CANADIAN TAX Highlights

Editor: Vivien Morgan, LL.B.

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Reg 105 Revisited: Weyerhaeuser

Regulation 105 is an important tool for ensuring the appropriate taxation of non-residents that carry on business in Canada. Regulation 105 reads in part: "Every person paying to a non-resident person a fee, commission or other amount in respect of services rendered in Canada . . . shall deduct or withhold 15 percent of such payment."

Historically, the CRA has taken an extremely broad view of what constitutes an amount "in respect of services" and has demonstrated a "when in doubt, withhold" mentality in its published administrative positions and audit activity. The CRA's view was not without support, given prior judicial interpretations of the phrase "in respect of" and the approaches taken to regulation 105 in cases such as *Ogden Palladium Services (Canada) Inc.* (2001 DTC 345 (TCC)).

The recent case of *Weyerhaeuser Co. Ltd.* (2006 TCC 65), however, puts a brake on the CRA's zealous application of regulation 105. In *Weyerhaeuser*, the corporate taxpayer paid over $14 million to arm's-length non-resident contractors in the ordinary course of its business. Although the taxpayer withheld and remitted on the payments for services rendered in Canada, it did not withhold on amounts paid to reimburse the contractors for their out-of-pocket expenses, nor did it withhold on amounts paid for the time spent by the contractors in travelling to Canada to render such services. The minister reassessed the taxpayer, taking the position that withholding was required on all of the amounts because they were all "in respect of" services rendered in Canada.

The taxpayer's appeal was substantially successful. Although the court disagreed with the taxpayer's argument that regulation 105 was ultra vires the Income Tax Act, it nevertheless held that the scope of regulation 105 cannot exceed the authority of its enabling legislative provision, paragraph 153(1)(g). The TCC said that paragraph 153(1)(g) required that tax be withheld "for services" and thus denoted acceptable withholding as that which attached to an amount paid as a fee or other remuneration for services and that had the character of income in the recipient's hands. This conclusion, the TCC continued, was supported by the purpose of subsection 153(1). Subsection 153(1) did not represent not a final tax, but rather was a withholding on account of the non-resident's income tax liability to Canada; accordingly, the provision's purpose was to create an initial reservoir for those payments potentially and ultimately caught by the Canadian tax net. Thus, withholding under regulation 105 was permissible only from those payments "having the character of remuneration for services rendered in Canada and thus potentially taxable by Canada in the non-resident's hands."

The TCC also dismissed the Crown's argument that the taxpayer had provided insufficient proof of the payments' purpose. In the absence of evidence to the contrary, the contractors' invoices were held to be sufficient to substantiate the nature of the fees paid.

Regarding the payments at issue, the TCC determined that amounts paid as reimbursements fell outside the ambit of regulation 105 because they did not have the requisite quality of income. With respect to payments for time spent in transit, the court held that amounts paid for travel to Canada were not subject to withholding because they were earned outside Canada, but amounts paid for travel within Canada were subject to withholding because they were income "earned in Canada." It is interesting that the court did not require that there be a direct nexus between the fee and the actual service rendered in Canada, as the taxpayer had implicitly argued. Fees paid for items such as travel may be incidental to or in furtherance of services, but they nevertheless appear to remain within the scope of regulation 105—because they are "in respect of" services—provided that the relevant activity is within Canada.

Albert Baker
Deloitte & Touche LLP, Vancouver

Grant J. Russell
Kellough & Partners LLP, Vancouver

In This Issue

Splitting Pension Income

A new pension-splitting measure announced by Finance on October 31, 2006 may permit a taxpayer who has income eligible for the pension income credit to reduce his or her family's overall tax bill starting in 2007.

Income splitting saves taxes by shifting income from the hands of a family member in a higher tax bracket to the hands of a second family member in a lower tax bracket; the shifted income is taxed at a lower rate, or not at all if the second family member's income is low enough. Canada's tax laws generally prevent most types of income splitting among family members, except in specific circumstances. Beginning in 2007, a taxpayer can split with his or her spouse (or common-law partner) certain types of pension income, depending on his or her age. For a taxpayer 65 and over, income from lifetime annuity payments under a registered pension plan (RPP), a matured registered retirement savings plan (RRSP), or a deferred profit-sharing plan and payments out of a registered retirement income fund may qualify for income splitting. For a taxpayer under 65, pension income eligible for splitting includes lifetime annuity payments under an RPP and certain other payments received as a result of the death of the taxpayer's spouse. (The CPP system already allows a taxpayer to split CPP income with his or her spouse under certain conditions.)

To take advantage of this opportunity, a taxpayer need not take action until the 2007 personal income tax returns are prepared in April 2008. At that time, the higher-income spouse can allocate up to 50 percent of his or her eligible pension income to be taxed in the hands of the lower-income spouse. The allocated amount is deducted from income on the tax return of the higher-income spouse and included in the income of the lower-income spouse and taxed at his or her lower marginal rate.

The optimal amount of split pension income that produces the greatest tax savings varies greatly among couples, depending on each spouse's income. A taxpayer may also need to take into account the impact that the increase in his or her spouse's taxable income may have in reducing or eliminating the personal tax credits that the spouse could otherwise claim or transfer to the taxpayer to claim on his or her tax return. The spouse's potential OAS clawback may also be affected. A taxpayer must analyze the options to determine the optimal amount of pension income to split with his or her spouse when their tax returns are prepared. If a taxpayer intends to take advantage of pension income splitting in 2007 and must pay quarterly tax instalments, he or she may wish to estimate the 2007 taxes payable to determine the potential impact of income splitting on the 2007 instalment payments.

Jim Yager
KPMG LLP, Toronto

IRS To Centralize Top Issues?

According to informal conversations with IRS personnel and clues from its recently released *Industry Directives*, it appears that the IRS is on the verge of rolling out a significant new initiative designed to centralize complete control over the identification, development, and resolution of certain key issues targeted for heightened enforcement focus.

Under this new initiative, the IRS will identify and rank issues according to their compliance risk. Issues and areas presenting the most significant compliance risk are labelled as tier 1. Each tier 1 issue is assigned to an executive with nationwide jurisdiction who oversees the issue's development and has complete authority over its treatment, thus ensuring consistency with IRS National Office guidance.

No official IRS publication has launched the new tier 1 initiative, but three recent directives refer to the new system: non-shareholder contributions to capital (Code section 118), the domestic production deduction (Code section 199), and Code section 936 possessions corporations exit strategies are designated as tier 1 issues. In the summer of 2006, IRS Commissioner Mark Everson presented Congress with a list of the IRS's top enforcement targets that included additional issues. It is expected that most if not all of those issues will be, or already are, also designated as tier 1: the research and experimentation credit (Code section 41); the transfer of intangibles offshore and cost sharing; transfer pricing; abusive foreign tax credit transactions; foreign earnings repatriation (Code section 965); abusive hybrid instrument transactions; mixed service cost; and executive compensation (Code section 409A).

The final list of all tier 1 issues is not yet known, nor is the precise effect of the new initiative on their resolution. However, this initiative is clearly another step in the IRS's trend of removing discretion from examination teams and centralizing control over major issues in specific National Office functions. A majority of these issues are international tax matters, and it is thus likely that IRS officials will consult with their peers in Canada, Australia, the United Kingdom, and other key jurisdictions.

Steve Jackson
Ernst & Young LLP, Toronto

Confederation Cost-Benefit Scorecard?

Every year, a provincial government or an academic organization uses Statistics Canada's Provincial Economic Accounts to determine how much the federal government has contributed to or taken out of provincial economies. The federal deficits and surpluses ("net lending," in national accounts terminology) are usually popularly interpreted

Federal Government Surplus or Deficit, by Province, 2004

	millions of dollars
Newfoundland and Labrador	–2,386
Prince Edward Island	–725
Nova Scotia	–4,486
New Brunswick	–3,186
Quebec	–2,123
Ontario	20,784
Manitoba	–3,680
Saskatchewan	–2,769
Alberta	8,961
British Columbia	1,892
Yukon	–630
Northwest Territories	–501
Nunavut	–1,014
Canada	5,714

as the gains or losses from Confederation—in effect, as a scorecard. This year, Statistics Canada itself published the first analysis of federal bottom lines for 2004 in the February 2007 edition of the *Canadian Economic Observer*. The analysis included an extensive discussion of why the results do not represent a measure of the benefits of belonging to Confederation (http://www.statcan.ca/cgi-bin/downpub/listpub.cgi?catno=11-010-XIB2007002).

The results are summarized in the table, but the caveats deserve more attention than can be provided in this short article. The Statistics Canada analysis points out the difficulties of allocating the benefits of federal spending among the provinces, from the concrete question of who benefits from a rescue helicopter that is based in one province but serves many, to the abstract issue of who benefits from the holding of federal debt when the interest flows to the head office of a pension fund with annuitants across the country. Similar questions arise with the allocation of federal revenues. For example, collections of employment insurance contributions from employers are allocated according to the province where the corporate offices are situated, regardless of where the employees are resident.

Still greater problems arise when the federal government has a national surplus or deficit. How is the surplus or deficit allocated? Beyond the strength or weakness of the numbers are fundamental questions about the benefits of belonging to Confederation. Equalization goes directly to only some provinces, but it provides buying power to bolster the markets of other provinces.

The Statistics Canada article should become the definitive publication on balance-sheet federalism, but it will not wipe out the concept of a scorecard on Confederation.

David B. Perry
Canadian Tax Foundation, Toronto

Canco Deducts Foreign Sub's Losses

In *Avotus* (2006 TCC 505), a Canadian corporation whose foreign subsidiary carried on business as its agent was allowed to claim the sub's losses in its own income tax return. The CRA had deleted the subsidiary's income and losses from the taxpayer's return, arguing that the subsidiary carried on business on its own behalf. Relying on an intercompany agreement and agency law, the TCC held that the taxpayer could in effect treat the separately incorporated foreign business as a branch.

Avotus was a Canadian-resident corporation involved in the business of telecommunications expense management. Mr. M owned 50 percent of Avotus's shares; two other individuals owned the rest. In 1994, Mr. M moved from Canada to Puerto Rico and decided to expand the business into the Puerto Rican market. In 1994, Avotus incorporated Americas as a wholly owned subsidiary in Puerto Rico. Using a Puerto Rican corporation and not a branch enabled Mr. M to obtain a work visa and allowed the business to open a local bank account. Americas proceeded to lease premises, hire employees, and purchase equipment in its own name and generally to carry on the business of selling Avotus products and services. Americas's financial statements and Puerto Rican tax returns were prepared on the basis that it carried on business on its own account.

An intercompany agency agreement, however, provided that in entering into any contracts or otherwise effecting any business transactions, Americas was acting solely as the agent of Avotus. A preamble stated that the Canadian company intended to carry on business in Puerto Rico "directly . . . and not through a subsidiary": Americas would act on behalf of Avotus in entering into all agreements and otherwise assuming obligations, and it would assign all related rights and liabilities to Avotus. Americas received no compensation for its services. The Puerto Rican business operations resulted in losses in the first three of the four years at issue, and in income in 1999; Avotus reported the losses and income in its financial statements and Canadian tax returns because it took the position that all income and loss "of" its agent Americas belonged to Avotus as principal.

The TCC agreed that a valid agency relationship had been created and that the losses and income thus belonged to Avotus. The FCA in *Merban Capital* (89 DTC 5404) had said that "the basic rule [is] that a taxpayer can deduct only expenses *it* incurred to earn *its* income" (emphasis in the original); in contrast, the TCC quoted the FCTD in *Denison Mines* (71 DTC 5375): "It is conceivable that there may be an arrangement between the shareholder and the company which will constitute the company, the shareholder's agent, for the purpose of carrying on the business and so make the business that of the shareholder."

Although there was some uncertainty regarding the duration of the agency, the court found that such an arrangement was in place during the relevant taxation years, and thus the business carried on by Americas in its capacity as agent was Avotus's business. Accordingly, Americas's income, deductions, and losses belonged on Avotus's tax return, even if they had also been reported inconsistently for Puerto Rican tax purposes. The court dismissed the Crown's argument that the sub could not be an agent because an agent could not do what the principal was not legally able to do: there was never any prohibition against Avotus's carrying on business in Puerto Rico.

The TCC did not concern itself with Puerto Rico's right to tax Avotus, and no double tax convention applied. (Puerto Rico is not covered by the Canada-US treaty.) However, the OECD's December 2006 *Report on the Attribution of Profits to Permanent Establishments* contains significant guidance regarding source-country taxation of a so-called dependent-agent PE, such as Americas. Assume that Americas earned a fee for acting as its Canadian parent's agent and that a Canada-Puerto Rico treaty based on the OECD model was in place. According to the OECD report, Puerto Rico would have taxing rights over two different taxpayers in respect of the local agent: Americas in its capacity as a resident corporation and Avotus in its capacity as a non-resident with a dependent-agent PE. Consequently, to determine the full extent of profits taxable by Puerto Rico, two different analyses are required: the first (under article 9) determines whether Americas was compensated for its agency services on an arm's-length basis by its parent, and the second (under article 7) determines which Avotus profits are attributable to its local dependent-agent PE. According to the OECD, even after Americas has been taxed in Puerto Rico on its profits determined by the article 9 transfer-pricing analysis, additional amounts of business profits allocated under the article 7 analysis may also attract Puerto Rican tax. Even if one does not agree with the OECD's position, it should be kept in mind in situations where article 5(5) of a treaty applies to an agency arrangement between associated enterprises.

In the context of Canadian tax law, the TCC's decision in *Avotus* is an interesting reminder that a properly documented agency relationship (with which the parties' conduct is generally consistent) may effectively result in a consolidation of a corporate shareholder's and its subsidiary agent's profits and losses. It is also interesting that Avotus planned to carry on business in another jurisdiction through a dependent-agent subsidiary, a result that taxpayers usually try to avoid. In this case, the tax planning effectively led to a Canadian version of a US check-the-box election: the Canadian business obtained the foreign legal and commercial benefits of corporate personality in respect of a business that it treated as a branch for domestic tax purposes.

Matias Milet
Osler Hoskin & Harcourt LLP, Toronto

Alabama Addback Statute

Over the past few years, 18 US states have enacted statutes limiting the deductibility of certain expenses paid from one affiliate to another. Typically, deductions for interest and royalty expenses paid to an affiliate are disallowed if the deductions result in a tax benefit in one state and no corresponding tax increase in another jurisdiction. Addback statutes and exceptions vary by state and often affect common cross-border tax-planning structures used by Canadian corporations. A recent much-awaited lower court decision in Alabama held that an Alabama taxpayer's royalties paid to affiliates based in Delaware were deductible in computing Alabama taxable income (*VFJ Ventures, Inc. v. Alabama Department of Revenue*, docket no. CV-03-3172). Alabama is expected to appeal the decision.

VFJ Ventures manufactured jeans and related products in Alabama and maintained two distribution facilities in the state. VFJ licensed trademarks from two Delaware-based affiliates and paid arm's-length royalties for the use of the trademarks. The affiliates had employees and office space in Delaware, where they owned, managed, and licensed several trademarks to VFJ, other affiliates, and third parties. The terms of the licensing agreements with unrelated third parties were identical to those with VFJ.

VFJ deducted the amount of royalties paid to the affiliates in computing its Alabama taxable income. Alabama's addback statute required a corporation to "add back otherwise deductible intangible expenses and costs directly or indirectly paid, accrued, or incurred to one or more related members" unless one of several exceptions applied. On examination, Alabama disallowed the deductions for royalties paid by VFJ. VFJ argued that the statutory "unreasonable" exception applied because it would be unreasonable to add back the royalties in the circumstances.

At trial, the court noted that the statute did not define "unreasonable" and looked to the legislative intent—namely, to prevent abusive deductions and to ensure that income fairly attributable to Alabama is taxed in Alabama. The court found that the tax authorities' addback was unreasonable in this case because VFJ's royalty payments were not abusive: they had economic substance and business purposes, and they represented real and necessary costs of doing business for VFJ. The court said that disallowing VFJ's deductions would distort the amount of VFJ's income fairly attributable to Alabama. The affiliates carried on "substantial activities that [were] vital to the business operations of the [corporate] group." The court's conclusion "was not altered by the fact that the transactions may have been motivated by tax considerations."

The decision is favourable, but it does not deny that royalty deductions may be unreasonable and disallowed. The decision demonstrates that qualifying for the "unreasonable" exception requires a fact-intensive analysis; in *VFJ Ventures*, the exception was supported because the related companies that owned the intangibles had true operating businesses.

Jeffrey Brown and Ian Bristol
KPMG LLP, Toronto

Roadblock to Foreign Private Equity?

Financing Canadian Innovation, by Stephen A. Hurwitz and Louis J. Marett (available at www.cdhowe.org) argues that some of Canada's tax laws, such as its section 116 certificate requirements, impede foreign investment by private equity firms and act as tax barriers to foreign capital and to the incidents of foreign investment such as knowledge of the US market, customers, distribution channels, suppliers, and strategic partners. Canadian businesses receive about one-third of the funding that their US competition receives. The following discussion summarizes the commentary.

Section 116 clearance certificate. The procedure to limit tax withheld on the sale of a private Canco by a non-resident is said to be time-consuming, expensive, complex, and uncertain. A private equity partnership must disclose the identity and residence of all of its partners to benefit from the treaty capital gains exemption—a daunting task for large partnerships, such as those whose partners include other funds. An interest in a partnership that invests mainly in Canadian private equity may also be taxable Canadian property. There is a long list of required supporting material; for example, individual and corporate partners in a US private equity firm may be required to submit copies of their most recent home-country income tax returns and a letter from their tax authorities confirming their residence. All applicants must obtain a Canadian tax identification number; an individual must submit a second prescribed form (form T1261), together with original or certified identification documents (such as a birth certificate and passport).

The 45 CRA tax services offices have different and often inconsistent practices and procedures. Approval time is unpredictable and ranges from several weeks to (more often) four to eight months, creating the risk of an intervening decline in the securities' FMV. The CRA rarely issues a section 116 clearance certificate to a US private equity firm before the closing of sales of private company stock. On closing, the purchaser withholds 25 percent of the gross sale proceeds (including any non-cash consideration), and remits it within 30 days of the month's end; a CRA comfort letter may allow deferral of remission until the certificate is issued. The applicant must also file a Canadian income tax return for the year to report the sale, even if no tax is due or payable. Many US private equity firms have agreements prohibiting general partners from entering into arrangements that require limited partners to file tax returns in foreign jurisdictions or to disclose certain private information such as tax returns, thus precluding them from investing in Canada. As a result of Canada's extensive treaty network, Canada does not tax most non-residents on capital gains from the sale of stock of private Canadian companies, limiting the potential tax leakage targeted by the clearance process.

A solution may be to provide limited exceptions from withholding for, say, the sale of stock in a private Canadian opco by a US private equity investor, or to streamline the process by filing a claim for treaty benefits with the purchaser in lieu of a CRA certificate. Any solution should avoid government approval or a certification process with significant administrative burdens. Compliance may be monitored by requiring either the vendor or the purchaser to submit, shortly before the sale, formal written notice confirming the factual requirements for legal compliance.

Limited liability companies. An LLC is considered a corporation in Canada. But if it elects partnership treatment under US tax law, the CRA says that it is not a US resident eligible for treaty relief, partly on the basis of the SCC decision in *Crown Forest* ([1995] 2 SCR 802) that only an entity liable to tax in the treaty-partner country is eligible for treaty relief. Many US private equity firms have some LLC partners and face double taxation on Canadian investments, but Canada gains no discernible benefit. A Canada-US treaty protocol has been under negotiation for seven years; as an alternative, the CRA could administratively allow protection for LLC partners in private equity firms.

Tax-free rollovers. The Canadian vendor cannot roll its Canco shares in exchange for non-Canco shares, but a private equity investor can roll its shares in exchange for Canco's. As a result, the Canco shares may be sold for a lower price. Proposals to extend tax-free rollovers to all Canadian investors appeared in federal budgets for four years, but they eventually disappeared; in November 2006, Finance indicated that there was no timetable for the change. With appropriate safeguards, the CRA could collect tax when the Canadian resident disposed of the forco's rollover stock.

CCPC status. A CCPC by definition cannot be controlled by non-residents or public corporations. A CCPC enjoys appreciable tax benefits, all of which may be jeopardized by a foreign private equity firm's significant investment.

Arguably, a CCPC's special tax status should be based on the level of business activity and/or the number of employees in Canada, and not on Canadian control, ownership, or incorporation; thus, tax benefits would be granted for significant and continuing economic benefit to Canada. Alternatively, a limited exception could apply while a Canadian company (1) is at an early stage of development, (2) has domestic or foreign private equity investment of a certain level, and (3) maintains a certain level of employees and business in Canada.

Jack Bernstein
Aird & Berlis LLP, Toronto

INTERNATIONAL TAX AUDITS

The February 2007 report of the Auditor General (AG) indicates that the CRA has become increasingly concerned with the tax risks associated with international transactions. Although the AG found that the CRA is now better able to identify potential non-compliance with the tax rules in international transactions, the CRA still needs to improve in (1) providing international tax auditors with better information on global business issues in specific industry sectors, (2) ensuring that there is enough international tax audit expertise in all CRA offices that handle high-risk files, and (3) matching non-resident tax data.

The AG's 2007 report says that aggressive tax planning, which included international tax compliance, has been one of the CRA's top four compliance priorities since 2004. As noted in the report, the CRA estimates that over 16,000 Canadian corporate taxpayers report some type of foreign transaction with related parties that, in total, involve an amount estimated to exceed $1.5 trillion in 2005.

The 2005 federal budget allocated $30 million annually to the CRA to enhance its efforts to address aggressive international tax planning. The CRA is using these funds to research tax avoidance and to increase the number of international auditors and tax-avoidance auditors. As of March 31, 2006, the CRA had 320 international auditors and researchers and 210 non-resident auditors and program officers. As noted in the AG's report, the CRA's total international audit reassessments increased to $941 million in 2006 from $778 million in 2001 (to $729 million from $300 million, respectively, from international transactions by large corporations).

Auditors now use checklists and other planning tools to help them determine whether a corporation may be non-compliant and to begin transfer-pricing and foreign affiliate audits. In addition, the time budgeted for an international audit of a large corporation has increased significantly.

According to the AG, most of the risk-assessment data used by the CRA come from its foreign reporting database, T2 schedules, and transfer-pricing documentation; all of these data are much less extensive than those used by other tax administrations, especially in Australia and the United States. The Australian tax authorities can obtain access to all information on large international cash flows—access that is denied to the CRA because of the Canadian government's concerns about privacy. The IRS has available to it information from the much more extensive reporting required of US corporate taxpayers on their transactions with foreign affiliates, and it also can obtain access to information from 20 exchange-of-information agreements that the United States has with non-tax-treaty countries.

The AG recommends that the CRA seek access to broader information on the current international business practices of industry groups and on specific taxpayer transactions when it can demonstrate that such access would improve the identification and assessment of the emerging international tax risks or improve compliance with international tax rules. The 2007 report revealed that the CRA has increased the use of information requests from foreign jurisdictions, but concluded that CRA auditors are still not making sufficient use of the CRA's powers to make such requests when a taxpayer fails to provide the information voluntarily.

The AG reports that international tax non-compliance—measured by tax audit recoveries—continues to be a significant audit issue in large corporations: in the last four years, about 30 percent of the large corporate reassessments in Canada arose from audits of international tax issues. The AG reports a wide range in the value of international reassessments across TSOs in that period: only 25 percent of those recoveries came from the GTA offices, but more than 40 percent of the large corporations with non-arm's-length international activity file their tax returns in the GTA. The AG recommends that the CRA develop appropriate strategies to ensure that the international audit approach to, and the coverage for, large corporate taxpayers, relative to tax risk, is consistent across the country.

The AG says that the CRA has some inconclusive results in its compliance and risk-assessment studies of the investment, pension, and business income paid to non-residents subject to Canadian tax, partly because of poor data quality on the information slips provided by taxpayers and partly because the CRA has had difficulty matching the information to the proper taxpayer. The AG recommends that the CRA seek legislative changes requiring all non-resident individuals, corporations, and trusts that are subject to Canadian tax to have and use tax numbers, a mechanism that would permit the CRA to match electronic data, improve compliance and risk assessments, and streamline enforcement activities.

Paul Hickey
KPMG LLP, Toronto

François Vincent
KPMG LLP, Montreal

Regulation Intra Vires

Tax legislation may be challenged if it attempts to impose a tax that is outside the constitutional authority of the enacting government. (See "Unconstitutional Tax Recoverable," *Canadian Tax Highlights*, February 2007.) Moreover, tax statutes, like other complicated legislation, typically authorize the making of accompanying regulations to fill in the details of the legislative scheme. This so-called subordinate legislation cannot exceed the scope authorized by the enabling statute; if it does, it is ultra vires. The recent TCC decision in *Weyerhaeuser* (2007 TCC 65) illustrates the principle's strength and limits in challenging the revenue authorities whose regulations exceed their statutory mandate.

Paragraph 153(1)(g) requires a payer of "fees, commissions or other amounts for services" to withhold "the amount determined . . . [by] prescribed rules." In accordance with that mandate, regulation 105 was promulgated to require withholding from a payment to a non-resident for a "fee, commission or other amount in respect of services rendered in Canada." In *Weyerhaeuser*, the taxpayer was reassessed because it failed to withhold from, inter alia, reimbursements of a non-resident's out-of-pocket costs.

The TCC said that the basic principle was clear: "The power to make regulations is limited to that which Parliament has conferred in the statute." The court concluded that the wording of paragraph 153(1)(g) was directed to payments in the nature of income, as were all of paragraphs (a) to (t) in subsection 153(1). In its plain meaning, the enabling authority—paragraph 153(1)(g)—embraced amounts paid for services but not reimbursements of expenses incurred in the provision of those services. (A long line of cases establishes the non-taxability of reimbursements of out-of-pocket expenses.) The purpose of the provision led to the same conclusion. It was intended to ensure the availability of funds from which any tax liability could be paid if the taxpayer was ultimately determined to be liable to tax in Canada. The subsection is not a charging provision; it did not impose a tax but merely required withholding on account of a potential tax liability. Withholding on a reimbursement—not a taxable amount—would not further the purposes of paragraph 153(1)(g) or the Act as a whole. Requiring withholding would be contrary to the interests of Canadian industry: if non-residents were required to wait until they filed a return to obtain a refund of 15 percent of expenses reimbursed, it would create a disincentive to offer services to Canadian clients. Furthermore, the CRA cannot, by administrative fiat in its IC, establish "administrative exceptions" for withholding, impose requirements beyond those created by the Act, or establish standards of proof that a taxpayer must meet.

However, the regulation was not ultra vires merely because the phrase "in respect of" had been described as being "of the widest possible scope" by the SCC in *Nowegijick* ([1983] 1 SCR 29). That case was decided in the context of the Indian Act and was shaped by the Crown's obligation to native peoples. In the case at hand, the TCC preferred to "read down" the regulation. The governing principle was that an enactment—"of Parliament, a legislature or a subordinate body to which legislative power was delegated"—should be interpreted so that "its operation is restricted to matters within the power of [its] enacting body" (*McKay*, [1965] SCR 798). Regulation 105 was interpreted as intra vires and thus applied only to matters that were within the mandate of the enabling subsection 153(1)—that is, amounts that were potentially taxable in Canada. The TCC also suggested that it could have reached the same result by effectively "rewriting" the regulation to render it intra vires, because it was confident that the governor in council would have exercised his regulation-making power in that manner had he properly recognized the power's limits (*British Columbia Ferry Corporation*, [2001] 4 FC 3, and *Société des alcools du Québec*, 2002 FCA 69).

Weyerhaeuser is an example of how the validity of a tax may be challenged on the basis that it is ultra vires the enabling legislation. The case also demonstrates the uphill battle a taxpayer may face, especially given the principle that courts should attempt, if possible, to read down otherwise ultra vires regulations to render them intra vires. Notwithstanding the reading-down doctrine, however, the ultra vires argument remains important, especially when the revenue authorities rely on regulatory requirements to establish exemption from or liability for tax. The rejection of the IC's requirements casts a clear light on this second layer of administrative decision making and emphasizes that the Crown's assumptions or approaches may not withstand judicial scrutiny.

Robert G. Kreklewetz and Simon Thang
Millar Kreklewetz LLP, Toronto

Deferred Compensation: US Traps

Most Canadian employers with executives who are subject to US taxation are generally aware that non-qualified deferred compensation plans for these employees must be reviewed to ensure compliance with or exemption from Code section 409A, enacted in 2004. Employers generally have until the end of 2007 to formally amend their plans (IRS Notice 2006-79), which in the interim must be operated in good faith compliance with section 409A.

Section 409A dramatically changed the rules governing non-qualified deferred compensation, eliminating much of the flexibility that had been a hallmark of deferred compensation. (Some deferrals are grandfathered.) Significant new restrictions are imposed on benefit deferrals and distributions, and changes are made to the form and time of payment. Penalties for non-compliance are steep (immediate taxation of all vested amounts, interest, and a 20 percent excise tax), underscoring the need for careful attention to the new rules. Compliance has been complicated by the delay in the issuance of final regulations. Proposed regulations were issued on September 29, 2005 (Reg-158080-04); final regulations promised for the spring of 2006 have not materialized, leaving employers to cope with interim guidance and many unanswered questions.

Most employers have focused their reviews on traditional non-qualified deferred compensation plans, such as supplemental executive retirement plans (SERPs) and excess benefit plans. But the definition of deferred compensation under section 409A is extremely broad and covers a wide range of plans and arrangements that may have as yet escaped an employer's review. Employers need to expand the scope of their reviews to include many non-traditional compensation arrangements or else risk inadvertent violations of section 409A.

Most non-qualified **stock options**, for example, are explicitly exempt, but only if they are not discounted: the exercise price must equal or exceed the underlying shares' FMV at the date of grant. Discounted options must comply with section 409A or be subject to tax and penalties at vesting. Similar rules apply to stock appreciation rights. Practically speaking, recipients may be required to exercise discounted options at a time identified when they were originally granted. Much of the benefit is lost because the recipient no longer has the flexibility to choose the tax year of the options' exercise and thus the income inclusion. Privately held companies also face the burden of demonstrating that their options are issued at FMV to escape the clutches of section 409A.

Full-value stock options (including incentive stock options) are initially exempt, but may inadvertently attract the new rules if they are impermissibly modified to effectively result in a new grant for section 409A purposes. If the exercise price is below FMV at the date of the new grant, the previously exempt options are now tainted. Some modifications—such as acceleration of vesting—are permitted, but changes to the terms of existing options should be made cautiously. For example, employers commonly extend the exercise period for employees who are terminating employment. Such an extension is permissible if it does not surpass the later of the end of the calendar year after, and two and a half months after, the former option's expiry date. Longer extensions result in the option's generally being subject to, and in violation of, section 409A from the date of the original grant, regardless of the exercise price.

Severance arrangements should also be examined carefully. Severance provided on involuntary termination may be exempt if it does not exceed two times the lesser of the compensation and the qualified plan limitation ($225,000 for 2007), and it is fully paid by the end of the second calendar year following the termination year. A payment that fails to meet the severance exception may nevertheless meet another exception. For example, severance paid on involuntary termination meets the short-term deferral exception if all payments are made within two and a half months after the end of the termination year. However, severance agreements often provide for benefits on voluntary termination by the executive with "good reason," and current guidance excludes severance payments made under such an agreement from both the severance and the short-term deferral exceptions, even if the actual event that triggers payment is involuntary termination.

Non-exempt severance payments must comply with section 409A. Generally, the time and form of payment must be specified from the outset in the employment agreement or severance plan, and timing changes are strictly limited. For example, accelerating payments from instalments to a lump sum is not permitted. Severance payable to certain key employees of publicly traded companies may require a six-month delay in payment.

A wide variety of **other plans and arrangements** have a deferred compensation element, including severance policies, deferred bonus plans, and phantom stock plans. Affected benefits are commonly found wrapped into other agreements, such as individual employment, consulting, and change-of-control agreements. Any arrangement or agreement should be examined if a payment to a service provider for a right to compensation that became legally binding in a year is deferred to a later year. Offending agreements may cover a single person or non-employees, such as directors, independent contractors, and partners who provide services in return for compensation.

Anita Coles Costello
Hodgson Russ LLP, Buffalo

HAND-DELIVERED MAIL

A change in the CRA's policy of date-stamping hand-delivered documents has important implications for SR & ED claimants, particularly because the CRA no longer has legislative authority to accept late-filed SR & ED claims.

Every CRA local office previously provided, on a taxpayer's demand, date-stamping for hand-delivered documents. This service was terminated in 2006, leaving

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taxpayers with two choices: drop their documents in the local CRA office mailbox or have them date-stamped by the post office. Neither alternative guarantees that all the documents will reach the CRA taxation centre safely and be processed. Late-filed, misplaced, or lost documents may result in interest and penalty charges. The CRA policy change caused widespread consternation, and on December 7, 2006, the minister responded by saying that the CRA will date-stamp envelopes but not the documents themselves: "While CRA counter staff cannot confirm the completeness or acceptability of the contents . . . they will stamp the sealed envelope with the date of delivery, assuring taxpayers that a record of the transaction has been created."

Stamping of documents is particularly important to SR & ED investment tax credit (ITC) claimants because of the strict filing deadline. Prescribed forms T661, T2SCH31 (for corporations), and T2038(Ind) (for individuals) must be filed no later than 12 months to the day after a taxpayer's income tax return filing due date for the year when the SR & ED expenditure was incurred. If the SR & ED claim is not filed on time, the SR & ED ITCs are lost, and no grace period is allowed. Before November 17, 2005, a taxpayer could request in certain situations that the minister waive the filing deadline. However, Bill C-33 (first reading in the House of Commons on November 22, 2006) eliminates this possibility and effectively removes any recourse for SR & ED claimants unable to file an SR & ED claim on time, even in circumstances beyond their control such as a death in the family, fire, or flood.

If (as sometimes happens) the CRA misplaces any prescribed form or the project descriptions, a claimant cannot prove that a complete SR & ED claim that met the requirements of the law was filed on time, because each document was not date-stamped. In practice, the CRA assistant director of SR & ED could decide to accept a late-filed claim, but this discretion is purely administrative: the law no longer authorizes the acceptance of late-filed claims. To ensure that a claim is not jeopardized, an SR & ED claimant should file its claim early enough to give the CRA time to review the claim and confirm that it is in order. The same caution applies to some amended SR & ED claims. The minister's announcement also encourages tax filers to use the CRA's electronic services, but at present a complete SR & ED claim cannot be filed electronically.

Mel Machado
PricewaterhouseCoopers LLP, Ottawa

Foreign Tax News

Italy

The Italian Supreme Court confirmed the PE treatment for VAT purposes of a Panamanian company that was carrying on taxable transactions in Italy through an Italian affiliate.

France-Quebec

A new social security agreement between France and Quebec entered into force on December 1, 2006.

United States

The IRS will waive penalties for underpayment of US estimated tax by US residents and citizens who live and work abroad and claim the foreign earned income exclusion and the foreign housing cost allowance.

Netherlands

In *Amurta* (case C-379/05), the ECJ has been asked to decide whether the exclusion from the dividend withholding exemption of non-resident shareholders with more than 5 percent but less than the minimum participation in the parent-sub directive is compatible with the free movement of capital in the European Union.

Denmark

Major tax amendments following the ECJ decision in *Cadbury Schweppes* (case C-196/04) are intended to counter tax planning by buyout funds and to make CFC rules compliant with EU law, including reducing the corporate income tax rate from 28 to 22 percent.

Japan

Tax reform proposals introduce anti-avoidance rules for cross-border reorganizations after September 2007. New measures improve APA application procedures and administration and introduce new tests for tax havens when shares have different voting rights on the distribution of shares or have different rights to claim company distributions. Effective April 1, 2008, the non-ownership-transfer finance lease is treated as a sale and purchase and not as a rental.

Vivien Morgan
Canadian Tax Foundation, Toronto