CANADIAN TAX Highlights

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GST Non-Compliance Costs

The GST rate reduction to 6 percent effective July 1, 2006 was a welcome and highly publicized part of the May 2006 federal budget. Less welcome and less well known are technical changes to the Excise Tax Act (ETA) that dramatically increase the cost of GST non-compliance.

■ Currently, ETA subsection 280(1) imposes a penalty and interest for failure to remit or to pay an amount on time, calculated at 6 percent and at the prescribed rate, respectively. Effective April 1, 2007, that penalty and interest are replaced with interest only at a new higher prescribed rate that effectively includes a 4 percent penalty bump. The current prescribed rate of interest on late and deficient GST payments and refunds is determined by reference to the rate charged on 90-day treasury bills and is adjusted quarterly (3.57 percent for the third quarter of 2006). Effective April 1, 2007, the new prescribed rate is (1) for amounts payable to the minister, the treasury bill rate rounded up to the nearest whole percentage, plus 4 percent; and (2) for amounts payable to the taxpayer, the treasury bill rate, rounded up to the nearest whole percentage, plus 2 percent. Thus, as of April 2007, these changes harmonize the interest rate paid to and by taxpayers on overdue amounts under the ETA, the Excise Act, 2001, and the Income Tax Act.

■ The reduced rate and the change from a penalty to an interest characterization may initially appear to be taxpayer-friendly. Also effective April 1, 2007, however, GST-related interest payable (including interest payable under subsection 280(1)) becomes non-deductible for income tax purposes.

■ The automatic 6 percent penalty will be eliminated, but new section 280.1 levies a penalty for late-filed returns equal to 1 percent of the outstanding balance, plus an additional 0.25 percent per month for each complete month that the return is outstanding, to a maximum of 12 months. This change applies to GST returns required to be filed after March 2007.

■ Effective April 1, 2007, the minister's discretion to waive or cancel interest and penalties under section 280 (and new section 280.1) is limited to amounts that became payable in any of the preceding 10 calendar years. That discretion is currently unlimited.

These changes increase the cost of ETA non-compliance and perhaps offset the ameliorative effect of the 1 percent rate reduction. A related issue is whether the newly higher and perhaps punitive prescribed rate of interest allows a taxpayer's claim for a due diligence defence. The courts have recognized the due diligence defence for penalties under subsection 280(1) if certain criteria are met (*Consolidated Cdn. Contractors Inc.*, [1998] GSTC 91 (FCA)), but not for the interest thereunder. If the higher interest amount is found to be punitive and in fact to constitute a penalty, the door may be open for the due diligence defence under the principles in *Sault Ste. Marie* ([1978] 2 SCR 1299).

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In This Issue

No Reverse Onus

In *Anchor Pointe Energy Ltd.* (2006 TCC 424), Bowman CJ concluded that the reverse onus did not apply to facts assumed by the minister subsequent to the expiration of the reassessment period.

This is the third procedural round for Anchor Pointe's 1991 taxation year, and the substantive issues are yet to be decided. Anchor Pointe purchased seismic data for cash and a promissory note and sought to deduct that amount as a Canadian exploration expense (CEE). In the reassessment issued in 1994, the minister said that the taxpayer could claim CEE up to the seismic data's FMV (the cash portion only). The taxpayer filed a notice of objection in 1994, claiming CEE on the promissory note.

Some six years later, in March 2000 and after the assessment period had expired, the minister confirmed the reassessment on the basis that the seismic data acquired was not in fact CEE because it was not used for the purpose of determining the existence, location, extent, or quality of an accumulation of oil and gas, but rather had been acquired for the purpose of resale and was inventory. Thus, there was no CEE deduction. The minister said that the confirmation was based on the FCA judgment in *Global Communications* (99 DTC 5377) (which had not been issued at the time of the original reassessment). On a motion to expunge those reasons from the pleadings, the minister argued that the reasons for an assessment or reassessment included all the reasons in the entire "processing of assessing tax liability" from the first action after a tax return is filed to the final action (in this case, the confirmation). The taxpayer argued that the pleadings in the Crown's notice of reply to the notice of appeal that related to the March 2004 confirmation should be struck out: the reassessment was essentially a new reassessment that was statute-barred. Eventually, the Crown filed an amended reply that clarified that the particular facts (based on *Global*) were assumed after the reassessment. The FCA also said that regardless of any new basis of assessment, the amount of tax assessed could not increase after the normal reassessment period had expired. Thus, no tax increase could be gained from the denial of the CEE deduction for the cash consideration.

The minister's amended pleadings were now before Bowman CJ on the procedural question of which party has the onus of proof for the assumptions of fact considered in the amended pleadings and in the underlying confirmation. The TCC reviewed extensively the origin and history of the shifting of the onus of proof in tax cases between the taxpayer and the minister. The SCC (most recently in *Hickman Motors* (97 DTC 5363)) established that, in the normal course, the minister must make assumptions of fact as a basis for the assessment or reassessment. The onus is then on the taxpayer to adduce sufficient evidence—which need not be much—to rebut the minister's assumptions. If the taxpayer does so, the minister can then produce contrary factual evidence. The judge must decide the case on the usual civil standard—the balance of probabilities—depending upon which side had the balance in its favour because of where the burden finally lay.

The TCC concluded that the normal-course rules relating to the reverse onus of proof (which first rests with the taxpayer) do not apply where, as in *Anchor Pointe*, the minister first raises the factual assumptions at the confirmation stage. The minister has the onus of proof for such assumptions of fact.

The TCC said, "[T]he rules established by the [SCC] for challenging an assessment followed for decades are so thoroughly entrenched that it would be inappropriate to impose an additional burden on a taxpayer of demolishing further 'assumptions' or findings of fact made by the Minister in confirming the assessment at the objection level. The reverse onus . . . in tax litigation and the substantial body of jurisprudence . . . developed around it are unique. . . . If the rules are to be changed it is either Parliament or the [SCC] that must do so. . . . 'To allow the Minister to sit back and "cherry-pick" developments from recent cases and use them to bolster the rationale for the original assessment or reassessment under the guise of making assumptions which the taxpayer must then disprove seems an unduly [onerous] burden to place on the taxpayer.' "

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GAAR: Partnership Rollover

In *Ceco Operations Ltd.* (2006 TCC 256), the TCC applied GAAR to a partnership asset rollover. A sale of a business contemplated two years before the transactions was structured via a partnership with the purchaser in 1998: Ceco rolled business assets to the partnership under subsection 97(2) for cash and a partnership interest. The purchaser injected cash equal to the value of Ceco's partnership interest and the partnership used the cash to invest in preferred shares of a company; that company and Ceco were owned indirectly by the same holdcos. The TCC said that the series of transactions was a patent abuse of subsection 97(2): GAAR applied to deny the partnership asset rollover.

In 1996 and 1997, shareholders of a Canco that manufactured and sold logging equipment were considering a sale of the Canco's business, which was eventually housed in Ceco (incorporated February 26, 1998 in contemplation of the sale). Ceco was indirectly owned by six holdcos, each owned by key Ceco employees. The TCC noted that, as a result of a review undertaken by tax advisers between late 1997 and early 1998, the form of the intended transaction changed from a share sale to an asset sale; thus, a partnership, not a corporation, was formed to acquire the business. A new corporation, a sister to Ceco, was also formed.

On March 2, 1998, Ceco and an arm's-length Canco (Purchaserco) agreed to carry on in partnership the business of manufacturing and selling forestry equipment. On that day, Ceco sold its business assets to the partnership for \$35.5 million, both jointly electing under subsection 97(2) at \$17.1 million: Ceco received \$16.9 million FMV of boot and one class F partnership unit with an \$18.6 million FMV (total \$35.5 million FMV). Purchaserco subscribed for class E partnership units. On that day, the partnership had cash of about \$18.7 million from Purchaserco's partnership unit subscription and from each partner's equity contributions; the next day it used the cash to subscribe for \$18.7 million preferred shares of the newly formed sisterco. The partnership agreement contained a "backflow preventer" provision to prevent the partnership from retaining any value, whether capital or income, from its investment in the sisterco preference shares. On March 6, 1998, the sisterco used the \$18.7 million cash from its share subscription to subscribe for special class A preferred shares in the holdcos.

In November 2002, the CRA reassessed Ceco for its 1999 taxation year, including in Ceco's income the $18.7 million that would have been included if the partnership had paid additional cash boot instead of the class F unit partnership interest. Among other things, the CRA argued that GAAR applied. The TCC said that the sisterco served as a stepping stone that facilitated the movement of $18.7 million from the partnership to the holdcos. The sisterco also enabled Ceco to say that it did not receive any of the consideration paid by the partnership for Ceco's business assets. The TCC noted that the one key shareholder was unable to explain the role of the sisterco and its preferred shares issued to the partnership, "except to agree that it was on the advice of his tax advisors."

The TCC found that the transactions identified by the CRA in its GAAR argument formed a series undertaken exclusively to defer tax on the portion of the sale price represented by the class F unit. The TCC did not find credible Ceco's evidence regarding the possible reinvestment of the funds by the holdcos into the partnership. "The decision to structure the transaction in the manner ultimately adopted was made after consultation with tax advisors." Although technically the class F unit was an interest in a partnership within the meaning of subsection 97(2), "[i]n the real world . . . it was symbolic only. In practical terms, it represented nothing more than an undertaking to pay $18.7 million for [the sisterco's] preference shares, which were of no practical value to the partnership by reason of the Partnership agreement" (including the "back-flow preventer" provision). It was "hardly a coincidence" that the price paid by the partnership for the sisterco's preferred shares was almost the same as the value of the class F unit. The TCC said, "In that symbolic role the Class 'F' share was clearly worth $18.7 million during the brief period prior to the purchase of the [sisterco] preference shares and the payment of the consideration which replaced the Class 'F' share. As I see it the use of the avoidance transactions to secure the rollover and permit the 'tax deferred proceeds' to reach the Holdcos results in a patent abuse of ss. 97(2)." GAAR applied, and thus Ceco received $18.6 million additional proceeds of disposition on its asset transfer to the partnership, for total proceeds of $35.5 million.

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Falling Gasoline Taxes

The seemingly inexorable rise in gasoline prices has stirred public resentment and has led to calls for reductions in the federal and provincial taxes on motor fuel. What is lost in the debate is the fact that both taxes have declined as a percentage of the total price.

Taxes on Gasoline, 2006

	Provincial gasoline taxes, cents per litre	Excise and sales taxes as a percentage of pump prices: Average over six months	Reduction of 20 percent in pump price	Increase of 20 percent in pump price
NL	16.5	36.6	42.0	32.5
PE	20.9	35.3	40.6	31.3
NS	15.5	36.5	41.8	32.4
NB	14.5	35.7	41.0	31.6
QC	16.7	38.3	43.7	34.1
ON	14.7	31.5	36.4	27.7
MB	11.5	28.3	33.1	24.8
SK	15.0	30.7	35.6	26.9
AB	9.0	26.2	30.7	22.8
BC	20.5	35.3	40.6	31.3
National average	14.5	32.6	37.7	28.7

A recent study from the Department of Finance, available at www.fin.gc.ca/toce/2006/gas_tax-e.html, offers a useful summary of the structure of taxes on motor fuel across the country. The federal 10-cent-per-litre tax and the various provincial rates shown in the table do not change as the price of gasoline changes. The GST and the HST in the three Atlantic provinces apply to both the basic price and the federal and provincial excise taxes. The result, as shown in the table, is an average rate of tax of 32.6 percent of the final selling price, using the figures developed in the Finance study. The pre-tax price for gasoline in major cities in each province was used in the calculation; the prices represent an average over the first six months of 2006.

The study noted that average crude oil prices rose by 20 percent over that period and even more over the past two years. The table recalculates gasoline prices to reflect either a 20 percent increase in pump prices over the six-month average or a 20 percent reduction in pump prices to approximate the situation over a longer period. As shown, the national average tax rate would have been approximately 37.7 percent when prices were 20 percent lower, and only 28.7 percent when prices were increased by 20 percent over the six-month average. Lower taxes, however, are scant comfort as the pump prices continue to rise.

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Beneficial Ownership

The CRA has embarked on a review of international structures and appears willing to pursue files aggressively to stem perceived treaty shopping. The focus is on structures that enjoy reduced or eliminated withholding tax on the flow of dividends, interest, or royalties from

Canada because the treaty-country-resident recipient is the income's beneficial owner.

The CRA's latest approach posits that the true beneficial owner of dividend income is the recipient's parent and, in the case of a back-to-back payment of interest or royalties, the ultimate recipient. Abusive treaty shopping is said to exist if the recipient resides in a treaty jurisdiction and must remit the funds to another party, typically resident in a different jurisdiction. At the May 8, 2006 annual international tax seminar of the IFA (Canadian Branch), the CRA confirmed this new project and said that it challenges payments to any recipient that has no office, employees, activities, or significant other assets and must remit the payments to a third party.

What constitutes beneficial ownership of income is not clear; the term has received some attention in domestic settings, but none in Canadian tax treaties. Section 3 of the Income Tax Conventions Interpretation Act provides that a term undefined, or not fully defined, in a Canadian treaty is given its meaning for the purposes of the Income Tax Act as amended from time to time, and not as of when the treaty was entered into. The ITA does not define beneficial ownership. *Covert v. Nova Scotia (Minister of Finance)* ([1980] 2 SCR 774) said that the beneficial owner can ultimately exercise the rights of ownership over the property. If domestic law is relevant, the term may have different meanings in different countries; arguably, the domestic laws of the recipient's country of residence should prevail because it has the right to tax the income.

Articles 10, 11, and 12 of the 1977 OECD model treaty required that the recipient of dividend, interest, and royalty income be the beneficial owner. The commentary said that the change ensured that a mere nominee or agent could not be used for the sole purpose of accessing reduced treaty rates; the model treaty text was amended in 1995 to clarify this point. The OECD report entitled "Double Taxation Conventions and the Use of Conduit Companies," adopted by the OECD Council on November 27, 1986, states: "[T]he provisions would, however, apply also to other cases where a person enters into contracts or takes over obligations under which he has a similar function to those of a nominee or an agent. Thus, a conduit company can normally not be regarded as the beneficial owner if, though the formal owner of certain assets, it has very narrow powers which render it a mere fiduciary or an administrator acting on account of the interested parties (most likely the shareholders of the conduit company)."

The 2003 OECD commentary says, "The term 'beneficial owner' is not used in a narrow technical sense, rather, it should be understood in its context and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance." The commentary also says that a conduit corporation may be different from an agent or nominee if it is the formal owner, but it may not be the beneficial owner if it has very narrow powers that render it a mere fiduciary or administrator in its dealings with the parties. Arguably, a conduit corporation that does not act like an agent or trustee is the beneficial owner. Although not binding on treaty countries, the CRA's approach generally follows the OECD commentary unless Canada has entered a reservation; Canadian courts tend to accept that approach and generally regard the model treaty commentary as an authoritative source for treaty interpretation. (See *Crown Forest Industries*, 95 DTC 5389 (SCC).)

Uncertainty grew after the UK Court of Appeal in *Indofood* ([2006] EWCA Civ 158) held that a recipient company is an agent or nominee if it has very narrow powers over the income. The practical approach is to ask whether the recipient receives any direct benefit from the income. If the recipient will likely use the funds (although perhaps it is not legally required) to service its liability to the parent, then it is difficult to say that it has the "full privilege" of the funds. The recipient is not the beneficial owner but a mere nominee if the parent would likely claim the funds as its own. *Indofood* concluded that the term "beneficial owner" should be given its international fiscal meaning and not its meaning under the domestic law of contracting states; at the 2006 IFA seminar, the CRA said that it has not yet reached a conclusion on this issue. *Indofood* was not a tax case, and although it is not a binding precedent a Canadian court will likely consider it in the absence of other authority. The section 3 reference in the Income Tax Conventions Interpretation Act to domestic law may also bear on the issue.

The CRA is now challenging the payment of a dividend to a Dutch company with Swedish and UK parents, saying that it was not the beneficial owner: it had no office, employees, or other assets in the Netherlands, and the parents advanced all the funds to pay Dutchco's expenses (*Prevost Car Inc.*). At the IFA seminar, the CRA indicated that the holdco was obliged to pay dividends and therefore the conduit principle applied. The relevant taxation years predate the 2003 OECD commentary. The case's hearing was apparently scheduled for August 2006. But the CRA's interpretation of beneficial ownership extends beyond that in *Prevost*: it is reviewing, for example, royalties paid under a sublicence to a Dutchco that in turn paid a royalty to a non-treaty-country-resident corporation, and the CRA will question whether the income's initial recipient has an office and employees. Although the model commentary notes that the beneficial ownership limitation applies to a recipient nominee, agent, or conduit, the 1977 commentary says that the fact that a conduit's main purpose is to hold assets or rights is not enough to deny it beneficial owner status. For example, an entity with no employees may have engaged a third party in the same jurisdiction to provide management and bookkeeping services and an office. (See *ESG Holdings Ltd.*, [1976] CTC 295 (FCA).) Bilateral negotiations to establish a broader definition of the term "beneficial owner" for treaty purposes would ensure that all treaty parties are working from the same premises. Many of Canada's treaties—for example those with Belgium, Chile, Germany, and Ireland—contain specific limitation-on-benefits provisions. The United States also relies on domestic conduit financing legislation to challenge abusive conduit structures.

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Temporary Inversion Regs

The IRS issued temporary and proposed regs under Code section 7874 (Reg-112994-06, TD 9265) aimed at corporate inversion transactions in which a foreign entity replaces the US parent of a multinational corporate group. The rules, enacted as part of the American Jobs Creation Act in October 2004, have caused significant uncertainty for both US and Canadian practitioners engaged in structuring a wide variety of cross-border transactions, including reorganizations, acquisitions, and public offerings of both debt and stock in Canada. The new regs are Treasury's second round of guidance on the scope of the inversion rules (see "Corporate Inversions Update," *Canadian Tax Highlights*, April 2006) and offer welcome clarification, especially on (1) what constitutes an "indirect" acquisition of substantially all of the assets of a domestic corporation or partnership; and (2) what constitutes substantial business activities in the foreign parent company's home country. Anti-abuse provisions apply to the use of publicly traded foreign partnerships and options and similar interests to avoid the inversion regime.

■ **Indirect acquisitions.** An inversion may occur when a foreign corporation directly or indirectly acquires substantially all the assets of a US corporation or partnership and thereafter at least 60 percent of the forco's stock is held by the US entity's former shareholders. The technical language of the rules did not clearly indicate whether an inversion occurred on an indirect acquisition, such as when a Canco acquired stock of another Canco that owned a USco's stock. The new regs clarify that an acquisition of a foreign corporation that owns stock in a US corporation does not constitute an "indirect" acquisition of the USco under section 7874; the result is reasonable because the USco was foreign-owned before the acquisition, and thus the change in ownership at the foreign upper tier caused no adverse US tax consequences.

■ **Substantial business activities.** A legislative safe harbour exists if a Canadian acquiror's expanded affiliated group (EAG) has substantial business activities in Canada. (The ownership threshold of an affiliated group, defined in Code section 1504(a), is lowered to 50 percent, and foreign corporations are included.) Early indications suggested that the test for "substantial" business activities might be similar to modern limitation-on-benefits provisions in US tax treaties such as that with the Netherlands. The new regs take a different approach. Two tests determine whether the Canadian business activities are substantial in relation to the EAG's total business activities. (1) A facts-and-circumstances test considers such non-exclusive factors as operational activities involving property, employee head count and payroll in Canada, sales in Canada, management based in Canada, the residence of owners or investors in Canada, and the EAG's historical presence in Canada. In the absence of precedent applying this test, it is of little practical value in structuring current deals. (2) A more useful test provides a safe harbour in which the EAG is treated as having substantial business activities in Canada if (a) after the acquisition, the EAG employees based in Canada account for at least 10 percent, by head count and compensation, of total employees; (b) after the acquisition, the total value of EAG assets located in Canada represents at least 10 percent of the total value of its assets; and (c) during the 12 months ending on the last day of the accounting period in which the acquisition is completed, the EAG's sales in Canada account for at least 10 percent of its total sales. EAG assets are defined as tangible property used in the active conduct of a trade or business; the definition specifically excludes intangibles. This mechanical safe harbour test should provide much-needed certainty for practitioners structuring deals.

■ **Anti-abuse provisions.** The regs set out two structures perceived to be abusive. The legislation applies to surrogate foreign corporations, and the IRS was concerned that taxpayers might attempt to avoid the inversion rules by using a foreign partnership as the acquiring entity. The IRS says that it will treat a publicly traded foreign partnership as a foreign corporation, notwithstanding that the partnership meets the qualifying income exception to classification as a corporation under the "publicly traded partnership" rules. Thus, the inversion regime expressly applies to the numerous Canadian income fund deals structured as publicly traded partnerships for US tax purposes. The regs also provide that options, warrants, convertible debt, and similar interests in the Canadian acquiror held by a former shareholder of the expatriated US entity are treated as exercised to the extent that as a result of the exercise the 60 and 80 percent continued ownership thresholds are met. Practitioners using exchangeable shares and similar interests must count such interests in the inversion calculation.

■ **Effective date.** The new regs initially applied to acquisitions completed after June 5, 2006, but a July 28, 2006 IRS Notice (2006-70) rendered the regs inapplicable to situations in which a binding commitment to an acquisition that would result in an inversion was entered into before December 29, 2005 but was not completed by the June 6, 2006 cutoff. Acquisitions of options or similar interests, for example, falling within those dates are not counted in the inversion calculation.

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New Dividend Tax Regime

Draft legislation of June 29, 2006 contains the 2006 federal budget proposal for a new tax regime to reduce personal taxes on eligible dividends paid after 2005. (The proposal and provincial and territorial responses were discussed in "Reduced Tax on Dividends," *Canadian Tax Highlights*, June 2006.) Refinements to the rules are likely to be forthcoming. From 2005 to 2006, the top federal personal income tax rate on eligible dividends is reduced from 19.58 to 14.55 percent.

Eligible dividends include those (1) paid after 2005 by a CCPC out of eligible dividends from public corporations and other non-CCPCs or out of non-investment income, and (2) paid after 2005 by a public corporation or another non-CCPC resident in Canada; in either case, the dividend must have been paid out of income subject to the federal general corporate income tax rate (22.12 percent in 2006). To determine a corporation's ability to pay eligible dividends, the draft legislation creates two new pools commencing with the 2006 taxation year: the general-rate income pool (GRIP) for CCPCs and the low-rate income pool (LRIP) for non-CCPCs. A CCPC can distribute eligible dividends to the extent that its GRIP has a positive balance at the taxation year-end. The GRIP includes (1) post-2000 taxable income that has not benefited from the small business deduction, is not investment income, and was not dividended out before 2006, and (2) dividends received by the CCPC after 2005 that either were eligible dividends or were paid by the CCPC's foreign affiliate. The GRIP is reduced for eligible dividends paid in the previous year and losses carried back from a year to the three previous years. A non-CCPC must pay non-eligible dividends before eligible dividends to the extent that it has an LRIP at the time. A non-CCPC's LRIP includes the non-eligible dividends it receives. A GRIP or LRIP balance increases if a non-CCPC becomes a CCPC or vice versa, respectively; a pool balance may be affected if a corporation was party to an amalgamation or windup. For the dividend to be eligible, the payer corporation must so designate the dividend by providing each recipient with written notice at the time of the payment (or within 90 days after the legislation receives royal assent for dividends paid before then). Comments on the draft legislation are not due until September 15, 2006, making it unlikely that the 90-day period will expire before December 31, 2006.

A new 20 percent tax under part III.1 on excess designations applies to a CCPC that during the year designates and pays eligible dividends in an amount in excess of its GRIP at year-end, and to a non-CCPC that pays an eligible dividend when its LRIP has a positive balance. The tax is imposed at 30 percent on the entire dividend amount if the excess designation results from an attempt to artificially manipulate a corporation's GRIP or LRIP. Any part III.1 tax is payable by the corporation's balance-due day for the taxation year. If the excess designation was inadvertent and thus the 20 percent part III.1 tax applies, the corporation can elect to treat all or part of the excess designation as a separate non-eligible dividend; part III.1 tax does not apply to the elected amount. The election must be made with the concurrence of certain shareholders and must be filed within 90 days after the mailing of the notice of assessment that deals with the part III.1 tax. (If the dividend was paid before the draft legislation received royal assent, the filing deadline for the election is 30 months thereafter.) Commencing with the 2006 taxation year, a new filing requirement is imposed on a Canadian-resident corporation that pays taxable dividends (eligible or non-eligible) in a taxation year: by its filing due date for the year, it must file a return for the year under part III.1 in prescribed form that contains an estimate of its liability for part III.1 tax.

The draft legislation permits a CCPC to elect to be treated as a non-CCPC for the purposes of the new dividend regime and the small business deduction. A CCPC that files this election is not permitted to claim the small business deduction, and all its business income is subject to the general federal corporate income tax rate and can be distributed as eligible dividends. An electing CCPC is not required to maintain a GRIP, but it is subject to the dividend regime that applies to non-CCPCs and must compute its LRIP.

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Personal Tax Planning: 2006

The 2006 federal budget introduced personal tax changes that taxpayers may want to keep in mind during the coming months to help minimize their 2006 tax liability and to optimize their new government benefits.

- A taxpayer who uses public transit should be sure to maintain proper documentation to claim the new transit-pass tax credit on his or her 2006 personal tax return. The credit applies to monthly or longer passes for transit, including local buses, streetcars, subways, commuter trains or buses, and local ferries. The credit is available for travel after June 2006, even if the pass was purchased before then. Individual taxpayers can claim the credit for their own transit costs or costs of their spouses, common-law partners, or dependent children under 19. To support a claim for the tax credit, the pass must display (1) an indication that it is valid for a month (or longer), (2) the date or period for which the pass is valid, (3) the name of the transit authority issuing the pass, (4) the amount paid for the pass, and (5) the rider's identity. If the pass does not contain all this information, the CRA says that a dated receipt will support a claim.

■ A family may be entitled to receive $100 per month for each child under age 6 as a new universal child-care benefit. A taxpayer who does not receive the current child tax credit because his or her income exceeds the phase-out threshold may have to apply to receive the universal child-care benefit. To apply, a taxpayer must complete the form usually used to apply for the child tax benefit (available on the CRA's Web site) and mail it to his or her local Tax Services Office. A family who already receives the child tax benefit will receive the universal child-care benefit automatically; the new benefit is taxed in the hands of the lower-income spouse.

■ A taxpayer who donates public company shares to a charity after May 1, 2006 need not pay tax on any capital gain. Public company shares acquired through an employee stock option plan may also qualify for the exemption. The donor still receives a tax credit for the shares' donation.

■ Unclaimed allowable business investment losses (ABILs) are not included in the newly enacted extended 20-year carryforward period for non-capital losses; ABILs retain their 10-year carryforward period and become net capital losses thereafter. An ABIL is generally a capital loss that arises on the arm's-length disposition of shares or debt of a small business corporation. The ABIL (one-half of the business investment loss) is fully deductible from ordinary income; an ordinary allowable capital loss (one-half of a capital loss) is deductible only against capital gains.

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Subsection 88(3): More Changes

A recent Finance comfort letter dated April 12, 2006 and comments from a practitioners' panel at the May 8, 2006 IFA international tax seminar in Montreal signal additional changes to proposed subsection 88(3) and the separate and elected application rules for a qualifying liquidation and dissolution (QLD).

■ **Proposed subsection 88(3).** It is not clear whether these changes are effective after February 27, 2004 or when they are released.

1) Proceeds of disposition of distributed property. Under the February 27, 2004 technical amendments, a foreign affiliate's (FA 1's) stock that is excluded property (EP) of a disposing FA is deemed disposed of for proceeds equal to ACB or a greater elected amount up to FMV. For other property, proceeds equal FMV. The IFA seminar announced new rules. Any non-EP with an accrued gain is disposed of for FMV proceeds and non-EP with an accrued loss is disposed of for the relevant cost amount (as defined in the August 16, 2005 comfort letter). Any EP is disposed of at its relevant cost base, defined for subsection 88(3) as the greatest of the property's relevant cost amount (per the 2005 comfort letter); any proceeds received by the disposing FA on the distribution, including the assumption or settlement of an obligation; and an elected amount up to FMV.

The 2005 comfort letter loosely described "relevant cost amount" as proceeds that did not result in gain or loss. In an arm's-length acquisition of control of the disposing FA, such proceeds may range from tax cost to FMV at the time FA 1 became an FA without triggering income, gain, or loss because paragraphs 95(2)(f) and (f.1) eliminate such amounts that accrued before it had FA status. It now appears that in such a case the proceeds are the property's FMV when FA 1 became an FA of the taxpayer (paragraph 95(2)(f)). The proceeds of capital property are its ACB plus any accrued gain or less any accrued loss attributed to the pre-FA period. The disposing FA should recognize no gain or loss, relying on paragraphs 95(2)(f) and (f.1). But for property that is a share of an FA, it is not clear whether the proceeds under this no-gain-or-loss rule are affected by a subsection 93(1) election. Proposed subsection 93(1.4) prohibits such an election if paragraph 88(3)(a) applies; perhaps this prohibition should be rewritten to include any FA stock distributed. This new proceeds rule is welcome because it allows a rollout of loss property, other than the portion accrued before FA status to the taxpayer, in a non-QLD transaction. But not allowing loss recognition for non-EP is punitive if FAPI must be realized on non-EP with accrued gains. The change also permits a potential rollout at tax cost of non-FA-share EP.

2) Taxpayer treatment for amounts distributed. The IFA seminar comments confirm that if the disposing FA's shares are redeemed or if it is liquidated, the distribution amount is deemed to be first a return of foreign paid-up capital (FPUC) and then a dividend subject to normal rules, including the creation of a subsection 40(3) gain if pre-acquisition surplus or a return of FPUC drives ACB negative. Any subsection 40(3) gain may be reduced by a subsection 93(1) election over consolidated net surplus; any deemed dividend portion of the distribution reduces the surplus of the disposing FA and not of any lower tiers. For any non-redemption, non-liquidation distribution, such as a dividend, the taxpayer may elect that any portion be a deemed return of FPUC (regardless of the legal form).

3) New benefit rule. The IFA seminar indicated that a subsection 88(3) shareholder benefit rule will apply to a distribution not in respect of shares. The benefit is ordinary income, not a dividend, to the shareholder, and the rule will specify that subsection 15(1) does not apply.

4) FPUC. The 2006 comfort letter confirms that FPUC and other amounts required to be determined under subsection 88(3) (including for the purposes of a QLD) are computed in Canadian dollars. However, if non-cash property is transferred to the disposing FA, the amount of resulting FPUC is determined from the tax cost to the disposing FA of the property acquired; but if the property is stock of another FA of the taxpayer, the FPUC equals the transferred FA shares' FPUC. The exchange rate for converting the ACB of distributed EP is not delineated; presumably the spot rate on the date of distribution would be used.

■ **QLD.** The 2006 comfort letter adds the following to the details contained in the 2005 comfort letter: "relevant cost amount," used in directing the rollout of all property and FPUC, has the meaning discussed above; any loss realized by the taxpayer in respect of a share of the disposing FA is deemed nil; and this updated version of QLD issues is effective for electing liquidations and dissolutions beginning after February 27, 2004. No additional insight is provided into whether the 90 percent ownership threshold for a QLD requires that the stock be owned by a single taxpayer or whether, for example, all stock owned by related persons is aggregated.

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IRS Business Valuation Guidelines

In July 2006, the IRS Valuation Policy Council released IRS *Business Valuation Standards*, which sets out guidelines for the development, resolution, and reporting of business and similar valuation issues. An IRS valuator must reasonably justify any departure from the guidelines. The successful completion of an IRS valuation assignment must include planning, identifying critical factors, documenting specific information, and analyzing the relevant information, all of which must be recorded in the working papers. The guidelines promulgate three types of practice standards—development, resolution, and reporting—and provide guidance on reviewing a taxpayer's valuation.

(1) Development guidelines cover planning, identifying, analyzing, preparing working papers, and reviewing; necessary information includes that enumerated in IRS Revenue Ruling 59-60, issued in 1959 and long the guidepost for US tax-purpose valuations. (CRA *Information Circular* 89-3 incorporated some items.) The IRS valuator must determine the completeness of a taxpayer's valuation report; the apparent adequacy and relevance of the data and the propriety of any adjustments thereto; the appropriateness of the valuation method and techniques used; and whether the taxpayer's analyses, opinion, and conclusions are appropriate and reasonable. In the event of disagreement, reasons must be provided; if the IRS valuator disagrees with factual representations, underlying assumptions, methodology, or conclusions, he or she should conduct the additional fact finding, research, and/or analyses necessary to arrive at an appropriate value.

(2) Resolution guidelines require an IRS valuator, after fully considering all relevant facts, to make efforts to arrive at a resolution of the matter as early in the examination as possible. "Credible and compelling work by the valuator will facilitate resolution of issues without litigation. . . . The valuator will work in concert with the internal customer and taxpayer to attempt to resolve all outstanding issues."

(3) Reporting guidelines indicate the specific information that must be included or addressed in an IRS valuation report and that must provide convincing and compelling support for the conclusions reached. The IRS report must contain all information necessary for a clear understanding of the valuation analysis and how the conclusions were reached. The contents of the valuation report are also specified.

The IRS guidelines are similar to, but not as detailed or comprehensive as, the mandatory practice standards of the Canadian Institute of Chartered Business Valuators, whose standards and ethics are followed by the CRA's Business Valuation Equity Program as a matter of policy. CRA valuators advise the CRA audit groups—general, specialized, and international—and the appeals section, and they provide expert opinions on technical valuation and FMV determinations of private and public securities, partnerships, proprietorships, intangible assets, and other business equities for tax purposes.

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SCC on Interpretation

The SCC recently ruled against the taxpayer in *Placer Dome* (2006 SCC 20), a decision on the interpretation of the definition of "hedging" in the Ontario Mining Tax Act. The SCC comments on statutory interpretation expounded on the role of purpose, expanded on the residual presumption in favour of the taxpayer and the burden of proof in tax cases, reviewed the impact of the CRA's administrative practices on statutory interpretation, and

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confirmed that in tax statutes the presumption against tautology provides that courts should avoid interpretations that render part of a statute meaningless or redundant. This article focuses on the comments on statutory purpose and its role in the interpretive process, which appear to contradict earlier SCC statements in *Canada Trustco* (2005 SCC 54) and which create confusion about when in the interpretive process a provision's underlying purpose or context is examined.

In *Placer*, the SCC begins its analysis by quoting from its *Canada Trustco* decision and reiterating certain rules of statutory interpretation: (1) The words of the Act are to be read in tier entire context and in their grammatical and ordinary sense harmoniously with the scheme and object of the Act and Parliament's intention. (2) Taxpayers are entitled to rely on the clear wording of taxation provisions in structuring their affairs; precise and unequivocal statutory language plays a dominant role in the interpretive process. (3) However, if the statute's words result in more than one reasonable interpretation, the ordinary meaning plays a lesser role and the Act's context and purpose play a greater role. (4) Statutory context and purpose may reveal latent ambiguities in provisions that initially appear ambiguous. The SCC then said that "legislative purpose may not be used to supplant clear statutory language"; thus, the court appears to resile from its *Canada Trustco* stance of a "textual, contextual, and purposive" approach that rejected literal statutory interpretation. The SCC effectively ascribes an exclusive—not a dominant—interpretive role to the words of a statute when they are clear and unambiguous, and it does away with the concept of latent ambiguity as described in *Canada Trustco*.

The principles in *Canada Trustco* and *Placer* are difficult to reconcile, especially in light of the SCC's non-tax decision, released two weeks after *Placer*, in *Canada 3000 Inc.* (2006 SCC 24). The SCC quoted from its other decisions on statutory interpretation and said, quoting from *Bell ExpressVu* (2002 SCC 42),

> [O]ne must consider the "entire context" of a provision before one can determine if it is reasonably capable of multiple interpretations. . . . It is necessary, in every case, for the court . . . to undertake the contextual and purposive approach set out by Driedger, and *thereafter* to determine if "the words are ambiguous."

Without directly referring to *Canada Trustco*, the SCC in *Canada 3000* appears to endorse the principles laid out there, and it also seems to mandate a search for latent ambiguities by looking to context and purpose before concluding whether the words of a provision are clear.

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FOREIGN TAX NEWS

Italy

On June 6, 2006, the Local Tax Commission held that the use of an Italian VAT number in the invoices of a non-resident individual established a PE in Italy, and hence the commission denied the taxpayer a VAT refund. Although the taxpayer said that the Italian tax authorities assigned him the VAT number without his knowledge, the commission stressed that he had never sought to annul it.

Japan

As of March 20, 2006, the Japanese National Tax Agency expanded its transfer-pricing administrative guidelines to cover intangibles transactions and cost contribution arrangements (CCAs). Defined intangibles are attributable to human resources and organizational structures created through business operations—for example, the nature, level, and extent of an employee's competence, knowledge, processes, and networks. In the absence of a written contract, the use of an intangible by a related party is a deemed grant of the right to use it. In a CCA, each participant's proportionate share of the contributions to the arrangement will be adjusted by reference to its share of the expected benefits derived from the activity, such as R & D activities, in accordance with the arm's-length principle.

United Kingdom

On July 19, 2006, the Finance Act 2006 was enacted, implementing proposals in the March 2006 budget and the December 2005 pre-budget report.

Treaties

The **Greece-Iceland** treaty was signed on July 7, 2006. The **Estonia-Slovenia** treaty entered into force on June 26, 2006, effective after 2006.

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