CANADIAN TAX Highlights

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## PORTFOLIO DEBT AND PARTNERSHIPS

To help US companies raise capital, for decades the United States has provided tax incentives to encourage foreign investment in the US marketplace—for example, the longstanding exemption from the 30 percent withholding tax otherwise applicable to interest on portfolio debt held by foreign investors. Proposed regulations issued on June 13, 2006 (REG-11875-06) finally settle the treatment of a debt instrument issued by a US entity and held by a foreign partnership or trust.

The portfolio debt exemption requires that the foreign investor cannot have a 10 percent or more ownership interest in the US issuer (a corporation or a partnership). Various attribution rules determine the 10 percent owner status, but it was unclear how the limitation applied to a debt instrument held by a partnership (or trust): is the test applied at the partnership (or trust) level, or at the level of the partners (or owner or beneficiary)? The issue stimulated a significant body of commentary from practitioners, particularly with respect to partnerships: rather than each investor holding a direct interest in the investment vehicle, a group of investors often forms a partnership to participate in the investment.

The Treasury and the IRS concluded that the 10 percent owner limitation applies at the partner level, even though the partnership is the debt instrument's legal owner, because the choice of treating a partnership as an aggregate of its partners or as an entity separate from its partners depends on which characterization is more appropriate to carry out the law's purposes. The Treasury noted that "[t]he approach taken . . . is supported by the statute and legislative history which convey Congress' desire to facilitate the efficient and effective flow of foreign capital to U.S. borrowers while distinguishing true portfolio investors in the obligor from foreign persons making direct (10 percent) equity investments in U.S. operations." The proposed reg notes that for tax purposes, the partner is the beneficial owner of the interest paid to the partnership, because the partner, not the partnership, is taxed on the income. Furthermore, imposing a 10 percent ownership limitation at the entity level is likely to "impair the free flow of foreign capital to U.S. business." Often the individuals or other entities that are partners in a partnership are unrelated and are using the partnership investment vehicle solely for non-tax reasons; thus, there is "no apparent abuse" in such arrangements. The Treasury concluded that it would be "inapposite to the statutory framework and underlying purpose of the statute" to apply the 10 percent owner limitation at the entity level.

The proposed reg reaches a similar result for interest paid to a simple or grantor trust. A simple trust is required to distribute all income currently to the beneficiary, who is taxed on the income. Special rules treat the person who has settled a grantor trust as the trust's owner for tax purposes and tax the settlor on income received by the trust. As in the partnership ruling, the Treasury concluded that the 10 percent ownership limitation should apply at the beneficiary or owner level, not at the trust level.

The certainty provided by the proposed regs—assuming that they are finalized—is widely applauded by practitioners. Many types of investment vehicles characterized as partnerships, grantor trusts, or simple trusts hold US-issuer debt obligations. The uncertainty previously surrounding the portfolio debt exemption's availability for foreign investors posed significant concerns to investors and their tax advisers. The proposed regs conform to the realities of a modern marketplace in which unrelated investors often join together in entities to further investment objectives, and they recognize the non-abusive nature of these investment combinations.

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### In This Issue



## TREATIES AND PARTNERSHIPS

In a 2004 ruling, the CRA raised concerns for taxpayers and advisers when it said that it was reconsidering its position that treaty benefits are available when a Canadian resident pays certain amounts to a partnership whose partners are treaty residents. In May 2006, the CRA informally indicated that it has completed its review and that its position remains unchanged: partners resident in a treaty country can access treaty benefits. Notification will follow in an issue of *Income Tax Technical News*.

The question of the relevant rate of withholding tax on payments to partnerships arises in a variety of circumstances, most often when a partnership formed in Canada with US partners is treated as a corporation under the US check-the-box rules. The partnership is used, for example, to hold interest-bearing indebtedness of a related Canadian operating company. If interest or royalties are paid by a Canadian subsidiary to a partnership of US corporations (that has checked the box and is thus regarded as a Canadian corporation for US tax purposes), can the partnership be looked through for Canadian tax purposes to allow the partners access to treaty benefits? Both interest and royalties can enjoy a reduced 10 percent withholding tax rate under the Canada-US treaty.

The CRA's 2004 ruling said that its lookthrough approach vis-à-vis the partners was being reconsidered because it appeared to be inconsistent with the OECD model treaty's commentary on article 1 (paragraph 6.2). At the May 2004 International Fiscal Association (Canadian Branch) tax seminar, the CRA stated that any change in its position would be announced in an issue of *Income Tax Technical News* and that the grandfathering of existing structures might be necessary. At a meeting late in 2005, Wayne Adams, the director general of the Income Tax Rulings Directorate, said that the CRA had not completed its review; Finance officials would discuss the matter when they met with their US counterparts concerning the fifth protocol to the Canada-US treaty near year-end. No announcement has been made of the discussion's outcome.

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## GST Rate Reduction

The GST rate reduction from 7 percent to 6 percent became law on June 22, 2006. The reduction is straightforward, but implementation involves some complex transitional rules.

The technical effective date of the reduction is July 1, 2006. Generally, an invoice for goods, services, or intangibles issued before July 2006 attracts the 7 percent rate; an invoice issued thereafter attracts the 6 percent rate. However, 7 percent GST applies if (1) the invoice issued after June 2006 is dated earlier; (2) the invoice would have been issued earlier but for undue delay; (3) an agreement in writing requires payment before July 2006; or (4) consideration for the supply is paid before July 2006. Special rules apply if the supply was effectively completed in May 2006 but not invoiced until after June 2006. For example, if goods are sold and ownership or possession passes before June 2006, but an invoice is not issued until after June 2006, the invoice is deemed issued on June 30 and the supply is subject to the 7 percent rate. Similarly, real property contracts substantially completed by May 2006 attract 7 percent GST even if they are invoiced after June 2006.

The old rules on deposits and holdbacks apply. True deposits—amounts not yet applied toward the purchase price—made before July 2006 benefit from the 6 percent rate if they are applied to the purchase price after June 2006. Holdbacks not otherwise paid, payable, or expired before July 2006 also benefit from the lower rate. Leases fall under the general rule: payments made or required to be made before July 2006 are taxed at 7 percent; payments required and paid after June 2006 are generally subject to the lower rate. Other special considerations may apply. Imported goods released from customs control after June 2006 are taxed by the Canada Border Services Agency at 6 percent; goods released before then attract the 7 percent rate. Two new anti-avoidance rules (ETA sections 274.1 and 274.2) are aimed predominantly at certain related-party situations that attempt to benefit from the GST rate reduction through a tax saving.

Special transitional rules for a variety of situations—including deemed supplies, taxable benefits, employee and partner rebates, allowances, change-in-use situations for capital property, and streamlined methods of accounting—are detailed in several CRA publications, generally available on the CRA Web site. A special telephone information service has been set up at 1-866-959-7797 (English) and 1-866-959-7798 (French) to answer rate-reduction questions. The service is available from 8:15 a.m. to 8:00 p.m. local time.

If too much GST has been charged, section 222 deems anything collected "as or on account" of GST to be held "in trust for Her Majesty in right of Canada" and ultimately remittable to the Crown. A number of options exist for returning over-collected GST to the recipients (with the simultaneous reduction in the registrant's net tax amount), including the section 232 procedure that requires a credit note to be issued, with prescribed information. Alternatively, the recipient, if it is a registrant and involved exclusively in commercial activities, can simply choose to take an input tax credit for the full amount charged (permitted under CRA policy) or to claim a section 259 rebate for tax paid in error.

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## GST Credit

Because GST credits are refundable in order to improve support for children and alleviate the regressive impact of the GST, the CRA has developed a highly specialized operation to administer the credits. Not only is the administration separate from the normal collection and enforcement of the personal income tax, but the reporting is also separate. The CRA's compilations of income tax statistics no longer contain any information on these credits, and no comparable analyses of either program are available in other publications. As a result, an article in the June issue of *Perspectives on Labour and Income* from Statistics Canada is particularly useful, albeit limited.

The article, entitled "The GST Credit," which is available at http://www.statcan.ca/english/freepub/75-001-XIE/75-001-XIE2006106.pdf, examines the size and structure of the GST credit for 2003, and the distribution of the credits by family type and income. There are a number of useful graphs and charts, but, unfortunately, no supporting figures that back up the analyses and enable the reader to explore further. Much of the analysis is based on the 2003 survey of labour and income dynamics, so the definitions of "family" and "family income" do not coincide with those developed from the income tax system and used for the administration of the GST credit.

**GST Summary Statistics**

| | 1991-92 | 2004-5 |
|---|---|---|
| Total GST revenue, $ billion | 15.5 | 34.0 |
| GST revenue as a percentage of total federal revenue | 12.0 | 16.0 |
| GST revenue as a percentage of personal disposable income | 3.2 | 4.4 |

The article notes that over one-third of all persons aged 16 and older benefited from the credits, and 7.5 million of the 13 million families in Canada received credits. GST revenue outpaced other federal tax revenue between 1991-92 and 2004-5. Part of this difference can be explained by the reduction in personal and corporate income tax rates over the period, but because certain exceptions, such as basic groceries, are allowed, GST revenue has increased faster than personal disposable income. The table summarizes some relevant GST statistics. The article noted that because the analysis is based on a broad definition of "family," one-third of families with income over $100,000 received a credit in 2003.

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## Half Deduction for Client Gifts

In *Stapley* (2006 FCA 36), the FCA recently held that food and entertainment vouchers provided to the taxpayer's clients as part of his business advertising expenses were eligible for a 50 percent deduction only. The taxpayer argued for full deductibility because he did not consume any part of the items himself. Using the "text, context, and purpose" approach to statutory interpretation outlined by the SCC in *Canada Trustco* (2005 SCC 54), the FCA said that although the purposive approach supported the taxpayer, the scheme of the legislation (context) and the plain wording of the relevant subsection (text) prevailed.

Mr. S, a self-employed real estate agent, marketed and sold residential properties. As part of the advertising for his business, Mr. S bought gift certificates for food and beverages and tickets for various concerts and sporting events and provided them to clients who had purchased or sold homes through his business. Mr. S did not consume any of the food and beverages or attend any of the events, nor did he have control over how his clients used the vouchers and tickets. Mr. S deducted 100 percent of the costs of the vouchers and tickets (about $53,000), ignoring subsection 67.1(1), which generally allows a 50 percent deduction of business expenses "in respect of the . . . consumption of food or beverages or the enjoyment of entertainment," with some exceptions. The CRA disallowed 50 percent of Mr. S's claim.

The TCC found in Mr. S's favour: because Mr. S did not participate in consuming the food and beverages or enjoying the entertainment provided by the gift certificates and tickets, the amount Mr. S paid for those items constituted a reduction in, or rebate of, his real estate commission—a form of discount for the purpose of gaining income. The decision was made under the TCC informal procedure and has no precedential value.

The FCA clearly structured its analysis on the SCC's approach (set out in paragraph 10 of *Canada Trustco*):

> The interpretation of a statutory provision must be made according to a textual, contextual and purposive analysis to find a meaning that is harmonious with the Act as a whole. When the words of a provision are precise and unequivocal, the ordinary meaning of the words plays a dominant role in the interpretive process. On the other hand, where the words can support more than one reasonable meaning, the ordinary meaning of the words plays a lesser role. The relative effects of ordinary meaning, context and purpose on the interpretive process may vary, but in all cases the court must seek to read the provisions of an Act as a harmonious whole.

In analyzing the grammatical and ordinary sense of the words in subsection 67.1(1), the FCA found that although Mr. S's expenditures served a business purpose, and although only his clients consumed the food and beverages and enjoyed the entertainment, the expenses were still "in respect of" such consumption and enjoyment. The meaning of that phrase suggests "the widest possible scope," and thus the expenses were caught by the plain wording of the provision. In analyzing the context, the FCA concluded that subsection 67.1(1) is a broadly drafted rule with 11 exceptions. Because several specific exceptions were found in section 67, including subsection 67.1(1) itself, Parliament clearly would have added an exception in the case of no personal consumption, if that had been its intention. The FCA said that the legislative scheme suggests that the provision does not require personal use by the taxpayer, and thus Mr. S could not deduct the full amount of the expenses.

However, the FCA noted that this result may not accord with the purpose of the provision, referring to the 1994 budget supplementary information, which says: "The deduction with respect to business meals and entertainment expenses is currently restricted to 80 per cent of such expenses to reflect the fact that they contain an element of personal consumption." Because Mr. S did not consume the food or enjoy the entertainment in question, he was not attempting to deduct any personal or living expenses under the guise of business expenses; therefore, the deductions did not constitute an abuse of the provision. Thus, a purposive approach to the construction of the provision supported the TCC decision that allowed Mr. S a full deduction. However, even though Mr. S's expenses were incurred to produce income from a business, they were also "in respect of the human consumption of food or beverages or the enjoyment of entertainment" as set out in subsection 67.1(1) and were therefore caught by that wording and were only 50 percent deductible.

The FCA added that it seemed unfair to cut Mr. S's deduction by half. If he had purchased flowers or books for his clients, he could have deducted the full cost or he could have fully "deducted" rebates on his real estate commissions or gifts of cash to his clients. The FCA said that section 67.1 in its current form interferes with taxpayers' business decisions and how they allocate their marketing budgets.

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## Corporate Rate Recap

This year's budgets decrease corporate income tax rates for both big and small businesses, although most of the reductions are not effective until after 2006. Many rate cuts affecting 2006 fiscal years were announced previously. Table 1 shows 2005 and 2006 combined general, M & P, and small business rates.

**Table 1 Combined Corporate Income Tax Rates (December 31 Year-End)**

| | General and M & P rate* | | CCPC small business rate | |
|---|---|---|---|---|
| | 2005 | 2006 | 2005 | 2006 |
| | *percent* | | | |
| Federal | 22.12 | 22.12 | 13.12 | 13.12 |
| Alberta | 33.62 | 32.49 | 16.12 | 16.12 |
| British Columbia | 34.86 | 34.12 | 17.62 | 17.62 |
| Manitoba | 37.12 | 36.62 | 18.12 | 17.62 |
| New Brunswick | 35.12 | 35.12 | 15.37 | 14.87 |
| Newfoundland & Labrador | 36.12 (27.12) | 36.12 (27.12) | 18.12 | 18.12 |
| Northwest Territories | 36.12 | 34.86 | 17.12 | 17.12 |
| Nova Scotia | 38.12 | 38.12 | 18.12 | 18.12 |
| Nunavut | 34.12 | 34.12 | 17.12 | 17.12 |
| Ontario | 36.12 (34.12) | 36.12 (34.12) | 18.62 | 18.62 |
| Prince Edward Island | 38.12 (36.02) | 38.12 | 19.87 | 18.79 |
| Quebec | 31.02 | 32.02 | 22.02 | 21.23 |
| Saskatchewan | 39.12 (32.12) | 37.61 (32.12) | 18.12 | 18.12 |
| Yukon | 37.12 (24.62) | 37.12 (24.62) | 17.12 (15.62) | 17.12 (15.62) |

* Figures in parentheses are M & P rates.

Alberta, British Columbia, Manitoba, and the Northwest Territories enjoyed reductions in their general (and M & P) rates in 2006; Saskatchewan's general rate also dropped. Prince Edward Island's M & P rate increased in 2005, as did Quebec's active income rate in 2006. After 2007, the federal surtax is eliminated for all corporations, and the federal general (and M & P) rate declines in stages from 2008 to 2010; thus the federal general (and M & P) rate, including surtax, declines from 22.12 percent in 2006 to 19 percent after 2009. Decreases are also expected after 2006 in Manitoba's and New Brunswick's general (and M & P) rates and Saskatchewan's general rate; Quebec's active income rate further increases in stages starting in 2008.

Provincial small business rates declined in four provinces in 2006: Manitoba's fell from 5 to 4.5 percent on January 1, 2006, and falls to 3 percent on January 1, 2007; New Brunswick's small business rate—the lowest in Canada—fell from 2.5 to 2 percent on July 1, 2005 to 1.5 percent on July 1, 2006, and falls to 1 percent on July 1, 2007; Prince Edward Island's fell from 7.5 to 6.5 percent on

**Table 2 CCPC Small Business Taxable Income Threshold**

| | Effective date | From | To |
|---|---|---|---|
| | | *dollars* | |
| Federal | January 1, 2007 | 300,000 | 400,000 |
| Alberta | Unchanged | 400,000 | |
| British Columbia | Unchanged | 400,000 | |
| Manitoba | Unchanged | 400,000 | |
| New Brunswick | July 1, 2005 | 425,000 | 450,000 |
| | July 1, 2006 | 450,000 | 475,000 |
| | July 1, 2007 | 475,000 | 500,000 |
| Newfoundland & Labrador | January 1, 2007 | 300,000 | 400,000 |
| Northwest Territories | January 1, 2007 | 300,000 | 400,000 |
| Nova Scotia | April 1, 2005 | 300,000 | 350,000 |
| | April 1, 2006 | 350,000 | 400,000 |
| Nunavut | January 1, 2007 | 300,000 | 400,000 |
| Ontario | Unchanged | 400,000 | |
| Prince Edward Island | January 1, 2007 | 300,000 | 400,000 |
| Quebec | January 1, 2006 | None | 400,000 |
| Saskatchewan | July 1, 2006 | 300,000 | 400,000 |
| | July 1, 2007 | 400,000 | 450,000 |
| | July 1, 2008 | 450,000 | 500,000 |
| Yukon | January 1, 2007 | 300,000 | 400,000 |

April 1, 2005 and decreases by 1.1 percentage points annually, on April 1 of each year, until it reaches 1 percent on April 1, 2010; and Quebec's preferential rate fell from 8.9 to 8.5 percent on January 1, 2006 and to 8 percent on March 24, 2006. The federal budget decreased the federal small business rate from 12 to 11.5 percent on January 1, 2008 and to 11 percent on January 1, 2009; on January 1, 2007 the small business taxable income threshold increases from $300,000 to $400,000. Changes to small business thresholds in all jurisdictions are outlined in table 2.

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## US Citizens in Canada, Part 2

This article continues from last month, highlighting some asymmetries between the Canadian and US tax systems.

■ **Qualified domestic trusts (QDOTs).** A non-US citizen married to a US-citizen Canadian resident may defer US federal estate tax on the spouse's death until his or her own death. The QDOT enables a claim for an estate tax marital deduction and may also qualify as a spousal trust for Canadian tax; neither US estate tax nor Canadian tax is triggered on the asset transfer to the QDOT. Problems may arise in Canada if the assets are rolled to the QDOT and then sold during the surviving spouse beneficiary's lifetime.

■ **Foreign reporting requirements.** A $10,000 penalty applies if form 5471 ("Information Return of US Persons with Respect to Certain Foreign Corporations") is not filed to report ownership of 10 percent or more of a foreign corporation's shares. Form 8621 ("Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund") must be filed to report a PFIC interest. Form 3520 ("Annual Return To Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts") (and possibly form 3520-A, "Annual Information Return of Foreign Trust with a US Owner") reports foreign trusts, including those established by a non-beneficiary US citizen. Form 3520 is also used to report a US citizen's receipt from a foreigner of a gift or inheritance exceeding US$100,000 (US$10,000 from a foreign partnership or corporation). Treasury form TD F 90-22.1 ("Report of Foreign Bank and Financial Accounts") must be filed for foreign accounts that a US citizen owns, has signatory power over, or otherwise controls. Other reporting requirements may apply. Substantial civil and possibly criminal penalties can apply to a non-resident US citizen who fails to satisfy US tax-filing obligations; the IRS is stepping up its publicity campaign and its enforcement efforts to encourage compliance.

■ **Reorganizations.** A US-citizen Canadian resident who engages in a traditional Canadian estate freeze triggers US gift tax. In the typical freeze, common shares are exchanged for a Canco's fixed-value preference shares without a cumulative dividend and redeemable for the exchanged shares' FMV. New commons are issued for nominal consideration. To avoid US gift tax on the exchanged shares' FMV, the frozen preference shares must yield a reasonable cumulative dividend, and new commons cannot be issued for nominal consideration; a junior equity exemption requires the next generation to invest at least 10 percent of the business's value. A Canadian ULC may also prove advantageous.

■ **Residential property.** The Canadian exemption generally eliminates tax on the sale of a principal residence. However, a US citizen married to a Canadian citizen can avoid US tax on only US$250,000 of the gain; if holding periods are met, the balance is taxed at a maximum 15 percent federal rate.

■ **Renouncing US citizenship.** A dual US-Canadian citizen who anticipates a substantial increase in assets or income and who is considering renouncing US citizenship may find it generally less costly to renounce sooner rather than later. For example, a child born in Canada to a US citizen may have derivative US citizenship; the child may be a beneficiary under a will of a wealthy non-US-citizen parent or grandparent. Alternatively, a US citizen without substantial assets or income may be a beneficiary under a non-US-citizen spouse's will.

To terminate US citizenship or long-term residence status for US tax purposes, notice must be given to the secretary of state or the secretary of homeland security, and form 8854 ("Initial and Annual Expatriation Information Statement") must be filed with the IRS. Form 8854 must be filed annually; if it is not filed, a US$10,000 penalty applies. US tax returns must be filed for 10 years even in the absence of taxable income. A non-US citizen who gives up a US residence visa (green card) held for at least 8 years and a US citizen who gives up US citizenship are subject to a 10-year expatriation tax regime for US income, estate, and gift tax purposes. An individual subject to the 10-year expatriation regime who spends more than 30 days in the United States (60 days with qualifying employment) in any of the 10 years following expatriation is subject to US income tax, estate tax, and gift tax on his or her worldwide income, worldwide estate, and gifts wherever they are made.

An individual whose average net tax liability over the five preceding years did not exceed US$131,000 (indexed), whose net worth is less than US$2 million, and who can prove the filing of tax returns for those years is exempt from the expatriation rules. Also exempt is a dual US-Canadian (or third-country) citizen since birth—for example, an individual who was born in Canada and whose US citizenship was immediately applied for and obtained by the US-citizen parent; the individual must (1) never have had a US passport, (2) never have been a US resident, and (3) not have spent more than 30 days in the United States in any of the previous 10 years. A similar exemption exists for a Canadian (or third-country) citizen who is US-born and renounces before age 18½.

During the 10 years post-expatriation, the individual is taxed on US-source income and certain foreign-source income and suffers gift tax on gifts of US assets, including stocks, bonds, and other intangibles with a deemed US situs. (Cash gifts made outside the United States are exempt from US gift tax.) Certain non-recognition provisions cease to apply if the transferred property involves US-source income or assets. Removal from the United States of appreciated tangible personal property (such as art, aircraft, or automobiles) with an aggregate FMV exceeding US$250,000 triggers a gain subject to US tax; this rule applies for 15 years beginning 5 years before expatriation. Certain US-source property may be transferred to a controlled foreign corporation without incurring US tax, but income or gains on the property are subject to US tax in the 10-year period. If, during the 2 years pre-expatriation, an expatriate owned more than 50 percent of the shares of a forco earning non-subpart-F income, earnings and profits accumulated before expatriation are subject to tax if they are realized in the form of dividends or gains on the sale of the shares during the 10-year period.

An avoidance rule applies if a sale is delayed beyond 10 years by the use of a put or a call. Foreign tax credits may be claimed for foreign taxes on the income subject to US tax under the 10-year regime. The expatriation rules override any treaty provision. The value of the shares of certain forcos is subject to US estate tax if the expatriate dies within the 10-year period.

Although the Senate-passed legislation to impose a departure tax on expatriates has once again failed to be enacted, further efforts may succeed. The Senate proposal, similar to Canada's departure tax, deemed a disposition immediately before the relinquishing of US citizenship (or long-term resident alien status); taxable income and gains were broad enough to include deferred compensation, pensions, and certain assets held in trust.

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## Corporate Tax Measures: Substantively Enacted?

Selected corporate tax changes from the provinces' 2006 budgets and the status of related legislation are outlined below. Tax measures are generally considered substantively enacted for the purposes of Canadian GAAP when the bill receives first reading in the provincial legislature comprising a majority government (currently, all provinces except Nova Scotia). Under US GAAP, Canadian tax measures are considered substantively enacted when the bill receives royal assent.

■ **British Columbia.** The 2006 budget contains no corporate tax rate changes.

■ **Alberta.** The corporate tax rate was reduced from 11.5 to 10 percent, effective April 1, 2006, by Bill 34 (Alberta Corporate Tax Amendment Act, 2006; first reading on April 10, 2006, royal assent on May 24, 2006.)

■ **Saskatchewan.** The general corporate income tax rate was reduced from 17 to 14 percent for 2006, 13 percent for 2007, and 12 percent for 2008; the small business threshold increased from $300,000 to $400,000 for 2006, $450,000 for 2007, and $500,000 for 2008 (Bill 64, Income Tax Amendment Act, 2006). The capital tax rate for non-financial corporations was decreased from 0.6 to 0.3 percent for 2006 and to 0.15 percent for 2007; capital tax is eliminated by 2008. The capital tax resource surcharge rate was reduced (Bill 63, Corporation Capital Tax Amendment Act, 2006). Bills 63 and 64 received first reading on April 21, 2006 and royal assent on May 19, 2006.

■ **Manitoba.** The general corporate tax rate was reduced from 15 to 14.5 percent effective after 2005 and to 14 percent effective after 2006. The small business rate was reduced from 4.5 to 3 percent effective after 2006. The capital tax deduction is increased from $5 million to

$10 million, effective for fiscal periods beginning after January 1, 2007. The implementing bill (Bill 42, Budget Implementation and Tax Statutes Amendment Act) received first reading on June 5, 2006.

■ **Ontario.** Elimination of Ontario's capital tax was accelerated by reducing the rates in 2007, two years earlier than previously announced. Bill 81 (Budget Measures Act, 2006), implementing a 5 percentage point reduction in various capital tax rates for 2007 and 2008 and certain other 2006 budget measures, received first reading on March 23, 2006 and royal assent on May 18, 2006.

■ **Quebec.** A 2006 budget bill has not yet been tabled. However, Bill 15 was introduced to implement certain measures announced in Quebec's 2005 budget and in information bulletins published by Quebec Finance in 2004 and 2005. Bill 15 also includes a previously unannounced retroactive tax measure regarding the taxation of trusts, as well as GAAR amendments. Bill 15 (An Act To Amend the Taxation Act and Other Legislative Provisions) received first reading on May 9, 2006 and royal assent on June 13, 2006.

■ **New Brunswick.** The general corporate tax rate was reduced from 13 to 12 percent effective after 2006. The provincial large corporations capital tax rate was reduced from 0.3 to 0.25 percent in 2006, 0.2 percent in 2007, and 0.1 percent in 2008 (the tax is eliminated effective January 1, 2009). Implementing Bill 77 (An Act To Amend the New Brunswick Income Tax Act) received first reading on June 6, 2006.

■ **Nova Scotia.** The 2006 budget continued to phase out the large corporations capital tax, which is scheduled for elimination by 2012. Bill 97 (Financial Measures Act) received first reading May 11, 2006, two days after the budget was tabled, but died on May 13, when a provincial election was called and the provincial legislature dissolved. The currently legislated date for elimination of the tax is 2009.

■ **Prince Edward Island.** The small business tax rate is reduced over five years from 6.5 percent to 1 percent in increments of 1.1 percentage points per year starting April 1, 2006 and ending April 1, 2010. Bill 42 (An Act To Amend the Income Tax Act) received first reading on May 11, 2006.

■ **Newfoundland and Labrador.** The 2006 budget contains no corporate or personal tax rate changes.

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## US Excise Tax: Wireless Services

Treasury has conceded the legal dispute over the federal excise tax on long-distance telephone service. Justice will not pursue litigation, and the IRS will issue full refunds of tax (plus interest) on long-distance services, wireless cellular services, and prepaid telephone calling-card purchases. Refunds cover all periods previously protected with refund claims and periods billed from March 1, 2003 to July 31, 2006. The IRS has also directed telecommunications vendors to cease collecting and remitting federal excise tax on such services billed after July 31, 2006. The tax remains in effect on local telephone service.

IRS Notice 2006-50 (2006-25 IRB 141) announced the IRS's acquiescence to the US appeals courts' decisions on the long-distance excise tax under Code section 4251. The courts held that a telephone communication is not a taxable telephone service if it is a toll charge that varies only with elapsed transmission time, and not with distance (time-only service). The notice also provides guidance on requests for a credit or refund of excise tax paid for non-taxable toll telephone services. Refund claims already filed for periods billed before March 1, 2003 continue to be processed under historical IRS procedures. For all claims for periods billed after February 28, 2003 but before August 1, 2006, a taxpayer may include a request for a refund or credit of federal excise tax charged on long-distance services, wireless (cellular) services, and prepaid telephone calling-card purchases only on its 2006 federal income tax return. Individuals may claim a safe harbour amount if they paid all taxes billed by the service provider after February 28, 2003 and before August 1, 2006, or they may claim the actual amount of tax paid. A corporate taxpayer may claim a refund only for the actual amount of tax paid and must retain detailed records that substantiate the refund amount for each month. Any part of the credit or refund attributable to tax that was deducted as an ordinary and necessary business expense must be included in income for the tax year in which the credit or refund is received or accrued. If a taxpayer requests a credit or refund of the actual amount of tax paid, interest on the credit or refund must be included as income in the taxpayer's income tax return for the tax year in which the interest is received or accrued.

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## Quebec SR & ED Changes

Before Quebec's April 21, 2005 budget, its scientific research and experimental development (SR & ED) incentive program was unique among the various provinces. For example, even without a Quebec PE, a Canadian business that subcontracted SR & ED activities into Quebec could claim, inter alia, the refundable tax credit on SR & ED salaries and wages and the refundable tax credit for university research. The budget proposed that to access those credits a taxpayer must carry on a business in Quebec and have a PE there.

On June 9, 2006, the Quebec National Assembly adopted Bill 15, which implements some budget measures including the SR & ED changes applicable for SR & ED expenditures incurred after budget date (unless the contract was entered into before that date) and in a fiscal year of the taxpayer that begins after that date.

Bill 15 adds further restrictions on Quebec SR & ED incentives. A taxpayer can claim the refundable SR & ED tax credits only if it is reasonable to consider that the SR & ED activities carried on by the taxpayer, or on its behalf, relate to a business carried on by the taxpayer in an establishment located in Quebec and that the SR & ED activities may lead to or facilitate an extension of that business. It is not clear how these provisions will be interpreted, although it appears that some technical and commercial relevance must connect the SR & ED and the Quebec PE's activities, making access to the tax credits perhaps problematic for a company whose Quebec PE carries on a business in a field distinct from that to which the SR & ED relates. Companies claiming Quebec SR & ED credits must wait for more guidance from the program's administrators on the new legislation's scope of application, but in the meantime they should be aware of the potential impact on their claims.

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## Ontario PST on Software

In recent months, both British Columbia and Ontario have seen PST developments in respect of software. In a surprising and welcome move, British Columbia eliminated PST on all services to software effective February 22, 2006. Ontario's developments have been less felicitous: as part of continuing efforts to increase taxpayers' awareness of software issues, Ontario Finance recently reissued RST Guide 650, "Computer Programs and Related Services." The revised guide covers key topics such as custom programs, taxable services, modifications, and some fair value rules; by and large the existing policy is reinforced, but new commentary on taxable services may create further uncertainty.

In defining taxable installation services, the guide highlights the activity of "verifying the existence of prerequisite programs," even though a legislative exemption exists for the "determination and verification of hardware and software prerequisites." More importantly, however, other services previously exempted administratively—such as project planning, data management, and general advisory services—now appear to qualify for exemption only if they are the only service provided, they are provided with only non-taxable services, or they are not required in order to supply a taxable service. According to Ontario Finance, a "non-taxable service [that] must be performed in order to supply a taxable service" forms an integral part of the overall taxable supply and is therefore taxable even if invoiced separately. This conformity to the concept of single versus multiple supplies so often debated in the GST realm appears to contradict the generally unconditional exemption previously afforded these services. Larger software installation projects often include project planning, which may take place at different stages, and data management: if all such services are now taxable, it is a significant and surprising change. Seemingly inconsistently, separate charges for training services remain non-taxable even if sold with taxable services.

The guide also seems to reinforce Ontario Finance's view that a program qualifies as custom software only if all rights to its source code are relinquished to the purchaser by the developer. This view may effectively nullify the exemption because software is often developed with "new" code intermingled with more mundane subroutines that are reused or shared. Notwithstanding the guide, in informal discussions Ontario Finance has indicated a willingness to review the manner in which such intellectual property rights are transferred.

The guide's broad statements may create additional conflict in an audit, an exercise in which general positions are often favoured over nuanced views that may be more appropriate. Ontario Finance should be applauded for its creativity in developing the pilot project that attempts to simplify the tax calculation for small businesses, but the PST's complexity contrasts starkly with the boldness of British Columbia's recent move to achieve simplicity.

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## USSC Upholds State Incentives

On May 15, 2006, the US Supreme Court handed down its much-awaited decision in *DaimlerChrysler Corp. v. Cuno* (126 S. Ct. 1854). (See "Ohio ITC Unconstitutional," *Canadian Tax Highlights*, February 2005.) The court held that the plaintiffs in the case lacked federal standing to challenge the tax incentives offered to DaimlerChrysler by Ohio, thereby overturning an earlier federal appellate court decision that invalidated such incentives because they were in violation of the US constitution. The immedi-

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ate impact of the decision is a victory for the states and pro-business tax policies. However, the constitutionality of targeted business incentives remains unclear because the decision was based on procedural, not substantive, grounds.

Ohio and the City of Toledo granted DaimlerChrysler income and property incentives worth $280 million to build a new vehicle-assembly plant near an existing Jeep facility. The package included a 10-year property tax exemption from Toledo and two school districts, and a non-refundable investment tax credit (ITC) against the Ohio corporation franchise tax for the purchase and installation of machinery.

A group of plaintiffs, including Toledo residents who paid state and local taxes, filed a lawsuit arguing that the tax breaks discriminated against taxpayers that locate new businesses outside Ohio, in violation of the commerce clause of the US constitution, which prohibits discrimination against interstate commerce. The complaint was originally filed in state court, but DaimlerChrysler and Toledo removed the case to the federal court system, where the District Court held that the property tax exemption and the ITC at issue did not violate the commerce clause. On appeal, the Sixth Circuit Court of Appeals unanimously upheld the constitutionality of the property tax exemption but found that the ITC discriminated against interstate commerce and therefore amounted to a constitutional violation.

The reversal of that decision by the US Supreme Court is no doubt a favourable outcome for businesses. But the decision did not address the merits of the case, and thus the constitutionality of the tax incentives has been left susceptible to subsequent challenges. Future litigation of this issue is likely—a factor that crystallizes the theoretical uncertainty over the ongoing availability of, and the advisability of taking advantage of, various tax incentives in many states. However, Congress may choose to provide protection for state tax incentives: it has clear constitutional authority to allow such interference, although the states themselves are not permitted to interfere unilaterally with interstate commerce. In fact, proposed legislation introduced in Congress in 2005 authorizes states and localities to provide such tax incentives for the purposes of promoting economic growth; if enacted, that legislation will render any *Cuno*-type challenge a moot issue.

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# Foreign Tax News

## US-Canada

On December 23, 2005, the competent authorities signed a memorandum of understanding setting out the principles, guidelines, and procedures for resolving factual disagreements in mutual agreement cases under the treaty. An independent review by an appeals review panel is mandated for the resolution of any factual disagreement in a mutual agreement procedure. The process does not apply to cases involving treaty interpretation or if the taxpayer failed to cooperate with either competent authority (unless they agree otherwise). The panel's decision is not precedential.

## European Union

On May 11, 2006, the European Commission announced that it will submit a legislative proposal by year-end to modernize the current law on financial services and insurance transactions, and launched a public online consultation.

A European Parliament working group is considering a measure to tax phone text messages and e-mails at 1.5 cents and 0.00001 cent per message, respectively.

## Republic of China

Effective June 2, 2006, a flat 20 percent withholding tax on dividends distributed by ROC corporations directly to foreign corporations standardizes the taxation of such dividends.

## United Kingdom

Revenue and Customs published draft legislation to stop tax avoidance in structured factoring arrangements that effectively allow tax relief for both interest and loan principal; these financial arrangements are recharacterized as loans.

## Australia

A new penalty regime for tax shelter promoters may apply for those participating in tax avoidance and tax evasion schemes, effective for conduct engaged in after April 10, 2006. The penalties should not apply if the scheme was implemented in compliance with rulings that covered all participants.

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