CANADIAN TAX Highlights

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BENEFICIAL OWNERSHIP: INDOFOOD REVISITED

Her Majesty's Revenue and Customs (HMRC) recently issued draft guidance on its interpretation of the English Court of Appeal's decision in *Indofood* ([2006] EWCA Civ 158). The guidance outlines HMRC's practice on claims for relief from UK withholding taxes under UK treaties in light of *Indofood*.

Indofood, an Indonesian company, sought to raise capital by issuing internationally marketed loan notes. A Mauritian special-purpose vehicle (SPV) was used to access the Indonesia-Mauritius tax treaty and reduce Indonesian withholding tax on interest from 20 percent to 10 percent. The notes were redeemable early if Indonesian law changed to increase withholding above the 10 percent treaty rate, unless "reasonable measures" by the issuer could avoid the effect of the change. When Indonesia terminated its treaty with Mauritius and the withholding rate rose to 20 percent, Indofood's request for early redemption was denied: the noteholders' trustee said that the use of a Dutch SPV could accomplish the same result under the Indonesia-Netherlands treaty. (For more details, see "Beneficial Ownership: Special-Purpose Vehicles," *Canadian Tax Highlights*, May 2006.) The CA concluded that the Dutch SPV was not the beneficial owner of the interest payable by Indofood for the purposes of the Indonesia-Netherlands tax treaty, but was merely a conduit: it did not receive "the full privilege to directly benefit from the income." In a separate judgment, the chancellor went on to say that the term "beneficial owner" should be given an international fiscal meaning, not its meaning under the domestic law of contracting states. *Indofood* was not appealed.

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In the draft guidance, HMRC says that in its view the "beneficial ownership" decision in its relation to tax treaties is now part of UK law, but the CA's decision is fully consistent with existing UK policy and thus in general does not significantly affect current administrative practice. HMRC says that the decision applies to all tax treaty articles referring to beneficial ownership and covers treaty articles on interest, royalties, and, if appropriate, dividends. The treaty's objective should be considered; if the treaty is not being abused, there is no need to apply the "international fiscal meaning" of beneficial ownership referred to by the CA. The guidance accepts that there is no need to apply that meaning to transactions involving SPVs, quoted eurobonds, and funds investing in UK loans such as collateralized debt or loan obligations (CDOs or CLOs): the object of a treaty is likely just as easily met using the UK domestic law meaning of beneficial ownership.

HMRC does not propose to revisit existing treaty clearances on structures that may be affected by *Indofood* until the clearances expire, or to take retrospective action to remove treaty benefits unless it emerges that significant facts were omitted or misrepresented when the clearance was agreed to and the issue of beneficial ownership was broached before the clearance was given.

The guidance is intended to cover the majority of situations in which *Indofood* may create uncertainty. Cases that fall outside the eight examples given in the guidance must be considered individually. At the next suitable revision date, HMRC will include the guidance in its International Manual, which is publicly available from HMRC's Web site at http://www.hmrc.gov.uk.

The CRA is currently considering the meaning of *Indofood* and whether it establishes an international "treaty meaning" of beneficial ownership. At the May 8, 2006 annual international seminar of the IFA (Canadian branch), the CRA noted that the Canadian impact depends on the Canadian courts' reaction to *Indofood*. A Canadian court will have the first opportunity to consider *Indofood* in *Prevost Car* (2004-4226 (IT) G); pleadings were submitted in July 2004, but a trial date has yet to be set. It will be interesting to see how the Canadian courts approach *Prevost*: the case involves the beneficial ownership of dividends, which requires a different analysis than interest.

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Multistate Tax Issues

For a Canadian company doing business in the United States, nexus is the most talked-about issue from a US state tax perspective. Many companies fail to realize that a treaty-based exemption may provide protection from federal taxes, but generally not from state taxes. Ultimately, the issues are whether a company has nexus in a state and, if so, what can be done about it. Companies need to be constantly aware of potential state tax issues arising from nexus, but a variety of options are available to resolve multistate tax problems.

Not every company that engages in business activities in the United States falls within every state's tax jurisdiction. The US constitution generally limits a state's ability to impose tax obligations on an out-of-state company, based on the nexus concept. "Nexus" refers to the nature and frequency of contacts that an out-of-state company must establish in a state before it attracts taxation. The nexus requirement is constitutionally based, but it is also found in most states' tax laws.

Two recent rulings underscore how easily a Canco can create nexus in the United States. In a New York advisory opinion, a company headquartered in Washington state was absolved of any responsibility to collect New York sales taxes on sales of its promotional materials because it had no physical presence in New York. (See *The Sourcing Business*, TSB-A-06(14)S.) However, the state tax department also recognized that New York nexus was created by minimal activities such as the solicitation of business through employees (or independent contractors) or the delivery of products otherwise than by a common carrier. A large US retailer of books and music recently completed a long string of litigation in California courts involving so-called attributional nexus (*Matter of Borders Online, Inc. v. State Board of Equalization*, 129 Cal. App. 4th 1179; 29 Cal. Rptr. 3d 176 (1st Dist. 2005)). Attributional nexus can exist even if a taxpayer lacks physical presence in the taxing state: the activities of an agent or, more commonly, an affiliated entity within the state are attributed to the corporation located outside the state. In the *Borders* case, the California courts found that the state could impose a sales tax collection requirement on Borders Online—an out-of-state company that had no physical presence in California—because of its connection to its parent, Borders Inc., which maintained sufficient physical presence in California. Similar rulings have come out in New York, Tennessee, New Mexico, and other states in recent years. This issue often arises when a Canco sets up a US sub to handle all or some of its US operations. Under attributional nexus, a US sub's activities can be attributed to its Canadian parent, which then may have nexus for sales or corporate income tax purposes in several states.

Practically speaking, however, how likely is it that a particular state will raise nexus concerns? And assuming that the Canco is willing to comply, is there an efficient way to deal with the possibly overwhelming prospect of addressing all the issues that may arise in perhaps dozens of states, each with different tax rules? Unfortunately, US states have stepped up efforts to uncover non-compliant taxpayers. Some states have created "nexus squads" designed to find previously undetected taxpayers; many states cross-check federal tax filings; and—most importantly for Canadian companies—many states now have information-sharing arrangements with other states and federal agencies, including US Customs. For example, New York, Pennsylvania, and Michigan have information-sharing arrangements with US Customs offices, which have recently led directly to the initiation of state tax audits. It may be inevitable that any company that maintains somewhat regular contacts in the United States will fall within the nexus radar of many US states.

Depending on the facts, various approaches may be taken to resolve these multistate tax concerns. If the non-compliance period is brief, many companies consider prospective compliance only, which still leaves open the possibility of investigations and audits for prior periods. Other companies, particularly in the cross-border context, often consider the creation of a new, generally US, legal entity to handle all US operations prospectively. A new, untainted entity engages in the business activities and, it is hoped, avoids prior years' issues attached to the old Canco, but the strategy leaves the Canco still exposed to audits and investigations for prior years' taxes. If the prior years' liability is extremely significant, or if Canco's non-compliance spans more than just a few tax years, participation in state voluntary disclosure programs allows a taxpayer to come forward voluntarily and comply with a state's taxing provisions without fear of civil or criminal penalties or excessive lookback periods. Generally, states limit a taxpayer's back taxes to three years' taxes plus interest, and they limit any audits or investigations to the same three-year period. A program designed by the Multistate Tax Commission assists taxpayers with voluntary disclosures in several states. Under another multistate project, the Streamlined Sales Tax Project, many states offer amnesty to a taxpayer who is willing to participate prospectively. That amnesty is available only in participating states, and participation may create other issues for particular taxpayers, but it requires prospective compliance only and participants are absolved of all earlier years' sales tax responsibility.

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Joint Committee: New Dividend Tax Regime

The CBA-CICA Joint Committee on Taxation (JCT) recently sent a submission to the Department of Finance detailing its concerns and suggestions regarding the June 29, 2006 draft legislation for the new dividend tax regime, which reduces the income tax rate on eligible dividends paid to individuals by large corporations. The 17-page submission addresses 27 issues on four topics: designation of eligible dividends; opening general-rate income pool (GRIP); other GRIP and low-rate income pool (LRIP) issues; and miscellaneous issues. Bill C-28, tabled on October 18, 2006 to implement the new dividend tax regime, does not appear to address many of the JCT's recommendations. Highlights of the submission follow.

■ **Eligible dividends paid by a non-CCPC.** Since most dividends paid by non-CCPCs to Canadian residents qualify as eligible dividends, a non-CCPC's compliance burden would be reduced if it could make a blanket election to have all dividends paid by it to Canadian residents treated as eligible, except for dividends it designated as ineligible. The JCT recommends the introduction of an election mechanism that automatically treats a non-CCPC's dividends as eligible.

■ **Method for designating dividends.** Proposed subsection 89(14) requires a corporation to notify in writing each person or partnership to whom it pays a dividend that it has been designated as eligible (in whole or in part). The JCT recommends consideration of less onerous notification methods.

■ **Designation of a portion of a dividend.** It is not clear whether a subsection 89(4) designation must be made for the full amount of the dividend paid on a class of shares or whether it can be limited to the portion paid to particular shareholders. The JCT recommends that a corporation be able to designate portions of dividends as eligible, allowing flexibility in the designation's application to a portion of a dividend and to particular shareholders.

■ **Designation after payment of dividend.** The draft legislation does not permit a dividend's post-payment designation as eligible. The JCT recommends that a CCPC have the right to make a post-payment designation, perhaps limited to situations where its GRIP increased as a result of an event such as a reassessment or the amendment of an amount reported in a tax return. The right should be exercisable for a reasonable period of time, such as 90 days after the event; on reassessment, the exercise period should run from the expiry of the appeal period regarding the final determination. The JCT also recommends that a recipient of a post-payment designated dividend have the right to be reassessed on the basis that the dividend is eligible, even if the year of receipt is statute-barred.

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International Tax Comparisons

The OECD produces an annual survey of tax burdens in its member countries. This year's edition shows that Canada remains a relatively low-tax jurisdiction in comparison with many of the European members, but it has yet to bring its tax burden levels down to those prevailing in its nearest neighbour and biggest trading partner, the United States.

There are many methods of comparing tax burdens between countries, but only the ratio of total tax collections to gross domestic product (GDP) takes into account all taxes and near-taxes within each country. The comparisons cannot, of course, take into account the services provided by those taxes. In addition, the net fiscal position of the public sector has a significant impact on the long-term stability of the tax burden and the level of public services.

The OECD survey indicates that in 2005, taxes collected by all Canadian governments equalled 33.5 percent of GDP, significantly higher than the 26.8 percent ratio shown for the United States, but below the G7 countries' average of 36.3 percent. Once again, Sweden recorded the highest ratio (51.1 percent in 2005) and Mexico showed the lowest ratio (19.0 percent in 2004, the latest figure available for that country).

The full survey details the relative importance of each type of tax in the mix in each country. Canada relies more heavily on personal income taxes (excluding social security contributions)—equivalent to 16.0 percent of GDP—than all but eight other members.

The table summarizes the changes for the G7 countries over selected years during the period 1990 to 2005. Data

Total Tax Collections as a Percentage of GDP, Selected Years

	1990	1995	2000	2003	2004	2005
Canada	35.9	35.6	35.6	33.6	33.5	33.5
France	42.2	42.9	44.4	43.1	43.4	44.3
Germany	35.7	37.2	37.2	35.5	34.7	34.7
Italy	37.8	40.1	42.3	41.8	41.1	41.0
Japan	29.1	26.9	27.1	25.7	26.4	na
United Kingdom	36.5	35.0	37.2	35.4	36.0	37.2
United States	27.3	27.9	29.9	25.7	25.5	26.8

na Not available.

necessary to estimate the preliminary figure for Japan in 2005 are not available.

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Ontario CIT Agreement

Ontario signed a new tax collection agreement with the federal Department of Finance on October 6, 2006 to collect and administer Ontario's corporate income tax. Ontario businesses can make combined payments starting in 2008 and file a single return for 2009 and later years. A CRA notice said that the CRA will provide the same services to businesses that pay Ontario corporate income tax that it currently provides for federal income tax—payments processing, returns processing, audit, appeals, and collection of accounts receivable. The agreement requires Ontario to change its definition of "taxable income" to parallel the federal definition. In late October 2006, Ontario released draft rules designed to provide an appropriate transition to the use of federal tax attributes for balances such as unclaimed capital cost allowance, tax losses, and other pools. After 2008, Ontario will also eliminate its income addback of a portion of certain management fees, rents, royalties, and similar payments to certain non-residents; the addback generally imposes a 5 percent tax on those payments.

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Defined Benefit Plan Design

In 1990, Canadian defined benefit (DB) plans had 4.6 million members; that number remained unchanged in 2004, even though the paid workforce had increased by 22 percent over the period. The relative importance of DB plans has declined for many reasons. Younger participants do not appreciate the value of DB plans. Courts and legislatures have effectively decided that the plans' surpluses belong to employees but that deficits are employers' responsibilities. Poor returns and increasing costs associated with an older workforce make DB plans a financial drain on sponsors. Accounting changes may result in dramatic fluctuations in business expenses and earnings.

Although the DB plan is attractive to many employees and is the plan of choice for the public sector and unions, membership in existing DB plans is likely to continue to decline. Many larger employers are considering freezing existing DB plans, closing them to new entrants, and stopping the accrual of defined benefits for current members. The plan of choice is rapidly becoming the defined contribution (DC) plan or, for those averse to any form of pension regulation, the group RRSP. Under those plans, investment risk and mortality risk—both assumed by the DB plan sponsor—are the responsibility of DC plan members, who are less able to bear and manage these risks. The governor of the Bank of Canada recently observed that this transfer of risk exerts a negative impact on overall economic efficiency.

The US pension industry attempted to stop the decline of DB plans by developing hybrid plans that keep investment and mortality risk with the employer but incorporate DC plan features: 25 percent of US DB plan members now belong to hybrid plans. For example, under the cash balance (CB) plan, a participant earns credits that are equal to a percentage of his or her salary and that in turn earn guaranteed interest credits. At retirement, the pension is the amount that can be purchased with the credit balance. The employer funds the plan, bears the investment risk, and ensures that funds are sufficient to pay pensions until death. The CB plan has evolved because on a DB plan's conversion into a CB plan its US sponsor can access the DB surplus to fund the CB credits, since the CB plan is considered a type of DB plan. A recent court decision that deflected challenges to CB plans as age-discriminatory (*Cooper v. IBM*, docket no. 99-829-GPM, 7th Cir., August 7, 2006) and the enactment of the Pension Protection Act of 2006 (Pub. L. no. 109-280) place CB plans on relatively solid footing.

As the ever-shifting law now stands, Canadian DB sponsors can access DB surplus, either by contribution holidays or, after conversion to a DC arrangement, by using the surplus to make contributions. A CB plan—considered a DB plan under the Act—may be attractive because of its relative simplicity and the promised return's predictability. Assume that a CB plan promises contributions of 5 percent of earnings, with an earnings credit of 5 percent per annum, and that a participant earns $50,000. The year 1 CB credit is $2,500. For a DC plan, the pension credit and resulting RRSP contribution room would be easy to calculate and would not be a function of age. For a DB plan, the lifetime benefit accrued under the plan for the year must first be calculated on the assumption that the individual has attained age 65 using an annuity factor—likely one that captures the form of benefit payable under the CB plan and prevailing interest rates. With an annuity factor of 9, the pension credit for year 1 is $1,900 (9 × $2,500/9 – $600). For year 2, assuming no increase in earnings, another $2,500 is credited, as well as a $125 interest credit on the year 1 contribution, yielding a balance of $5,125 at the end of year 2; the pension credit for year 2 is $2,025 [($5,125/9 – $2,500/9) × 9 – $600]. In effect, the interest credit is added to the year 2 pension credit, in contrast to a DC plan, where the earnings on contributions attract no pension credit.

Moreover, the treatment of a guaranteed rate of return is uncertain. The price of the guarantee may be the inclusion of the interest credit in the pension credit's calculation, or the CRA may disallow the guarantee entirely, raising the question of how a rate of return is determined. Restrictions imposed on transfers from DB to DC plans are also problematic. If we use a more conservative annuity factor of 10, the pension credit for year 1 is \$1,650 (9 × \$2,500/10 – \$600); for year 2, \$1,762.50 [9 × (\$5,125/10 – \$2,500/10) – \$600]. On termination at the end of year 2 before age 50, the DB-to-DC transfer restrictions allow a tax-free transfer to a DC vehicle of only \$4,612.50 (\$5,125/10 × 9); the excess \$512.50 is included in income. (Transfer factors increase after age 50.) It would be more equitable to equate a CB plan for tax purposes with a DC plan, if the rate-of-return guarantee is reasonable. Not one CB plan has been registered in Canada; the tax attributes of the plan would be the subject of long and painful negotiation, with no certainty of a successful outcome.

US pension consultants are also marketing a hybrid variable annuities (VA) plan, which promises an annuity, starting at normal retirement age, of a percentage of earnings. To establish a cost for that promise, an interest rate (the hurdle rate) is stipulated. The individual is granted a number of shares, based on an arbitrary value, to track the investment performance of the assets that back the annuity. Assume that an individual earns \$50,000 in a 1 percent VA plan; in year 1, she earns a variable annuity of \$500; a share value of \$10 is set and she is granted 50 shares. The hurdle rate is 6 percent. The cost of the annuity is contributed by the employer, but the member determines how that contribution is invested. If the assets invested earn 6 percent, the share value remains at \$10 and the individual has 50 shares in respect of year 1; however, if they earn 4 or 8 percent, the share value decreases or increases by 2 percent to \$9.80 and \$10.20, respectively. Each year, the individual is granted shares whose total value equals the stipulated benefit rate times pensionable earnings. The share value fluctuates, depending on the performance relative to the hurdle interest rate. At retirement, the pension equals the total number of shares multiplied by the then present share value. The cost of the VA plan, like the cost of a DB plan, increases with age; but the members bear the investment risk, leaving only the mortality risk with the employer.

For tax purposes, the VA plan is a DB plan. At the end of each year, to determine the pension credit, the member is assumed to be 65 years old and to have commenced retirement. For year 1, the individual in the VA plan example has a pension credit of \$3,900 (9 × \$500 – \$600). If, at the end of year 2, the share value increases to \$10.20 (because the actual return is 2 percent better than the hurdle rate), the individual receives 49.02 shares (\$500/\$10.20) for year 2, assuming no increase in pensionable earnings. The pension credit for year 2 is \$3,990: 9 times the difference between the total normalized pension earned at the end of year 2 (99.02 × \$10.20) and the pension earned at the end of year 1 (50 × \$10.00), less \$600. The higher share value results in an increase in the value of the year 1 pension, which increase generates a pension credit for year 2. This is similar to the analysis for the CB plan: DC-like earnings are subjected to DB treatment. The problem is compounded if the investment return is less than the hurdle rate. It is not clear how the loss in value of year 1's pension is reflected, if at all, in the calculation of year 2's pension credit. The DB-to-DC transfer rules also pose a significant problem.

Almost all new plans established in Canada are DC plans or group RRSPs. The only growth opportunity for new DB plans appears to be the individual pension plan, which provides certain tax-deferral advantages to older employees with sufficient past service and income. Even if sufficient demand for hybrid DB plans such as the CB and VA plans exists, they are not accommodated by current tax rules and only legislative change can make them viable.

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Capital Gains Versus Dividends

Recent changes to federal and provincial tax rates on eligible dividends narrow the tax gap between those dividends and capital gains. Investors may wish to re-evaluate their year-end tax situation for 2006 and their investments for 2007 and beyond.

Ontario, Alberta, Quebec, British Columbia, Manitoba, Saskatchewan, and the federal government announced tax rate cuts on eligible dividends paid to individuals by large corporations; Newfoundland and Labrador's tax rate on eligible dividends will increase.

The table shows the combined federal-provincial top marginal tax rates on dividends for 2006, based on rates announced to date, and the top marginal rates on capital gains for all provinces for 2006. The gap between the rates for capital gains and eligible dividends has narrowed considerably. In Alberta, British Columbia, and Saskatchewan the tax rate on eligible dividends is lower than the rate on capital gains; for non-eligible dividends, the gap has widened in Alberta, Quebec, and Manitoba, but not in Ontario and Saskatchewan. Despite the other provinces' tax cuts in eligible dividends, Alberta maintains its tax rate advantage on all types of income received by individuals. Now Alberta's tax rate on eligible dividends

2006 Top Combined Marginal Tax Rates

	On eligible dividends	On non-eligible dividends	On capital gains
		percent	
British Columbia	18.5	31.6	21.9
Alberta	18.1[a]	24.6	19.5
Saskatchewan	20.4	28.3[b]	22.0
Manitoba	23.8	35.2	23.2
Ontario	25.0[c]	31.3	23.2
Quebec	29.7[d]	36.3[d]	24.1
New Brunswick	na	37.3	23.4
Nova Scotia	na	33.1	24.1
Prince Edward Island	na	32.0	23.7
Newfoundland and Labrador	32.5	37.3	24.3

na Not available.

[a] Alberta announced a decrease to 14.5 percent by 2009. [b] Saskatchewan announced an increase to 30.8 percent by 2007. [c] Ontario announced a decrease to 22.3 percent by 2010. [d] Applied to dividends paid after March 23, 2006.

is lower than the personal tax rate on capital gains in every province.

As a result of what seems to be a technical oversight in the draft legislation, a large dividend received by an individual, including a trust, may trigger alternative minimum tax (AMT) because the 14.55 percent federal dividend tax rate on eligible dividends is lower than the 2006 and 2007 federal AMT rate—15.25 percent and 15.5 percent, respectively.

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Owner-Manager Year-End Tips

The approaching year-end calls for owner-managers to focus on their remuneration strategy: the optimal salary-dividend mix for all family members minimizes overall taxes. Proposed federal personal income tax cuts for eligible dividends may affect that strategy and impose new compliance requirements on corporate payers. Alberta, British Columbia, Manitoba, Ontario, Quebec, the Northwest Territories, and Saskatchewan—but not Newfoundland and Labrador and Nova Scotia—have harmonized with the federal changes; the other provinces and territories have not announced specifics.

Corporate Level

■ Compute the CCPC's general-rate income pool (GRIP) at its 2006 year-end to determine its ability to pay eligible dividends.

■ Designate qualifying eligible dividends via written notice to each recipient at the time of payment (or within 90 days after the legislation receives royal assent for dividends paid before then). If an excess designation is made, all or part of it may be elected to be a separate non-eligible dividend.

■ Consider distributions in the following order: (1) eligible dividends that trigger a refundable dividend tax on hand (RDTOH) refund; (2) ineligible dividends that trigger a refund; (3) eligible dividends that do not trigger a refund; and (4) ineligible dividends that do not trigger a refund.

■ If the CCPC has a positive GRIP and RDTOH, consider pre-year-end eligible dividend distributions that trigger a dividend refund.

■ If a CCPC has large accumulated pre-2001 retained earnings from high-rate taxable income, consider the election to treat it as a non-CCPC and thus allow eligible dividend distributions out of those earnings. However, the non-CCPC must first deplete its low-rate income pool (LRIP) by paying non-eligible dividends.

■ A CCPC that will become a non-CCPC (for example, by going public or becoming controlled by non-residents) or vice versa should consider the proposals' impact.

Individual Level

■ Re-evaluate post-2005 strategy for receiving salary versus dividends. The lower tax rate on eligible dividends may enhance a shareholder-manager's preference for receiving dividends from income subject to the general corporate rate, but salary may reduce alterative minimum tax exposure.

■ Many factors should be considered, including the owner-manager's marginal tax rate, the corporation's tax rate, any provincial health and payroll taxes, and the potential for maximizing RRSP contribution room and CPP contributions.

■ Corporations in Alberta, Manitoba, and Saskatchewan may wish to accelerate discretionary non-eligible dividends that trigger a dividend refund; in 2006, non-eligible dividend tax rates are lower. Conversely, corporations in Alberta and Ontario may wish to defer the payment of discretionary eligible dividends; after 2006, the eligible dividend tax rate falls.

■ Defer the receipt of other discretionary income until 2007: the federal government is hinting at a personal income tax rate reduction.

■ Forgoing bonus payments may render doubtful whether substantially all of a CCPC's assets are used in an active business and thus jeopardize qualifying small business corporation share status.

■ Tax is deferred if the corporation retains income when its tax rate is less than the individual's. The table shows the deferral from retaining active business income in lieu of paying salary to the shareholder, and the tax saving (or cost) of paying out the after-tax corporate income as a dividend.

Salary or Dividend?
December 31, 2006 Year-End and $10,000 ABI

	Eligible for SBD		No SBD; no M & P deduction		No SBD; M & P deduction	
	Deferral	Savings (cost)	Deferral	Savings (cost)	Deferral	Savings (cost)
			dollars			
Alberta	2,288	226	651	(576)	651	(576)
British Columbia	2,608	6	958	(258)	958	(258)
Manitoba	2,990	86	1,090	(420)	1,090	(420)
New Brunswick	3,197	25	*	*	*	*
Newfoundland and Labrador	3,153	97	1,353	(724)	2,253	(117)
Nova Scotia	3,013	306	*	*	*	*
Ontario	2,881	330	1,131	(472)	1,331	(322)
Prince Edward Island	2,858	263	*	*	*	*
Quebec	2,910	47	1,831	(188)	1,831	(188)
Saskatchewan	2,588	268	639	(631)	1,188	(193)
Northwest Territories	2,793	336	1,019	(170)	1,019	(170)
Nunavut	2,438	38	*	*	*	*
Yukon	2,528	155	*	*	*	*

* The province or territory has not announced its eligible dividend rates.

Note: The individual is assumed to be taxed at the top marginal income tax rate. Only federal and provincial income tax, the employer portion of provincial health tax, and the employee portion of payroll tax (for Northwest Territories and Nunavut) are considered. Quebec's figures apply to dividends (deemed) paid after March 23, 2006. The SBD figures for Yukon assume a non-M & P ABI rate; if the M & P ABI rate applies, the tax deferral and tax savings are $2,678 and $262, respectively.

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Managing Tax Audits

A taxpayer's successful management of the audit process reduces the likelihood that the CRA will take enforcement action.

Typically, when a CRA auditor contacts a taxpayer to commence the audit process, the taxpayer should understand the tax issues and be able to respond appropriately to queries. To that end, a taxpayer should defer the audit for a reasonable period in order to prepare the files and be familiar with the issues. Uncovering areas of possible exposure before the auditor attends allows the taxpayer to choose between discussing errors with the auditor at the beginning of the process and waiting to see how the audit progresses. Facilitating the relationship with the auditor by being transparent in the process can go a long way toward keeping the audit process in check.

When the auditor arrives, the taxpayer should provide adequate and comfortable working space. Access to documentation should be controlled; many an audit goes awry for a taxpayer because the auditor has independent access to files. A taxpayer should respond to all requests for documentation and information, but should provide nothing more. Access to employees and principals should also be controlled; all discussions and requests for information should be managed through one or two individuals who are completely familiar with the matters at hand. Auditors will attempt to glean additional information in casual conversations with employees. The audit of one entity often leads the auditor to other companies or individuals—a valid extension of the audit's scope—but auditors are not entitled to fish for information; the persons managing the audit must be familiar with the files and be able to ascertain the direction in which the CRA is moving.

A taxpayer must treat the auditor courteously and respectfully; rudeness to auditors or a failure to take them seriously may result in arbitrary reassessments. Failure to spend adequate time with the auditor at the outset may lead to frustrating additional and ongoing requests for information. Even if the auditor's position is ultimately incorrect, once a reassessment is issued the CRA may be unwilling to reverse it, even up to the eve of trial. Courteous treatment of the auditor may make a significant difference to the audit's substantive and procedural course.

In an audit, the CRA can require production of documents, books, and records and enter business premises on a reasonable basis, but it must obtain a warrant to enter a private home. The CRA often makes informal requests for information, and the taxpayer is advised to respond before a formal request is issued. The CRA has a separate and very broad right to require the production of documents and information for any purpose related to the administration and enforcement of the Act; a court order is required for information not related to specified, known taxpayers. The CRA can also access foreign-based information that may be relevant to the administration or enforcement of the Act, even if the request is broad or the information is available elsewhere. (See *1144020 Ontario Limited*, 2005 DTC 5315 (FC).)

The meaning of "document or record" is very broad and includes books of accounts, invoices, letters, memoranda, customer lists, security, and money. If the requested information is sensitive or if there are concerns about the revealing of trade secrets, a taxpayer may be able to extract a promise of confidentiality from the CRA. However, the requirement to disclose is not aborted unless solicitor-client privilege exists. A taxpayer should review the documents; those for which privilege is claimed should be separated, sealed, and clearly marked. The CRA can challenge the claim of privilege in court.

Privilege does not extend to communications between accountants and their clients; solicitor-client privilege is required for the proper administration of justice, a factor that does not apply in accountant-client relationships. However, if the accountant is acting as the client's agent in dealings with solicitors, communications with the accountant may be protected by privilege. If privilege is an issue, the solicitors may choose to retain the accountants directly; a clear intention to extend privilege to the communications may be sufficient to establish privilege.

The provision of privileged communications to the accountants may constitute a waiver of the related privilege. *Philip Services Corp. v. Ontario Securities Commission* (2005 CanLII 30328 (Ont. SCJ)) held that the privileged communication was given to the accountants for the sole and limited purpose of conducting the audit, without any intention on the client's part to waive privilege. The court suggested that the waiver must be evidenced by an express written intention to do so: the provision of the document to the accountants was not sufficient evidence of such intention. Other cases have been less definitive on the issue, and taxpayers should exercise caution to avoid any risk that privilege could be seen as having been waived.

Not all documentation prepared by a client's solicitors carries privilege, which extends to confidential communications. Legal opinions and memoranda (including drafts) are usually privileged, but agreements, resolutions, other corporate documents, and confidential notes included on non-privileged documents are not.

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IRS Valuation Guidelines

In addition to business valuation guidelines, the IRS has now issued three more sets of valuation guidelines for IRS personnel on intangible property, tangible personal property, and real property. IRS valuators must be able to reasonably justify any departure from the guidelines, which incorporate the US government's ethical and conduct standards applicable to all IRS employees.

Affected intangible property includes computer software; patents, inventions, formulae, processes, designs, patterns, trade secrets, and knowhow; copyrights; trademarks, trade names, and brand names; franchises, licences, and contracts; methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, and technical data; and other items whose value is derived not from their physical attributes but from their intellectual content or other intangible properties. Valuations of assets owned and/or transferred by or between controlled taxpayers may present substantive issues that the guidelines do not address. The guidelines cover development, planning, identification, documentation (including working paper requirements), and analysis. Rules govern the review of a taxpayer's intangible property valuation and any report of the review's results.

An IRS valuator must try to resolve a case after fully considering all relevant facts and to resolve issues as early in the examination as possible. "Credible and compelling work by the [IRS] valuator will facilitate resolution of issues without litigation . . . [by] work[ing] in concert with the internal customer and taxpayer to attempt to resolve all outstanding issues." A valuator must "employ independent and objective judgment in reaching conclusions and . . . decide all matters on their merits, free from bias, advocacy, and conflicts of interests." The report of the valuator's findings must provide "convincing and compelling" support for the conclusions reached, and at a minimum must contain information relating to those items in the identification, documentation, and analyses required to support the IRS valuator's assumptions, analyses, and conclusions. Similar rules apply in the other guidelines.

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Nature of Damages

In *Valley Equipment* (2006 TCC 510), the TCC confirmed that an award of damage for a breach of contract (the termination of a dealership arrangement) is proceeds of disposition from property if the contract represents a capital asset of the business. The decision illustrates that the tax treatment may turn on how the court that awarded the damages describes their nature.

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Valley Equipment Limited (VEL) operated a John Deere dealership from 1964 until 1995, when the relationship became strained and John Deere terminated the dealership agreement. At the trial for breach of contract, the court found that John Deere had wrongfully cancelled the dealership agreements, and it awarded VEL damages. VEL did not include the damages in income on the basis that it had not disposed of any property but had received compensation for John Deere's wrongful conduct. The TCC confirmed the minister's assessment that the damages were taxable as proceeds of disposition of a capital property (the dealership agreement) and yielded a taxable capital gain. The TCC considered whether the damages were awarded to compensate for tortious conduct and calculated on the basis of the lost opportunity to sell the business, or to compensate for the unlawful cancellation of the dealership agreement—a right within the definition of property—and were proceeds of disposition of property.

"Property" is defined in subsection 248(1) of the Act as property of any kind whatever, whether real or personal or corporeal or incorporeal, and includes a right of any kind whatever. "Proceeds of disposition," defined in section 54, includes the sale price of property that has been sold and compensation for property unlawfully taken. VEL argued that the right under the dealership agreement was not property because it could not be sold or transferred without John Deere's consent, but VEL clearly had something valuable to sell under the agreement because the day after the dealership agreement was terminated VEL negotiated a third-party deal to sell its John Deere division for $500,000 and its parts and service equipment at cost. VEL thus had property—the right to do business as a dealer—that was unlawfully taken when John Deere cancelled the agreement. The TCC said that the word "taken" in the proceeds definition does not mean that "one must remove something and give it to someone else."

The reasoning behind the damage award was critical to the characterization of the damages for tax purposes. The TCC noted that the other court's judgment was "close to one hundred pages long . . . [and] recounts a sequence of events replete with copious duplicities on the part of John Deere . . . and its representatives. His findings of fact point to a very blatant and shameful picture of cunning and deception initiated to undermine [VEL's] contractual arrangements . . . [and] made numerous findings of acts of bad faith on the part of John Deere." But the judgment failed to explicitly link that conduct to the damages award; the TCC concluded that the damages were awarded for breach of contract, not as compensation for tortious conduct. In the passage that concluded that VEL was entitled to damages, the judgment was "concise and definitive in respect to the nature of the damage award" as damages for wrongful cancellation of the contract, but did not refer to a tort. In obiter, the TCC said that even a damage award for tortious conduct is not necessarily a tax-free windfall.

The taxpayer might have had a more agreeable tax result if the language of the judgment that awarded the damages had been explicit in its impact of the bad faith conduct on the award and its quantum. A taxpayer may be wise to seek tax advice in advance of receiving a damage award or negotiating a settlement in order to achieve the appropriate characterization for tax purposes. In *Valley Equipment*, the wordy and ambiguous trial judgment did not support a position that some of the damages awarded compensated for bad faith conduct; if it had, tax-free treatment might have been appropriate for those damages.

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Foreign Tax News

Russia

A Supreme Commercial Court guideline distinguishes between acceptable tax planning and evasion and avoidance. The former "bad faith taxpayer" test is replaced by an "unjustified tax benefit" concept. The burden of proof is on the tax authorities. A tax benefit lacks justification if the underlying transactions are economically or commercially unreasonable or when a transaction's form does not coincide with its substance. The guideline sets out criteria that may indicate evasion, such as absence of qualified personnel; additional indications include one-time unusual transactions, extensive use of intermediaries, tax offences committed in the past by the taxpayer or currently by its contractors, and conducting transactions outside its seat. The court confirmed that sham transactions are null and void and may be recharacterized, and that tax, interest, and penalties may be imposed without court approval.

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