CANADIAN TAX Highlights

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Lending to Trusts: Subsection 75(2)

If a trust property is held on condition that it may revert to the person from whom it was received, subparagraph 75(2)(a)(i) applies, and any income or loss from the property and any taxable capital gain or allowable capital loss from its disposition is attributed to that person. No intention to benefit another person is required, and an unwary taxpayer may inadvertently fall within the rule.

Because of the paucity of jurisprudence on subsection 75(2), practitioners have had to rely on CRA administrative positions for guidance in setting up compliant trust structures. Regarding loans to trusts, the CRA has said that a "genuine loan" of cash to a trust will not by itself result in the application of subsection 75(2) if the loan is outside and independent of the trust's terms. The CRA also says that the rule is invoked by any loan, genuine or otherwise, of an income-producing property other than cash.

The CRA has taken a strict view of what constitutes a "genuine loan" and, in the absence of an all-inclusive statement delineating when a loan can be considered genuine, has listed the hallmarks of a genuine loan as (1) a written and signed acknowledgment of the loan by the borrower and an agreement to repay it within a reasonable period of time; (2) evidence that the borrower gave security for the loan; (3) evidence that interest on the loan was paid; and (4) evidence that actual repayment was made.

The recent TCC decision in *Howson* (2006 TCC 644) considers the application of subsection 75(2) to a loan made to a trust. The taxpayer was a South African who planned to move to Canada with her husband and children. As part of their departure planning, the Howson trust was settled by a friend of the Howson family in order to establish a trust structure intended to qualify for the 60-month tax exemption for new Canadian immigrant beneficiaries—in this case the taxpayer, her husband, and their children. In June 1994, the taxpayer lent ZAR748,000 to the Howson trust. The loan was not documented at the time, but it was reflected in the Howson trust's financial statements and on T1141 forms filed on behalf of the taxpayer. In June 1997, the taxpayer and the Howson trust documented the loan in writing. In July 1994, the taxpayer became a resident of Canada for Canadian tax purposes. The minister reassessed the taxpayer's 1996, 1997, and 1998 taxation years to include in her income the income that was earned by the trust and that was attributable to the loan.

The Crown conceded that a genuine loan was not caught by subsection 75(2), and the Tax Court agreed: "[A] *bona fide* loan is, on its face, not subject to reversion by the terms of the trust. It returns to the lender by operation of the loan itself and the law of creditor rights." The Crown argued that the loan was not a genuine loan but rather a contribution to the trust corpus and could therefore revert to the taxpayer in her capacity as a capital beneficiary. Presumably the Crown, following the CRA's administrative position, had concluded that the loan was not a "genuine loan" and did not exist because no interest was paid on it, no contemporaneous written agreement was entered into, and no security was provided.

On the basis of the oral testimony of the taxpayer and her husband, the written agreement (although it was not contemporaneous), the trust's financial statements, and the lack of any evidence suggesting that the loan was not a loan, the court found that the evidence overwhelmingly supported the taxpayer's position that she lent the funds to the Howson trust. The court stated that a finding that a loan existed does not require that interest be charged, and that the trust's providing security would make little commercial sense because the Howsons were the only beneficiaries.

The decision confirms that subsection 75(2) does not apply to loans to trusts and stands for the proposition that proving the existence of a loan does not require that the taxpayer meet the CRA's exacting administrative standards. *Howson* also calls into question the correctness of the CRA's position that a bona fide loan of income-producing property other than cash triggers the application of subsection 75(2). If one accepts the court's conclusion that a bona fide loan is not subject to reversion by the terms of the trust but returns to the lender by operation of the loan itself and

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the law of creditor rights, then the nature of the loaned property should be irrelevant.

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Appeals and Tax in Dispute

In a report of the monthly tax practitioners' meeting (December 12, 2006), the CRA's Appeals Branch breaks down into several categories the cases that it has dealt with over the past five years, providing the number of cases and the amount of disputed tax in each category. The CRA also reports that more than 6,600 cases are currently before the courts, and provides statistics on fairness requests.

According to the CRA, the Appeals Branch receives 45,000-65,000 objections per year relating to income tax, GST/HST, excise tax, CPP, and EI. About 92 percent are resolved administratively; of the 8 percent of objections appealed to the courts, one-third are withdrawn by the taxpayer, one-third are settled before being heard by the courts, and one-third are heard. For example, the Appeals Branch dealt with 53,741 cases in 2005-6—about 90 percent (48,201) related to T1s; about 1 percent (388) related to large corporations' T2s; and about 5 percent (2,728) related to small and medium-sized corporations' T2s. The remaining 4 percent were related to investigations, SR & ED, tax avoidance, and "other."

As the table shows, the 2005-6 cases involved just over $2 billion of tax in dispute. Large corporations' T2s represent only about 1 percent of the cases but about 39 percent of the total tax in dispute in all cases; the 5 percent of cases involving other corporations' T2s represent about 18 percent of disputed tax. The 90 percent of cases involving T1s represent only about 21 percent of disputed tax. Of the $2 billion of tax in dispute, the CRA says that it "retained" about 59 percent (about $1.2 billion) and "relinquished" about 41 percent (about $800 million) to taxpayers.

The Appeals Branch also reports that as of November 29, 2006, 6,613 cases were before the courts, involving about $1.83 billion in disputed federal income tax and GST. Of these cases, the 92 percent (6,090) at the TCC involved about 86 percent ($1.57 billion) of the total amount in dispute for all court levels. About 40 percent of the TCC cases (2,669) were heard under the informal procedure but involved only about 1.4 percent of the tax in dispute; the remaining 60 percent (3,421) were heard under the general procedure and involved about 84 percent of the tax in dispute. A further 339 cases involving about $83 million were heard at the Federal Court, 183 cases involving about $171 million were heard at the FCA, and one case involving $6 million was heard at the SCC.

The CRA says that it approved about 36,000 fairness requests in 2005-6, but it does not say how many requests it denied. About $626 million in penalties and interest were waived under the fairness provisions during the period.

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Appeals and Tax in Dispute

Type of taxpayer	Number of cases (2005-6)	Amount in dispute ($ millions)	Percentage of total amount
T1s individual	48,201	422	20.7
T2s large corporations	388	788	38.7
T2s other corporations	2,728	360	17.7
Other categories	2,424	468	22.9
Total	53,741	2,038	100.0

Agents' GST Rebates

Under the Excise Tax Act, GST is imposed on the value of goods imported into Canada and is payable by every person liable under the Customs Act to pay customs duty. Frequently, the GST is actually paid first by the customs broker, who acts as the importer's agent and is usually reimbursed by the importer. In the recent *United Parcel Service Canada Ltd.* case (2006 TCC 450), the TCC held that if an agent overpaid GST on the importer's behalf, the agent was entitled to claim the rebate.

United Parcel Service Canada Ltd. (UPS) carried on business as a courier, bringing shipments from foreign locations into Canada for delivery to Canadians. Under the Customs Act and the ETA, such shipments sometimes attract Canadian customs duties and almost always attract GST, both payable at the border. UPS acted as the licensed customs broker and thus paid those customs duties and GST; normally, it sought reimbursement for these amounts from its customers. However, on occasion it mistakenly overpaid GST. Rather than seeking a reimbursement of these overpayments from its customers and having them claim GST ITCs or rebates themselves, UPS had the customers sign a credit note effectively authorizing UPS to claim a GST rebate for the amount of the overpayment. Further, if a customer had an active brokerage account with UPS, the two parties signed a general agency agreement constituting UPS as the customer's agent for the purposes of dealing with the Canada Border Services Agency and paying GST. The minister disallowed the rebate UPS claimed under subsection 296(2.1), and also assessed interest and penalties.

In the TCC, the Crown argued that the GST was paid by UPS on behalf of its customers and only the customers were entitled to any GST overpayments. The Crown also argued that UPS had a variety of ways at its disposal to recover the cost of the overpayments, but claiming a GST rebate was not one of them. The TCC disagreed, mainly because UPS made the GST overpayments as its customer's agent and was jointly and severally liable for the amount of GST payable. Also, on principles of fairness UPS should be entitled to recover the overpayments because it alone paid the money and was out of pocket. Furthermore, the Customs Act and the ETA seemed to authorize that approach. In interpreting those acts, the court noted that it was important to follow an approach that achieves a sensible, practical, and common-sense result that is consonant with the legislative scheme. Thus, the court held that it was consistent with the scheme of the ETA to allow a person who had paid the GST, and had an obligation to pay it, to recover any amount of overpayment.

Turning to the specific provisions of the Customs Act, the court noted that all persons who report imported goods, and their agents, are jointly and severally liable for duties levied on the goods. Further, ETA section 212 imposes GST on every person who is liable under the Customs Act to pay duty on imported goods: clearly, UPS was jointly and severally liable for the duties under the Customs Act and was therefore liable to pay GST. The court said that further elaboration or comment was unnecessary and that the provisions and the case law were clear: "UPS was a person liable to pay the GST on the imported goods. It overpaid it and was entitled to the rebate which it could claim under the mechanism of subsection 296(2.1)."

The result is good news for taxpayers. If an agent has overpaid tax and is obliged to pay the tax, it follows that the agent should be entitled to a rebate not claimed by the principal. For customs brokers and other similar agents, this reduces administrative headaches in recovering GST overpayments on imports, because the principal need not submit the necessary documentation itself. On the other hand, a more detailed analysis might have shed more light on the important and complex issues of agents and their eligibility for ITCs and GST rebates, etc. An agent's eligibility for ITCs and GST rebates should follow mainly from an application of agency law principles (such as the agent's standing in the principal's shoes) and not an approach that emphasizes "a sensible, practical and common sense result." The case has been appealed to the FCA. It will be interesting to see whether other taxpayers attempt to extend it to other fact patterns in which an agent overpays tax.

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Non-Taxable Individuals

The 2006 edition of the CRA's annual analysis of income statistics, available on the Web at http://www.cra-arc.gc.ca/agency/stats/gb04/pst/final/tables-e.html, provides surprising information on the number of individuals who paid no income tax in 2004. Of the 23.5 million tax returns filed in that year, 7.3 million showed no tax payable. Most significantly, only 1,820 of those non-taxable returns reported total income over $100,000.

Non-taxable returns were last examined in 2004 (see "Non-Taxable Individuals Again," *Canadian Tax Highlights*, September 2004); 3,300 high-income non-taxable returns were reported for the 2002 tax year, equal to 0.5 percent of all returns over $100,000. The 2004 statistics indicate that of the 0.2 percent of high-income individuals who paid no tax, 1,580 reported assessed incomes between $100,000 and $250,000, and only 240 had incomes over $250,000. (Because the CRA statistics round all counts of returns to the nearest 10, such small numbers are approximate.)

The table is modelled on the table in the earlier article, and shows that most non-taxable returns are concentrated at the low end of the income scale. In 2004, 79.5 percent of these returns showed incomes less than $15,000, compared with 77.4 percent two years earlier. Many individuals in this income range filed tax returns only in order to collect refunds of tax owing or to qualify for tax credit programs provided by the federal and provincial governments. Those with incomes between $15,000 and $25,000 accounted for 17.9 percent of the non-taxable returns filed, up from 14.1 percent in 2002.

The table shows that only 3.3 percent of all employment income was accounted for by non-taxable individuals, but nearly 17.5 percent of retirement income—old age security, Canada and Quebec pension plans, and other pensions or

Non-Taxable Returns Statistics as a Percentage of All Returns Statistics, 2004 Tax Year

	By income class					
	Under $15,000	$15,000 to $25,000	$25,000 to $50,000	$50,000 to $100,000	$100,000 and over	Total
Non-taxable returns . . .	79.5	17.9	1.7	0.3	0.2	31.3
Employment income . . .	2.5	0.5	0.2	..	..	3.3
Retirement income . . .	10.8	5.8	0.7	0.1	..	17.5
Exempt income . . .	59.8	15.5	5.5	0.5	0.2	81.6

.. Less than 0.1 percent.

superannuation—was received by those who paid no tax. Over 81.6 percent of exempt income, which is made up of workers' compensation, social assistance, and net federal supplements, was reported by individuals who paid no tax; three-quarters of that total exempt income on non-taxable returns was reported by those with incomes below $25,000.

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ACB: Legislative Surprise

Two surprise measures in the November 9, 2006 notice of ways and means motion (now Bill C-33) effectively deny an adjusted cost base (ACB) step-up (1) on a conversion of contributed surplus into paid-up capital (PUC), and (2) on the issue of shares as a stock dividend, to the extent that the resulting deemed dividend is deducted from the recipient's income under subsection 112(1).

The first measure seems to be directed at situations where contributed surplus is created on a rollover to a corporation of property with an FMV exceeding its ACB. The consequent contributed surplus booked for accounting purposes cannot subsequently be used to increase the ACB of the shares issued by the corporation via a PUC increase. Corporate law generally allows a stated capital increase from retained earnings or surplus accounts of the corporation.

The second measure seems to have broader application: it simply denies ACB recognition when shares are issued as a stock dividend—out of retained earnings or contributed surplus—and seems directed at the use of a stock dividend as a mechanism to increase a shareholder's ACB. Corporate law generally appears not to limit the amount of a dividend that a corporation can pay as long as the solvency test is met.

Both measures apply if a dividend was deducted under subsection 112(1) and therefore was not subject to subsection 55(2), perhaps suggesting that Finance does not consider subsection 55(2) to be fully effective in preventing abusive situations involving dividends. One casualty of these new measures may be safe-income planning, which frequently uses stock dividends to increase the ACB of shares of a target corporation that is about to be sold. Finance officials indicate informally that the new measures were not directed against safe income planning, but it is not yet certain whether this view will become an official clarification.

Owing to the broad impact of these new measures and the lack of guidance on their specific intended target situations, it is not clear whether situations not directly covered by the new rules are considered to be abusive. For example, can a shareholder receive a cash dividend (not subject to subsection 55(2)) that is subsequently recapitalized in the shares' PUC? What if a shareholder simply receives such a cash dividend in excess of retained earnings and does not invest it back into the corporation? What if PUC is increased with retained earnings or other surplus accounts such as appraisal surplus? One hopes that the government will clarify its position as soon as possible.

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US Foreign Portfolio Investment

U.S. Taxation of Foreign Portfolio Investors, by Leonard Schneidman (Boulder, CO: Boulder Publishers) provides an in-depth focus on US taxation for a foreign investor in the US capital markets. The publication is sold as a service updated monthly.

■ The text details the seven key areas relevant to non-US nationals seeking to earn US interest, dividends, and trading gains. The author recaps the rules and regulations and provides planning tools and real-world examples needed to determine investor classification; the taxation of interest, dividends, and trading gains; withholding tax requirements; and the reporting, disclosure, and exchange of information required by the IRS. The two areas most problematic for non-US nationals—the determination of whether they are engaged in a trade or business in the United States and the structuring of an inbound investment transaction—are covered in depth.

■ Foreign investors face the loss of US tax benefits if they engage in a trade or business while conducting their investment activities. The author carefully sets out rules that separate "investing" (long-term appreciation due to increase in value of the corporate enterprise) from "trading" (seeking profit on short-term fluctuations of value in the marketplace). He explains why investing does not constitute being engaged in a trade or business, but trading does. The Code's specific statutory safe harbours for foreign investors who trade on their own account in stocks, securities, or commodities are described in detail.

■ A separate chapter describes the structuring of inbound transactions, including hedge funds, which have enjoyed a spectacular rise as the pooled investment vehicle of choice in the United States for sophisticated investors, both domestic and foreign. Schneidman's service is the only international tax publication to focus on the tax challenges faced by foreign portfolio investors using these structured transactions.

■ The general 30 percent tax on US-source interest is discussed; the numerous exceptions make taxability to a foreign investor more a matter of poor planning than Code design. Dividends also attract the full rate, which may be treaty-reduced; derivatives such as equity swaps may produce the economic equivalent of dividends without US tax.

■ The complex withholding requirements imposed on payers of US-source income to a foreign investor are explained: the income's beneficial owner must identify his US or foreign status and classification (individual, corporation, partnership, etc.) to the withholding agent.

■ A number of rules govern how a foreign investor reports his US-source income, discloses his ownership, and exchanges information with his own country. The investor may encounter a number of US tax forms relating to taxpayer identification, withholding of tax and reporting of income, and estate and gift taxes. Other non-tax US information reports may apply, including the new disclosure requirements resulting from the passage of the Patriot Act, which touches foreign portfolio investors by virtue of its "know your customer" rules. Hedge funds are valued by their investors for their secrecy as well as for their investment return, but they no longer accept anonymous investors.

■ The growing trend worldwide is to greater disclosure of tax information. For example, the European Union's Tax Package includes an automatic exchange of information and taxation of cross-border interest payments to EU-resident individuals. Their investments in the US market may be indirectly affected, because the tax package's "equivalent measures" requirements may increase pressure on the United States to require reporting to the IRS of bank deposit interest paid to non-resident aliens.

■ The implications of the transfer taxes (estate and gift taxes) that may be imposed on non-resident aliens holding US portfolio investments at the time of death are discussed. US bilateral estate tax treaties with 17 foreign countries seek to avoid double taxation of the estate caused by different bases for the imposition of death taxes.

■ An included CD-ROM can be used to search both the book and all relevant IRS documentation and filing instructions, as well as to relate the book's commentaries to specific IRS filing requirements. A second CD-ROM includes the book's table of contents and index in seven languages: Chinese, English, French, German, Japanese, Russian, and Spanish.

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Tax Shelter Update

Two apparently irreconcilable tax shelter decisions, *Maege* (2006 DTC 3193) and *Baxter* (2006 DTC 2642), have been appealed to the FCA and will likely be heard consecutively. (See "No Tax Shelter Advice," *Canadian Tax Highlights*, June 2006.) Questions presented at the 2006 CRA Round Table touched briefly on the two decisions.

Maege and *Baxter* represent conflicting views on the interpretation of the "tax shelter" definition in subsection 237.1(1). *Baxter* adopted the more traditional legal meaning—representations as statements or actions meant to induce a person to enter into a contract; such representations must be made directly to the taxpayer by a third party. In contrast, *Maege* held that statements or representations need not be explicit or even made by a third party for the taxpayer to rely on; the court applied a more convoluted, theoretical construct whereunder the individual taxpayer was said to have made the offending representation to herself. The *Baxter* interpretation seems more consistent with the scheme of subsection 237.1(1) (which primarily deals with the registration and identification of tax shelters) as well as prior case law such as *Will-Kare Paving & Contracting* (2000 DTC 6467). In *Will-Kare*, the SCC stated that where a phrase in the Act has a legal meaning and an ordinary meaning, the legal meaning is to be preferred.

At the 2006 Round Table, when asked about the effect of these conflicting cases on its administrative position with respect to tax shelters, the CRA wisely responded that its position will remain unchanged until after the FCA has rendered judgment. In a follow-up question, the CRA was asked whether the cost of a tax shelter includes interest expense relating thereto. The questioner noted that at the 1989 Round Table, the CRA had stated that interest and other expenses are included in the numerical test in determining whether a particular investment was a tax shelter (see the earlier article cited above). At the 2006 Round Table, the CRA said that currently it did not consider interest to be part of the cost of a tax shelter, but interest was clearly relevant on the expense side of the numerical test. Except in certain defined circumstances, the concept of cost in the Act does not include related expenses; in our view, the CRA's interpretation is correct and consistent with the Act. However, it is difficult if not impossible to reconcile *Maege* and *Baxter*, and it is hoped that the FCA decisions and then CRA administrative practice will clearly eschew *Maege* in favour of the time-honoured approach in *Baxter*.

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New Dividend Tax Regime: Provincial and Territorial Update

All provinces and territories (except Nunavut) have responded to federal draft legislation that introduces a new tax regime to reduce personal taxes on eligible dividends. Six of these jurisdictions have also increased their dividend tax credits on non-eligible dividends: Saskatchewan's increase is not effective until 2007, and Manitoba and Quebec

Table 1 Dividend Tax Credit Rates

		Type of dividend								
	All,	Non-eligible				Eligible				
	2005	2006	2007	2008	2009	2006	2007	2008	2009	2010
					percent					
AB	6.40	6.00	5.50	4.50	3.50	7.50	8.00	9.00	10.00	10.00
BC	5.10	5.10	5.10	5.10	5.10	12.00	12.00	12.00	12.00	12.00
MB	5.00	4.87	3.67	3.67	3.67	11.00	11.00	11.00	11.00	11.00
NB	3.70	3.70	3.70	3.70	3.70	12.00	12.00	12.00	12.00	12.00
NL	5.00	5.00	5.00	5.00	5.00	6.65	6.65	6.65	6.65	6.65
NS	7.70	7.70	7.70	7.70	7.70	8.85	8.85	8.85	8.85	8.85
ON	5.13	5.13	5.13	5.13	5.13	6.50	6.70	7.00	7.40	7.70
PE	7.70	6.50	6.50	6.50	6.50	10.50	10.50	10.50	10.50	10.50
QC*	10.83	8.00	8.00	8.00	8.00	11.90	11.90	11.90	11.90	11.90
SK	8.00	6.00	6.00	6.00	6.00	11.00	11.00	11.00	11.00	11.00
NT	6.00	6.00	6.00	6.00	6.00	11.50	11.50	11.50	11.50	11.50
NU	4.00	4.00	4.00	4.00	4.00	na	na	na	na	na
YK	5.86	4.45	4.45	4.45	4.45	11.00	11.00	11.00	11.00	11.00

* For dividends paid or deemed to be paid after 2005 and before March 24, 2006, Quebec's rate is 10.83 percent for both non-eligible and eligible dividends.
na Not announced.

Table 2 Top Combined Personal Tax Rates

		Type of dividend								
	All,	Non-eligible				Eligible				
	2005	2006	2007	2008	2009	2006	2007	2008	2009	2010
					percent					
AB	24.08	24.58	25.21	26.46	27.71	18.18	17.45	16.00	14.55	14.55
BC	31.58	31.58	31.58	31.58	31.58	18.47	18.47	18.47	18.47	18.47
MB	35.08	35.25	36.75	36.75	36.75	23.83	23.83	23.83	23.83	23.83
NB	37.26	37.26	37.26	37.26	37.26	23.02	23.02	23.02	23.02	23.02
NL	37.32	37.32	37.32	37.32	37.32	32.52	32.52	32.52	32.52	32.52
NS	33.06	33.06	33.06	33.06	33.06	28.35	28.35	28.35	28.35	28.35
ON	31.34	31.34	31.34	31.34	31.34	25.09	24.64	23.96	23.06	22.38
PE	31.96	33.61	33.61	33.61	33.61	24.44	24.44	24.44	24.44	24.44
QC*	32.81	36.35	36.35	36.35	36.35	29.69	29.69	29.69	29.69	29.69
SK	28.33	30.83	30.83	30.83	30.83	20.35	20.35	20.35	20.35	20.35
NT	29.65	29.65	29.65	29.65	29.65	18.25	18.25	18.25	18.25	18.25
NU	28.96	28.96	28.96	28.96	28.96	na	na	na	na	na
YK	28.64	30.49	30.49	30.49	30.49	17.23	17.23	17.23	17.23	17.23

* For dividends paid or deemed to be paid after 2005 and before March 24, 2006, Quebec's rate is 32.81 percent for non-eligible dividends and 28.61 percent for eligible dividends.
na Not announced.

tied their increases to reductions in their small business rates. Only Nova Scotia and Newfoundland and Labrador have not harmonized with the new federal rules; by keeping their provincial top personal rate on eligible dividends at approximately the same level as their top personal rate on non-eligible dividends, these provinces apparently intend to preserve their share of provincial taxes. (See "New Dividend Tax Regime," *Canadian Tax Highlights*, August and October 2006.)

Tables 1 and 2 compare dividend tax credit rates and top combined personal income tax rates on non-eligible and eligible dividends. Table 2 shows that in 2006, Alberta had the lowest combined rate on non-eligible dividends (24.58 percent) and the Yukon had the lowest combined rate on eligible dividends (17.23 percent). In 2010, when the changes are fully phased in, Alberta will have the lowest top combined tax rate on both non-eligible (27.71 percent) and eligible (14.55 percent) dividends. Table 2 also shows that in all years Newfoundland and Labrador has the highest top combined rate on non-eligible (37.32 percent) and eligible (32.52 percent) dividends.

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New US Passport Rules and Expatriates

Beginning January 23, 2007, a US citizen travelling by air between the United States and Canada, Mexico, Central America, South America, the Caribbean, or Bermuda must present a valid US passport or Air NEXUS card to enter the United States. The same requirement may come into effect as early as January 2008 for a US citizen travelling between the United States and those countries by land or sea. These new travel restrictions are a result of recommendations made by the 9/11 Commission, and are designed to enable US Customs and Border Protection (CBP) to screen most passengers arriving in the United States from foreign travel points in order to intercept travellers who (1) are identified as or suspected of being terrorists or having affiliations with terrorist organizations, (2) are the subject of active warrants for criminal activity, (3) are currently "inadmissible" or have previously been deported, or (4) otherwise have been identified as potential security risks or raise law enforcement concerns. Despite the express national security purpose, the new passport requirement may have ancillary US tax consequences, particularly for US citizens living in Canada.

The US-tax expatriation regime applies to a US citizen who renounces his citizenship and who meets one of three objective tests on the date of expatriation: (1) the individual's net worth is US$2 million or more; (2) his average US tax liability over the prior 5 years was US$136,000 (for expatriations in 2007); or (3) he fails to certify, under penalty of perjury, that he has complied with his US tax-filing obligations for the prior five years. (The regime also applies to an individual who was a lawful US permanent resident in at least 8 of the preceding 15 years and surrendered his green card.) If the expatriating US citizen meets any of these tests, certain US income, estate, and gift tax consequences from which an expat is normally exempt may apply during the 10 years following expatriation. In addition, the expat is treated as a US citizen, fully taxable on worldwide income, if he is physically present in the United States for more than 30 days in any of the 10 calendar years after expatriation.

Narrow exceptions may apply to an expatriating citizen (not a long-term green-card holder) who otherwise meets the average tax liability or net worth tests, but the expat must certify his US tax compliance (and have in fact filed for the past 5 years) and must comply with initial reporting requirements, including filing form 8854 ("Initial and Annual Expatriation Information Statement") and providing notice of expatriation to the Secretary of State. An exception is available for an expatriating citizen who (1) was born a dual citizen of the United States and another country, (2) continues to be a citizen of the other country, and (3) has had no substantial contacts with the United States. In this context, having substantial contacts with the United States means that the individual (1) was never a US resident under Code section 7701(b) tests (including meeting the mechanical "substantial presence" test), (2) has never held a US passport, and (3) was not present in the United States for more than 30 days during any calendar year in one of the 10 years preceding the individual's loss of citizenship. The requirement of never having held a US passport may now become more of an issue given the new rules requiring passports for US citizens travelling abroad.

An individual may be a dual citizen of the United States and Canada if, for example, he was born in the United States to Canadian parents. However, such an individual may not realize that he is a US citizen. When he applies for a Canadian passport and names the United States as his place of birth, he creates a record of his US citizenship that will appear in the passport. When he later uses the Canadian passport to enter the United States, CBP will probably notice that the individual is actually a US citizen, and in light of the new passport requirements will advise him that he must obtain a US passport to enter the United States. Many individuals who find themselves in these circumstances will obtain a US passport because it facilitates entry into the United States, but they will do so without considering the US tax implications of obtaining the passport. Once the new passport rules go into effect, such an individual may or may not be required to obtain a US passport; it is unclear whether the new rules require a US citizen who holds a Canadian passport to also obtain and present a US passport to enter the United States. Of course, once an individual obtains a US passport, he loses the ability to renounce his US citizenship and to qualify for the dual citizenship exception to the expat tax regime, because the exception requires that the dual citizen never have held a US passport. Accordingly, a US citizen who lives in Canada, who is considering expatriation, and who may meet the net worth or tax liability tests but may also qualify for the dual-citizenship exception should consider his options before he obtains a US passport.

In addition, the new passport requirements expressly allow CBP to share the information it obtains with various federal law enforcement agencies, including those with which it has certain agreements, such as the departments of Justice, Treasury, State, and Commerce. The past several years have seen greater cooperation between CBP (formerly CIS) and the IRS with respect to information sharing and data collection. (See "Data Sharing: IRS and CIS," *Canadian Tax Highlights*, August 2004.) The expat rules, which were enacted in their current form in 2004, specifically coordinate the tax and immigration procedures and rules applicable to expats. Therefore, a US citizen residing in Canada who obtains a US passport in compliance with the new rules should be aware that doing so may have significant US tax consequences. Furthermore, although we are unaware of the law's ever being enforced, any former US citizen may be denied entry into the United States if he has officially renounced his US citizenship and is determined by the attorney general to have renounced it for the purpose of US tax avoidance (the so-called Reed Amendment). Therefore, possible exclusion from entry into the United States after expatriation is a risk that should be considered before the expatriation decision is made.

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FIE Proposals Overview

On November 9, 2006, Finance released the sixth version of proposed legislation dealing with the taxation of non-resident trusts (NRTs) and foreign investment entities (FIEs), generally effective for taxation years beginning after 2006 (not after 2002 as previously proposed). The draft legislation (now Bill C-33) received first reading on November 22, 2006.

The 1999 federal budget proposed a legislative response to perceived abusive structures that defeated the objectives of current section 94.1. Under the new regime, a taxpayer's non-exempt participating interest in a FIE triggers the inclusion of income imputed at a prescribed rate. Generally, any non-resident entity is a FIE unless at the end of its taxation year (1) it is an exempt foreign trust; (2) the carrying value of its investment assets does not constitute the majority of the carrying value of all its property; or (3) its principal undertaking is not an investment business. The new draft does not fundamentally change the draft legislation of July 18, 2005, but there are some significant technical changes.

- The definition of arm's-length interest now includes participating interests if identical interests with a readily obtainable FMV are listed on a prescribed stock exchange.
- Legislative reference to a list of particular facts to determine whether a principal undertaking is an investment business has been eliminated so as not to restrict the consideration of relevant facts and circumstances.
- A new gross revenue test supplements the net accounting test to determine whether a principal undertaking exists. A taxpayer may elect not to treat an entity's principal undertaking as an investment business if its gross revenues from investment property and businesses are less than its gross revenues from other businesses.
- Financial statements for these purposes must be prepared in accordance with generally accepted accounting principles (GAAP) developed and established, or adopted, by the Accounting Standards Board of Canada for use in Canada. The latest proposal is broadened and deems GAAP established either by the Financial Accounting Standards Board for use in the United States or by the International Accounting Standards Board to be similar to Canadian GAAP.
- An interest in a partnership is not an exempt interest if the taxpayer so elects, or if the taxpayer fails to comply with a minister's information request within 120 days.
- The deadline for complying with document and information requests under proposed paragraphs 94.1(2)(e), (p), (q), and (r) is extended from 60 to 120 days. The compliance threshold, which used to require that the information provided be "satisfactory to the Minister," now requires that the information "reasonably be considered to be sufficient" to make the relevant determinations.

The deferral of the effective date for this new and complex regime is a welcome change from the original retroactive date. Taxpayers who paid tax on the basis of the proposed FIE rules for any of 2003, 2004, or 2005 are presumably entitled to refunds. However, many aspects of the latest proposals are carried over from the 2005 and earlier drafts and have been the subject of much criticism. For example, it is probably unrealistic to assume that a taxpayer has all information necessary to determine whether a particular entity is a FIE. Also, a FIE is not eligible for tax-deferred transfers, such as a subsection 85(1) rollover. Although welcome changes have been made from the original proposals, the complexity and compliance burden of the rules is generally perceived as outweighing the benefit of the additional tax revenue generated.

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No Misrepresentation for Reassessment

The TCC in *Petric* and *Mont-Bleu Ford Inc.* (2006 TCC 306) held that the taxpayers had not made any misrepresentations on their tax returns attributable to neglect, carelessness, or wilful default in connection with the FMV of a property transferred from the corporation to its individual shareholder. As a consequence, the CRA could not open otherwise statute-barred returns to reassess the taxpayers outside the normal reassessment period.

In *Petric*, Canco owned two parcels of vacant land (the property). In 1996, a potential tenant told Canco's shareholder (Mr. P) that it would consider taking a 50-year lease on the property (and an adjacent property) from Mr. P if he purchased the adjacent property. Mr. P had the property appraised in order to mortgage it to finance the

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adjacent property's purchase. He did not tell the appraiser about the potential tenant because he did not want to risk having to pay a higher price for the adjacent property if its vendor learned of the potential tenant. In July 1996, Canco transferred the property to Mr. P for the appraised value of $2 million, and Mr. P acquired the adjacent property. In August 1996, Mr. P and the potential tenant signed a long-term lease agreement.

In mid-2000 (within the normal reassessment period), the CRA reassessed Canco's and Mr. P's 1996 tax returns on the basis that the property's FMV was $2.8 million, as determined by the CRA's appraiser. Thus, the CRA increased Canco's proceeds of disposition of the property to $2.8 million from $2 million; it also increased Mr. P's taxable income for a shareholder benefit under subsection 15(1) on the appropriation of the property. The taxpayers objected.

In late 2002, the CRA again reassessed Canco and Mr. P's 1996 returns, that time on the basis that the property's FMV was actually $4.3 million. The CRA's appraiser arrived at this value using the "income approach," factoring into the property's FMV the income from the 50-year lease. All the parties agreed that the 2002 reassessment was made beyond the normal reassessment period, and could only be made under subparagraph 152(4)(a)(i) if the CRA could demonstrate that the two taxpayers made a misrepresentation on their returns attributable to neglect, carelessness, or wilful default.

The CRA argued that the taxpayers were neglectful when they failed to advise their appraiser of the potential long-term lease agreement and thus they misrepresented the property's FMV on their 1996 returns. The taxpayers argued that the lease should not be considered in determining the property's FMV because it was only a conditional agreement when the property was transferred and might never have become legally effective. The taxpayer's appraiser testified that even if he had been aware of the lease agreement, he would not have changed his valuation.

The TCC noted that FMV is a controversial issue to be settled according to the facts. The TCC also noted that the CRA disputed the taxpayer's FMV of the property during the normal reassessment period, but it had waited until the period had expired before it requested the formal appraisal report showing the $4.3 million FMV.

The TCC found that unless the taxpayers' view of the FMV was unreasonable to the extent that it could not have been honestly held, the taxpayers had not made a misstatement attributable to neglect, carelessness, or wilful default; the court held that the taxpayers' reported FMV for the property was not unreasonable. The TCC was not sure that it agreed with the taxpayers' analysis of the property's FMV in 1996—which was based on the lease agreement's being conditional at that time—but it accepted that the taxpayers believed that this conditional agreement did not affect the property's value at the time of its disposition.

Interestingly, the TCC also said that even if the CRA believed that there was a misrepresentation, it could not rely thereon because, knowing of the lease's existence, it obtained its own appraisal and even reassessed the taxpayers on the basis of that appraisal in 2000, within the normal reassessment period. (For the purposes of the 2000 reassessment, the CRA appraiser stated that he had only appraised the property in a very cursory fashion, and a formal appraisal report was not mandated until after the limitation period had expired.) At that point, there was no further reliance on any representation made by the taxpayers, and the CRA was in a position to determine the property's FMV by itself. Thus, the CRA could not rely on the taxpayer's alleged misrepresentation to assess outside the normal reassessment period.

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Foreign Tax News

OECD

On December 21, 2006, a new OECD report was released on the attribution of profits to a PE, including new versions of part I (general considerations), part II (banking), and part III (global trading). The report is intended to apply the 1995 transfer-pricing guidelines in the context of the relationship between a PE and the rest of the enterprise.

European Union

The EU Commission invites member states to adopt a coordinated approach to cross-border loss relief. The limited availability of cross-border loss relief is said to be one of the most significant obstacles to business activity, particularly for small and medium-sized enterprises, and to reduce EU firms' competitiveness in the world market.

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