CANADIAN TAX Highlights

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## Attribution of Profits to PEs

On December 21, 2006, the OECD published new versions of parts I-III (General Considerations, Banks, and Global Trading) of its Report on the Attribution of Profits to Permanent Establishments based on the arm's-length principle described in its 1995 transfer-pricing guidelines. A June 2005 draft of part IV dealing with insurance enterprises is being redrafted for future consultation. Further comments are not requested on parts I-III, which should thus be viewed as final. Following are some key points from part I as it applies to non-financial institutions.

■ **Functionally separate entity and a two-step analysis.** As in the August 2004 draft, an assumed functionally separate entity is the preferred interpretation of the model treaty's article 7(1). "[T]he authorised OECD approach is that profits to be attributed to a PE are the profits that the PE would have earned at arm's length if it were a legally distinct and separate enterprise performing the same or similar functions under the same or similar conditions, determined by applying the arm's length principle under Article 7(2)." Attributing profits to a PE is a two-step process: (1) determine the PE's activities and conditions via a functional and factual analysis, including the allocations of assets, risks, and free capital and the identification of its relevant dealings with its home office, and (2) determine its profits on the basis of a comparability analysis and the application of transfer-pricing methods premised on those allocations.

■ **Attributing risks and assets by significant people functions.** Risk, functions, and capital indicators are used to attribute profit to a PE. The 2004 draft's attribution of risks and assets between a PE and the home office rested on key entrepreneurial risk-taking (KERT) functions; for non-financial services businesses, the revised report relies on significant people functions. The report emphasizes the potential analytical difference between significant people functions related to the assumption and management of risk versus the acquisition and management of assets. (The KERT concept continues for parts II and III because of the special relationship between risks and financial assets in the financial services industry.) The business community was critical of the 2004 draft's use of the KERT concept, but except for its treatment of tangible assets, the new report appears to differ little in substance. The nomenclature has changed, but not the exclusive reliance on significant people functions to attribute risks and intangible assets. The report clearly says that in the context of a single legal entity (PE and home office), risks cannot be separated from the relevant people who assume and manage them: business risks follow their related people functions.

■ **Tangible assets.** Tangible property should be attributed to the place where it is used, not to the location of the significant people functions related to its acquisition and management. Ownership of a distribution warehouse maintained in the home office's country is not attributed to the PE even if PE-located employees play a significant role in managing the distribution process. Similarly, a warehouse in the PE country is attributed to the PE, even if inventories are centrally controlled at the home office. This approach is probably preferable to a pure people function; but "use" is an inherently imprecise concept, and little guidance is given to identify asset use through functional analysis. The adoption of a use-based test may not be fully supported by all OECD member countries.

■ **Intangibles.** The discussion of intangible property's attribution is significantly expanded from the 2004 draft, and essentially confirms that all intangibles are allocated on the basis of the significant people functions related to their development, acquisition, and management for both categories of intangibles (trade and marketing). As for the attribution of income to other assets, the relevant people functions require active decision making, including the acceptance and management of individual risks and portfolios of risks associated with the development and maintenance of intangible property.

■ **Dependent-agent PEs.** The 2004 draft gave rise to concern on the part of the business community that the scope of the dependent-agent rules was being expanded to give countries hosting limited-risk sales, distribution, and research entities more taxing jurisdiction over non-resident enterprises. The revised report clarifies that the

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OECD does not intend to broaden or modify the dependent-agent PE definition under model treaty article 5.

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## Quebec Dividend Tax Regime

Quebec Finance has gone on record as saying that the pending Quebec legislation covering the new dividend tax regime will harmonize with the federal legislation's definitions of eligible and non-eligible dividends and other aspects of the legislation. Federal amounts and designations will be used for Quebec purposes. Quebec Finance commented on these harmonization measures at the 2006 APFF Congress round table held on October 4-6, 2006 (question 5). A summary of some of those comments follows.

■ The new Quebec dividend tax regime will incorporate federal balances and designations. For example, an election by a CCPC not to be considered a CCPC for federal purposes is deemed to have been made for Quebec purposes too.

■ Unlike the federal system, the new Quebec regime will not include penalties of 20 and 30 percent on excess eligible dividend designations.

■ Dividends received from public companies constitute an important portion of mutual funds' income. Generally, these dividends are eligible dividends and are allocated to the funds' unitholders. Quebec Finance was asked if it would consider, for simplicity, applying special rules to mutual funds so that mutual funds would not have to track dividends received before and after March 24, 2006 and issue federal and Quebec slips showing different amounts to the unitholders. For example, the use of an "average rate" could reduce the compliance burden. Quebec Finance said that it saw no reason to tax a dividend at a different rate because it was received by a mutual fund: the new Quebec regime will not include special rules for mutual funds.

■ Quebec Finance has no plans to change the way investment income is treated for Quebec purposes, either by introducing a mechanism permitting a corporation to recover part of the corporate tax paid on such income, or by reducing the dividend tax rate on the after-tax investment income distribution to individuals.

■ Quebec Finance was asked if it was considering using the federal application date of January 1, 2006 for the new dividend tax regime instead of the announced date of March 24, 2006 (for dividends paid after March 23, 2006). Quebec Finance said that the Quebec application date will remain March 24, 2006, because generally the new Quebec dividend tax regime results in an increase of Quebec tax and thus it is not appropriate to apply the regime retroactively to January 1, 2006.

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## A Waiver's Limits

Over the last few years, the Crown has managed to expand the scope of the grounds for a reassessment, based on the FCA's expansive reading of subsection 152(9) in *Loewen* (2004 DTC 6321). The court's recent decision in *Honeywell Limited* (2007 FCA 22) puts a limit on what the Crown can use as a basis for reassessment using a waiver filed by the taxpayer: the reassessment grounds are limited to the matters specified in the waiver.

Honeywell was a Canadian subsidiary of Honeywell US, which owned a number of European subsidiaries including Honeywell BV (a Netherlands sub). Honeywell BV allegedly carried on an active business for the purposes of section 95. In 1991, Honeywell borrowed approximately $115 million from various financial institutions to capitalize its wholly owned sub, Honeywell NV, which acted as a Finco and on-loaned funds at interest to Honeywell BV. In filing its returns for the years in issue (1992 to 1994), the taxpayer availed itself of the exception to FAPI in clause 95(2)(a)(ii)(B). Although the literal requirements of the section were satisfied, before the reassessment period expired the minister concluded that the transactions constituted a misuse of the provisions and that GAAR applied. The CRA said that the unwritten policy underlying the clause and the related FAPI provisions contemplates that the foreign affiliate availing itself of the clause must be a foreign affiliate of a Canadian-based multinational. The CRA said that section 245 should apply to recharacterize the transaction as simply a $115 million loan from Honeywell to Honeywell BV and apply the normal accrual rules in paragraph 12(1)(c) for corporations that earn interest income.

Relying on the waivers given by Honeywell, the CRA did not reassess immediately. The waivers were given with respect to "Interest income being reassessed under paragraph 12(1)(c) of the Income Tax Act by reason of the application of Section 245." The minister eventually reassessed, and Honeywell appealed to the TCC. During the exchange of documents leading to an examination for discovery, the minister came across information suggesting that the transactions giving rise to the reassessments were part of a series in which the $115 million was repatriated to the US parent of Honeywell to repay its debts and was not used by Honeywell BV in its active business; thus, the interest earned on the $115 million loan did not fall into the FAPI exception. The minister sought to amend the reply to allege that the FAPI rules applied, and that GAAR applied because they had been misused: the funds were not used in Honeywell BV's active business, and the interest earned by Honeywell NV was FAPI. The procedural argument turned on the interpretation of subparagraph 152(4.01)(a)(ii), which provides that a reassessment may be made after the normal reassessment period "only to the extent that it can reasonably be regarded as relating to . . . a matter specified in the waiver." The Crown argued that the "matter specified" encompassed any type of income attributed to Honeywell from Honeywell NV; the taxpayer argued that the terms of the waiver explicitly confined the minister to a reassessment based on the original GAAR argument. The Crown argued that the rule must be interpreted in the light of subsection 152(9), which generally allows the minister to advance an alternative argument in support of an assessment at any time. In the TCC decision, Bowman CJ noted that including interest income in paragraph 12(1)(c) because of a GAAR recharacterization is entirely different from including a foreign affiliate's passive income in Honeywell's income by applying the FAPI rules.

The FCA essentially affirmed the TCC's decision, and noted that a waiver is a bargain between the taxpayer and the minister. The taxpayer gives up its right to assert the expiry of a limitation period; in return, the minister may reassess outside the period but is limited to the issues specified in the waiver. From a policy perspective, if the minister had been successful, taxpayers in general would be more reluctant to grant a waiver if it effectively gave the minister carte blanche to reassess the year at any time for any reason. The decision should also serve to remind taxpayers to be cautious and seek professional advice before granting a waiver.

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## Provincial Tax Comparisons

It is only a coincidence that our annual summary of tax burdens appears in the dead of winter. Once again, Alberta is the province with the lowest tax burden, and all three territories' burdens are even lower. The comparisons in the table are based on data from Statistics Canada's Provincial Economic Accounts; information for the calendar year 2004 is the latest available.

There are many ways of comparing tax loads, but the single ratio of total taxes collected to gross domestic provincial product (GDPP) provides an unambiguous measure of the combined effect of all taxes on the economy of each province and territory. That ratio cannot necessarily be used to evaluate the tax position of a particular family or business.

The table shows that in 2004 all taxes collected in Alberta were equivalent to only 24.6 percent of GDPP. In Quebec, on the other hand, the ratio was the highest at 38.3 percent, well above the national average of 33.2 percent. This measure of tax burden does not take into account royalties imposed by the provinces on the extraction of natural resources. Not surprisingly, such royalties were

**Comparisons of Tax Ratios by Province, 2004**

| | All taxes collected | Taxes and royalties |
|---|---|---|
| | *% of GDPP* | |
| Newfoundland and Labrador | 27.2 | 27.3 |
| Prince Edward Island | 36.6 | 36.6 |
| Nova Scotia | 34.5 | 34.5 |
| New Brunswick | 33.1 | 33.4 |
| Quebec | 38.3 | 38.4 |
| Ontario | 34.6 | 34.6 |
| Manitoba | 33.6 | 33.8 |
| Saskatchewan | 31.1 | 33.9 |
| Alberta | 24.6 | 29.5 |
| British Columbia | 31.5 | 33.8 |
| Yukon | 22.4 | 22.6 |
| Northwest Territories | 17.5 | 17.5 |
| Nunavut | 20.6 | 20.6 |
| National average | 33.2 | 34.4 |

highest in Alberta at 4.9 percent of GDPP in 2004. Including such levies in the comparison, as shown in the second column of the table, raises Alberta's ratio to 29.5 percent, well above the 27.3 percent ratio recorded for Newfoundland and Labrador, but still well below the national average. With higher production of more expensive oil and gas in the past two years, however, the ratios including royalties for the two oil-producing provinces in the east and for the western producers will be higher for 2005 and 2006.

The federal burden was highest in Ontario in 2004 at 16.2 percent of GDPP and lowest in Newfoundland and Labrador at 11.1 percent. Provincial taxes were highest in Quebec—17.3 percent of GDPP—due in part to the transfer of income tax room from the federal to the provincial government. Alberta recorded the lowest provincial burden, 7.2 percent. Local taxes were only 1.2 percent of GDPP in Prince Edward Island in 2004, but they amounted to 3.8 percent in Ontario.

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## Absolute but Indeterminate

In *General Motors* (2006 TCC 638), the TCC decided, on the basis of a rectified agreement and direct evidence of the parties' intention, that for its 1996 tax year GM could deduct amounts credited to a so-called contingency fund. In a previous case, that court disallowed a deduction for the 1995 year's accruals.

GM and the union representing its auto workers (CAW) negotiated the creation and continuation of an account, the special Canadian contingency fund (SCCF). Pursuant to a memorandum of understanding (MOU), GM accrued $2 to the SCCF for each overtime hour worked in excess of a specified number of straight-time hours. The amount in the SCCF was slated "to support" a legal services plan and child-care programs and "to finance" a supplementary unemployment benefit (SUB) program, "and then only if needed." No funds were set aside, although amounts paid by GM and debited to the SCCF were said to be paid "from" the SCCF. Both the legal services and the SUB arrangements were trusteed, and they also received contributions from other sources. When the trustee required funds or when a particular formula threshold was attained, GM paid the amounts to the trustee and debited the SCCF. The child-care program was administered by the CAW; following a request from the CAW to apply SCCF accruals, GM satisfied itself that the request was within the agreed-upon parameters and then honoured the request and debited the SCCF. The SCCF could also be used to fund jointly agreed-upon initiatives, although there were none at the relevant time. At the end of the term of the collective bargaining agreement, the parties could negotiate the use of any remaining SCCF balance.

At the end of GM's 1995 taxation year, the SCCF balance was $13.6 million. The CRA denied a deduction for that amount: the TCC and the FCA agreed, and the SCC denied leave to appeal. The TCC concluded that the MOU did not impose any liability on GM and that there was no identifiable creditor that could make a legally enforceable claim with respect to the SCCF. The SCCF might represent a GAAP liability, but it was a contingent liability because payments therefrom depended on acceptance of a CAW request (the child-care programs) or attaining defined thresholds (other funding cases). GM may have had a legal obligation to accrue, but not to pay. The obligation's contingent nature was reinforced by the phrase "and then only if needed."

The FCA agreed that the requirement to accrue amounts in the SCCF did not create an absolute liability in 1995. GM was not obliged to pay unless certain contingent events occurred. Because no funds were set aside, no absolute liability or identifiable debt was incurred by GM. There was no identifiable creditor, and the FCA was not prepared to speculate on the CAW's rights and remedies under the collective bargaining agreement with GM. The court stressed that the parties could have created an absolute liability by agreeing on the segregation or setting aside of funds.

With the benefit of these judicial comments, GM sought and obtained an order from a labour arbitrator to retroactively rectify one paragraph of the MOU. The rectified paragraph indicated that GM's obligation to add to the SCCF was to be computed in accordance with the agreed formula; a "for greater certainty" clause stipulated that the obligation to add to the SCCF accrued and became absolute as the overtime hours were worked. The rectified paragraph also noted the parties' agreement that the SCCF accruals were to be used exclusively for the benefit of the CAW members and other appropriate CAW purposes determined in accordance with other MOU provisions.

The deductibility of the SCCF accruals was then litigated anew, this time for GM's 1996 tax year: the CRA had denied a $7.7 million deduction for SCCF accruals. The TCC said that the 1996-year facts differed in two respects from those in the case involving the 1995 year: the MOU had been retroactively rectified, and evidence of the intention of the parties was adduced.

The court found that the rectified MOU paragraph was ambiguous as to when the obligation to pay arose. By itself, that paragraph did not clearly state whether the obligation to expend arose when the overtime hours were worked or when the specific object of the expenditure was identified. The rectified paragraph thus did not necessarily disclose an absolute obligation for GM to pay before allocation to particular uses, only an absolute obligation to make an accounting entry. GM and CAW officials gave affidavit evidence that it was always intended by both parties that GM's obligation to expend the SCCF accrued amounts on SCCF programs arose as soon as the overtime hours were worked, even though the particular SCCF program recipient may not yet have been determined. The TCC gave considerable weight to the affidavit evidence, which clarified that the rectified and otherwise ambiguous MOU paragraph imposed on GM an obligation in 1996 to expend the $7.7 million in the future. The court held that the other MOU provisions described how and when the SCCF was to be spent; they did not detract from the central requirement that the SCCF accruals be expended.

The TCC specifically addressed two points in the FCA decision on GM's 1995 tax year. First, the fact that no obligation was imposed on GM to segregate or contribute funds did not mean that no absolute liability was incurred. Second, the creditor of the liability, at least in the case of a GM bankruptcy, was the union: it would seek to make good on GM's promise.

By itself, the MOU's rectification was not enough to ensure GM's victory. But for the common evidence of intention, the Crown might very well have prevailed. There appears to be an unstated concern with deductible accruals for future employee benefits. The Act provides deductions for employer contributions to registered employee plans, such as pension plans, and specifically disallows deductions for unpaid salary or wages, pension benefits, retiring allowances and the other unpaid employment remuneration. On the basis of this decision, accruals in an SCCF-type account used to defray health and welfare benefits might be deductible but limited to current-year distributions, given the CRA's view that health and welfare plans are plans of insurance. Although subsection 78(4) does not appear to have been argued, *General Motors* does point out its limitations. The accruals made by GM were not "salary, wages or other remuneration"; they were absolute obligations to expend amounts that may or may not have been "other remuneration." A legislative change may be imminent.

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## Unconstitutional Tax Recoverable

The ability of the provinces to levy taxes is subject to some important constraints under the Constitution Act, 1867. A recent SCC decision (*Kingstreet Investments Ltd. v. New Brunswick (Department of Finance)*, 2007 SCC 1) illustrates the broad influence of constitutional principles on the ability of taxpayers to recover invalid provincial taxes.

The tax at issue was a New Brunswick user charge paid by a licensed vendor on a percentage of the retail price of liquor sold. The user charge was levied ostensibly to defray the regulatory cost of the provincial liquor licensing scheme, but the annual revenue far exceeded the annual cost of the scheme. The taxpayer, who paid over $1 million in user charges, sought restitution for unjust enrichment from New Brunswick, saying that the user charge was an indirect tax and thus ultra vires under section 92(2) of the Constitution Act.

The trial judge concluded that the user charge was a tax and that it was indirect because it was passed on to the taxpayer's ultimate customers. The charge was therefore ultra vires, but restitution was denied because of a passing-on defence and because fiscal chaos might ensue if public authorities were required to repay ultra vires taxes. The New Brunswick Court of Appeal was not prepared to immunize the province from repayment, but the passing-on defence prevented full restitution: only user charges paid after the commencement of legal proceedings could be recovered because they were paid under "protest and compulsion."

The issue before the SCC was whether money paid to a provincial taxing authority under ultra vires legislation was recoverable. The SCC focused on constitutional principles, emphasizing that the concept of "no taxation without representation" is central to democracy and the rule of law. The court held that a taxpayer who has paid an ultra vires tax has a right to restitution because a government's collection and retention of ultra vires taxes undermines the rule of law: to deny restitution would condone a breach of this fundamental constitutional principle. As a corollary, the SCC rejected the immunization rule that would excuse the province from repaying an ultra vires tax for policy reasons: the immunization rule also undermines the rule of law. (A government can prevent fiscal chaos by, for example, a suspended declaration of invalidity and the enactment of retroactive but valid taxes.)

The passing-on defence is said to be justified because a taxpayer who passes on the tax to others suffers no deprivation and receives a windfall from recovery. But in the case of claims for recovery of unconstitutional taxes, the SCC rejected the defence for several reasons: (1) it is inconsistent with a basic premise of restitution law that provides restoration of what was taken without justification but is not founded on compensation for loss; (2) it is economically misconceived; and (3) a commercial context presents inherent impediments to proving that the loss was not passed on. The court thus did not have to deal with the exception to the passing-on defence for tax paid under protest or compulsion, and it concluded that the exception should be discarded for payments made to public authorities under ultra vires legislation or as a result of otherwise valid legislation that was misapplied.

The court also concluded that the ordinary principles of unjust enrichment should not be applied to claims for recovery of ultra vires taxes: restitution for ultra vires taxes is a separate category of restitution. The analytical framework for unjust enrichment developed for different purposes, and its application is inappropriate to the levy of ultra vires taxes for which the taxpayer has recourse "as a matter of constitutional right." However, the taxpayer's restitution claim was subject to the provincial limitations statute, which imposed a six-year limitation period: only taxes paid during the six years preceding the filing of its notice of objection were recoverable.

*Kingstreet* has broad implications for all taxpayers seeking to recover taxes paid under ultra vires legislation, for which the SCC's decision outlines in fairly broad terms a constitutional right to restitution; the case is also of interest for a government that applies otherwise valid legislation incorrectly and collects a levy. The case illustrates the overriding influence of fundamental constitutional principles in the tax context and is a reminder of the courts' checks-and-balances function. "The Court's central concern must be to ensure the constitutionality of fiscal legislation." The decision suggests some further important questions. Are there limits to recovery of ultra vires taxes other than limitation periods? To what extent will the constitutional principles applied in *Kingstreet* come into play for a tax that is intra vires but suffers from a lesser constitutional defect (such as its being inoperable or inapplicable) or is valid but is simply misapplied? The bottom line may be that the revenue solution of retroactively enacting valid taxes can effectively nullify restitution claims.

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## Beneficial Ownership

The **OECD model treaty** and most international treaties reduce withholding tax on dividends, interest, and royalties if the recipient is their beneficial owner. The beneficial owner generally has power and enjoyment over the income; ownership of the underlying property is not determinative. The OECD commentaries are often followed by tax authorities and are relevant in the determination of the international fiscal meaning of terms. The 1977 commentary disregarded an intermediary that was an agent or nominee or a fiduciary with narrow powers. The 1986 OECD report on conduit companies, "Double Taxation Conventions and the Use of Conduit Companies," recommended that changes be made to treaties to prevent treaty benefits being ceded under the principle of pacta sunt servanda. The 2003 OECD commentary expanded the term "beneficial owner" beyond its narrow technical sense to reflect the treaty's object and purpose, including the avoidance of double taxation and the prevention of fiscal evasion:

> It would be . . . inconsistent with the object and purpose of the [treaty] . . . to grant relief or exemption where a resident of a Contracting State, otherwise than through an agency or nominee relationship, simply acts as a conduit for another person who in fact receives the benefit of the income concerned. [The 1986] report . . . concludes that a conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties.

Since the 1986 OECD report and the UK *Indofood* decision ([2002] EWCA Civ. 158), tax authorities have taken a factual rather than a legal approach. Even if an intermediary is not a nominee, agent, or fiduciary and is thus the legal owner, the third party to whom the intermediary remitted funds may be regarded as the true beneficial owner.

If there is no treaty definition and no domestic tax definition of "beneficial owner," article 31 of the **Vienna Convention on the Law of Treaties** provides that the terms of the treaty are given their ordinary meaning in their context and in light of the treaty's object and purpose. Article 32 allows recourse to supplementary means of interpretation, including the treaty preparatory work and the circumstances of its conclusion, in order to confirm the ordinary meaning under article 31, or to refine a meaning that is ambiguous or obscure or leads to a manifestly absurd or unreasonable result. It is implicit that the supplementary matters must have existed when the treaty was ratified. In *MIL (Investments)* (2006 DTC 3307) the TCC did not refer to OECD commentaries subsequent to the ratification of the Canada-Luxembourg treaty.

Some **EU legislation** may be relevant in determining the international fiscal meaning of "beneficial ownership." Article 4 of the EU interest and royalty directive provides that a company of a member state is the beneficial owner of interest or royalties received for its own benefit and not as an intermediary such as an agent, a trustee, or an authorized signatory for some other person. A PE is the beneficial owner if it is effectively connected with the underlying property or right and the payments are subject to corporate income tax in the PE's situs member state. The EU savings directive (2003/48/EC) is intended to ensure that cross-border interest payments are actually taxed in the residence member state of the beneficial owner through an efficient exchange of information and is likely to be relied upon by many European countries in interpreting beneficial ownership in treaties with non-EU countries. The ECJ may also focus on whether the interposed entity actually was established and carried on genuine economic activities in the host country. (*Cadbury Schweppes*, case C-196/04(ECJ), September 12, 2006.)

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## Pilot Not Resident

The TCC recently found in *Laurin* (2006 TCC 634) that the taxpayer, an Air Canada pilot, was not resident in Canada.

Mr. L built a house in St-Lazare, Quebec, and lived there with his girlfriend, Ms. D, who became its one-half owner. In 1993, Mr. L and Ms. D broke up, and Mr. L sold his half interest in the house and furnishings to Ms. D. Mr. L cancelled his health and car insurance, exchanged his Canadian driver's licence for a US licence, sold his car, closed all his Canadian bank accounts except those required by Air Canada to pay him, and moved to Belize. In 1996, Mr. L moved to the Turks and Caicos Islands.

For 1993 through 1995, the CRA assessed Mr. L as a non-resident. In 1996 Mr. L concentrated on international flights, particularly southeast Asian routes, for which he obtained postings in Vancouver and Winnipeg. For the years in issue (1996-2000), the CRA assessed Mr. L as a Canadian resident. During those years, Mr. L spent time in Canada, particularly in and around Montreal, where he had family and friends. Mr. L brought all his necessities when he stayed with his friends and family, never establishing himself in any of their homes. Mr. L never spent more than 183 days in Canada during any of the years in question, nor did he stay at the St-Lazare house.

Because Mr. L was resident during those years in the Turks and Caicos (with which Canada has no tax treaty), Canada's treaty rules on dual residence did not apply: Mr. L could be a resident of Canada for Canadian tax purposes and simultaneously a resident of a non-treaty country.

An individual can be a Canadian resident if he meets one of the deeming rules in subsection 250(1)—for example, by sojourning in Canada for at least 183 days (the 183-day test) or by being ordinarily resident in Canada (subsection 250(3)). The CRA assessed Mr. L as a resident of Canada on the basis of several assumptions that contradicted the taxpayer's evidence and position. The TCC considered five of the CRA assumptions to be key: (1) Mr. L was involved in a common-law relationship with Ms. D during the relevant years; (2) they built a house together; (3) that house remained available to Mr. L during those years; (4) Mr. L spent more than 183 days in Canada in three of the four years; and (5) Mr. L never severed his residential ties with Canada. The TCC found, and the CRA admitted, that Mr. L did not sojourn at least 183 days in Canada during any of the years in question. The Crown had not pleaded that Mr. L was ordinarily resident in Canada, but the TCC considered the issue, citing *Hauser* ([2005] 4 CTC 2260 (TCC)) as its primary jurisprudence. Unlike the taxpayer in *Hauser*, who was found to be a Canadian resident after moving to the Bahamas, Mr. L did not have a home available to him in the house he formerly shared with Ms. D; he had no Canadian mailing address; he did not establish a sense of permanence at any of the homes he stayed at during his visits; he had no investments or business activities in Canada; and although he did have sons living in Montreal, he rarely saw them. In fact, two of Mr. L's visits to Montreal were for medical reasons and one was because of his mother's death.

The TCC said that jurisprudence established that "[w]here the Minister's assumptions have been 'demolished' . . . the onus shifts to the Minister to rebut the prima facie case made out by [the taxpayer] and to prove the assumptions. . . . [If] the Minister adduces no evidence . . . the taxpayer is entitled to succeed." The taxpayer had demolished the CRA's assumptions and the CRA was unable to provide evidence to support a finding that Mr. L was ordinarily resident in Canada.

The CRA then argued that Mr. L was a resident of Canada because of his visits to Canada, his employment with a Canadian airline, and the presence of his family and friends in Canada. The TCC said that such an argument represented a badly stated assumption that Mr. L had not severed his residential ties with Canada, but the court concluded that he had: residual friendships and employment connections do not themselves create residence.

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## Eligible Dividend Administrative Guidelines

On December 20, 2006, the CRA released administrative guidelines that clarify the application of the new dividend tax regime to eligible dividends and also provide transitional relief to the corporate payer of eligible dividends and to trust and partnership recipients. (Bill C-28, tabled May 2, 2006, received second reading in the Senate on January 31, 2007.)

The CRA reiterated that for 2006 only, a corporation can make an eligible dividend designation on a T3 or T5 slip, or it can make the designation by notifying shareholders on its Web site, in its corporate reports (quarterly or annual), or in other shareholder publications. The CRA's comments with respect to post-2006 designations are summarized in the accompanying table.

**Summary of CRA's Comments on Post-2006 Designations**

| | Designation | | |
|---|---|---|---|
| Payer | Where | When | Statement |
| Public company | ■ Web site—applies to all dividends paid until notice is removed;<br>■ quarterly or annual report—applies to all dividends paid during a quarter or year; or<br>■ other shareholder publication. | Before or at the time dividends are paid. Frequency depends on where notice of designation was made. | ■ The dividend is an eligible dividend, or<br>■ all dividends are eligible dividends unless indicated otherwise. |
| | Press release announcing dividend declaration. | Each time a dividend is declared. | The dividend is an eligible dividend. |
| Non-public company | ■ Letter to shareholders;<br>■ dividend cheque stub; or<br>■ if all shareholders are directors, in a notation in the minutes. | Each time a dividend is paid. | The dividend is an eligible dividend. |

It is uncertain from Bill C-28 whether a designation can apply to part of a dividend paid on a particular class of shares. As an administrative concession for dividends paid in 2006, the CRA will allow corporations to split the dividend into two separate dividends (for example, 80 percent eligible and 20 percent non-eligible) and pay the two separate dividends in one cheque. However, partial designations are not permitted for dividends paid after 2006;

to pay both eligible and non-eligible dividends on the same class of shares after 2006, a corporation must declare and pay two separate dividends.

The CRA also said that, whatever year the dividend is paid, a designation of eligible dividends must apply to all shareholders of a particular class. A corporation cannot designate as eligible only the portion of a dividend paid to certain shareholders of a particular class and consider as non-eligible the remainder of the dividend paid to other shareholders of that class. The CRA added that notification of the payment of an eligible dividend must be given to all shareholders, even if a shareholder's mailing address is not in Canada or if non-resident withholding tax is withheld; the out-of-country address of record is not proof of non-residence. The CRA confirmed that the payment of otherwise eligible dividends to non-resident shareholders does not jeopardize the status of eligible dividends paid to resident shareholders.

Administrative relief is extended to a trust that received dividends in 2006 if, before the deadline for issuing its own T3 slips, the trust had not been notified whether the dividends were eligible. The trust may make reasonable assumptions in identifying eligible dividends, but it must reissue T3 information slips and T3 returns promptly if the assumption is inaccurate (except for amounts less than $100). For mutual fund trusts with December 15 year-ends, dividends received from December 16, 2005 to December 31, 2005 do not qualify as eligible dividends. The trust may use a reasonable method to estimate the amount of non-eligible dividends received in the stub period, such as 1/24 of all dividends it received in its 2006 taxation year. For dividends paid to a partnership, their eligible or non-eligible status flows through to the partners: dividends designated as eligible and paid to a partnership retain that status when allocated to resident partners.

**Nunavut** announced that its eligible dividend tax credit rate is 6.2 percent commencing in 2006; its non-eligible dividend tax credit rate remains 4 percent. As a result, the top combined federal-Nunavut personal income tax rate is 22.24 percent, commencing in 2006, for eligible dividends and remains at 28.96 percent for non-eligible dividends.

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## GST: De Facto Importer

The CRA recently issued a draft revised policy statement P-125R, "Input Tax Credit Entitlement for Tax on Imported Goods" (December 19, 2006), which discusses and illustrates with 25 examples how to determine who is entitled to claim an input tax credit (ITC) for GST paid on the importation of goods. The CRA is asking for comments on the draft policy by March 31, 2007; to that end, and for the educational value of its abundant examples, the draft is a must-read.

The draft focuses on two concepts: de facto importer and constructive importer. A de facto importer, the broader term, is any person who causes goods to be imported and who, if registered, may be entitled to recover the import GST. In the simplest scenario, the de facto importer can be a non-resident GST registrant who imports equipment for its use in the delivery of services to Canadian customers; but if more than one party is involved, the person who physically imports the goods may not always be the de facto importer and thus may not be entitled to recover the import GST. In order to identify the de facto importer, proposed section 178.8 of the Excise Tax Act introduces the concept of "constructive importer."

The constructive importer is the last person to whom a supply of goods is made outside Canada. Under proposed subsection 178.8(2), where goods are imported for consumption, use, or supply by the constructive importer, ITC entitlement rests with the constructive importer regardless of who physically imports the goods. For example, if a non-resident registrant sells goods to a Canadian customer, delivers the goods outside Canada, and agrees to facilitate importation by acting as the importer of record for Customs purposes, the non-resident cannot claim an ITC for the import GST: only the Canadian customer, the constructive importer, may claim the ITC, subject to the normal ITC requirements. Subsection 178.8(3) allows the parties to elect, in prescribed form, to shift the ITC entitlement back to the physical importer, who then must charge GST on the supply as if it was made in Canada.

The draft contains a wealth of examples to assist in understanding the application of section 178.8. One noteworthy example involves a non-resident GST-registered manufacturer who sells goods to a Canadian retailer, with delivery of the goods in Canada. The parties agree that the Canadian retailer will be the importer of record and pay the tax on importation. The non-resident must charge GST to its customer, who must also pay GST on the goods' importation. There is no constructive importer because there is no supply outside Canada, but the retailer is the de facto importer because it caused the goods to be imported into Canada. The retailer's two GST payments are fully recoverable but may wreak havoc on cash flow.

In another example, a registered non-resident acquires goods from a non-resident manufacturer outside Canada and resells them to a Canadian retailer. The goods are shipped directly from the non-resident manufacturer's site to the retailer, who acts as the importer of record and pays import GST. The registered non-resident is the constructive importer, the last person to whom a supply of

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goods (from the manufacturer) was made outside Canada. However, the CRA has stated that if the registered non-resident does not claim the ITC to which it is entitled under these rules, the Canadian retailer who paid the import GST may recover it. This is an interesting and welcome administrative concession, but it appears to contradict the proposed rule. It is not clear why similar administrative concessions cannot be made for ITCs inadvertently claimed by parties who do not qualify as the constructive importer in situations that inflict no loss on the fisc.

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## Deemed Year-End Trap

New rules covering a spectrum of issues were required to implement the recent change in the taxation of dividends. For example, subsection 249(4.1) deems a taxation year to occur when a corporation becomes or ceases to be a CCPC and the ordinary acquisition-of-control rules in subsection 249(4) do not apply. The wording of the rules has an unexpected side effect.

The technical notes to subsection 249(4.1) indicate that it is relevant for determining the amount of eligible dividends and affects the calculation of a corporation's GRIP and LRIP pools. The underlying policy objective is apparently to ensure that a corporation's pool balances within a fiscal period are not inadvertently affected by transactions that do not fall within the normal acquisition-of-control rules, such as when a shareholder ceases to be a resident of Canada and when a corporation loses its CCPC status. As drafted, the rule deems a year-end when a corporation ceases to be a CCPC: ceasing to be a CCPC is quite different from the corporation's control being acquired, a situation whose consequences are described in subsection 249(4). This nuanced difference means that the potential application of paragraph 251(5)(b) must be considered when subsection 249(4.1) applies. (See "Paragraph 251(5)(b): Good News and Bad News," *Tax for the Owner-Manager*, January 2003, for a discussion of some other planning issues and opportunities arising from this anti-avoidance provision.)

Paragraph 251(5)(b) provides that a person who has any type of right to acquire shares is deemed to be in the same control position with respect to the corporation as if he owned the shares. Practitioners are generally well aware of the potential risks of this rule in the context of structuring purchase and sale transactions. Fortunately, one of the potentially costly penalties arising from the rule's application is offset by the relief in paragraph 110.6(14)(b): for the purposes of determining qualified small business corporation share status (defined to include whether a corporation is a small business corporation or a CCPC), paragraph 251(5)(b) does not apply to rights created under a purchase and sale agreement. In the absence of a potential enhanced capital gains deduction, the possibility of losing CCPC status has not raised a real timing concern in the negotiation of many deals, even if the acquiror was a non-resident or public company. However, subsection 249(4.1) now triggers a year-end on the signing of the purchase and sale agreement, in addition to the year-end expected under subsection 249(4) when the shares are actually acquired. This additional year-end may create problems with time-sensitive items such as shareholder's loans and unpaid amounts that would otherwise have been cleaned up in the period between negotiating and closing the transaction. Although unofficially Finance has said that the potential for an additional year-end arising from proposed subsection 249(4.1) was not contemplated when the legislation was drafted, it is currently not planning any changes to the draft legislation to alleviate the problem.

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## Foreign Tax News

### France

On December 29, 2006, the Supreme Administrative Court overturned an appellate court decision and held that a Scottish bank was not the beneficial owner of dividends for the purposes of the France-UK treaty. The bank paid its US parent an amount equal to the net dividends before withholding for the dividend coupons; the transaction was held to be a loan.

### OECD

Terms of reference were published on January 17, 2007 for a study on the role of tax intermediaries such as law firms, accounting firms, and financial institutions in relation to unacceptable tax minimization plans.

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