CANADIAN TAX Highlights

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CRA-Finance Round Table

During the CRA Round Table presentation at the Canadian Tax Foundation's 2006 annual conference, Wayne Adams of the Income Tax Rulings Directorate responded to a number of international questions.

Paragraph 95(6)(b). The CRA is waiting for decisions on cases similar to *Univar* (2005 TCC 723). The CRA acknowledged that although the prior draft circular contained little guidance on the rule's application, many examples were offered—a "permission slip" approach to acceptable tax planning. Three situations were noted in which the CRA subsection 95(6) committee approved the rule's application: (1) the shares were issued principally to avoid subsection 85.1(4); (2) the shares were acquired in lieu of lending money to avoid subsection 17(2); or (3) the shares were sold non-arm's-length in order to inflate exempt surplus.

IT-343R. The CRA is not currently working on updating IT-343R ("Meaning of the Term Corporation," September 26, 1977) regarding the tax characterization of foreign entities. The CRA generally follows the two-step approach. (See Marc Darmo, "Characterization of Foreign Business Associations" (2005) vol. 53, no. 2 *Canadian Tax Journal*.) No hard and fast rule establishes the weight given to any one factor: the CRA considers the nature of the rights in the entity's assets, the right to participate in profits or receive distributions, the right to vote or participate in the organization's decisions, the right to share in the assets' distribution on a windup, and the liabilities of the various parties under the law and agreements. The CRA is currently evaluating whether a Liechtenstein or Austrian foundation, a Dutch cooperative, a Canada-China JV, and a Chilean mining association are corporations and whether a Pakistan association is a partnership.

Thin capitalization, pushdown accounting. When a Canco implements pushdown accounting in respect of a foreign acquisition and good retained earnings are reclassified as contributed surplus, the CRA continues to view them as retained earnings for thin capitalization purposes. Contributed surplus not arising from a shareholder contribution is ignored.

Tax shelters. In response to a question from the floor regarding the Joint International Tax Shelter Information Act, no new information was released regarding CRA activity.

Brian Ernewein of Finance indicated that the next round of foreign affiliate amendments will probably not come out until the new year (and, it is hoped, early in the year). Finance hopes to finalize a new Canada-US tax treaty protocol in the not too distant future.

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In This Issue

Treaty Limitation Period Prevails

The TCC in *Canwest Mediaworks Inc.* (2006 TCC 579) applied a limitation period in the Canada-Barbados treaty, not the longer period provided by Canadian domestic law, because of a taxpayer-provided waiver. The CRA was thus precluded from including $660,000 of FAPI in the taxpayer's 1997 income.

Canwest International (Barbadosco) was a Barbados resident and a controlled foreign affiliate (CFA) of CanVideo Television (Canco), a Canadian-resident corporation. In its 1996 taxation year, Barbadosco earned $660,000 of interest income from a Canadian bank that was included in its income for Barbados tax purposes. Canco did not include the interest as FAPI in its income; the TCC said that there was no suggestion of fraud, wilful default, or neglect by Canco.

In December 1997, the CRA issued Canco an original notice of assessment stating that the interest was not included in its 1997 taxation year income as FAPI. Before the normal reassessment period expired, Canco provided a waiver for the FAPI. In August 2004, the CRA issued a reassessment that included the FAPI in Canco's 1997 taxation year income. The reassessment was issued within the domestic time constraint because of the waiver, but outside the five-year treaty limitation period. The parties apparently agreed that the treaty limitation period was paramount, if it applied: the only issue was whether the treaty limitation period was trumped by another treaty article.

Article XXVII(3) of the Canada-Barbados treaty (the limitation-period paragraph) states:

> A Contracting State shall not, after the expiry of the time limits provided in its national laws and, in any case, after five years from the end of the taxable period in which the income concerned has accrued, increase the tax base of a resident of either Contracting State by including therein items of income which have also been charged to tax in the other Contracting State. This paragraph shall not apply in case of fraud, wilful default or neglect.

Article XXX(2) (the FAPI paragraph) states:

> Nothing in this Agreement shall be construed so as to prevent Canada from imposing its tax on amounts included in the income of a resident of Canada according to section 91 of the Canadian *Income Tax Act*.

The TCC was asked whether the treaty's limitation-period paragraph was overridden by its FAPI paragraph. The CRA argued that the FAPI paragraph was clear and must be given priority over the limitation-period paragraph, which is a provision in the treaty that "can be construed so as to prevent Canada from taxing FAPI." The taxpayer argued that the two paragraphs "can live in harmony" because the FAPI paragraph deals with Canada's jurisdiction to tax, whereas the limitation-period paragraph is a procedural limitation provision only. The paragraphs can be read cohesively by allowing the CRA to assess FAPI under the FAPI paragraph, but only within the limitation period in the limitation-period paragraph. The TCC agreed: the limitation-period paragraph does not prevent the taxation of FAPI. Canada can tax FAPI within the five-year period if it was included in income for Barbados tax purposes. "In effect, Canada is not 'prevented' from imposing tax by Article XXVII(3); [but here] it is precluded from imposing tax by . . . not [doing so] on a timely basis."

The TCC said that the phrase "shall be construed so as to" supported its view of the interplay between the two treaty provisions; the phrase requires a consideration of the wording of other treaty articles, not of the specific facts regarding a specific taxpayer. The correct question was whether other articles on their face eliminated Canada's authority to tax FAPI, not whether Canada's taxation of FAPI was prevented in specific situations.

The TCC found further support by looking at the articles' intent. A CRA expert witness said that provisions such as the FAPI paragraph were included in treaties to preserve or ensure Canada's right to "get at FAPI"; he understood the limitation-period paragraph to be a relieving provision, setting a maximum time limit within which either country must adjust the taxpayer's income. The TCC further analyzed the intention behind the FAPI paragraph. The court noted both the CRA's point that the intention is clear from the words and it is thus inappropriate to rely on extrinsic sources to determine intention, and the taxpayer's point that the correct interpretation acknowledges that the treaty negotiators inserted the paragraph to remove any uncertainty regarding Canada's right to tax FAPI, an intention made clear by a review of other treaty provisions and extrinsic sources such as academics' opinion, the OECD model treaty, and case law.

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Ontario Land Transfer Tax Refunds

In November 2006, Ontario Finance released a new bulletin, "Refunds of Land Transfer Tax" (LTT 2-2006), which replaces the previous bulletin and outlines the procedures for obtaining refunds of land transfer tax. This bulletin is of particular interest to taxpayers who have overpaid land transfer tax or are first-time purchasers of newly constructed homes (as detailed in LTT 4-2003).

Overpayments occur, for example, when there is an error in the calculation of tax paid, when an incorrect rate is applied to the purchase price, when double tax is paid on the same conveyance, or when tax is paid on an exempt sale. The first-time purchaser of a newly constructed home is allowed up to a $2,000 refund of land transfer tax. The purchaser usually claims the refund at the time of registration; alternatively, the refund may be claimed directly from the ministry. Refunds are also available if land transfer tax was paid on the registration of a caution or notice of any kind—for example, a notice of an agreement of purchase and sale—but the transfer has not taken place, has not been assigned, and is at an end.

To apply for a refund, the purchaser must prepare a written request setting out the reason for the refund. There is no standard application form. Every refund application submitted must include (1) evidence that the tax was paid and a photocopy of the documents bearing the Land Registry Office's notation that the tax was paid; (2) a copy of the relevant purchase and sale agreement; and (3) a copy of the statement of adjustments. If tax was paid and an exemption applies, documentation supporting the exemption must be supplied. Information regarding various regulatory exemptions from land transfer tax may be obtained online at www.trd.fin.gov.on.ca; the Land Transfer Tax Act and other Ontario statutes and regulations are available at www.e-laws.gov.on.ca. A first-time purchaser of a newly constructed home must also supply a copy of the Ontario New Home Warranty Certificate and an original sworn Land Transfer Tax Affidavit for First Time Purchasers of Newly Constructed Homes. (See LTT 4-2003 for details.) Applications must be forwarded to the Land Taxes Section, Ministry of Finance, PO Box 625, 33 King Street West, Oshawa, ON L1H 8H9 (telephone 905-433-6361).

For most land transfer refunds, the application must be received by the ministry within four years from the date the tax has been paid, but the application deadline is 18 months for a first-time purchaser of a newly constructed home. There is no time limit on a refund claim for a transfer that has not taken place.

The minister may require additional information. Audit procedures may give rise to a notice of assessment of a refund that is determined to be excessive. The minister may assess or reassess any person within four years from the day on which the tax becomes payable. No limitation period exists if there has been misrepresentation attributable to neglect, wilful default or carelessness, fraud, or failure to deliver any return required under the Act.

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Lower Income Taxes

The CRA recently released its annual compilation of statistics on personal income tax for the 2004 taxation year (http://www.cra-arc.gc.ca/agency/stats/gb04/pst/final/menu-e.html). The final set of four tables provides tax data on the operation of the tax system over the past 38 years, adjusted to offset the effect of inflation. The data illustrate not only the growth in the number of taxpayers and their income and tax burden, but also the changes in the average tax bill.

In 1966, only 6.3 million Canadians paid income tax in Canada; the total tax bill (federal and all provincial taxes except for Quebec) amounted to $3.4 billion, expressed in the equivalent of 1992 dollars. By the 2004 tax year, the number of taxpayers had risen to 16.2 million, and their tax exceeded $133.9 billion in 1992 dollars. While the number of taxpayers has risen significantly, the number of non-taxable returns has risen much faster. In 1966, only 1.5 million Canadians filed returns and paid no tax, but by 2004 this number had risen to 7.4 million, primarily because low-income non-taxable individuals filed returns to claim federal and provincial refundable tax credits.

The accompanying table shows that average income in constant dollars has risen dramatically over the period. Average income per taxable return rose from $5,193 in 1966 to $11,974 in 1975 and to $46,445 in 2004, although some of this increase reflects different treatment of items such as capital gains and grossed-up dividends. Average tax paid per taxable return increased from 10.3 percent of income in 1966 to 15.3 percent 4 years later. The ratio climbed over the next 30 years, reaching 18.9 percent in 1989 and an all-time high of 19.7 percent in 1997. From the 19.6 percent shown for 2000, the ratio dropped quickly to 18.1 percent in 2001, and to 17.8 percent in the last three years.

Taxable Personal Income Tax Returns
Selected Taxation Years 1966 to 2004

Tax years	Number	Average income ($)	Tax as % of income
1966	6,276,579	5,193	10.3
1970	7,641,731	6,447	15.3
1975	8,491,745	11,974	15.3
1980	9,906,842	18,896	15.6
1985	11,247,093	25,652	16.7
1990	13,795,990	31,430	19.3
1995	14,026,670	34,686	19.3
2000	15,411,650	41,998	19.6
2004	16,172,670	46,445	17.8

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Income Tax and Customs Valuation

The CRA recently clarified why a transfer price developed for income tax purposes cannot be used for customs duty purposes. New *Information Circular* 06-1 (October 5, 2006), "Income Tax Transfer Pricing and Customs Valuation," details the factors that may cause divergent transfer-pricing and customs values when the CRA and the Canada Border Services Agency (CBSA) use different valuation methods for the same goods transferred internationally between related parties. The IC was issued after three years of public consultation. The analysis underscores that it is imperative that taxpayers' documentation for both customs valuation and income tax transfer-pricing purposes be both sound and consistent with the relevant statute.

The IC states that the CRA uses primarily the comparable uncontrolled price (CUP) method, and the CBSA uses primarily the transaction value method. The two methods' starting points are different, and their prescriptions for adjusting, adding, and deleting expenses vary significantly. When the two methods are compared, problems arise—for example, the "purchaser in Canada" for customs purposes and the "taxpayer" for income tax purposes may not be the same party; the determination of the comparable price (for transfer pricing) differs from the price paid or payable (for customs), and different adjustments are allowed; and price reductions after import are treated differently under the two methods.

In some situations, the resale method may be used to determine a transfer price; similarly, the deductive value method may be used for customs purposes. For both pricing methods, the starting point is the goods' resale price to an arm's-length party. However, the cost pools can be significantly different when costs are deducted to determine the transfer value. Specifically, for customs valuation expenses must be deducted regardless of whether they are included in operating expenses; costs that are not operating costs generally need not be considered when one is establishing a transfer price for income tax purposes.

The cost-plus method may be used when the CUP does not produce a reliable measure of an arm's-length price for transfer-pricing purposes. Under the hierarchy of methods set out for customs valuation, the computed-value method (CVM) may be used in certain circumstances. Although both the cost-plus method and the CVM begin with production cost, different treatment of other factors may result in the determination of two different prices.

If no other method can be applied, the residual method may be used for customs purposes, thus allowing the application of any other prescribed method in a "flexible manner," using guidance from the principles in the World Trade Organization Valuation Agreement. When no prescribed transfer-pricing methods can be applied, the CRA uses transactional profit methods such as the profit-split method and the transactional net margin method (TNMM). The profit-split method does not resemble any methods used by the CBSA, but the TNMM somewhat resembles the CVM. Moreover, because certain calculations differ between these methods and the methods used by the CBSA, the prices ultimately determined may also differ.

The IC discusses the CRA's advance pricing arrangement (APA) program, which helps taxpayers achieve transfer-pricing certainty in their transactions with non-arm's-length non-residents. Canadian customs officials generally accept transfer prices established through an APA, subject to adjustments mandated by customs legislation. The IC says that there is potential for more formal customs participation in the APA process to provide certainty regarding customs valuation of future imports.

The IC says that transfer-pricing documentation may be suitable for customs purposes and vice versa, but its overall tone suggests that reasons for different transfer-pricing and customs values are abundant and varied. In practice, transfer-pricing methods and documentation are generally acceptable for customs purposes subject to adjustments required—for example, for royalties and assists. As a cautionary note, the IC repeatedly states that import prices cannot be adjusted downward for customs purposes (as they can for transfer-pricing purposes).

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Owner-Manager Tips for the 2006 Year-End and Early 2007

Following are some tax issues that owner-managers may need to address before the 2006 year-end and in early 2007. (See also "Owner-Manager Year-End Tips," *Canadian Tax Highlights*, November 2006.)

Corporate Income

■ Corporate taxpayers subject to the small business rate may wish to defer income until after 2006 by maximizing 2006 discretionary deductions such as capital cost allowance in order to benefit from the increase in the federal small business threshold from $300,000 to $400,000 in 2007 and the decrease in the federal small business rate from 13.12 to 11.5 percent in 2008 and to 11 percent by 2009. Small business rates also decrease in Manitoba, New Brunswick, Prince Edward Island, and Saskatchewan in 2007.

■ Similarly, corporations taxed at the general rate may wish to defer income by maximizing 2006 discretionary deductions to benefit from future reductions: the federal general corporate income tax rate falls from 22.12 to 20.5 percent in 2008, to 20 percent in 2009, to 19 percent in 2010, and to 18.5 percent in 2011; the general rates also decline in New Brunswick in 2007 and in Manitoba and Saskatchewan in 2007 and later years.

■ Conversely, corporations in Quebec may wish to minimize discretionary deductions in 2006 and 2007 to maximize income taxed at the lower corporate income tax rates in effect in those years. The Quebec rate on active business income above $400,000 increases from 9.9 percent in 2006 to 11.4 percent in 2008 and to 11.9 percent in 2009.

Deadlines

■ Pay final corporate income and capital tax balances and all other corporate taxes imposed under the Act within two months after year-end (three months for some CCPCs).

■ File claims in respect of SR & ED expenditures or investment tax credits within 18 months after the year-end; the CRA can no longer waive the deadline.

Sale of Property

■ If eligible small business investments were sold in 2006, invest the proceeds in other such investments by April 30, 2007 to defer all or part of the capital gain.

■ If capital property was sold in 2006 in exchange for debt, the capital gain's recognition may be deferred by claiming a capital gains reserve for up to four years.

■ Structure the business so that it becomes or remains eligible for the $500,000 capital gains exemption.

Shareholder Loans

■ Re-evaluate whether the corporation should continue to pay deductible interest on shareholder loans to the corporation so as to reduce active business income to the $300,000 threshold (higher in some jurisdictions). The lower tax rate on eligible dividends may negate this strategy.

■ Repay shareholder loans from the corporation no later than one tax year after the amount is borrowed (exceptions apply).

Property Tax

■ To challenge a property tax bill, the company must appeal the property value assessment, generally received early in the year, before the mailing of the tax bill. (Ontario may not mail a property value assessment in 2007, but the appeal must be filed by March 30, 2007.)

■ If an Ontario company has a vacancy in a commercial or industrial facility in 2006, it may be able to claim a property tax refund by filing a request by February 28, 2007.

Tax Incentives

■ Ensure that new federal incentives are claimed for 2006. For example, the federal apprenticeship job creation tax credit is available on salaries and wages paid to apprentices after May 1, 2006.

■ Take advantage of provincial tax incentives and changes to these incentives. For example, Quebec allows an additional 100 percent deduction for employee transit passes whose cost the company has reimbursed; Manitoba has a hiring incentive for co-op graduates; Manitoba and Saskatchewan have enhanced manufacturing and processing investment tax credits; and British Columbia, Nova Scotia, Ontario, and Saskatchewan have enhanced media incentives.

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FIEs and NRTs; Child-Care Benefits

FIE and NRT rules' effective date deferred. Finance recently reintroduced legislation proposing changes to the taxation of income from foreign investment entities (FIEs) and non-resident trusts (NRTs) (Bill C-33; first reading November 22, 2006). The measures generally follow the draft proposals released for comment in 2005 except for the effective date: the measures generally take effect for taxation years beginning after 2006, not 2002. As a result, investors have until the end of 2006 to reconsider their FIE and NRT investments in light of these proposals. Investors who reported income and paid tax for 2003, 2004, and 2005 based on the proposed rules may be entitled to refunds.

Attribution rules and universal child-care benefits. Parents of children under age six who receive the new $100 per month universal child-care benefit (UCCB) should be aware that the Act is being amended so that the parent can transfer the payment to the child without attribution applying to income earned on the amount transferred. The attribution rule in subsection 74.1(2)—that any income or loss that a minor derives from property lent or transferred to him or her is included in the transferor's income for tax purposes—does not apply to income earned on child tax benefit amounts received; Bill C-28 (first reading October 18, 2006) also excludes income arising from UCCB amounts received.

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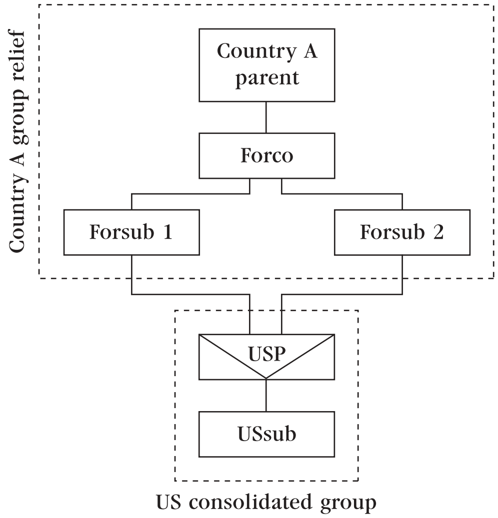
IRS Recharacterizes Repo

The IRS recently issued a legal memo dealing with a UK company that had used repo and reverse hybrid financing techniques for their US subs, techniques regularly used by Canadian corporations for their US operations. ILM 200645018 concluded that a transaction initially characterized for US tax purposes as a secured financing arrangement between a US corporation, its domestic sub, and a foreign lender could be subjected to further recharacterization under Code section 894. Thus, payments initially deemed to be interest payments from a US corporation to a related foreign entity were recharacterized under section 894 as dividend distributions.

In the structure illustrated in the accompanying figure, a parent corporation in country A wholly owns another country A corporation, Forco, which in turn wholly owns two country A subs, Forsub 1 and Forsub 2; all these corporations participate in country A group relief. Forsub 1 and Forsub 2 together own US Parent (USP), a partnership that elects to be taxed as a corporation for US purposes; but because it is still a fiscally transparent entity under the laws of country A, USP is a domestic reverse hybrid entity (DRH) under reg. 1.894-1(d)(2)(i). USP wholly owns a US corporation, USsub, which is included on USP's consolidated federal income tax return.

USP, USsub, and Forco entered into a secured financing arrangement pursuant to a series of agreements and



transactions whereby USsub issued a preferred share to Forco in exchange for cash. Forco agreed not to sell the preferred share to any third party; USP had the right to buy back the share for the same amount Forco paid to acquire it, and USP may also be required by Forco to buy the share after a certain period. The arrangement was intended to be treated for US tax purposes as a secured loan by Forco and a secured borrowing by USP—a repurchase or repo financing. It was also intended that USP be treated as the preferred share's owner and, consistent with secured financing treatment, that payments on the preferred share by USsub directly to Forco be treated first as non-deductible deemed dividend payments from USsub to USP and then as deemed interest payments from USP to Forco that are deductible payments by USP for US tax purposes and exempt from US withholding tax under the applicable treaty. For country A purposes, the transactions are treated as direct payments of dividends from USsub to Forco.

A general rule under reg. 1.894-1(d)(2)(ii)(B)(1) applies when (1) a US entity makes a payment to a related DRH (USP) that is treated as a dividend under either US law or the law of the jurisdiction of a related foreign interest holder in the DRH and that foreign interest holder is treated under its own domestic law as deriving its proportionate share of the payment; and (2) the DRH makes a US-tax-deductible payment to the related foreign interest holder (or to certain other related persons) on which US withholding tax is treaty-reduced. To the extent that the payment by the DRH does not exceed the payment made to it by the related domestic entity that is treated as derived by the related foreign interest holder, the payment by the DRH is treated for the purposes of the Code and any applicable treaty as a dividend distribution within the meaning of section 301(a). Furthermore, reg. 1.894-1(d)(2)(ii)(A) provides that generally an item of income paid by a DRH to its interest holder has the same character as it has under US law. As a result, the deemed interest payments from USP to Forco were treated as dividend distributions, and USP's interest expense deduction was disallowed. The IRS also ruled that because the applicable treaty allowed a withholding tax on dividends paid by a US corporation, the deemed dividend payments by USP to Forco attracted US withholding tax.

The IRS took no issue with a repo's being a secured financing transaction for US tax purposes. Instead, because the repo characterization created payments that were offside the reverse hybrid regulations, the IRS used the section 894 rules to shut down the transaction. ILM 200645018 also notes that USP subsequently rolled down the shares of USsub and the repo agreements to a new intermediary US holding company, which had the effect of taking USP (the DRH) out of the financing chain. As a consequence, the section 894 rules no longer applied and the benefits of the secured financing transaction were restored.

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Barbados on US Dividend List

The IRS recently announced (IRS Notice 2006-101, October 30, 2006) that Barbados has been formally added to the list of foreign countries that qualify for the 15 percent preferential US federal tax rate on dividends paid by a foreign corporation to US non-corporate shareholders. In 2003, the US federal tax rate was reduced to 15 percent on certain dividends paid by a US corporation and a qualified foreign corporation to US non-corporate shareholders. A qualified foreign corporation must, inter alia, have been formed in a foreign country that has a comprehensive tax treaty with the United States that includes an adequate exchange-of-information program. Notice 2006-101 formally acknowledges that the US-Barbados treaty now meets these requirements because the second protocol to the treaty became effective in December 2004.

Canada is also on the list of qualified foreign countries, but two additional tests must be met before dividends paid by a Canco qualify for the 15 percent tax rate: (1) the Canco must qualify for benefits under the Canada-US treaty's limitation-on-benefits article; and (2) the Canco must not be a passive foreign investment company (PFIC) in the year in which the dividend is paid or in the preceding year. In general, a PFIC is a foreign corporation that (1) is not a controlled foreign corporation (CFC) and (2) has excessive passive income or passive assets. If a Canco is a CFC (more than 50 percent owned by US citizens or residents), dividends paid by it generally qualify for the

15 percent rate, as does a gain from a sale or disposition of its stock recharacterized as a dividend under Code section 1248. However, a CFC's subpart F inclusions do not generally qualify for the low rate; this impediment, coupled with an inability to claim foreign tax credits for Canadian taxes paid on subpart F income of a CFC (with respect to shares held by US non-corporate shareholders), continues in some cases to encourage US non-corporate shareholders to use an Alberta or Nova Scotia unlimited liability company in lieu of a Canco to hold passive assets so as to be able to claim such foreign tax credits.

For dividends paid by a non-PFIC Canco to US shareholders, the 15 percent US tax rate combined with the availability of foreign tax credits for Canadian withholding taxes imposed on dividends (at 5 or 15 percent) normally results in little or no net US federal tax on the dividends. The fear that the Democrats might increase the 15 percent rate after they took control of the US Congress in the November 2006 elections has not been realized, and the new Democratic leadership has expressed no such intention.

Many a Canadian parent corporation uses a Barbados subsidiary to hold intellectual property rights or to facilitate the sale of goods to the United States, including sales to ultimate US customers and to its US subsidiaries. A Barbados sub is often formed as an SRL that elects to be treated as a disregarded entity or partnership for US federal tax purposes: the sub thereby opens the door to attempts at accessing certain benefits under the Canada-US treaty, most notably the PE protection for business profits. However, treaty protection for passive income such as royalties or interest payments received by an SRL is generally denied under section 894 because of the SRL's hybrid nature. Where possible, tax planning for the use of SRLs to sell goods into the United States normally includes an attempt to structure the sales to qualify as foreign-source income under the Code, a protective measure against any IRS attempt to extend the reach of section 894 to include active sales income or to otherwise deny benefits therefor under the Canada-US treaty.

Attempting to qualify for benefits under the US-Barbados treaty with respect to royalties or interest payments from US payers to Barbados IBCs or SRLs can be extremely difficult and often impossible if the Barbados entity is owned by non-Barbados residents and qualifies for preferential tax rates in Barbados. However, the addition of Barbados as a qualified foreign country for the purposes of the 15 percent US federal tax rate on dividends is welcomed for its impact on dividends paid to US shareholders by Barbados corporations that also meet the other requirements for qualified foreign corporation status.

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GST on Internet Subscription Fees

Because GST is designed to apply only to goods and services consumed in Canada, the Excise Tax Act (ETA) zero-rates many exports of goods and services. The only exported intangibles that are zero-rated are intellectual properties. In *Dawn's Place* (2006 FCA 349), the FCA held that membership fees paid by non-residents to access a Canadian-operated Web site were not zero-rated.

Dawn's Place operated an adult-content Web site that was accessible to Canadian residents and non-residents on payment of a membership fee; subscribers also had a right to download and store images or video on one computer. Dawn's Place did not charge GST on any of the membership fees paid; the CRA assessed on the basis that the fees were consideration for a taxable supply made in Canada. Section 10 of part V of schedule VI of the ETA zero-rates "a supply of an invention, patent, trade secret, trade-mark, trade-name, copyright, industrial design or other intellectual property or any right, licence or privilege to use any such property" to an unregistered non-resident recipient.

The TCC held that the membership fees paid by non-registered non-residents were zero-rated because Dawn's Place was supplying its subscribers with a right to use copyrighted material that it owned, placing supplies prima facie within section 10; the court referred the matter back to the minister to determine which subscribers were non-resident non-registrants. The FCA agreed that the Web site content was subject to copyright, but found that the character of the supply was mere access to the Web site, not the use of the copyright. Thus, the supply was outside the scope of section 10. According to the FCA, the grant to store material on a subscriber's computer only gave subscribers permission to make a single copy, and was a necessary incident of the supply that did not change its essential nature. Section 10 applied only to situations where copyright is transferred to another person or where one person is entitled to use that copyright.

The FCA thus rejected the argument that section 10 applies to any supply of copyrighted work if permission to copy that work is granted (provided that other requirements are met). The FCA said that section 10 applied only to the supply of a bundle of rights that makes up the copyright, and not to transactions where incidental copying of copyrighted material was permitted. In support of this interpretation, the FCA referred to the most recent commentary on article 12 (royalties) in the OECD model treaty, which contains a functional test that focuses on identifying the essential consideration for which the payment is made: "Thus, in a transaction that in essence is an acquisition of data or images transmitted electronically, any incidental copying is merely the means by which the data is captured and stored. The essential consideration for the payment . . . is the data, not the use of the copyright, even though the copyright is incidentally used." The court declined to base its decision on the doctrine of neutrality—zero-rating the online fees would be similar to zero-rating exported magazines—because the doctrine was a guideline for the development of tax policy and the court had no basis for determining whether or to what extent section 10 was intended to give effect to that doctrine.

Some academics have suggested that a licensing of copyright is the implicit result of granting access to a Web site. With the evolution of the Internet and electronic commerce, the FCA's decision may be too narrow a reading of that zero-rating provision. The decision's effect runs counter to the purpose of the part V zero-rating provisions, which is to relieve from GST supplies used or consumed outside Canada by non-residents in order to maintain the competitiveness of Canadian businesses in the global marketplace. Without other planning, the *Dawn's Place* decision could render Canadian Web sites less competitive than their global competitors by 6 percent—the amount of the GST.

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Securities Lending Arrangements

Under a securities lending arrangement (SLA), the borrower is required to compensate the lender for amounts paid on the security—such as a dividend—during the term of the loan. A dividend compensation payment is deemed to be a taxable dividend.

Proposed subsection 260(5) provides that the deeming rule (now in proposed subsection 260(5.1)) applies where an amount is received (1) under an SLA from a Canadian resident, or from a non-resident that paid it in the course of carrying on a business in Canada through a Canadian PE, or (2) from or by a Canadian-resident registered securities dealer in the ordinary course of a business of trading in securities. These conditions are essentially the same as those already in place.

Existing subsection 260(6) allows a two-thirds deduction for a dividend compensation payment to a borrowing registered securities dealer, including a partnership whose members are all registered securities dealers. Proposed subsection 260(6) also allows a deduction to any borrower for non-dividend compensation payments if the borrowed security was disposed of and the gain or loss was included in income; otherwise, the deduction is limited to an amount, to which the compensation payment relates, that has been included in income of the borrower or a related party. New subsections 260(11) and (12) deal with partnerships. A corporate or individual partner is treated as receiving its specified proportion of any dividend compensation payments received by the partnership. Treatment of the corporation (or individual) and the partnership as the same person is intended to attribute the partnership's reasons for entering into the arrangement to the partners. A corporate partner is also treated as being obliged to pay its specified proportion of a dividend compensation payment that is received from the partnership and that is deemed received as a taxable dividend. For the purpose of the dividend refund rules in section 129, a corporate partner is deemed to have paid its specified proportion of the partnership's non-deductible dividend compensation payment. An individual partner may deduct dividend compensation payments deemed received by another person as a taxable dividend. A partner's specified proportion reflects its share of the partnership's total income or loss for the period; if that income or loss is nil, the proportion is computed as if the partnership had $1,000,000 of income.

Non-SLA compensation payments receive different treatment. A technical interpretation (CRA document no. 2001-0087365, September 11, 2001) considered the treatment of compensation payments made to a security lender by a security borrower on the completion of a short sale. The SLA rules did not apply because the securities were not qualified securities. The TI said that a short sale is on capital account if it is entered into to hedge a taxpayer's position with respect to shares held on capital account, and the borrower's disposition of the new securities that were purchased to settle its obligation to the security lender yields a capital gain or loss. The TI said that there was no reasonable basis on which to conclude that the borrower's compensating payments formed part of the new securities' cost, and thus the payments were not included in computing the borrower's gain or loss on the new securities' disposition. And because the transaction was on capital account, the payments were not deductible in computing income. However, if interest income earned on the cash collateral held by the lender generally exceeds the short dividends that must be paid out in respect of the short sales, it is arguable that the borrower earns income from the transaction that encompasses the short sale, the lodging of cash collateral, the payment of short dividends, and the closing out of the short position.

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CANADIAN TAX Highlights

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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Foreign Tax News

Status of Canada's Tax Treaties

In force (86)
Algeria
Argentina
Armenia
Australia
Austria
Azerbaijan
Bangladesh
Barbados
Belgium
Brazil
Bulgaria
Cameroon
Chile
China (PRC)[1]
Croatia
Cyprus
Czech Republic
Denmark
Dominican Republic
Ecuador
Egypt
Estonia
Finland
France
Germany
Guyana
Hungary
Iceland
India
Indonesia
Ireland
Israel
Italy
Ivory Coast
Jamaica
Japan
Jordan
Kazakhstan
Kenya
Korea, Republic of
Kuwait
Kyrgyzstan
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Nigeria
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Philippines
Poland
Portugal
Romania
Russia
Senegal
Singapore
Slovak Republic
Slovenia
South Africa
Spain
Sri Lanka
Sweden
Switzerland
Tanzania
Thailand
Trinidad & Tobago
Tunisia
Ukraine
United Arab Emirates
United Kingdom
United States
Uzbekistan
Venezuela
Vietnam
Zambia
Zimbabwe

Signed but not yet in force (6)
Finland
Gabon
Italy
Korea, Republic of
Lebanon
Mexico

Under negotiation/ renegotiation (14)
Barbados
Bolivia
Colombia
Costa Rica
Cuba
Egypt
Greece
Madagascar
Malaysia
Namibia
Serbia and Montenegro
Singapore
Turkey
United States

[1] This treaty does not apply to Hong Kong.
Source: Finance Canada (www.fin.gc.ca).

Treaties

China and **Pakistan** signed a free trade agreement on November 24, 2006. Tariffs will be reduced for 85 percent of dutiable goods in the first five years and eliminated for 30 percent in the next three years.

Tax Havens

Canada's House of Commons Finance Committee said in its recommendations for inclusions in the 2007 budget that Canada should crack down on the use of tax havens. A Statistics Canada report of last year indicated that Barbados, Ireland, Bermuda, the Cayman Islands, and the Bahamas are the most popular tax havens; Canadians hold an estimated $88 billion offshore.

European Union

The Economic and Financial Affairs Council agreed to restructure VAT legislation to enhance clarity and rationality, and extended special VAT arrangements for e-commerce to the end of 2008. Measures aimed at combating VAT fraud will be developed for presentation in June 2007.

The European Union adopted a communication on the more effective use of R & D tax incentives to promote R & D investment, job creation, and economic growth. In 2002, the European Union set a 2010 target for R & D investment of 2 percent of GDP. The communication notes that the diversity of recent incentives from 15 member states increase complexity and impede trans-European collaboration. Incentives restricted to domestic activities are incompatible with the EU treaty; incentives applicable to a specific group or sector may be incompatible state aid.

United States

Treasury has updated the US model treaty and technical explanation for the first time in 10 years. Updated IRS procedures for seeking US competent authority relief under treaties (Rev. proc. 2006-54, November 17, 2006) include general requirements and special procedures for small adjustments; for correlative relief for foreign-initiated adjustments; for a simultaneous IRS appeals procedure for the same issue under the competent authority procedure; and for relief to adjust a taxpayer's accounts and repatriate amounts following an allocation of income between US and foreign corporations under section 482.

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