCC, that each case on which GAAR is applied depends on its own facts. The TCC noted its decisions in two GAAR cases: *Evans* (2005 TCC 684) and *Overs*. In *Evans*, a case involving a capital gains exemption monetization strategy, the TCC found that each section of the Act relied on was used for its intended purpose, and thus there was no abuse of the Act when each section operated according to its design. *Overs* involved a taxpayer's claim to deduct carrying charges and interest expenses incurred on a loan made by a bank to his spouse to acquire shares from him. The taxpayer used the sale proceeds to repay a shareholder loan (and to avoid a subsection 15(2) income inclusion). As in *Lipson*, the taxpayer did not elect out of the spousal rollover on the sale of shares to his spouse, and the attribution rules under subsection 74.1(1) applied to attribute the spouse's losses (or income) to the taxpayer. In *Overs*, the TCC found that GAAR did not apply because the transactions could not be considered "abusive tax avoidance" transactions.

The TCC in *Lipson* said that in both *Evans* and *Overs* there was a factual underpinning of commerciality or estate planning. "The scheme involved here has no such redeeming features. Drawing the line between abusive and acceptable tax avoidance requires the exercise of judgement. It is not a purely mechanical process, nor is it either a discretionary or a subjective determination. It involves the application of the principles enunciated by the [SCC]." The TCC said that *Lipson* was an obvious example of abusive tax avoidance. If there was any commercial or other non-tax purpose served by transferring Mr. L's shares to Ms. L, it was secondary to the objective of making the interest on the home's purchase deductible by Mr. L. As a result, GAAR applied.

It is difficult to draw clear inferences from the TCC's recent GAAR decisions—in favour of the taxpayer in *Evans* and *Overs* and against the taxpayer in *Desmarais* (see "GAAR on CGE Monetization," *Canadian Tax Highlights*, April 2006) and *Lipson*—about the circumstances in which GAAR will apply.

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RRSPs AND RRIFs

A recent article in Statistics Canada's *Perspectives on Labour and Income* (April 2006, vol. 7, no. 4), available at http://www.statcan.ca/english/freepub/75-001-XIE/1040675-001-XIE.pdf, provides useful information on the effect on retired taxpayers of the forced conversion of RRSPs at age 69. Although the tax burden is raised for most taxpayers, those with very low taxable incomes may experience a significant tax hit. The study reinforces the wisdom of the growing trend to use a variety of plans to provide for retirement instead of relying exclusively on RRSPs.

The study points out that nearly two-thirds of RRSP assets are held by persons with employer-sponsored registered pension plans. Those pensions, combined with Canada or Quebec pension plan benefits and Old Age Security payments, may provide sufficient retirement income to obviate the need to draw down RRSP assets. When these retirees reach age 69, however, the mandatory conversion is triggered. Thanks to a special database developed to trace changes in a sample of taxpayers over time, I was able to identify the additional income, beginning at age 70, that is triggered by the conversion of the RRSPs to annuities or RRIFs. (At the same time, however, RRSP income reported from withdrawals and related annuities falls.) The modelling indicates that this additional income is taxed at relatively high marginal rates, confirming the perception that RRSPs do not produce lower tax rates on the deferred income than the rates payable during the taxpayer's income-earning life. The results for all retirees aged 69 in 2001 and 70 in 2002 are summarized in the table.

Effect of Forced Conversion of RRSPs, 2001 and 2002

Percentage of income from C/QPP and OAS/GIS		
More than 75 percent		
Addition from conversion		$450
Reduction in RRSP benefits		$ 40
Effective tax rate at age 69	1.2%	
Effective tax rate at age 70	1.7%	
50 to 75 percent		
Addition from conversion		$1,300
Reduction in RRSP benefits		$ 310
Effective tax rate at age 69	6.3%	
Effective tax rate at age 70	7.1%	
Less than 50 percent		
Addition from conversion		$3,400
Reduction in RRSP benefits		$ 590
Effective tax rate at age 69	20.7%	
Effective tax rate at age 70	20.9%	

The study also notes the effect of forced conversion on low-income retirees whose taxable income is increased by the additional income at age 70. Those low-income retirees may also lose benefits under the federal guaranteed income supplement and a number of provincial and local geared-to-income benefits, leading to a marginal rate in excess of 100 percent on the additional income.

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DE FACTO CONTROL

In two recent cases, the TCC and the FCA found that a taxpayer had de facto control of a corporation that consequently had to share the small business deduction (SBD) limit with other corporations controlled by the taxpayer.

In *Corpor-Air Inc.* (2006 TCC 75), the TCC said that companies owned separately by spouses were deemed associated through de facto control. Mrs. S owned 100 percent of Corpor-Air Inc., an airline-counter service provider, and Mr. S owned 100 percent of several other corporations in the airline support and maintenance business ("the S Group"). The S Group (associated companies) together shared a maximum SBD limit. Corpor-Air claimed its own SBD.

It appeared to the TCC that Corpor-Air's sole shareholder, Mrs. S, was not involved in decisions about it or its day-to-day operations; Corpor-Air was also economically dependent on the S Group corporations owned by Mr. S. Thus, the TCC concluded that Mr. S had de facto control of Corpor-Air under subsection 256(5.1) even though Mrs. S was the sole shareholder. The S Group corporations and Corpor-Air were thus associated for SBD purposes. The TCC rejected the taxpayer's argument that de facto control is not possible when de jure control is present, a finding consistent with its earlier decision in *Rosario Poirier* ([2002] 4 CTC 2346) that de facto and de jure control can co-exist.

In *Plomberie JC Langlois Inc.* (2006 FCA 113), the FCA upheld the TCC's decision that Mr. R, the 50 percent shareholder and sole director of Plomberie JC Langlois (Opco), had de facto control of the corporation. The FCA based its decision primarily on the evidence that Mr. R caused Opco to lend money interest-free to other companies that were wholly owned by him ("the R Group") and also had Opco guarantee other third-party loans obtained by the R Group.

Mr. P and Mr R, unrelated shareholders, each owned 50 percent of Opco's shares. Mr. P was a plumber; he had the necessary licences and skills to operate Opco's plumbing business, and he took care of Opco's day-to-day activities. Mr. R—the sole director, president, and secretary—looked after the administrative side of the business and controlled the finances. Mr. P and Mr. R signed a shareholders' agreement providing that every decision not dealing with the ordinary business of Opco must be approved by a unanimous shareholders' resolution. Opco did not charge interest on the loans to the R Group, nor did it receive compensation for the guarantee, and the transactions were not approved by the required shareholders' resolutions. The TCC concluded that Mr. R had de facto control of Opco because of his position as its sole director, president, and secretary. Although Mr. P's skills were important and necessary for the operation of Opco's business, his position in the company was not a control position. The TCC held that Mr. P's role resembled that of an employee more than that of a director, since he executed the work but made no business decisions.

Opco argued, on the basis of *Duha Printers* (98 DTC 6334 (SCC)) that the TCC erred in law by ignoring the shareholders' agreement. Opco also argued that Mr. P and Mr. R were equally involved in the business decision-making process. The FCA found that the loans to the R Group and the guarantee of its loans had nothing to do with Opco's normal business. Further, the FCA was not satisfied with Mr. P's explanation for consenting to the loans and guarantee without compensation, because they represented no financial interest to him. The FCA said that the TCC correctly disregarded the shareholders' agreement; because the parties involved did not enforce it, it was not important in assessing who controlled Opco. The FCA also found that Mr. P played no business decision-making role and that Mr. R was the "dominant entity" that possessed de facto control of Opco under subsection 256(5.1). Thus, Opco was associated with the R Group and had to share the SBD.

Ontario ULCs? Ontario is considering allowing the incorporation of unlimited liability corporations (ULCs) under the Ontario Business Corporations Act (OBCA). On April 3, 2006, Ontario released a 39-page consultation paper regarding this and other possible reforms to modernize the OBCA. Currently, only Nova Scotia and Alberta allow the incorporation of ULCs.

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DUHA NOT CONTROLLING?

In *Duha Printers* (98 DTC 6334), the SCC elevated the unanimous shareholders' agreement (USA) to a status equal to that of articles of incorporation as a factor to be considered in determining corporate control. Other shareholders' agreements that do not meet the definition of a USA—even though they may also limit directors' powers—were specifically excluded from relevant factors. Duha was a corporation subject to the Canada Business Corporations Act (CBCA), which affords special status to a USA—not a private agreement—by making it generally enforceable by way of a restraining or compliance order (section 247). However, a significant number of Canadian corporations are governed by corporate statutes that do not have a similar provision for USAs, such as those in British Columbia, Alberta, Ontario, and Nova Scotia.

The Nova Scotia statute has no specific provisions for shareholders' agreements. Nor does the British Columbia statute, although it does allow any person (not just a director) to have the powers of a director if the articles so provide. Accordingly, the analysis of control in *Duha* concerning USAs may have limited or no relevance to corporations governed by these statutes.

The shareholders' agreement provisions in Alberta's and Ontario's corporate law statutes pose more difficult interpretive issues. The Alberta statute is much more expansive than the CBCA in terms of matters that can be included in shareholders' agreements; it specifically allows an agreement between all shareholders that deals with many matters other than assuming the power of managing the business. Alberta law makes little distinction between that kind of private shareholders' agreement and a USA, which removes or limits directors' management powers. For example, all Alberta shareholders' agreements can be enforced by a court order for compliance. In addition, each corporation must keep a copy of its shareholders' agreement at its head office as part of an Alberta corporation's records. The Alberta law does, however, provide that if the shareholders' agreement removes the powers of directors to manage the business—that is, when it is like a USA—then the shareholders are subject to all liabilities to which directors would be subject. These three factors (enforcement by way of compliance order, obligation to keep a record, and assumption of directors' liabilities) were cited by the SCC in *Duha* as part of the rationale for a CBCA USA's special status.

The legislative provisions in Ontario are less clear. Indeed, the only explicit references to a USA in the Ontario Business Corporations Act are in the context of a written declaration by a single shareholder and in the provision dealing with compliance orders. The OBCA does provide that a written agreement between all shareholders (and others) may restrict or remove the directors' powers; it is unclear whether only this kind of agreement—a CBCA-like USA—or any agreement between all shareholders can be subject to a court-ordered compliance order in Ontario. Ontario requires that any shareholders' agreement must be kept as a corporate record if it is "known to the directors." Presumably, a real USA will always be known to directors, so this record-keeping provision probably contemplates other shareholders' agreements too.

For corporate law purposes, Alberta and Ontario shareholders' agreements do not fit squarely within the framework of a USA as set out in the CBCA. Accordingly, it is arguable whether the SCC's analysis in *Duha* applies to Alberta and Ontario shareholders' agreements. *Duha* may have raised the bar for tax practitioners dealing with control issues, requiring consideration of any enforceable shareholders' agreement—regardless of the jurisdiction that governs the underlying corporation—to ascertain whether it removes or limits the directors' powers. In our view, only agreements that remove or limit the powers of directors to manage the business should be considered in determining corporate control.

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PROFESSIONAL CORPS: PERSONAL SERVICES BUSINESSES?

A CRA 2005 opinion letter (2005-0156741E5, issued January 30, 2006) considers whether, in the context of incorporating a professional practice, a professional corporation carries on a personal services business (PSB) if it and the professional are prohibited from competing with the corporation to which the professional services are provided.

In a 2004 advance tax ruling (2004-0084311R3), a professional service partnership transfers its business to a corporation (Newco); the former partners provide services to Newco directly as employees or independent contractors or through professional corporations formed by them. Compensation paid to independent contractors

and professional corporations is negotiated case by case and evidenced by a written contract. Newco's net income is expected to be less than the business limit; any amounts exceeding the limit are likely to be distributed by Newco as fees, bonuses, or similar payments. On the facts, the former partners and the professional corporations are not prohibited from competing with Newco, provided that they fully discharge their contractual obligations with Newco. The CRA ruled that the professional corporations did not carry on a PSB.

After the 2004 ruling was issued, the CRA was asked in a separate letter to opine on similar facts, except that the former partners and the professional corporations were subject to "certain competition restrictions." In such a case, was the professional corporation carrying on a PSB? In the 2005 opinion letter, the CRA responded that it could not conclude whether a PSB existed, but noted that whether a company carries on a PSB is a question of fact. One factor in the determination is whether the professional corporation and the incorporated employees are allowed to compete with Newco. The CRA commented that the existence of a non-competition agreement might indicate that the incorporated employee could be regarded as an officer or employee of Newco, and thus the professional corporation would be carrying on a PSB. The CRA also referred to RC4110—*Employee or Self-Employed?*—which discusses the factors to be considered when determining whether an individual is an employee or self-employed.

The CRA's comments indicate that members of professional service partnerships who are considering incorporating their practices may want to forgo implementing non-competition agreements. The existence of such an agreement may imply that the professional corporation carries on a PSB. In that case, the corporation's income will not qualify for the small business deduction and its shares will not qualify for the capital gains exemption for qualifying small business corporation shares.

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Selling into the US

What US tax obligations are incurred by a Canco selling into the United States? Consider a Canco that custom-manufactures a product; about 40 percent of its sales are delivered to US-based customers. All its employees and facilities are in Canada, and its continuing policy is to approve all sales in Canada. The company wishes to hire US-resident sales reps full time to solicit sales orders; the reps will have no authority to bind Canco contractually. Canco will not provide the reps with any office space, directly or indirectly; each may have a home office, but Canco will not subsidize the costs, and the location cannot be held out as a location of Canco. All purchase orders must be sent to Canada for acceptance or rejection; if accepted, the product is then produced in Canada and shipped directly to the US customer. The reps will not perform any training services, warranty or repair services, accounts receivable collection work, or other after-sale-type services.

On the facts in this scenario, it is quite unlikely that Canco has a PE subject to US federal tax by virtue of its hiring the reps as employees and stationing them full time in the United States. Absent a PE, Canco needs to establish a US payroll—for example, by opening a US bank account and hiring a US payroll services bureau to handle disbursements, withholdings, and filings. Canco must obtain US and state taxpayer identification numbers; federal form SS-4 ("Application for Employer Certification Number") must be filed to obtain an employer identification number. Provided that the reps cannot and do not contract on Canco's behalf and Canco does not open, directly or indirectly, a US office, Canco's US federal income tax filing obligation should be treaty-based only (form 1120-F, "US Income Tax Return of a Foreign Corporation"). Provided that only mere solicitation of sales occurs in the United States, Public Law 86-272 should shield Canco from any state's income-based taxation. Canco may still be liable for some state and local capital-based, net worth, business activity, or other franchise-type taxes, particularly in a rep's home state. Canco will become a sales tax vendor in more states and be required to collect and remit sales tax on sales of tangible property unless the goods are resold by each of the customers. Of course, the unique factual context in which any particular Canco procures and handles sales into the United States will determine that taxpayer's actual tax liabilities and obligations.

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GST ITCs for Dentists

A dental practice is capital-intensive, requiring the purchase of expensive tools and equipment, but GST paid thereon is generally not recoverable because most dental services are exempt supplies. An exception is a dentist's supply of cosmetic dental services (taxable at 7 percent) and sales and installation of artificial teeth and orthodontic appliances (zero-rated); ITCs can be claimed on purchases made for the purpose of making such supplies. The recent case of *Singer Inc.* (2006 TCC 205) expands the ITC entitlement for dentists.

The ITC calculation is simplified for dentists in a 2004 CRA interpretation letter ("Application of GST/HST to Supplies by Medical Practitioners Who Are Licensed To Practice the Profession of Dentistry," Headquarters Letter no. 52348, May 26, 2004). In allocating ITCs between exempt and taxable supplies, a dentist who supplies orthodontic appliances can claim ITCs based on an assumed price paid for the zero-rated supply of the appliance equal to 35 percent of the cost to the patient of the orthodontic treatment. This is only an estimate, however; the actual ITC entitlement must be calculated and a reconciling payment made at year-end. Under CRA policy, a dentist must separately identify to patients the charges for taxable supplies (the cost to the patient of the orthodontic appliance or artificial teeth and the related installation services) and exempt supplies (the cost of the exempt dental services) so that the taxable charges retain their zero-rated status. In addition, ITCs for capital property are an all-or-nothing proposition: they are available only if the property is used "primarily" (generally accepted to mean more than 50 percent) in commercial activities. For example, the CRA's administrative view is that the category "artificial teeth" includes crowns that replace more than 50 percent of a tooth. Thus, if a dentist purchases a machine to make crowns and it is used primarily in making supplies of artificial teeth, the dentist may claim full ITCs for GST paid on the purchase; but he or she can claim no ITCs if the machine is not primarily used for that purpose.

The dentist in *Singer* claimed ITCs of $14,900 calculated on a revenue-based method: annual zero-rated revenue was divided by total revenue, and total expenses were multiplied by the resulting 30 percent to arrive at the ITC amount. The CRA denied $12,705 of the claim, saying that the appropriate factor was 9 percent. The CRA apparently did not challenge the revenue-based formula, only the type of supplies characterized as zero-rated, allowing only supplies of artificial teeth and orthodontic appliances and not dental services (such as installation) and overhead expenses.

Bowman CJ dismissed the appeal because the dentist failed to provide evidence to show that he made taxable supplies of installing artificial teeth and orthodontic appliances, but in obiter he agreed with the taxpayer's reasoning. Even though the taxpayer lost, the case bears welcome news for the profession. *Singer* confirms that in addition to the devices themselves, the service of installing artificial teeth and orthodontic appliances is also zero-rated. The decision also implies that a revenue-based method is a fair and reasonable method for a dentist to use in determining ITC allocation.

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PFIC Lookthrough Ruling

PLR 200604020 (issued January 26, 2006) interprets favourably the Code section 1297(c) lookthrough rule for 25 percent owned subsidiaries of foreign (non-US) corporations. If Forco owns (directly or indirectly) at least 25 percent of another corporation's value, then, in determining whether Forco is a passive foreign investment company (PFIC), the lookthrough rule treats Forco as holding its proportionate share of the subsidiary's assets and as receiving directly its proportionate share of the sub's income. The statute does not address Forco's sale of the sub, and there are no related Treasury regulations, but the IRS has ruled that the lookthrough rule applies in characterizing the gain on such a sale.

Forco is a PFIC if it satisfies an income test (at least 75 percent of its gross income for the taxable year is passive, generally including dividends, interest, royalties, rents, annuities, and gain from the sale or exchange of passive-income-producing property) or an asset test (at least 50 percent of Forco's assets held during the taxable year produce passive income). For the purposes of applying the asset test, publicly traded corporations generally must use FMV in measuring assets; non-publicly traded corporations may use either FMV or adjusted basis, but they may use adjusted basis only if they are also controlled Forcos.

Unlike the controlled foreign corporation (CFC) regime, no threshold level of US ownership of Forco must be met to trigger potential application of the PFIC rules. And unlike the CFC regime, the PFIC regime does not tax US persons currently on Forco's income unless a QEF election is made: US persons are taxed on receipt of excess distributions, which include (1) gain recognized on the sale or deemed disposition of PFIC stock and (2) actual PFIC distributions that in total in the tax year exceed 125 percent of average actual distributions in the preceding three years. An excess distribution is allocated rateably to each day in the US shareholder's holding period for the stock. Current tax year and pre-PFIC holding period allocations are included as ordinary income in the current year; other PFIC period allocations are not included in income but are taxed at the highest US ordinary income rate (currently, 35 percent), plus an interest charge to reflect the benefit of deferral.

In the ruling, Forco sold all the stock of a wholly owned foreign sub that directly or indirectly owned the stock of several European Opcos. If the gain on the sale was classified as passive income, then Forco was a PFIC under the income test for the year. The taxpayer requested a ruling that the lookthrough rule of Code section 1297(c) apply to the gain on the sale, making it active income because it was attributable to the sale of active business

assets. Without the benefit of any analysis, the IRS concluded that the lookthrough rule applied and the gain was not passive income. The ruling is significant because it is the first time that the IRS has explicitly stated that the lookthrough rule applies to the sale of stock of a 25 percent owned subsidiary.

The legislative history of section 1297(c) supports the ruling's conclusion. The Conference Report of 1986 (HR rep. no. 99-841, 99th Cong., 2d sess. (1986), II-644) provides the following guidance on the rationale behind the lookthrough rule: "The conferees do not intend that foreign corporations owning the stock of subsidiaries engaged in active businesses be classified as PFICs. To this end, the agreement attributes a proportionate part of assets and income of a 25-percent owned corporation to the corporate shareholder in determining whether the corporate shareholder is a PFIC under either the asset test or income test."

Clearly, Congress did not want a Forco carrying on an active business through subsidiaries to be classified as a PFIC. Thus, it is reasonable to infer that Congress intended that a sale of those active subsidiaries would not cause the Forco to slip into PFIC status. The potentially dire consequences of PFIC classification on US shareholders only serve to underscore this conclusion. The ruling thus appears to be consistent with legislative intent and is welcome guidance to US taxpayers that own stock of a Forco.

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ONTARIO HEALTH PROFESSIONAL CORPS

After 2005, a physician or dentist practising in Ontario may form a professional corporation and split income with certain family members.

The 2000 Ontario budget proposed a made-in-Ontario tax system. Amendments to the Ontario Business Corporations Act (OBCA) and various professional statutes permit the incorporation of professional corporations in Ontario for professions governed by the Regulated Health Professions Act, including dentists and doctors. OBCA section 3.2(2) requires that a professional corporation be legally and beneficially owned directly or indirectly by members of the profession; regulations 39/02 (under the Regulated Health Professionals Act) and 665/05 (under the Ontario Business Corporations Act) allow a dentist's or physician's family members to own non-voting shares. Indirect ownership is possible, but the professional governing bodies will not allow a professional to own the professional corporation's shares through a wholly owned holdco, perhaps to ensure the flowthrough of professional liability; the acceptability of such structures existing for a very brief time is not clear. A professional corporation may carry on a business relating to the profession only and may invest surplus funds, but not in another business; investments should be accumulated in a separate company. A professional corporation's status survives, inter alia, the death of a shareholder, enabling an estate to sell the shares.

Income splitting by the payment of dividends to certain family members should be structured to avoid attribution. A spouse should either use his or her own funds or borrow to subscribe for shares, repaying the loan and accrued interest out of the first dividends. The OBCA defines family members as the spouse, a child (not a stepchild), a parent (not a grandparent), or a trust for minor children only. (The trust must be dissolved when the child reaches the age of 18.) Instead of using a trust, a family member may subscribe for a separate class of shares and give them to a minor child; no dividends are paid until the child reaches the age of 18. A family member with no other income can receive about $30,825 annually free of tax. The kiddie tax applies to dividends paid to minors. Surprisingly, tax rulings issued since 2004 indicate that subsection 56(2) (diversion of income) may apply to dividends paid to doctors' family members, although the SCC in *Neuman* ([1998] 3 CTC 177) suggests the contrary for dividends declared by a director in accordance with the shares' terms.

The CRA accepts that a professional corporation carries on an active business and is entitled to an SBD, yielding approximately 18.6 percent tax on the first $300,000 of active business income (ABI) per annum, 27.6 percent on the next $100,000, and 36.1 percent on the excess (plus 4.6 percent provincial surtax on income up to $1,128,000). Associated corporations share the benefit. If SBD-eligible after-tax income is reinvested, not distributed, the corporation has about 25.54 percent more funds to invest than a top marginal rate individual who earns the ABI directly. After-tax income can also pay down a mortgage on a building held for use in the practice. If the investment assets' FMV exceeds 10 percent of the total assets' FMV, the corporation may cease to be eligible as a small business corporation; corporate attribution applies to a spouse or minor child shareholder and the capital gains exemption is not available. Alternatively, funds may be loaned to or invested in another corporation—perhaps owned by a spouse—to avoid attribution. Growth in the investments may be protected from the professional corporation's creditors if the holdco shares held are non-voting redeemable non-retractable preference shares entitled to discretionary dividends.

Readers are invited to submit ideas or written material to *Canadian Tax Highlights*. Please write to Vivien Morgan in care of the Canadian Tax Foundation.

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Each corporate partner in a professional practice must share the SBD pro rata: if the partnership has 10 equal partners, each of them enjoys the low rate on only $20,000 of ABI. Professional corporations in group practices are being structured to avoid characterization as a partnership. Several tax rulings (for example, 2004-0084311R3 and 2004-0069011R3) deal with the incorporation of medical practices previously conducted as partnerships, but the concept should apply to the restructuring of a legal partnership. The partnership rolls the practice assets to a professional corporation ("the association") for shares. The professional partnership is dissolved and each partner receives a share of the association. Each physician forms a separate professional corporation to provide his professional services as a physician to the association for a fee. The association bills and collects OHIP, and pays the practice overhead. The CRA confirmed that the association and the other corporations are not in partnership; each may claim a full SBD. Presumably, GST does not apply to the fees paid by the association to the professional corporations for exempt services. The CRA said that subsection 56(2) (diversion of income) may attribute to physicians the dividends paid to family members.

A technical services corporation may also claim an SBD if it is not associated with the professional corporation. A technical service corporation in a medical or dental practice provides a GST-exempt service, such as hygiene services and lab work or X-rays and related reports; GST paid on management fees is not recoverable by a health professional.

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FOREIGN TAX NEWS

United States

The IRS released its 2005 annual report on the US advance pricing agreement (APA) program for transfer-pricing transactions (Announcement 2006-22, March 31, 2006). The report describes the program, the IRS personnel who carry out the APA process with the taxpayer, and the new application procedure outlined in Rev. proc. 2006-09. The APA process is described under the headings (1) application; (2) due diligence; (3) analysis; (4) discussion and agreement; and (5) drafting, review, and execution. Statistical data for the calendar 2005 program results are also included.

United Kingdom

Budget proposals of March 22, 2006 are generally effective from April 1, 2006 for companies and April 6, 2006 for individuals. The proposals include (1) a measure allowing a UK-resident parent company to claim group relief for losses of a subsidiary resident in the European Economic Area (EEA) or of an EEA permanent establishment if non-UK relief for the losses has been exhausted; (2) various anti-avoidance measures; and (3) changes in personal income taxation bands. The government intends to extend its powers to enter into international mutual assistance agreements for direct and indirect taxes.

New Zealand

A comprehensive tax reform was approved to reduce the tax burden on small businesses, attract new residents and expatriates, and phase in NZ$1.1 billion in corporate tax cuts over four years.

Italy

Several significant corporate tax rules were revised, including the 95 percent dividends exemption and the conditions under which foreign securities and participations are considered equivalent to domestic shares for the purposes of the capital gain exemption. New rules counter dividend washing and govern non-residents entering the domestic group tax regime.

Treaties

Mutual agreement under the **US-Spain** treaty was reached on the treatment of limited liability companies, S corporations, and other business entities treated as partnerships or disregarded entities for US tax purposes, retroactive after 1997. Brazil reduced withholding rates on dividends and royalties under the **Brazil-Spain** treaty.

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