CANADIAN TAX Highlights

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Outstanding Bills

The CBA-CICA Joint Committee on Taxation (JCT) recently sent a submission to the new minister of finance concerning several outstanding income tax proposals from the previous federal government. The JCT urges the new government to announce at the earliest opportunity its intentions regarding those proposals and to enact as soon as possible whatever outstanding proposals it intends to implement. The JCT is chiefly concerned about outstanding proposals for deductibility of interest and other expenses; foreign investment entity and non-resident trusts; foreign affiliate amendments; and general technical amendments (the most recent draft was released in July 2005). These proposals have been outstanding for up to six years.

The JCT notes that the proposals' long period in draft, their periodic revision, their extensiveness and complexity, their application in some cases to past taxation years, and the new government's silence regarding its intentions combine to increase taxpayers' uncertainty about the consequences of particular transactions and arrangements. The JCT urges the new government to take steps to reduce that uncertainty: (1) Announce as soon as possible which proposals it intends to proceed with. (2) Defer the effective date for the proposals relating to the deductibility of interest and other expenses until after the revised proposals are released. (3) Split the foreign affiliate amendments—200 pages in the most recent draft—into two separate packages: technical and other noncontroversial amendments, and more substantive amendments requiring further consultation. The effective dates on provisions under consultation should be deferred until details are finalized. (4) In the near future, introduce a bill to implement the foreign investment entity and non-resident trust rules, the general technical amendments, and the technical part of the foreign affiliate amendments.

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Foreign investment entity rules. These proposals sought to prevent Canadians from avoiding income tax by transferring funds to offshore trusts or accounts, and they have undergone several changes in each of five drafts. The complexity of the rules, the uncertainty about their final form, and the compliance burden they impose have induced taxpayers to file their tax returns without taking the proposed rules into account. If the government proceeds with these rules, the JCT submits that taxpayers should not be expected to undertake the onerous task of amending their prior tax returns and recommends that these rules take effect no earlier than taxation years beginning after 2006.

Relief from interest and penalties. Several outstanding proposals have retroactive effective dates. The JCT submits that Finance should include in the legislation a provision to waive any late payment interest, additional tax, and late-filing penalties that may arise because the proposals have retroactive dates. Alternatively, the CRA should publicly announce that it will waive these amounts. Such costs would be unfair to taxpayers who chose to file their returns under previously existing law and to taxpayers such as non-resident trusts that have not filed returns because the current rules do not apply to them.

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Change of Trustees

Recently released *Income Tax Technical News* (ITTN) No. 34, April 27, 2006, reports and expands on the CRA's round table comments at the Canadian Tax Foundation's 2005 annual conference concerning a change in any trustee of an inter vivos trust that controls a corporation. The round table question stated that the CRA's latest position "could have widespread consequences for corporations that have trusts as shareholders."

In May 2005, a CRA TI said that a change of one or more trustees in an inter vivos trust holding a majority of a corporation's voting shares resulted in a new group controlling the corporation and, subject to the exceptions in paragraph 256(7)(a), an acquisition of the corporation's control (see Technical Interpretation 2004-0087761E5). Any losses incurred by the corporation before the change in trustees either are restricted or expire after the acquisition of control.

At the round table, the CRA was asked about the basis for the TI's conclusion that an acquisition of control occurred with a change of trustees, a conclusion apparently

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contrary to its published administrative position in paragraph 10 of IT-302R3 ("Losses of a Corporation—The Effect That Acquisitions of Control, Amalgamations, and Windings-Up Have on Their Deductibility—After January 15, 1987"). The ITTN acknowledges that whether a trustee or group of trustees controls a corporation is a question of fact; in the absence of evidence to the contrary, the CRA presumes that all the trustees form a group that controls because their fiduciary obligation to act in the beneficiaries' best interests makes it unlikely that two trustees could properly act together, to the exclusion of a third trustee, to control a corporation. The CRA was also asked why it does not extend the position in IT-302R3 to inter vivos trusts, given that the IT's position appears to be an administrative concession. At the round table, the CRA indicated that paragraph 10 of IT-302R3 deals with estates and replacement due to death or incapacity and therefore does not apply to inter vivos trusts.

The ITTN clarifies that the CRA's position in IT-302R3 was first adopted when a previous version of paragraph 256(7)(a) provided a legal basis for the CRA's position; a 1994 amendment to that paragraph removed that legal basis. Therefore, the CRA says that the position cannot be extended, and "consideration will have to be given to withdrawing the current bulletin position when the bulletin is next revised."

The CRA's comments seem to indicate that it will amend its position on the change in trustees of a trust that controls a corporation to apply to all trusts at some time in the future: at that time, when the CRA revises IT-302R3, it will consider such a change in trustees of an inter vivos or testamentary trust to result in an acquisition of control of the corporation. The ITTN says that the CRA has brought the matter to the attention of Finance, which recognizes that an issue exists.

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No Tax Shelter Advice

Two recent TCC cases interpret the tax shelter definition in section 237.1 with different results.

Whether a taxpayer acquires a tax shelter determines, inter alia, whether the investment must be registered to obtain related deductions. The cost of a tax shelter investment (or capital cost) may be reduced if there are limited recourse amounts or if the investment is in computer software.

The tax shelter reporting rules in section 237.1 were introduced in 1988; in 1995, their scope was broadened and made more uncertain. Numerous articles have explored the outer limits of the rules' application, including transactions normally regarded as purely commercial in which the investor acts as a principal in structuring the transaction. It was generally thought that two requirements must be met before an investment was a tax shelter. (1) To fall within the ambit of the introductory paragraph of the definition (the preamble test), there must be "statements or representations made or proposed to be made in connection with the investment," and (2) a numerical test must be met: at the end of a particular taxation year that ends within four years after the day the property was acquired, an amount (a loss in the case of a partnership) related to the property acquired (including rights to income) and represented as deductible in the year or a preceding year would equal or exceed the cost of the investment net of certain prescribed benefits.

In *Maege et al. v. The Queen* (2006 TCC 117), an accountant invested cash and a promissory note in a partnership that funded research into biotechnology innovations carried out by her scientist husband. Ms. Maege was her own tax adviser and apparently advised some third-party investors. It appeared at first that the preamble test was not met because she made no "statements or representations" to herself about her own tax consequences. Rip J found otherwise: Ms. Maege made mental or intellectual representations to herself. On this reasoning, it may be virtually impossible not to meet the "preamble test," reducing the tests for a tax shelter to the simple mathematical formula of the numerical test: whether the tax deductions over four years will equal or exceed the cost minus certain prescribed benefits (in this case, tax credits). This analysis should trouble tax advisers and their clients, because it means that many otherwise normal commercial transactions will be offside even if the parties operate as principals and do their own tax analysis without reliance on third parties.

Baxter v. The Queen (2006 DTC 2642) takes an entirely different approach. Mr. Baxter was an experienced lawyer who purchased a licence to use certain computer software on a leveraged basis, typical hallmarks of a tax shelter. Mr. Baxter received no statements or representations, and he worked out the tax consequences himself; evidence showed that offending statements or representations had been made to other taxpayers entering into similar transactions. The Crown argued that such statements or representations made to anyone tainted the investment for all taxpayers, but it did not go so far as to adopt the self-representation argument accepted by Rip J in *Maege*. The taxpayer said that it was not reasonable for his tax position to be determined by statements made to others.

Bell J agreed that the statements or representations must, at a minimum, have been directed to the taxpayer: "[H]ow can one expect a taxpayer . . . to be prejudiced by something he doesn't know and can't know?" However, the primary basis for the decision appears to be that the numerical test was not met. Bell J went back to basic principles. The taxpayer was not in partnership and claimed CCA directly so that there was no loss to which the rules applied. Furthermore, no amount could be said to have been represented to be deductible because a claim for CCA is an allowance, not an amount that can be incurred (citing *McKee*, 77 DTC 5345 (FCTD)).

The taxpayer also argued that the wording of the tax shelter rules was technically deficient; the numerical test required that an amount be represented as deductible, but the preamble refers to both statements and representations. A representation has a distinct legal meaning—a "statement of fact made to induce another to enter into a contract"—and is distinct from a mere statement. Bell J appeared to agree but decided the case on other grounds.

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Alcoholic Drinks: Cool Profits

In Statistics Canada's database on public finance, the latest information on government revenues from the control and sale of alcoholic beverages has recently been released. The wealth of data now available on the main site and accessible at no cost (http://www.statcan.ca/english/nea-cen/sub/govt.htm) makes it easier to retrieve the latest information on specific issues and background material to put those figures into perspective.

The table shows provincial revenue as reported in *The Control and Sale of Alcoholic Beverages in Canada* (catalogue 63-202-XWE). In 2004, the provinces and territories earned a total of $4.3 billion, which represented about 26.6 percent of total sales of alcoholic beverages in Canada. The distribution by provinces is included in the table.

The table also shows that this revenue represents a relatively small proportion of all provincial revenue—less than 2 percent across the country. The same section of the main Stats Can public finance Web site also provides information on provincial and territorial government revenues and expenditures. The provincial economic accounts, also available on the public finance Web site, reveal that provincial revenue from the control and sale of alcoholic beverages represented less than 0.0001 percent of personal disposable income.

The Stats Can public finance Web site is a major step forward in making public finance data accessible and affordable. The data tables are reinforced with explanatory material in all of the major statistical series in this area. Because the existing publications are also available for downloading, the arcane analysis of public revenues, spending, and debt is taken out of the few specialized libraries and onto the desks of anyone interested in examining the use of our tax dollars.

Provincial Revenue from the Control and Sale of Alcoholic Beverages, 2004

		As a percentage of		
	Amount, $ million	Alcoholic beverage sales	All provincial revenue	Personal income
NL	100	31.4	2.0	0.0099
PE	23	30.2	1.9	0.0083
NS	172	36.0	2.1	0.0087
NB	122	35.4	1.8	0.0080
QC	715	16.8	1.0	0.0044
ON	1,535	25.6	1.7	0.0050
MB	178	36.1	1.7	0.0071
SK	135	32.4	1.4	0.0063
AB	557	35.7	1.7	0.0064
BC	734	33.2	2.1	0.0077
Canada	4,298	26.6	1.6	0.0058

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Interest Offset

In 2000, interest offset rules were introduced to address the inequity of a corporate taxpayer's paying non-deductible arrears interest on tax payable for periods in which it owes, or has received, taxable interest on a refund amount (section 161.1). An example in the technical notes raises an issue concerning the limitation period for claiming an offset.

The offset mechanism involves having a specified reallocation amount deemed refunded to the corporation and then paid on account of an accumulated underpayment amount on a date specified for the offset. The periods of concurrent refund and arrears interest must begin after 1999, although the under- and overpayment amounts may arise in prior taxation years; the amounts offset may arise under parts I, I.3, II, IV, IV.1, VI, VI.1, and XIV. An eligible taxpayer must apply in writing as prescribed, or the application is deemed not made: the application must specify the amount to be reallocated and the effective date for the reallocation, and it must be made within the limitation period. The amount to be reallocated may not exceed the lesser of the corporation's accumulated overpayment and its accumulated underpayment, and the effective date for reallocation cannot precede the later of the date on which concurrent refund and arrears interest is computed and January 1, 2000.

However, determining the relevant limitation period may be a stumbling block. The application must be made within 90 days after the latest of several events. The technical notes contain an example in which a corporation's

1999 taxation year is first assessed $10,000 tax payable in a notice of assessment of September 1, 2000; $8,000 has already been paid, leaving $2,000 owing. No further payment is made. A notice of reassessment on February 1, 2001 increases tax payable by $3,000 to $13,000, leaving $5,000 owing.

The start of the limitation period for this fact pattern depends upon the interpretation of the words in paragraph 161.1(3)(a): "the first notice of assessment giving rise to any portion of the . . . underpayment amount to which the application relates." One interpretation is that the limitation period starts when the CRA issues an initial notice of assessment that notifies the taxpayer of an underpayment for a taxation year; that limitation period covers all underpayments for that year, even those subsequently reassessed (the initial interpretation). Under this interpretation, a corporation that was initially assessed for a nominal overpayment and later reassessed for a more substantial overpayment after the initial underpayment's limitation period has expired cannot apply for an interest offset in respect of its recently assessed overpayment until some later underpayment is initially assessed, and then only in respect of that other taxation year and period. This result seems unreasonable.

Alternatively, the limitation period may be more fluid and allow a reassessment to trigger the limitation period for an offset claim: a reassessment that increases the amount of an underpayment may become the "first notice of assessment" giving rise to any portion—the additional $3,000—of the now larger underpayment amount (the inclusive interpretation). The technical notes accept this inclusive interpretation but narrow it by assuming that the offset claim can only relate to the incremental portion of the underpayment ($3,000) established by the reassessment (the incremental interpretation). The technical notes' incremental interpretation appears to require a rewording of the statutory provision to read "the first notice of assessment giving rise to [*the*] portion of the . . . underpayment to which the application relates." The notes suggest that the legislation means that the claim must be made within 90 days of the assessment giving rise to that portion (of the assessment) and that the claim must relate to that portion only. A broader reading concludes that the claim must be made within 90 days of the assessment giving rise to any portion of the underpayment and that the total underpayment forms the basis for an offset claim. The use of the word "any"—and not "the"—preceding the word "portion" suggests that the phrase "to which the application relates" modifies the word "underpayment" and not the word "portion."

The technical notes' interpretation requires a complicated if not unworkable system for fractioning refund and payable limitation periods within a corporation's taxation years. Furthermore, the interpretation frustrates the equitable policy of providing relief to taxpayers where interest income and charges are computed on over- and underpayment amounts in respect of the same period; the determination time for the portions of amounts should be substantially irrelevant. If a refund amount has already been received by a taxpayer, subsection 161.1(5) provides a mechanism to facilitate interest offsets by imputing to the taxpayer arrears interest in respect of its use of the reallocated refunded funds from the effective date of the reallocation until such funds are repaid. Therefore, the CRA suffers no obvious revenue loss if a taxpayer claims an offset on a reassessment but has not previously applied for one in respect of lower refund or payable amounts. The broader inclusive interpretation is also supported by the language of subparagraph 161.1(3)(c)(v), which provides for an extension of the limitation period for situations in which a taxpayer has been notified of any portion of an overpayment amount if that overpayment amount has not previously been determined by notice of assessment.

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Reduced Tax on Dividends

Except for a minor change to the proposed federal dividend tax credit rate—from 19 percent to about 18.966 percent of the taxable dividend—the 2006 federal budget implemented the previous government's November 23, 2005 proposed reduction of personal taxes on eligible dividends paid after 2005 (see "Dividends: Personal Tax Decrease," *Canadian Tax Highlights*, January 2006). In 2006, the top federal personal income tax rate on eligible dividends decreases from 19.58 to 14.55 percent through a combination of an increase in the dividend gross-up (from 25 to 45 percent of eligible dividends received) and in the federal dividend tax credit (from 13.33 to 18.966 percent of grossed-up dividends). The provinces' reactions vary.

Eligible dividends include dividends paid after 2005 by CCPCs out of income that is not investment income (other than dividends from public corporations and other non-CCPCs) and is subject to the federal general corporate income tax rate (active business income not subject to the federal small business rate). Eligible dividends also include those paid after 2005 by public corporations and other non-CCPCs resident in Canada and subject to the federal general corporate income tax rate. Non-eligible dividends paid after 2005 do not benefit from the proposal.

Draft legislation implementing the budget proposal is expected this summer. Many issues unresolved by the budget proposal must be addressed. For example, the budget's notice of ways and means motion appears to

Quebec: Dividends Paid or Deemed To Have Been Paid

		After 2005 and before March 24, 2006		After March 23, 2006	
	In 2005	Non-eligible	Eligible	Non-eligible	Eligible
			percent		
Gross-up	25.00	25.00	25.00	25.00	45.00
Dividend tax credit*	10.83	10.83	10.83	8.00	11.90
Top Quebec rate	16.46	16.46	16.46	20.00	17.55
Top federal and Quebec rate	32.81	32.81	28.61	36.35	29.69

* On the grossed-up dividend.

Manitoba: Dividends Paid

		Non-eligible		
	In 2005	In 2006	In 2007	Eligible after 2005
		percent		
Gross-up	25.00	25.00	25.00	45.00
Dividend tax credit*	5.00	4.87	3.67	11.00
Top Manitoba rate	15.50	15.66	17.16	9.28
Top Federal and Manitoba rate	35.08	35.25	36.75	23.83

* On the grossed-up dividend.

indicate that corporations (such as public corporations) that generally pay eligible dividends must pay any ineligible dividends received first. In contrast, corporations that generally pay ineligible dividends (such as CCPCs that earn only investment income or active business income taxed at the small business rate) may first pay any eligible dividends received. The budget does not address whether the part IV tax rate (now 33.33 percent) is reduced on dividends paid by a public company, nor does it elaborate on the mechanism to calculate any refunds out of refundable dividend tax on hand on the payment of eligible dividends.

In its November 23, 2005 announcement to reduce the total tax paid on dividends from Canadian corporations to an amount close to that which is paid on distributions from income trusts, the previous government declared its intention to help "level the playing field" between income trusts and corporations. That objective can be met only if the provinces and territories follow the federal lead and similarly reduce their personal income taxes on dividends. To date, Nova Scotia is the only jurisdiction to say that it will not harmonize with the federal proposals: when the federal legislation is in place, Nova Scotia will adjust its dividend tax credit so that an individual continues to pay substantially the same provincial personal tax on dividends as he or she does currently. Alberta, Newfoundland and Labrador, Ontario, and Saskatchewan have indicated that they will await the release of federal legislation before making any final decision. New Brunswick, the Northwest Territories, Nunavut, and Yukon have been silent. British Columbia, Manitoba, Prince Edward Island, and Quebec say they will harmonize with the federal changes: their combined federal-provincial personal tax rate on eligible dividends will be lower in 2006 than it was in 2005. Only Quebec and Manitoba have provided specifics. Quebec's definition of eligible dividends parallels the federal definition, but it applies to dividends (deemed) paid after March 23, 2006, not after December 31, 2005. Unlike the federal proposals, Quebec's proposal modifies the tax treatment of non-eligible dividends.

For eligible dividends, the 2006 Quebec budget increases both the dividend gross-up (from 25 to 45 percent, matching the federal gross-up) and the dividend tax credit (from 10.83 to 11.9 percent). The top combined federal-Quebec rate for eligible dividends is lower in 2006 than it was in 2005: 32.81 percent on dividends (deemed) paid in 2005, and 28.61 percent after 2005 and before March 24, 2006. However, the combined rate rises to 29.69 percent after March 23, 2006, due to an increase in Quebec's top personal tax rate from 16.46 percent for eligible dividends (deemed) paid before March 24, 2006, to 17.55 percent subsequently. For non-eligible dividends, the top combined federal-Quebec rate increases from 32.81 percent for dividends (deemed) paid before March 24, 2006 to 36.35 percent subsequently; the increase occurs because Quebec's top personal tax rate on non-eligible dividends rises from 16.46 to 20 percent. Although Quebec's dividend gross-up remains 25 percent, its dividend tax credit declines from 10.83 to 8 percent. Unlike the Quebec personal tax changes on eligible dividends, the changes to the treatment of non-eligible dividends are apparently not contingent on the federal proposals' enactment, because they stem from the decrease in Quebec's small business rate.

Manitoba draft legislation (Bill 42) of June 5, 2006 adopts the federal definition of eligible dividends and modifies the 2006 tax treatment of non-eligible dividends, with further changes for 2007 and subsequent years tied into decreases in its small business rate. The changes for eligible dividends are contingent on the passage of the federal proposals; those for non-eligible dividends are not.

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Recreational Property ITCs

For a GST registrant to recover GST via an input tax credit (ITC) claim, the underlying supply must have been acquired "for consumption, use or supply in the course of commercial activities of the person." An all-or-nothing rule applies to purchases of capital personal property: unless the property is acquired for use primarily in commercial activities, no ITC is available (subsection 199(2) of the Excise Tax Act). De minimis rules also deem property and services to be used exclusively in a particular manner when they are used "substantially all" in commercial or non-commercial activities (ETA section 141). Although the ETA contains no equivalent to the income tax rule that completely denies a deduction for expenses related to a yacht, golf course, etc., ETA section 170 contains some narrower ITC restrictions. A GST registrant's ability to claim ITCs for recreational properties such as a boat, a ski chalet, or a cottage has been the subject of increased CRA scrutiny, as evidenced by the TCC's decision in *Coburn Realty* (2006 TCC 245).

The issue in *Coburn* was a real estate broker's use of a 36-foot cabin cruiser: if the boat was used primarily in commercial activities, the broker could claim an ITC for the $21,883 in GST paid on its importation. The broker argued that the boat was acquired for the purposes of entertaining clients and rewarding the 70 sales agents whom the broker retained as independent contractors. The TCC denied the ITC claim, saying that "actual use is frequently the best evidence of the purpose of the acquisition"; in fact, the boat's log, which was created ex post facto, evidenced that the boat was actually used primarily for entertaining friends and family. The court indicated in obiter that if the principal use of the boat changes—so that, for example, the high-earning agents are rewarded by cruises or clients are entertained or shown cottages through use of the boat—then an ITC may be claimed pursuant to the change-in-use rules in subsection 199(3).

Certain lessons may be learned from *Coburn Realty*. The determination of intended use, as indicated by the TCC, "boils down to a question of judgement and common sense." The statutory test in issue requires that the property be acquired for use "primarily" in commercial activities; historically, the CRA and most cases have accepted that "primarily" means more than 50 percent. The statutory test also focuses on the intended use of the property; *Coburn* said that "as a practical matter if property is in fact used primarily for commercial purposes it is a reasonable inference it was acquired for that purpose." The court's comments may be a conclusion relating to credibility: on the facts, there was no evidence of a commercial-use intent other than the taxpayer's assertion, which was not supported by the actual use. The TCC also pointed out that there are often a number of different ways to determine use, such as time spent, distance travelled, number of passengers, and number of sales visits. Furthermore, the ability to claim ITCs for capital personal property and real property is not a one-time event: change-in-use rules may apply later and allow an ITC or, alternatively, effectively require an ITC's repayment. GST registrants are therefore strongly encouraged to keep detailed records pertaining to the actual use of recreational properties. Alternative ownership structures may also be advantageous, such as a holdco's acquisition of the property for resupply by way of lease to third parties at FMV rentals, thus satisfying the primary-use test; deeming rules under ETA sections 155, 170, and 173 should be considered.

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Rule 14 Motions Near Death?

After about two years of uncertainty, Ontario sales tax practitioners now have some judicial guidance on the practical availability of motions under rule 14 of the Ontario Rules of Civil Procedure to resolve complex retail sales tax disputes.

Under the Ontario Retail Sales Tax Act, an appeal lies to the Ontario Superior Court of Justice for a sales tax matter disputed by a taxpayer. Historically, however, RST appeals must proceed by way of action in that court, which requires full legal procedures such as disclosure and examinations for discovery; if not settled, the RST appeal culminates in a full trial of the issue with oral evidence from witnesses. The rule 14 approach contemplates only the filing of affidavits and a circumscribed hearing of the issue based on those affidavits; the motions route is meant to determine questions of law only. Previous judicial decisions confirmed that the rule 14 motion process may be used, but some practitioners suggested that the rule 14 process, like any application process, contemplates situations where it is unlikely that any material facts are in dispute. Thus, practically speaking, in circumstances where the parties have not agreed on significant facts, it may be difficult to get through the motion process without being forced into a full trial. The recent decision of the Ontario Superior Court of Justice in *Bell Canada v. Ontario (Minister of Finance)* (2006 CanLII 12301) appears to confirm this concern.

Bell Canada involved the difficult RST question of whether, as the minister suggested, Bell's use of its network lines and circuits was a consumption of telecommunication services as a user (that is, for its own benefit) and therefore subject to RST. Bell claimed that the use of network lines and circuits was part of its overall operations, effectively what it provided to its customers, and a use on which RST had already been charged. Bell brought an application under rule 14 to decide the issue. The preliminary issue for the court was whether the case ought to be heard as an application or determined by a trial of issue: the court could convert the application into an action in the court under rule 38.10. (The parties had skirmished before on this issue in both this court and the Divisional Court; the Crown attempted to stop the process prematurely.) The court recognized that the issue raised by Bell could be described in simple terms, but that the "resolution of the issue involves a review of more complicated facts and statutory provisions."

The court first noted that one of the difficulties in dealing with the application under rule 14 was that the parties were not even in agreement about the question(s) that the court was being asked. Bell essentially framed the question as whether it was a consumer or user acquiring or receiving a taxable service at a sale in Ontario; the Crown asked a series of questions, including whether Bell was a producer of telecommunications and telecommunication services in the course of its business. The ultimate position of the Crown was that the factual findings sought by Bell to underpin its legal position could not be made on the evidence adduced by Bell in its application materials. Bell relied heavily on certain internal ministry documents, which the ministry said were for internal purposes only and did not represent agreed fact: the information had been provided by Bell and simply recited in the documents for internal discussion purposes and was not adopted or admitted by the ministry.

Ultimately, the court concluded that the "factual input necessary for the decision in this matter . . . properly should not be resolved on the basis of transcript evidence": a trial of the issue was required to determine all of the facts. The court reviewed the complex legislative provisions at issue (including fundamental definitional terms such as "consumer," "user," and "sale") and concluded that "[a] review of the numerous volumes of the Application Record, which include transcripts of cross-examinations on affidavits, reports and other documents, further emphasizes the nature of the differing positions of the Minister and Bell." In the court's view of the rule 14 process, a "party who utilizes [it] to obtain declaratory relief has to satisfy the Court on all the evidence that the relief sought is appropriate." In this case, Bell must discharge the evidentiary onus, and the court was "unable to conclude on the material and submissions before [it] that the onus on Bell has been met" because there were facts in dispute. "A trial is necessary where the resolution of a factual dispute involves matters of credibility or where the factual issues are sufficiently complex that to do justice to the positions of the parties, at least some oral evidence is required." However, because dismissing the motion might imply that Bell was taxable, the court ruled that material facts in dispute were best determined at a trial and so directed the matter.

It is hard to disagree with the Crown's position that significant questions and facts were in dispute. The rejection of information from internal ministry documentation suggested that Bell could not bootstrap on its own unsworn and untested statements. Although the questions raised by each party went to the same general point of whether Bell's actions with respect to network lines and circuits triggered tax, they were sufficiently different to pose a problem for the court under rule 14. *Bell* is a roadmap for any future rule 14 applications. A Crown counsel who wishes to avoid the process may simply demonstrate the complexity of the facts and issues before the court. Practically speaking, that sort of strategy is not easily countered by a taxpayer, who then has the onus of demonstrating that the facts and issues are not in dispute.

The court may also have been attempting to throw some cold water on the rule 14 process for complex RST appeals. The court observed that "[i]f this matter had proceeded in the manner envisaged under the RSTA, the onus would be on the Minister to justify an assessment against Bell under the Statute," and that it "might well be that the Minister could fail to discharge the onus under that process" and therefore may have had an interest in defeating the taxpayer under rule 14 in lieu of a trial. In order to avoid the possible implication that Bell was subject to tax, the court did not simply dismiss the application but instead directed that the matter be sent to trial.

Although the rule 14 process was more expedient, in this case the court questioned its cost efficiency. Taxpayers should address this question with their counsel in any contemplated rule 14 applications. Rule 14 procedures were intended to save time and money; but if the process fails, the matter must proceed to a full trial in any event. *Bell Canada* stands as a practical hurdle for taxpayers in Ontario looking to avail themselves of the rule 14 process to attack RST assessments when material facts are in dispute.

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US Citizens in Canada

US citizens resident in Canada may experience some friction between the two tax systems or unwittingly neglect their US tax obligations.

US returns. A failure to file a US return may attract civil and possibly criminal penalties. The IRS may assess at any time if no return is filed; no limitation period applies.

Foreign earned-income exclusion. A US-citizen Canadian resident may exclude US$80,000 (adjusted for inflation) of wages, salaries, and professional fees earned outside the United States if a timely election is filed on form 2555 (IRC section 911). Certain foreign housing costs (such as rent) exceeding 16 percent (but generally not more than 30 percent) of the US$50,000 inflation-adjusted limit may also be excluded. Without special permission, late-filed elections are not permitted if the return is filed more than one year late. Such exclusions create absolute tax savings if Canadian taxable income can be reduced for, say, an RRSP contribution.

Anti-deferral regimes. Complex tax-avoidance rules are designed to prevent the deferral of US tax by accumulating passive-type income in a non-US corporation.

1) Controlled foreign corporation. A CFC is a foreign corporation if more than 50 percent of its shares' votes or value are owned directly or indirectly in the aggregate, and at least 10 percent of the votes are owned individually, by US shareholders. Ownership of shares held by family members who are not US non-resident aliens may be attributed to the US citizen. A US shareholder owning at least 10 percent of the shares must report subpart F income—undistributed passive investment income, income from services provided to a related party, and certain other income. A US-citizen Canadian resident may generate subpart F income by forming a Canadian holdco to hold investments or an operating company to provide services to a related but non-associated company in order to take advantage of the small business deduction. A Nova Scotia or Alberta unlimited liability company (ULC) is ignored or treated as a partnership for US tax purposes and avoids the CFC rules; any Canadian corporate income tax paid by the ULC may be claimed as a foreign tax credit (FTC) by the US citizen against his or her federal income tax liability (subject to limitations).

2) Passive foreign investment companies. A foreign corporation is a PFIC if at least 75 percent of its gross income for the year is passive income—such as rents, royalties, dividends, interest, and gains on sales of investments—or at least 50 percent of its assets in the year generate such income. There is no minimum shareholding requirement. When the PFIC makes excess distributions, including gains realized on the sale of PFIC shares, the US shareholder suffers an interest charge on the deemed tax deferral from prior years' profits. A qualified electing fund election avoids the interest charge and subjects the electing shareholder to current tax on a pro rata share of the PFIC's current-year profits. The rule is especially onerous for a minority shareholder who has little control over the corporation's activities. Using a ULC avoids PFIC status.

Life insurance policies. Canada permits the tax-free accumulation of investment income in a Canadian exempt life insurance policy, but it taxes the increase in value of a US life insurance policy on a mark-to-market basis. For US tax purposes, any life policy that is not a modified endowment contract (MEC) receives more advantageous tax treatment: to be a non-MEC requires that the policy impose limits on how quickly a death benefit can be paid up through policy premium payments (generally seven years, although many non-MECs can be paid up in three to five years). Distributions are generally allocated to non-taxable basis recovery and then to taxable earnings. Generally, earnings in any policy accumulate tax-free, and the death benefit is tax-free when paid (unless the policy was transferred to a new owner for value). Qualifying non-MEC policy loans are not taxable events; but when the policy is surrendered, the policyholder is treated as having received and used a partially taxable distribution to repay the loan. MECs are treated in the same way, except that policy loans are treated as taxable cash distributions are; distributions (including loans) are allocated to taxable earnings first and then to tax-free basis; and a 10 percent penalty applies on distributions before age 59½. MEC limitations are not problematic if the policy is held until the insured's death, but non-MEC status ensures the flexibility to access the policy's cash value during the insured's lifetime.

Foreign trusts. A US-citizen Canadian trust beneficiary generally pays US tax, including a surcharge on accumulations, on distributions from that or another non-US trust (except a qualifying grantor trust created by another).

Gift and estate tax. A US citizen is subject to gift tax on gifts made and to US estate tax on death. Annual tax-free gifts may be made up to US$117,000 (inflation-indexed) to a non-resident alien spouse and US$12,000 to others: the general lifetime cap of US$1 million on inter vivos gifts does not apply. The Canada-US treaty allows a credit of some US estate tax against Canadian capital gains tax on death. The top US rate of gift or estate tax is 46 percent for 2006. A generation-skipping transfer tax effectively imposes a second estate tax on gifts or death transfers to, or for the benefit of, recipients or beneficiaries more than a generation removed from the donor.

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New FIRPTA Guidance

On May 23, 2006, IRS Notice 2006-46 announced that the IRS will issue final regulations under Code sections 897(d) and 897(e); those regs revise rules for inbound and foreign-to-foreign asset reorganizations involving the transfer of US real property interests (USRPIs) pursuant to the Foreign Investment in Real Property Tax Act (FIRPTA). The revisions are necessary because recently amended regs issued

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under section 368(a)(1)(A) allow statutory mergers or consolidations under foreign law to qualify as tax-free type A reorganizations; current regs and IRS guidance related to sections 897(d) and (e) do not contemplate that result.

Under section 897(a), the disposition of a USRPI by a non-resident alien individual or a forco is taxable as effectively connected income under sections 871(b)(1) and 882(a)(1), as if the taxpayer were engaged in a US trade or business. A USRPI is generally defined as any interest (other than an interest solely as a creditor) in US real property or an interest in a US corporation unless the taxpayer establishes that the corporation was not a US real property holding corporation (USRPHC) at any time during the shorter of the taxpayer's holding period and the five years preceding the date of disposition. A USRPHC is defined as any corporation if the FMV of its USRPIs is at least equal to 50 percent of the sum of the FMV of (1) its USRPIs, (2) its foreign real property interests, and (3) any of its other assets used or held for use in the trade or business.

If a forco distributes (including in a liquidation or redemption) a USRPI in an otherwise non-recognition transaction, gain is recognized pursuant to section 897(d)(1), except as provided in the regs. An exception applies if (1) at the time of the property's receipt, the distributee is taxable on its subsequent disposition and its basis in the distributee's hands is not greater than its pre-distribution adjusted basis plus any gain recognized by the distributing corporation, or (2) non-recognition treatment is provided for in regulations under section 897(e)(2). Temporary regs provide further guidance for section 897(d) distributions in the context of certain subsidiary-to-parent liquidations (section 332), spinoff transactions (section 355), and other non-recognition transactions (section 361); IRS Notice 89-85 revises the application of certain exceptions.

Generally, any non-recognition provision applies only on an exchange of a USRPI for an interest whose sale is otherwise taxable under Code chapter 1 (sections 1 to 1400T) (subject to section 897(d) and any regs issued under section 897(e)(2)). Temporary regs impose certain requirements for non-recognition transfers of USRPIs (section 1.897-6T(a)(1)). The IRS and Treasury decided that these temporary regs—and those issued for non-recognition transactions under sections 897(d) (and related Notice 89-85)—must be changed in light of the January 2006 final regs on statutory mergers and consolidations described in section 368(a)(1)(A). The IRS revisions address the new rules for statutory mergers and consolidations and include other changes to the section 897 regs.

The final regs intend to revise Notice 89-85 and Treasury reg section 1.897-5T(c)(4) relating to inbound asset type C, D, and F reorganizations so that they encompass section 368(a)(1)(A) statutory mergers and consolidations as well. The regs also revise Treasury regulation section 1.897-6T(b)(1) to take into account foreign-to-foreign statutory mergers and consolidations and to create two additional exceptions that provide a forco with non-recognition treatment on a USRPI's transfer in certain foreign-to-foreign asset reorganizations.

Taxpayers may rely upon the guidance in Notice 2006-46 before the final regs are issued. The final regs generally apply to distributions, transfers, or exchanges occurring after January 22, 2006 in the context of a statutory merger or consolidation; other changes in the regs apply to transactions occurring after May 22, 2006. However, taxpayers may generally apply the regs during any non-statute-barred tax year if they do so consistently for all transactions.

The new guidance allows greater flexibility in structuring mergers and consolidations with Canadian corporations and Canadian investors owning USRPIs. Not only may a merger under foreign law qualify for US tax-free treatment under section 368(a)(1)(A), but if USRPIs are involved, a merger may be structured to avoid FIRPTA.

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Foreign Tax News

United Kingdom

On May 25, 2006, Her Majesty's Revenue and Customs published a consultation document and explanatory notes on the tax law rewrite project's fifth bill, its first on corporation tax. On July 11, a deadline will be set for comments.

OECD

On May 11, 2006, the OECD published a nine-part manual on the implementation of exchange-of-information provisions for tax purposes. The manual advises on operational aspects and provides guidance for tax administrations.

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