Canadian Tax Highlights

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Treaty Shopping and GAAR

In its first treaty-shopping GAAR case, *MIL (Investments)* (2006 TCC 460), the TCC found for the taxpayer. The case addresses several aspects of GAAR, including determining what constitutes a series of transactions, their tax and non-tax purposes, and the concept of tax treaty abuse.

Before what the CRA considered the relevant series of transactions, the taxpayer (MIL) was incorporated in the Cayman Islands by a sole non-resident shareholder, Mr. B; MIL owned about 11.9 percent and Mr. B about 0.5 percent of the shares of Diamond Field Resources Ltd. (Canco), a Canadian public corporation. In June 1995, MIL rolled about 2.6 percent of its Canco shares to Inco Limited, another Canadian public corporation, for Inco shares, reducing MIL's direct holding in Canco to about 9.3 percent (9.8 percent combined with Mr. B's holding). In July 1995, MIL migrated from the Caymans to Luxembourg, and in the next month disposed of its Inco shares. Between December 1995 and May 1996, Canco was the target of competing acquisition attempts by Inco and another corporation: Inco's bid was successful, and MIL tendered its remaining Canco shares to Inco (the final sale) and realized a $426 million gain.

Under the Canada-Luxembourg treaty, gains from the sale of a Canco's shares by a Luxembourg resident were taxable in Canada only if the shares were part of a substantial interest in the Canco—10 percent or more—and their value was derived principally from immovables in Canada. MIL was a Luxembourg resident but owned directly less than 10 percent of the Canco shares when they were tendered to Inco for the final sale; it claimed treaty protection on the gain. In response to the CRA's GAAR attack, MIL conceded that it had received a tax benefit from the treaty. The issues were whether there was an avoidance transaction and whether it resulted in an abuse of the Act, or in this case of the treaty.

A single transaction or series thereof cannot be an avoidance transaction if it is undertaken primarily for bona fide purposes other than to obtain a tax benefit. Although it seems that the CRA did not argue that the final sale was undertaken primarily to obtain the tax benefit, the TCC noted that the sale was in response to the Inco offer, and it was "unimaginable" that that offer was made solely for MIL's tax benefit. Thus, the final sale was undertaken primarily for bona fide non-tax purposes and was not an avoidance transaction.

But the CRA apparently argued that both the share exchange with Inco and MIL's migration to Luxembourg were undertaken primarily to obtain a tax benefit in the form of treaty protection for the Canco shares' final sale under the takeover bid. Relying on the credibility of witnesses, the TCC concluded that the series of transactions before the final sale allowed MIL to monetize a small portion of its Canco investment by exchanging it for shares of Inco, a much larger corporation with a less volatile trading value. As it did in *CP Ltd.*, the TCC attached significance to the non-tax motivation behind the share exchange and the final sale: once MIL had a bona fide commercial reason for selling, it was appropriate to seek tax advice on the appropriate structure for the sale. Citing several cases, the TCC concluded that a "purely commercial transaction" designed to minimize tax is not an avoidance transaction: "the 'how' is subordinate to the 'why' of the sale."

The TCC also considered whether the final sale formed part of the series of transactions that included the share exchange and migration. The court recognized the SCC's comments in *Canada Trustco* and the fact that subsection 248(10) extends a series to include related transactions or events completed in contemplation of the series, but it observed that "contemplation" cannot encompass "mere possibility": that "would include an extreme degree of remoteness" incompatible with the goals of "consistency, predictability and fairness" also espoused by the SCC in *Canada Trustco* (2005 SCC 54). Given that the bidding war for Canco had not arisen or even been envisioned at the time of the migration, the TCC concluded that the final sale was not part of the same series. Because the share exchange, the migration, and the final sale were not avoidance transactions, GAAR could not apply. An analysis

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of GAARable abuse of a treaty was thus unnecessary, but the TCC said in passing that it involved the same approach as that applied for an abuse of the Act: the words of the treaty should be considered in light of their context and purpose to attempt to discern a clear underlying policy that was abused.

The TCC rejected the notion that a taxpayer cannot choose a jurisdiction of residence and treaty: "There is nothing inherently proper or improper with selecting one foreign regime over another. . . . [T]he shopping or selection of a treaty to minimize tax on its own cannot be viewed as being abusive. It is the *use* of the selected treaty that must be examined." The treaty exemption relied on was not in the OECD model treaty, and Canada must have specifically adverted to it in the treaty's negotiation. MIL's "reliance upon a treaty provision as agreed upon by both Canada and Luxembourg cannot be viewed as a misuse or abuse"; if "Canada [was] concerned with the preferable tax rates of any of its treaty partners, instead of applying section 245 [it] should seek recourse by attempting to renegotiate selected tax treaties." Time will tell whether Finance follows the US lead and seeks limitation-on-benefits clauses in future treaty negotiations.

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Deferred Income Benefits: Conjugal Breakdown

Rights in deferred income plans (RPPs, RRSPs, DPSPs, and RRIFs) may be assigned on the breakdown of a marriage or common-law partnership. The assignment may relate to property or maintenance, the former being capital in nature and the latter properly characterized as being on income account. If sanctioned by a court or required by written agreement, a division of property on conjugal breakdown may be effected by tax-deferred transfer between deferred income plans.

Transfers to settle maintenance obligations are not tax-deferred (TI 2006-0199271E5, August 23, 2006); they are included in the income of the transferor plan's member. The CRA has recognized the transfer of property rights substituted for maintenance obligations, but it is not likely to accept such a substitution for arrears of maintenance.

The treatment of direct payments is not spelled out in the Act. TI 2005-0144501E5 (April 6, 2006) considered the taxation of divided pensions. The governing interpretation bulletin (IT-499R, "Superannuation or Pension Benefits") states that pension entitlements divided at source in settlement of property rights are included in each party's income as a superannuation or pension benefit even if a single payment is made to the member who then transfers on the former spouse's portion. The TI indicates that the parties' intention with respect to taxability of the divided rights must be considered. On the TI's facts, a foreign pension could not be divided at source; the parties agreed that the plan member would pass on his former spouse's share of the pension to her and that each would pay his or her share of tax. The CRA considered that each party received a pension benefit and should bear the appropriate tax burden.

The CRA did not indicate whether intention was the governing criterion, nor did it restrict the effect of intention to payments that could not be divided at source. In *O'Brien* (2005 DTC 1539 (TCC)), a pension split at source was fully included in the member's income. The former spouse was not considered to have received a pension benefit because her entitlement arose not from the pension plan itself but from a court order; she took as a creditor of a beneficiary, not as a beneficiary of the plan. The court did not find any intention that the former spouse was to be taxable. By implication, the court would have carried out any intention of taxability manifested by the parties.

The importance of the parties' intention in these circumstances was first set out in *Walker* (2000 DTC 6025 (FCA)). Bowman CJ in *Andrews* (2005 DTC 1546 (TCC)) was troubled by the fact that he could not reconcile *Walker* with a number of well-established tax principles, but he nevertheless felt himself bound, as apparently does the CRA.

Accordingly, it appears that, on conjugal breakdown, parties can settle their property rights by tax-deferred transfers from one deferred income plan to another, in accordance with the Act's rules. If they so indicate, they can split a pension at source and have the two parties bear the tax on the amounts that they receive, or they can decide to have the plan member pay all the tax. If the pension cannot be split at source, the member can agree with the former spouse to retransmit his or her share, and their mutual intention will govern taxability.

There appears to be no theoretical reason why this analysis should not apply to any deferred income plan, to supplementary pension plans, or to retirement compensation arrangements. If intention can recharacterize a payment from a pension plan as something other than a pension benefit, then there is no reason why payments from other deferred income plans cannot be characterized as payments to taxpayers in their capacity as matrimonial debtors. The opportunities for planning are greater for plans other than RPPs, which are subject to a statutory limit on the amount that can be assigned on a conjugal breakdown. There is nothing to prevent the assignment of all of a supplementary pension, for example, with the assigning party bearing all or none of the tax. A non-resident husband could accept the full burden of tax on a supplementary pension—at a 25 percent rate—leaving the former spouse to receive all the pension assets free of tax. However, Bowman CJ's critique of *Walker* must be borne in mind: a "taxation by intention" rule may be fair, but it is not principled. The courts in future cases may choose to limit *Walker* to its particular facts.

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Belgium and Iceland: US Treaties

■ A new draft **US-Belgium** treaty was initialled on September 8, 2006, and is expected to be signed before year-end. A 0 percent withholding tax applies on dividends from a Belgian entity to its US parent that owned directly at least 10 percent of the share capital for at least 12 months. The 10 percent threshold is significantly lower than the threshold in other new US protocols, such as those with the Netherlands, Sweden, and Germany (all 80 percent), and it encourages US companies to invest in or through Belgium. For Belgian companies investing in UScos, the threshold is set at 80 percent for a US exemption.

The interest withholding tax is generally reduced to 0 percent. The scope of the limitation on benefits (LOB) allows more persons to benefit from the treaty provisions and includes a derivative benefits test, a provision for headquarters, and a provision for pension funds and certain other exempt organizations.

■ On September 28, 2006, the US Treasury announced completed negotiations on a new **US-Iceland** treaty. The treaty replaces the 1975 treaty after it is signed, approved by the US Senate, and ratified by each country. The treaty contains several significant changes (see Iceland Finance's news release at http://eng.fjarmalaraduneyti.is/media/wwr2006/WWR_280906.pdf). The release says that the treaty provides for a withholding tax on certain cross-border royalties, but it gives no further details: Iceland's other recently ratified treaties impose 5 or 10 percent withholding on royalties. The release says that a comprehensive LOB clause ensures that only eligible taxpayers enjoy treaty benefits, reflecting the current US tax treaty policy to deter treaty shopping.

A sunset clause applies 12 months from the date on which the treaty enters into force, an apparent reference to other US treaty provisions that allow taxpayers to elect to apply a former treaty for 12 months after a new treaty is ratified. (See article 10 of the protocol amending the US-Netherlands treaty, signed March 2004.) Thus, if the treaty is approved in 2007, it may take effect in 2008, or in 2009 because of the 12-month transition rule.

Importantly, the treaty continues the trend of including an LOB provision to eliminate treaty shopping; the current treaty is one of the few remaining without an LOB provision. US treaties with Poland and Hungary do not contain LOB provisions but are being renegotiated. Taxpayers that take advantage of the existing US-Iceland treaty should examine their current structures and consider alternatives: generally, an LOB provision requires that a treaty-country resident have beneficial ownership of the underlying entity.

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International Deficits and Surpluses

The recently released 2006 edition of *Fiscal Reference Tables*, available at http://www.fin.gc.ca/frt/2006/frt06_e.pdf, shows dramatically how Canada has transformed its deficit into healthy surpluses. In addition to tables that detail the public finance of governments at all levels in Canada, a series of tables offers summary information on the public sector finances of the G7 countries.

The international tables show that Canada is the only G7 country to record a surplus in 2005, equal to 1.7 percent of gross domestic product. That figure is well above the average for the whole group (a 3.7 percent deficit) and the US figure (a 3.8 percent deficit). The accompanying table shows Canada's unprecedented turnaround from its largest deficit of 9.2 percent in 1992; the G7 average deficit peaked in 1993 at 5.1 percent of GDP. Details in the fiscal reference tables show that Canada's transformation is attributable to a significant reduction in the relative importance of public spending. Public outlays at the depth of the recession in 1992 equalled 53.3 percent of GDP, but by 2005 they had dropped to only 39.3 percent. The comparable US ratios were 38.5 percent in 1992 and 36.9 percent in 2005.

Surplus or Deficit, as a Percentage of GDP, Selected Years

	Canada	United States	G7 average
1992	–9.2	–5.8	–4.8
1995	–5.3	–3.1	–4.2
2000	2.9	1.6	–0.1
2005	1.7	–3.8	–3.7

International public finance comparisons in absolute amounts have little meaning. It is more useful to concentrate on the relationship between the main aggregates and GDP. But when Canada's performance over the years from 1992 to 2005 is expressed in absolute dollars, it becomes clear that the significant decline in the relative size of government spending belies the fact that public sector spending actually increased over those 13 years. All levels of government have exercised restraint on the spending side, but it was the dramatic improvement in the Canadian economy that generated sufficient revenue to more than accommodate the additional spending.

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NEW CANADA-MEXICO TREATY

On September 12, 2006, a new Canada-Mexico treaty was signed with numerous modifications—for example, new anti-abuse provisions, a shift of taxing authority back to the source country, and lower gross withholding rates. The treaty is effective for all taxes on the first day of January following the year it enters into force.

■ Currently, a resident of a state is liable for tax on share gains of companies resident in the other state only if the shares are not quoted on an approved stock exchange there and the shares' value is derived principally from immovable property situated there. Under the new treaty, the gain is taxable in the other state only if the shares (or participations in trusts and partnerships) derive their value principally from immovable property there or the shareholder (and related persons) had at least a 25 percent share interest at any time in the previous 12 months. Since both countries currently tax foreign stock gains, this change will shift the primary taxing jurisdiction for such situations to the source jurisdiction. The new treaty eliminates the current treaty's relief from capital gains tax for tax-deferred reorganizations.

■ A specific anti-abuse rule is added to each of the dividend, interest, and royalty articles to deny benefits if an instrument was created or assigned to take advantage of the article. These broadly worded rules were presumably requested by Mexico, whose reservations to the OECD model treaty encompassed the right to include an anti-abuse rule—for example, for back-to-back arrangements. It is likely that Canada generally relies on the updated OECD commentary of the beneficial-owner requirement to prevent abuse, consistent with the CRA's oral comments on the subject at the 2006 annual Canadian IFA branch meeting and the *Prevost Car* case before the TCC.

■ The new treaty provides that the furnishing of services, including consulting services by an enterprise of one state in the other state, constitutes a PE if the services for a project (including connected projects) continue for an aggregate of more than 6 months within any 12 months.

■ General withholding tax rates are reduced for interest (from 15 to 10 percent); royalties (from 15 to 10 percent); and direct dividends (from 10 to 5 percent; the branch tax falls to 5 percent). The new 10 percent rate on interest and royalties should already be in effect on the basis of the current protocol's most-favoured-nation clause. The reduced dividend and branch rates benefit Mexican shareholders only because Mexico no longer imposes a domestic dividend withholding tax. The rate on trusts and estates, still 15 percent, does not apply if contributions to the entity, such as an RRSP, were tax-deductible.

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PROMOTIONAL DISTRIBUTIONS

Provincial legislation or administrative policy usually addresses the question whether PST applies to "free" but otherwise taxable goods or services included with a purchase of other taxable goods or services. Often, the rules stipulate that the purchaser of property and services used to provide the free goods or services is the taxable consumer, who must self-remit tax based on the fair value of the goods or taxable services provided. Generally, that purchaser qualifies for non-taxable treatment only if there is a true sale of the goods or services to an ultimate consumer at their full value; tax authorities also require full documentation of the "sale," including separate charges and separate invoicing. A recent leasing case seems to challenge the authorities' traditional views on qualifying documentation, perhaps allowing a purchaser to more easily argue that it sold the goods or services and thus acquired them on a non-taxable basis.

In a British Columbia social services tax (SST) case, *Craftsman Collision* (2006 BCSC 1310), a company claimed an SST refund for leased vehicles that it used in its autobody repair business as courtesy cars for its customers while Craftsman repaired their vehicles. Originally, Craftsman provided courtesy cars free of charge, but later charged customers an allowance for the courtesy cars as per an alternative transportation program (ATP) with the provincial automobile insurance provider (ICBC). The ATP allowance paid for transportation services provided to ICBC customers and was included in the work order for repairs, but Craftsman continued to enter "$0" as the price charged for the courtesy car in the separate replacement vehicle agreement (RVA).

If Craftsman re-leased the fleet of courtesy cars to its customers, it could treat its acquisition of the courtesy cars via a lease as SST-exempt under section 78(1)(b) of the SST Act. (In other PST provinces, the result would be the same.) The minister agreed that if the RVA had referred to the ATP allowance, Craftsman would be entitled to the SST refund, but the absence of an express charge in the RVA was fatal. The British Columbia Supreme Court rejected that view, because the customers who took courtesy cars entered into two contracts with Craftsman: the RVA and the work order. The ATP allowance portion of the work order amount was sufficient consideration for Craftsman to supply the courtesy car by entering into the RVA. Although Craftsman and ICBC effectively structured the arrangement to give the illusion of a "free" courtesy car, in reality the ATP allowance paid for the courtesy cars. The court concluded that Craftsman did in fact re-lease its rented vehicles to its customers for a lease price equal to the ATP allowance, and it granted a refund of the SST that Craftsman paid to lease the courtesy cars.

Craftsman is useful in a number of contexts, including situations where goods and services are provided for a single bundled fee. Often, the underlying agreement spells out that two separate things are being provided (for example, Internet access and the lease of a modem), but the invoicing to the customer is less than clear. If it is evident on the facts that payment was contemplated for both, the provider of the "free" goods or services may have a legitimate position that the goods were not free but were actually sold for a fair price—making them arguably non-taxable in the provider's hands. In that sense, the court's focus on the economic reality of the situation was appropriate in attempting to characterize the legal relationships created, and its conclusion may have been consistent with the notion that a free lunch is always paid for.

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CRA Accepts Rectification

The Ontario Superior Court of Justice (OSCJ) in *Di Battista v. 874687 Ontario Inc.* (2005 CanLII 51220) allowed legal rectification of a poorly implemented tax plan.

Two family members entered into a series of transactions intended to permit them to receive cash for their shares of a family business and allow its future growth to accrue for the benefit of other family members. The transactions' documentation frustrated that intention, and an unintended tax liability arose. The OSCJ issued a rectification order, which binds third parties, allowing the taxpayers to change the documentation and remedy the mistake because the true agreement between the parties—which was based on the transactions' minimizing or not attracting income tax—was frustrated. This conclusion followed the rationale in *Juliar* ((2000), 50 OR (3d) 728 (CA)), a significant case on when rectification orders may remedy tax mistakes. The OSCJ recalled a passage in *Juliar* that quoted from an English decision: "What is rectified is not a mistake in the transaction itself but a mistake in the way in which the transaction has been expressed in writing."

The OSCJ also said that the CRA had advised it by letter from counsel that the rectification relief sought on the taxpayers' application was not opposed. However, the CRA maintained its right to reassess any of the parties involved as a result of any tax consequences that might arise out of the application.

Previously, the CRA said that it would contest rectification orders in cases such as *Juliar* if the only basis for the order was an unforeseen tax liability that the taxpayer sought to alter retroactively. However, the CRA confirmed at the Canadian Tax Foundation's 2005 annual conference the continued general applicability of most of the favourable statements it made at the 2001 annual conference (published in *Income Tax Technical News* no. 22, January 11, 2002). Furthermore, the CRA will no longer necessarily contest a rectification just because the CRA was not aware of the taxpayer's application therefor; rather, as is the case for all rectification files, the CRA will challenge only abusive situations. The CRA cited five examples of rectification and its view on each situation. For further details of the CRA's current position on rectification orders, see ITTN no. 22 and "Canada Revenue Agency Round Table," paper no. 6A, in the Canadian Tax Foundations's 2005 Conference Report.

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Foreign Tax Credit Sourcing

The CRA says that the formulary apportionment method used in computing US state corporate business taxes is not acceptable for determining foreign-source income for Canadian foreign tax credits (FTCs) (2006-0181911I7, July 17, 2006).

Canco manufactures widgets in Canada and sells them in Canada and abroad; it has no US permanent establishment. The Canada-US treaty affords no protection from state corporate taxes on Canco's sales to US customers. Each state in which Canco carries on business generally computes the income subject to its tax by multiplying Canco's worldwide net income by a weighted average of three factors: (1) the percentage that Canco's gross revenue derived in the state is of its total gross revenue; (2) the percentage that its payroll paid to in-state employees is of its gross payroll; and (3) the percentage that its real and tangible personal property located in-state is of its total property. The gross revenue factor is weighted more heavily than the other factors, which results in a relatively high proportion of Canco's worldwide income being allocated to the states. Canco seeks a Canadian FTC in respect of the total state taxes paid. Is Canco entitled for FTC purposes to base its US-source qualifying income for subsection 126(2.1) on the formula-derived amounts used by the US states to levy tax? The CRA generally says that a reasonable proportion of a business's net income is allocated to each country in which it carries on business; little guidance exists on what is reasonable in this context.

The CRA opinion letter rejects the validity of US-state formulary apportionment for section 126 purposes. Although the CRA notes that no treaty applies to US state taxes, it adopts Canada's treaty approach for allocating profits to a PE. Formulary apportionment may be favoured by some, but on balance OECD members favour taxing a foreign branch as if it were a separate enterprise in its dealings with the domestic head office. Accordingly, the CRA concludes that for Canadian FTC purposes formulary apportionment is not a reasonable allocation method: it provides simplicity and certainty, but it may not reflect the true contributions made to the profit-making process by an enterprise's various localized activities. In this case, the goods are manufactured and sales concluded entirely in Canada; the formula-driven percentage allocated to the United States is not warranted. Canco should compute its US-source income on the basis of established transfer-pricing methods.

The CRA's comments indicate that it intends to apply the separate-entity and arm's-length principles to source-of-income determinations for FTC purposes even in the absence of a tax treaty. If applying those principles conflicts with foreign formulaic apportionment, source mismatches and thus incomplete crediting of foreign tax may result.

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No Partnership, Losses Denied

The TCC in *Makuz* (2006 TCC 263) held that a taxpayer was in fact not a partner and was not entitled to use the section 96 partnership rulers to access tax losses. The TCC's decision is consistent with its decision in *Whealy* (2004 TCC 377)and with the SCC's decision in *Continental Bank* ([1998] 2 SCR 298), which reaffirmed that a partnership was a business carried on in common with a view to profit.

Partnerships A and B, both formed under Texas law, had fiscal periods ending December 31, 1987 and March 31, 1988, respectively. On December 31, 1987, partnership B was formed to acquire a 99 percent partnership interest in partnership A for US$20; partnership A sustained a Cdn$43 million loss in its fiscal year ending on that date. The taxpayer argued that partnership B's share of the loss fell into its income for its fiscal year ending March 31, 1988. The taxpayer acquired a partnership interest in partnership B before March 31, 1988 and claimed its proportionate share of partnership B's loss, effectively accessing a Cdn$43 million pool of tax losses for about a US$3.7 million outlay.

In keeping with recent jurisprudence in *Witkin* ([2002] 3 CTC 184 (FCA)) and in *Continental Bank* and *Backman* ([2001] 1 SCR 367), the question was whether the appellant was a partner in a partnership as defined in relevant provincial law, even though the partnerships were foreign. The TCC quoted from *Continental Bank*:

> Section 2 of the [Ontario] Partnerships Act defines partnership as "the relation that subsists between persons carrying on a business in common with a view to profit." This wording, which is common to the majority of partnership statutes in the common law world, discloses three essential ingredients: 1) a business, 2) carried on in common, 3) with a view to profit.

A taxpayer may enter into a purported partnership primarily to secure a tax loss, but the TCC said that for the partnership to exist there must be an ancillary intention to carry on business in common with a view to profit, and the taxpayer's participation in partnership B did not meet this test. The taxpayer was not a partner in partnership B, the section 96 rules did not apply, and the taxpayer could not use the losses originating in partnership A. The TCC dismissed the appeal on the basis of the FCA's decision in *Witkin*, which established that partnership A's losses cannot flow through partnership B to the investors because they did not have the requisite purpose in investing in partnership B in order to carry on business in common with a view to profit. Further, the TCC expressed its view that taxpayers cannot avail themselves of losses that they have "purchased" in a transaction that lacks any credible commercial motivation other than the utilization of losses that accrued when the partnership was composed of different persons.

In obiter, the TCC added that without the benefit of the FCA decision in *Witkin* and the SCC decision in *Backman*, the TCC might have approached the issue differently by asking: "Did the investment have any genuine commercial animus apart from utilizing the losses?" If it had none, as was the case in *Mazuk*, the TCC would have dismissed the appeal regardless of the vehicle used to make the investment: partnership B was created to extend the time that the investors could access the losses.

The TCC said that it was not sure how the result would have differed if the investors had invested directly in partnership A before the end of its 1987 fiscal year, instead of through partnership B. "It is not legally accurate to say that one is 'buying losses.' You cannot legally buy a loss, but you can buy your way into a position in which you hope to avail yourself of someone else's loss, and that is just what the [taxpayers] were doing. I know of no provision in the *Income Tax Act* that permits one to claim a loss when one's only purpose in investing is, as a matter of commercial reality, to use someone else's loss."

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New Dividend Tax Regime

Draft federal legislation creates a new dividend tax regime that generates planning opportunities and clarifies uncertainties in the 2006 federal budget proposal. (See "New Dividend Tax Regime," *Canadian Tax Highlights,* August 2006.)

Because only a Canadian-resident shareholder can receive eligible dividends, different classes of shares for Canadian and non-Canadian resident shareholders allow a corporation to pay eligible dividends only on the Canadian residents' shares. A non-CCPC can distribute an unlimited amount of eligible dividends after its low-rate income pool (LRIP) is depleted, effectively paying them out of its retained earnings. A non-CCPC that acquires the shares of a CCPC should consider the draft legislation's impact on the choice of whether to amalgamate with or wind up the CCPC, or to continue to operate it as a separate entity. Amalgamation or windup creates an LRIP that the amalco or successor must distribute before it can pay eligible dividends.

A CCPC shareholder-manager should re-evaluate his or her post-2005 strategy for receiving salary versus dividends. The lower tax rate on dividends paid out of income taxed at the general corporate rate enhances the attractiveness of receiving dividends distributed out of such income, but salary may reduce a shareholder-manager's AMT exposure. The draft legislation appears to allow a CCPC to pay eligible dividends that trigger a dividend refund. In the absence of statutory ordering rules, a CCPC is likely to prefer to distribute dividends in the order indicated in the table. Clearly, a CCPC with a positive general-rate income pool (GRIP) and RDTOH (from part I tax or part IV tax) should distribute before year-end any dividends that may be designated as eligible and that trigger a dividend refund.

The computation of GRIP clarifies that in limited instances eligible dividends include post-2005 distributions of pre-2006 retained earnings. Full-rate taxable income earned in the 2001 to 2005 taxation years is added to the GRIP of a corporation that was a CCPC throughout its first taxation year that includes January 1, 2006. But there is no GRIP addition for such income from earlier years or for eligible dividends and dividends from foreign affiliates received before a CCPC's 2006 taxation year; thus, a CCPC

Order of Dividend Distribution

	Combined federal/ provincial personal tax rates*	Corporate tax refund
	percent	
1) Eligible dividends triggering a refund of part I or part IV tax	19	33.33
2) Ineligible dividends triggering a refund of RDTOH	31	33.33
3) Eligible dividends not triggering a dividend refund	19	none
4) Ineligible dividends not triggering a dividend refund	31	none

* The rates are for a hypothetical province whose reductions to its personal income taxes on dividends parallel the federal government's.

cannot distribute such amounts as eligible dividends. The draft proposal specifically includes in the GRIP dividends received by a CCPC from a foreign affiliate after the CCPC's 2005 taxation year. Losses carried back reduce a CCPC's GRIP at the end of the year in which the loss arises. For example, a loss arising in 2007 and carried back to 2006 reduces the GRIP at the CCPC's 2007 taxation year-end and not at the 2006 taxation year-end, so that a loss carryback does not trigger an excess designation.

Because the draft legislation seems to allow income from a personal services business to be distributed as an eligible dividend, incorporating an employee may be beneficial. The reduced tax cost of distributing income that exceeds the small business limit may make it more advantageous to structure a property rental business not as a specified investment business but as an active business by, for example, employing throughout the year more than five full-time employees. A CCPC may elect to be treated as a non-CCPC for the purposes of the new dividend regime and the small business deduction; thus, a CCPC with large pre-2001 retained earnings derived from high-rate taxable income may be able to distribute those earnings as eligible dividends. However, the LRIP addition for a CCPC that becomes a non-CCPC may reduce or nullify the strategy's benefit—particularly because, once the election is made, non-eligible dividends must be paid before eligible dividends. Immediately before a corporation becomes or ceases to be a CCPC (other than because of an acquisition of control), it has a deemed taxation year-end and thus cannot be a CCPC for part of a taxation year. Because a corporation must be a CCPC throughout a taxation year to claim the small business deduction, this requirement is met when the CCPC status change is elected.

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Canadians and US Real Estate 2

Tax consequences for Canadians investing in US real estate depend on the acquisition vehicle.

USco. The undistributed rental income of a Canco's wholly owned US sub is attributed to Canco unless, for example, it employs more than five full-time employees. Canco is not taxed in Canada on active-business dividends from USco, but 5 percent US withholding applies and no Canadian foreign tax credit is available. A "like kind" US exchange transaction by an active-business USco does not trigger Canadian tax. An active-business USco need file only a single, simpler, US tax return, and it avoids the Canada-US tax calculation differences and resultant mismatching.

Direct ownership of a USco exposes a Canadian individual to US estate tax, and dividends therefrom are taxable as ordinary income. Using an intermediary, Canco may allow the individual shareholder to benefit from the tax treatment afforded Canadian dividends. Only 5 percent US dividend withholding applies if the corporate shareholder owns at least 10 percent of USco's voting stock (15 percent for an individual shareholder). Management fees are treaty-exempt from US tax if the Canadian shareholder recipient has no US PE. Losses are locked in the USco; a US holdco and subs may file US consolidated returns.

US thin capitalization rules may disallow USco's interest deductions, and the payment of interest or capital to a Canco may attract US withholding at dividend rates. Earnings-stripping rules may disallow interest expense exceeding 50 percent of adjustable taxable income; a safe harbour exists for $1.50 of debt for each $1.00 of equity. Interest paid to a Canco suffers 10 percent withholding creditable in Canada.

FIRPTA withholding applies on the sale of USco shares or on non-dividend distributions from a real property holding corporation. After the asset is sold and US tax is paid, US withholding tax may be avoided on USco's liquidating distribution; separate UScos to hold each property may be preferable. The liquidation dividend from an active business is exempt surplus to a Canco parent. No FAPI arises on the capital gain on the sale by a US active business: otherwise, one-half of the undistributed capital gain is taxed in Canada with a deduction for US tax paid.

US limited partnership. A Canadian partnership (all partners are Canadian residents) enjoys a rollover of property from partners, a rollover on dissolution if each partner receives an undivided interest in each partnership asset and liability, a rollover on a partner's departure, and a rollover on a conversion to a sole proprietorship. A US partnership with a Canco general partner and Canadian individual or corporate limited partners also qualifies. If the US partnership carries on a trade or business, each partner is deemed to be so engaged and is taxable in the United States on effectively connected income; otherwise, a non-US partner can elect a US tax base of net effectively connected income. Canadian partners file Canadian and US tax returns.

A limited partnership is a flowthrough vehicle for US and Canadian tax purposes. Deductible losses are restricted by Canadian at-risk rules and by various US limitations such as passive loss rules. For Canadian tax purposes, each partner is taxed on his pro rata share of the partnership gain or loss.

A 35 percent US withholding tax applies to undistributed partnership income allocable to a non-resident individual or effectively connected net taxable income allocable to a non-US corporation; the tax can be claimed on filing a US tax return. A 30 percent US withholding applies on gross non-business rental income, unless withholding tax on effectively connected income is elected. A Canadian foreign tax credit for US tax paid applies up to the allocable Canadian tax.

A Canadian limited partner is subject to Canadian income tax if the partnership increases the property's mortgage above its original cost and distributes the excess proceeds to its partners. (In such a case, co-ownership may be preferable.) For Canadian tax, the partner's ACB goes negative, triggering an immediate capital gain; the gain is deferred for US purposes. Canadian replacement property rules do not apply on an exchange of foreign property. US and Canadian tax arises on the partnership interest's disposition; FIRPTA withholding applies and a Canadian foreign tax credit is available.

A tiered partnership, with a Canadian limited partnership as a US limited partner, can elect to be treated as a corporation for US tax purposes; the Canadian individual partners' exposure to US estate tax is eliminated because they are deemed owners of a non-USco's shares. The Canadian partnership may file a US tax corporate return and avoid multiple partner filings. The Canadian partnership receives a credit against US tax for any US withholding tax paid by the US partnership under section 1446.

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Interest Paid Too Late?

In *Grant* (2006 TCC 373), the spousal taxpayers ceased to be Canadian residents on December 30, 1998. Shortly before their departure, the taxpayers entered into a series of transactions with a financial institution as part of a departure trade, which, generally speaking, creates interest deductions to reduce the income tax of an individual who is planning to emigrate. Unfortunately, the deal failed to relieve them of tax on US$1.7 million.

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

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On December 24, the Grants borrowed approximately US$1 billion at interest and simultaneously invested the funds in notes issued by a wholly owned US sub of the lender financial institution. The notes and borrowings were due on January 4, 1999. The financial institution provided a bridge loan of US$1.5 million to pay the interest payable on December 31, 1998. The interest earned on the notes was not taxable because it was not received until after the taxpayers terminated their Canadian residence. In their part-year tax returns for the period in which they were resident—from January 1 until December 30, 1998—the taxpayers claimed a deduction of about US$1.5 million interest, which was disallowed; another US$200,000 was overlooked when the returns were prepared.

The Crown's primary argument was that none of the US$1.7 million was deductible under section 114 for a part-time resident because the interest was paid when the taxpayers were not resident in Canada. Alternatively, the interest expense was not deductible because paragraph 20(1)(c) precludes a deduction for interest on borrowings used to earn exempt income. Furthermore, GAAR should apply: the transactions were avoidance transactions—as conceded by both parties—and constituted an abuse.

The TCC confined its analysis to the primary argument. Section 114 determines the taxable income of a part-time resident in three steps. (1) Paragraph (a) divides the computation of income in division B of the Act (sections 3-108) into two periods: residence and non-residence. (2) Paragraph (b) allows a full-time resident a number of specific inclusions and deductions in the computation of taxable income under division C (sections 109-114.2). (3) Paragraph (c) allows "any other deduction for the purpose of computing taxable income to the extent that it can reasonably be considered" to apply to the Canadian residence period.

Both parties agreed that because interest was paid on December 31, after the taxpayers ceased to be resident, it was not taken into account in paragraph 114(a). The debate centred on paragraph 114(c): does it apply to deductions allowed in computing both income and taxable income—deductions under divisions B and C—or is it simply confined to deductions under division C? The taxpayers argued that six-sevenths of the interest paid by them was reasonably attributable to the part of the year when they were resident and that paragraph 114(c) allows division B and C deductions attributable to the residence period.

The court concluded that the wording in section 114 presents some ambiguity; but when a textual, contextual, and purposive interpretation is applied, it becomes clear that the deductions referred to in paragraph 114(c) are only those deductions permitted in computing taxable income under division C. Thus, the interest paid on December 31 was held not deductible. The court was troubled by the fact that if the taxpayers' interpretation was accepted, they could claim interest deductions on a cash basis under paragraph (a) and on an accrual basis under paragraph (c); in the result, cash-basis taxpayers could claim interest expense on an accrual basis and yet report income on a cash basis. The court was of the view that if Parliament had intended this result, it would have said so more clearly. The court did not analyze what would have happened if the interest had been paid during the period of residence.

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Foreign Tax News

United Kingdom

The European Court of Justice in *Cadbury Schweppes* (Case C-196/04) held that UK CFC legislation is contrary to EC law—except as it applies to artificial anti-avoidance arrangements—because it restricts freedom of establishment. Accordingly, the CFC rules must not apply if the CFC is established in and carries on genuine economic activities in a host member state, even if tax motives exist.

United States

The European Court of Justice dismissed the *RJ Reynolds Tobacco* appeal against two EU decisions to sue several US tobacco companies in the US courts to collect tax revenue from cigarette smuggling. The EC has petitioned the US Supreme Court to review a 2005 decision of the US Court of Appeals Second Circuit that foreign sovereigns cannot recover lost tax revenue in civil suits.

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