CANADIAN TAX Highlights

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RIGHT TO A FAIR TAX HEARING

Although the 1960 Canadian Bill of Rights sets out the fundamental rights underlying our justice system, it rarely has a perceptible impact in a Tax Court appeal. The TCC's decision in *Morel, Belchetz and Garber* (2007 TCC 109) provides an excellent example of the legislation's lasting impact.

During the 1980s, investors purchased units in limited partnerships with the promise that the partnerships would engage in yacht-chartering operations. Many years later, the partnership promoters were convicted of offences under the Criminal Code and the Income Tax Act for defrauding the public of tax revenues by making false claims to the CRA related to approximately $110 million in losses for 36 partnerships, and for defrauding the investors of their cash deposits, the value of promissory notes, and interest paid. Further convictions arose for causing or attempting to cause the investors and the Crown to rely on forged documents, including financial statements and invoices relating to the partnerships.

In civil appeals from subsequent reassessments denying partnership losses, the Crown argued that investors were precluded (under the doctrine of abuse of process by relitigation) from arguing that the losses arose from genuine partnership business operations. Although the investors were not parties to the criminal proceedings and had not had an opportunity to testify in them, the Crown said that findings of guilt in the criminal cases finally disposed of the question of whether the partnerships could qualify as sources of income under section 3 of the Income Tax Act. Giving effect to this position meant that investors would have their appeals dismissed without ever having an opportunity to present their cases.

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The Bill of Rights provides that fundamental freedoms in Canada include the right of the individual to enjoyment of property and the right not to be deprived thereof except by due process of law. The Bill of Rights also provides that every law of Canada (unless expressly declared to operate notwithstanding the Bill of Rights) shall be construed and applied so as not to deprive a person of the right to a fair hearing, for the determination of his rights, in accordance with the principles of fundamental justice.

Ruling on a preliminary determination of a question of law, Bowie J held that dismissing the investors' civil tax appeals as sought by the Crown would not be consistent with the right to a fair hearing, in accordance with the principles of fundamental justice, in determining the extent to which investors are obliged by law to surrender property to the tax collector. The court ruled that the right of the investors to a fair hearing includes the right to present evidence on their own behalf. Acknowledging that there are good reasons to avoid the potential for conflicting decisions from different courts where it is possible to do so and still do justice, the TCC said that in this case the credibility of the judicial system would not be enhanced by denying the investors the right to call evidence. The merits of the investors' positions in the appeals are not yet determined.

Coincidentally, the Ontario Superior Court of Justice made a similar finding on the ground of fairness in a tax law context in *Engels v. Merit Insurance Brokers Inc.* (2007 CanLII 6455). The CRA Appeals Division ruled that Engels was an independent contractor, not an employee of Merit. At that time he was advised that he had a right to appeal to the TCC, but he did not appeal. Subsequently, Engels sued Merit for damages for wrongful dismissal; Merit countered that it would be an abuse of process to permit the action to proceed because the tax ruling had determined that Engels was an independent contractor.

Engels argued that the doctrine of abuse of process did not apply because the tax ruling was not made in a judicial proceeding: the ruling was not made as part of a fair, unbiased, adjudicative process that provided the parties with an opportunity to know and meet the case against them. The court said that it was unnecessary to determine whether the tax ruling proceedings were judicial; a more fundamental reason for not applying the abuse-of-process doctrine to dismiss Engels's action was that it was not fair to do so. Fairness dictated that the original result should not bind Engels, who during proceedings leading to the tax ruling had no reason to appreciate that his classification as an employee would be significant to a claim he had not yet advanced. There had been no proper adjudication of the issue of whether Engels was an employee or a contractor.

Engels left open the question of whether a decision by the CRA Appeals Division is made in the course of a judicial proceeding. If it is, the Appeals Division must be much more scrupulous in observing taxpayers' fundamental rights, including the right of fairness in the objection process. Currently in parts of Ontario, the Appeals Division transfers review of a notice of objection to an appeals officer located in a city where the taxpayer does not reside, and it also refuses to meet with taxpayers and their representatives when a meeting is requested. Both practices raise obvious questions of fairness, especially because an informal survey of tax practitioners discloses that these practices are not uniform across Canada. Even if the courts do not conclude that the review of a notice of objection amounts to a judicial proceeding, fundamental fairness should be a hallmark of the notice-of-objection process.

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Barbados: Holdco Regime

On March 15, 2007, the *Barbados Advocate* reported the full text of Barbados' 2007 budget. Of interest to Canadian taxpayers is the government's stated objective to make Barbados a "premier location specifically for Holding Companies."

Two impediments to the objective of establishing Barbados as a jurisdiction of choice for holdcos currently exist: (1) Barbados income tax on dividends received by resident companies from non-resident sources, and (2) Barbados withholding tax on dividends paid by a resident company to non-resident shareholders out of foreign-source income. Both were acknowledged as a "major constraint" on the development of Barbados as a holding company regime. The budget proposed that beginning in 2007 dividends received by Barbados-resident companies (including companies licensed as international business companies [IBCs] under the International Business Companies Act, 1991) are exempt from Barbados tax on dividends received from a non-resident company if a 10 percent participation threshold is met and the shares are not held as a mere portfolio investment.

This change is welcome news to Canadian-based multinational groups. The change will result in a lower overall effective tax rate and will also permit a Canadian-based multinational group to implement a holding company structure that accesses Barbados' treaty network, which includes Canada, the United States, the United Kingdom, and China. The change also allows the maintenance of exempt surplus balances accumulated by lower-tier companies and repatriated to Barbados by way of dividend; those balances are otherwise reduced by the Barbados income taxes paid on the dividend's receipt. Furthermore, on payment of exempt surplus dividends to Canada, the change provides a larger addition to a CCPC's general rate income pool (GRIP, item G of the proposed definition); as a result, a larger amount may be designated as an eligible dividend available for the proposed enhanced dividend tax credit without the imposition of the proposed part III.1 tax.

In addition, Barbados proposes a withholding tax exemption for dividends paid by a Barbados-resident company to a non-resident shareholder from the company's foreign-source income. Except in unusual circumstances, this change currently has limited significance for Canadian-based multinationals, whose Barbados subsidiaries are typically licensed as IBCs and are therefore not subject to the withholding tax. However, the change may encourage foreign investors to invest in Canada through regular Barbados companies, which are generally eligible for benefits under the Canada-Barbados treaty.

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Tax Treaty Residence

Income Tax Technical News (ITTN) no. 35 (February 26, 2007) clarifies the CRA's position on when a person is liable to tax in a contracting foreign state for tax treaty purposes.

To qualify for the benefits under a Canadian tax treaty, a person must be considered a resident of a contracting state for the treaty's purposes. Treaty residence is also a prerequisite for certain dividend deductions under Canada's domestic foreign affiliate rules and regulations. To be a resident of a contracting state, a person must be liable to tax in that state under the residence article of the particular treaty.

The CRA's long-standing position has been that to be considered liable to tax for the purposes of the residence article of a Canadian tax treaty, a person must generally be subject to the most comprehensive form of taxation in the relevant country. For Canada, such subjection generally means full tax liability on worldwide income, a position supported by the SCC's decision in *Crown Forest Industries Ltd.* (95 DTC 5389).

ITTN no. 35 confirms this position. However, the CRA agrees that a person need not actually pay tax to the relevant jurisdiction in order to be considered resident there. Thus, in cases where a person's worldwide income is subject to a contracting state's full taxing jurisdiction but its domestic law either does not levy tax on a person's income or taxes it at lower rates relative to Canada, the CRA now generally accepts that the person is a resident of the other contracting state unless the arrangement is viewed as abusive (such as in the case of treaty shopping or if the person is a "resident of convenience"). The CRA considers a person a resident of convenience when the manner of a person's placement under the taxing jurisdiction of a contracting state to gain treaty benefits does not create any material economic nexus with that state.

A particular contracting state may tax an entity that has an attachment to that state at rates comparable to Canada's tax rates, but some of those entities may be exempt from taxation or taxed at low rates under special rules in the contracting state. Previously, the CRA did not consider those entities to be subject to the most comprehensive form of taxation in the relevant contracting state and therefore considered them not liable to tax and hence not resident in that state. Tax professionals suggested that this position could adversely affect charities and pensions and asked the CRA to review its position on the meaning of "liable to tax." At the Canadian Tax Foundation's 2005 conference, the CRA announced that it would review its position.

Although the CRA has modified its administrative position somewhat, the ITTN stresses that it is important to review the intention of the parties to a tax treaty in order to delineate the scope of the treaty's application, as set out in *Crown Forest*. Accordingly, the CRA says that determining residence for the purposes of a tax treaty remains a question of fact: each case is decided on its own facts, bearing in mind the intention of the parties to the particular treaty and the purpose of international tax treaties in general.

New dividend tax regime now law. Legislation in Bill C-28 to implement the new dividend tax regime received royal assent on February 21, 2007. If it has not already done so, a corporation has until May 22, 2007 (90 days after royal assent) to formally notify its shareholders of the designation of any eligible dividends paid before February 21, 2007.

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High-Income Taxpayers

At the end of the last century, Finance Minister Michael Wilson was criticized for complaining that Canada did not have enough rich people. A brief review of historical data contained in the CRA's annual compilation of taxation statistics shows improvement in that situation over the past 38 years.

The table shows that in 1966, only slightly more than 6 percent of all taxpayers had assessed incomes above that year's average of $5,193. Average incomes increased

Taxable Personal Income Tax Returns for Selected Tax Years

	Average assessed income, $	Percent of returns above average	Tax as percentage of assessed income
1966	5,193	6.2	10.3
1970	6,447	13.9	15.3
1980	18,896	34.1	15.6
1990	31,430	39.4	19.3
1995	34,686	37.4	19.3
2000	41,998	32.6	19.6
2004	46,445	35.6	17.8

almost steadily to a high of $46,445 in 2004, when more than 35 percent of taxable returns reported above-average incomes. The proportion of taxpayers with incomes above the average declined slightly from 1990 to 2000, but rose again in 2004.

The table also shows how the burden of the personal income tax has changed over the period. In 1966, tax represented only 10 percent of aggregate assessed income. By 1990, that percentage rose to over 19 percent, but the period of tax reductions by both federal and provincial governments brought tax down to less than 18 percent—still well above the very high top marginal rates of the 1960s.

Because of changes in the definition of taxable income, it is hazardous to compare income tax statistics over a long period of time. In the first two years shown in the table, for example, assessed income excludes any element of capital gains. The overall design of the tax system has changed dramatically over the period—with lower top marginal rates and flatter progressivity—but the higher tax-to-income ratios indicate that these changes did not hinder the tax system's revenue-raising capacity.

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Tax Fairness for Canadian MNCs

The 2007 federal budget proposal on restricted interest expense for foreign affiliate investments materially increases the tax burden on many Canadian MNCs, and in some cases may result in a meaningful loss of enterprise value.

The restricted interest expense proposal was drafted to cast as wide a net as possible by using a combination of broadly worded anti-avoidance language and the tracing principle underlying the interest deductibility rules. The resolution proposes that no deduction is allowed to a taxpayer "in respect of" interest and other borrowing costs "relating to" an investment in an FA. Both those qualifying phrases are generally considered to have expansive meanings. The provision can be read to include indirect FA investments such as one Canco's acquisition of another Canco that has both Canadian and foreign subsidiaries. Once the rule is triggered, there is no prescription for apportioning interest if the acquisition involves both FAs and non-FAs or if the acquisition is partially or fully funded with debt. There are also no rules that take into account refinancings or a substituted use of borrowed funds initially traced to an FA investment.

Restricted interest expense may be claimed to the extent that the Canco that made the FA acquisition or loan receives non-exempt FA income in respect of that FA. Non-exempt income is essentially interest income, taxable capital gains, FAPI, and dividends received net of any section 91 and 113 deductions. In most cases, a Canco does not generate enough non-exempt income to free up restricted interest expense entirely, resulting in a permanent disallowance of interest on borrowings used to invest in an FA. Borrowing for the purposes of loaning to an FA is generally not an ideal arrangement, in part because of foreign tax considerations, Canadian restrictions on crediting interest withholding tax, and foreign exchange considerations.

The rule's application is retrospective, and the grandfathering period is short—the lesser of 33 months for arm's-length debt (21 months for non-arm's-length debt) and the time to the debt's maturity. Unless the proposal is softened or the grandfathering is extended, the rule's retrospective application may be the aspect that causes most concern. For many Cancos, the 33-month grace period only delays the inevitable and may not allow them to moderate the rule's impact by, for example, a shift of some indebtedness against Canadian-source income so that tracing yields a more favourable result. Any restructuring by a Canco within the grandfathering period may trigger the rule's anti-avoidance component and frustrate the attempt to achieve what might be a fairer result. The budget document's background analysis indicated that this rule adapts existing tracing rules; however, it is not known whether navigating through the tracing rules is enough to achieve tax-deductible debt or whether the rule's anti-avoidance aspects (and GAAR) can override the affirmative use of the tracing rules. The rule's ambiguity and resultant uncertainty of application, and a taxpayer's inability to take action on prior or proposed transactions, combine to compound the unfairness of the rule's proposed implementation. Assume that a Canco has a large Canadian-based business. In early March 2007, it acquired a US business as the next step in its strategic growth. The Canco's only debt is the borrowing from arm's-length lenders in Canada to acquire the US operation. The proposal renders non-deductible all interest related to the borrowing, even though Canco has a substantial Canadian-based business that could have borne tax-deductible debt. Moreover, linking transitional relief solely to the borrowing date and not to the earlier of the borrowing date and the investment date does not give commercial recognition to the fact that a taxpayer may have locked itself into an acquisition before committing to a particular funding source.

The minister's policy objective is concerned with tax fairness, but there does not appear to be any analysis of the economic impact on Canadian corporations and their ability to compete globally. In particular, the proposal compromises the ability of Canadian businesses to compete in Canada's main investment and trading markets where interest deductibility is not thus restricted, and it leaves little doubt that they are thereby placed at a competitive disadvantage relative to their competitors from jurisdictions that allow more tax-effective means of financing business expansion. It is also noteworthy that any Canco that experiences a meaningful loss of enterprise value can be restructured with fully deductible debt through a foreign takeover that accesses the paragraph 88(1)(d) bump to extract foreign subsidiaries from under the Canco.

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Easing Interest Non-Deductibility?

The proposal to "ring-fence" interest expense relating to foreign investments is intended to maintain fairness; the budget papers say that the targeted practice resulted in "Canadian taxpayers indirectly subsidizing [MNCs'] international operations" and making it "more attractive . . . to locate new income-earning operations in a foreign country." Critics say that the proposal will make it more costly for Canadian MNCs to compete globally. Perhaps other rules that are also sometimes perceived as eroding the Canadian income tax base should be re-evaluated to determine whether fiscal room should be created to temper the proposal.

Our existing tax system makes it relatively easy for a foreign purchaser of a Canco that heads a multinational group (Target) to reorganize it and strip down its operations to those in Canada. As a result, the Canadian company becomes, from a management perspective, a branch that requires no sizable team of management, legal, and finance expertise positioned in Canada. In certain fact patterns, the new foreign owner can dispose of Target's foreign subs without attracting Canadian income tax. The foreign purchaser simply sets up a Canadian acquisition company (Bidco) to buy Target's shares. Often there is sufficient "excess purchase paid" by Bidco for the shares of Target (relative to Target's asset costs) and share ownership so that Target's merger or windup allows a "tax bump" to the merged entity's (or Bidco's) tax cost of Target's foreign subs' shares to their FMV at the time of Bidco's acquisition. The stage is set for an immediate sale by Forco of Target's foreign subs out from under it at FMV with no Canadian tax.

The bump rule was introduced to alleviate double tax and provide symmetry within the Canadian tax system. In practice, however, the Canadian vendor of a publicly listed Target is often either a tax-exempt entity or a non-resident that is treaty-protected from Canadian tax on the gain. A gain realized on Target's shares can relate to its foreign affiliates' "untaxed earnings" and other accrued gains. Perhaps the bump should be confined to situations where Target's bumped property (shares or other non-depreciable property) continues to be, say, ultimately Canadian-controlled. Or perhaps the bump could be limited to the tax paid by the vending parties along the way. The United States, for example, does not permit a step-up in tax basis on a deemed asset sale to a purchaser unless, inter alia, there is an equivalent tax hit to Target.

More protection to the Canadian tax base might be offered by amending the section 18 thin-cap rules, particularly given the federal budget signal of an eventual move to zero treaty withholding tax on interest paid to related US residents. More efficient barriers may be required to block a Canco's foreign owners from stripping out profit from Canadian operations via new and inappropriate in-house debt leverage. Typically, a foreign entity forms a special-purpose Canadian entity (Bidco) to acquire all a Canadian Target's shares. Bidco, which has no other assets, borrows most of the purchase price on the strength of a foreign parent guarantee. Bidco and Target are merged and the debt that tracks through to the surviving entity bears no economic relationship to the ability of the Canadian operations to service it. The existing tax-acceptable debt-equity ratio of 2:1 before disallowed interest applies where the loan to Canco is from a specified non-resident shareholder. Alternatives include various industry standards to dictate the level of leverage, or more sophisticated US-style earnings-stripping rules that sweep in Canadian loans with foreign parent guarantees or "keep-well" agreements. However, allowance may have to be made for a foreign-owned Canco that can no longer operate in Canada and compete as a consequence of the resulting higher cost of funds.

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US Accounting for Tax Benefits

FASB Interpretation no. 48, "Accounting for Uncertainty in Income Taxes" (FIN 48, June 2006), prescribes how public and private companies should recognize, measure, and disclose uncertain tax positions in their financial statements. FIN 48 is mandatory for financial statements for fiscal years starting after December 14, 2006. It requires companies to evaluate all "tax positions" and to recognize, for financial accounting purposes, only the tax benefits of those tax positions that are "more likely than not" to be sustained on examination.

FIN 48 applies to all entities that prepare financial statements in accordance with US GAAP, including US partnerships, C corporations, S corporations, and tax-exempt entities, and SEC-registered foreign companies. Thus, FIN 48 affects a USco's Canadian parent or subsidiary whose financial statements must be prepared in accordance with US GAAP, as well as a Canadian company that is registered with the SEC.

Under FIN 48, all (not just uncertain or aggressive) income tax positions (including foreign income tax positions) must be identified—a challenging task for companies that do business in multiple jurisdictions. FIN 48 applies to income taxes only, not to other taxes such as sales and use tax, VAT, and franchise tax. Affected "tax positions" include the decision not to file a tax return (including a return for a US state or foreign jurisdiction); a determination regarding whether a permanent establishment exists; the allocation of income between jurisdictions; the characterization of income on a tax return; the classification of an entity or a transaction as tax-exempt (including classifications of partnerships and non-profits); and any transfer-pricing issue. An entity subject to FIN 48 must do an inventory of all tax positions for all tax years still open to audit; but determining whether a year is auditable is complicated in a jurisdiction where the statute of limitations does not begin to run unless a return is filed. For example, if a Canadian company did not file a US tax return and did not make a treaty election because it believed it had no US permanent establishment, the statute of limitations is open on that tax position, and it may need to be considered for FIN 48 purposes.

Once all tax positions have been identified, a two-step analysis is employed. (1) The company must determine whether it is "more likely than not" (a 50 percent likelihood) that a tax position will be sustained on its technical merits, assuming that the position will be examined and evaluated with full knowledge of all relevant information;

the probability of a tax audit or whether the issue would be raised on audit is not relevant to this determination. (2) If it is determined that a tax position is more likely than not to be sustained on the merits, the company can recognize the tax benefit on its financial statements, but only in an amount determined under the rules—namely, the largest amount of the tax benefit that, in the company's judgment, has a greater than 50 percent likelihood of being realized in a settlement with the relevant tax authorities. The amount that cannot be recognized on the company's financial statements as a result of this analysis (the difference between the amount recognized for FIN 48 purposes and the amount reported on a tax return) is reflected as a liability on the company's financial statement relating to an uncertain tax position. The company must also accrue interest and, if applicable, penalties associated with the uncertain tax position. With respect to prior open years, the company is required to adjust its retained earnings rather than its current income tax expenses and net income on its balance sheet. As a practical matter, requiring the amount of a tax position that does not meet the more-likely-than-not standard to be reflected as a liability effectively provides a roadmap for IRS examining agents and other tax authorities.

Appendix A of FIN 48 contains several useful examples of how the two-step analysis should apply in practice. For example, paragraph A.21 breaks down the second step into tabular form. A tax position is assumed to meet the more-likely-than-not standard. The maximum tax benefit that can be recognized on the financial statements is determined on the basis of the "possible benefit outcomes" shown in the table:

Determination of the Maximum Tax Benefit for Financial Statement Purposes

Possible benefit outcome, $	Individual probability of occurring, %	Cumulative probability of occurring, %
100 (complete success)	5	5
80 (very favourable compromise)	25	30
60 (fair compromise)	25	55
40 (unfavourable compromise)	30	85
0 (total loss)	15	100

The possible benefit outcome of $60 is the largest benefit that is more than 50 percent likely to reflect the ultimate outcome; thus, $60 of the $100 benefit can be reflected in the financial statements. The $40 difference between the $100 reported on the return and the $60 thus shown as a benefit on the financial statements is reflected as a liability on the financial statements.

Implementation of FIN 48 raises significant accounting, auditing, and tax issues for US companies and Canadian companies registered with the SEC. Because FIN 48 is already in effect and compliance may be cumbersome for multinational companies operating in multiple jurisdictions, companies subject to these new disclosure rules should develop an approach for implementing FIN 48.

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Personal Tax Cuts for 2007

As a result of recent federal and provincial budgets, an individual's income tax may be reduced for 2007, depending on his or her circumstances and province of residence.

- A parent may benefit from a new non-refundable child tax credit announced in the 2007 federal budget, calculated as a prescribed percentage of $2,000 for each child under 18 at the end of the year, starting in 2007. The credit is worth about $310 per child for 2007 and is indexed for inflation. Unused credit amounts may be transferred between spouses.
- A single-income family may benefit from a 2007 federal budget increase to the spousal and wholly-dependent-relative credits (currently $7,581) that brings them up to the basic personal amount, which is $8,929 for 2007. This increase is worth up to about $209 for 2007.
- A taxpayer who disposes of qualified small business corporation shares and qualified farming and fishing property may benefit from an increase to the lifetime capital gains exemption. The 2007 federal budget increases the exemption to $750,000 (from $500,000) for such dispositions after March 18, 2007.
- As previously announced, a taxpayer who has income eligible for the pension income credit may be able to reduce his or her family's overall tax bill starting in 2007 by splitting that income with a spouse or common-law partner (see "Splitting Pension Income," *Canadian Tax Highlights*, March 2007).
- A Quebec shareholder of a CCPC may benefit if Quebec's 2007 budget delivered before the recent provincial election passes into law. That budget's cut to the corporate income tax rate on passive income results in almost perfect integration in 2007 for investment income (including capital gains) earned by a Quebec-based CCPC and distributed as dividends to individual Quebec shareholders. Thus, for most of 2007, the tax cost of an individual's earning investment income through a corporation subject to the Quebec corporate tax rate on passive income is not significantly higher than earning it directly, but the former increases in 2009 when other corporate tax rate changes take effect.

■ An individual in British Columbia should generally benefit from the province's plan to reduce the four lowest income tax brackets and from the phase-out of the provincial tax reduction. When fully implemented, the rate changes mean at least a 10 percent reduction in provincial personal income tax for an individual with income under $100,000. An individual earning $100,000 saves about $430 in provincial tax in 2007 and $864 in 2008. The provincial top marginal rate remains 14.7 percent.

■ An individual in New Brunswick generally pays more tax in 2007, because the government has increased the provincial tax rates on all tax brackets. The rate increase was relatively higher for the two lowest brackets (about 4.5 percent) than it was for the top bracket (0.6 percent). As a result, an individual earning $66,900 pays about $368 in additional provincial taxes in 2007.

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IRS Allows Rescission Doctrine

The IRS has ruled that a parent company may undo a merger and effectively restore the parties to the relative positions they would have occupied if the merger transaction had not occurred (PLR 200701019, October 5, 2006).

Parentco acquired for cash all the outstanding common stock of Sub 1, whose sole asset was all the outstanding common stock of Sub 2. Immediately thereafter, Parentco merged Sub 1 with and into it, leaving Parentco surviving. The merger's stated business purposes were to reduce state franchise tax exposure and maximize operational efficiencies. Shortly after the merger, Parentco experienced unexpected and significant weaknesses in two of its core businesses and determined that it might have to dispose of one or more lines of business, including Sub 1's, to raise capital.

Parentco's cost basis in Sub 1's stock evaporated when it was eliminated on Sub 1's merger into Parentco. Parentco inherited Sub 1's basis in its Sub 2 stock, presumably a lesser amount than what Parentco had just paid for Sub 1's stock. Thus, a subsequent sale by Parentco of the Sub 2 stock would have generated a gain. Realizing that the merger (and the resulting elimination of the cost basis) was a mistake, Parentco decided to reconstruct Sub 1. Parentco formed a new Sub 1 and contributed all the outstanding stock of Sub 2 as capital in exchange for all of new Sub 1's common stock. The new Sub 1 was incorporated in the same state as the old Sub 1, and its articles of incorporation and bylaws were identical to the old Sub 1's prior to the merger. On the basis of the parties' restoration, before the end of the tax year, of their relative positions had the merger not occurred, the IRS ruled that Sub 1 is to be treated as not having merged into Parentco and that the two are to be treated as two separate corporations at all times during the tax year. As a result, Parentco's cost basis in the old Sub 1 stock remains intact in the new Sub 1 stock.

In permitting the rescission, PLR 200701019 cites Rev. rul. 80-58 [1980-1 CB, 181] as support. In February 1978, individual A sold a tract of land to B for cash. The sale contract obliged A, at B's request, to accept reconveyance of the land from B if, within nine months of the date of sale, B was unable to have the land rezoned. In October 1978, B so notified A, and B reconveyed the land to A for the original purchase price. A and B were calendar-year taxpayers. Because the parties were returned to their same pre-sale positions, and the sale and rescission occurred in a single tax year, the ruling concluded that the original sale is disregarded for US federal income tax purposes.

PLR 200701019 is a generous extension of Rev. rul. 80-58. In Rev. rul. 80-58, the rescission occurred under an arm's-length contract that permitted A and B to undo the sale if B failed to obtain the necessary rezoning approval. Under the contract, A and B were returned to their original positions. In contrast, the idea of a rescission in the PLR was prompted by Parentco's post-merger realization that the merger was a mistake from a tax-planning perspective. Moreover, from a legal perspective, the merger eliminated one of the merger parties (old Sub 1), and thus the parties could not legally rescind the merger. Instead, Parentco incorporated new Sub 1 as a clone of old Sub 1. Nonetheless, the IRS determined that Parentco had effectively rescinded the merger for tax purposes.

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GST: Constructive Importer

A proposed change to the proposed but never enacted constructive importer rules attempts to correct an apparent drafting error.

Proposed section 178.8 of the Excise Tax Act, announced on October 3, 2003 and applicable to all goods imported on or after that date, sets out input tax credit (ITC) entitlement for division III GST paid on the importation of specified supplies. The rule is intended to ensure that ITC entitlement for the division III GST on goods sold or leased outside Canada and then imported for the consumption, use, or supply of the constructive importer (the supply's recipient outside Canada) is determined by the constructive importer's activities. Proposed subsection 178.8(2) provided that when goods supplied outside Canada were later imported for "consumption, use or supply by . . . the last person to whom a supply of the goods is made outside Canada [the constructive importer]," the division III GST then paid or payable was deemed paid or payable by or on behalf of the constructive importer and no other person. On a plain reading, the rule applies only if the goods were subsequently imported by the constructive importer and not by another person, such as the supplier. The rule thus seems to miss its very target. In contrast, the explanatory notes clearly state that the rule "deems imported goods that have been supplied outside Canada to be imported by the constructive importer of the goods and not by any other person."

Finance has corrected what was presumably a drafting oversight. The Sales Tax Amendment Act, 2006 revises proposed subsection 178.8(2) to provide that where a specified supply is made outside Canada, whether the constructive importer or another person imported the goods for the constructive importer's use, etc., it is the constructive importer who is deemed to have imported them. Thus, regardless of the actual importer's identity, new proposed subsection 178.8(2) deems the constructive importer to be the person who paid the division III GST on importation and thus the only person entitled to claim the ITC (subject to subsections 178.8(4) and (7)).

The revision, announced on November 27, 2006, is retroactive to the effective date of the original proposal. Once section 178.8 is enacted, it will be interesting to see who bears the costs of what appears to have been a drafting oversight and whether the CRA will attempt to assess constructive importers that relied on proposed subsection 178.8(2) as it stood from October 3, 2003 to November 27, 2006.

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Income Trusts: Non-Qualifying REITs

On March 27, 2007, Finance released revised legislation implementing the proposed entity-level tax for publicly traded trusts and partnerships.

Despite considerable lobbying pressure, the legislation, revised from the version originally announced on October 31, 2006, does not exempt energy trusts and does not extend the grandfathering beyond 2010. The "normal growth" guidelines announced on December 15, 2006 are incorporated by reference and may be revised periodically. A qualifying REIT is exempt from the rules if it satisfies four tests. (1) The REIT cannot own "non-portfolio property" other than qualified REIT properties that include a direct ownership in real estate and a defined security in a subject entity that also meets these four tests. (2) At least 95 percent of the REIT's revenue (not income, as originally proposed) for the taxation year is derived from rent from real properties, interest, capital gains from dispositions, and royalties. (3) At least 75 percent of the REIT's revenue (not income) for the taxation year is derived from rent from Canadian real property and mortgages thereon. (4) The FMV of Canadian real property, cash, and government debt must at all times comprise at least 75 percent of the REIT's equity value.

Several aspects of the tests are problematic for existing REITs.

■ No exemption is offered to REITs that operate hotels and nursing homes, such as Chartwell, Chip, Holloway, Inn Vest Legacy, and Royal Host. A business cannot be restructured into a separate taxable subsidiary owned by the income trust, as it can be in the United States, although it may be possible to structure the business prospectively so that it is operated by a sister entity and a stapled security is offered to the public, an approach adopted in Australia.

■ Income trusts that derive more than 25 percent of their revenue from US properties are offside, a rule that may affect H & R, Dundee, and IPC REITs.

■ A REIT cannot derive more than 5 percent of its income from management and other fees, fees for extra services not normally provided to tenants, or rents based on profits. It is assumed that a rent based on the tenant's gross revenue rather than profit is acceptable. This rule may protect REITs that own retail properties. If such income exceeds 5 percent, it may be possible for the REIT to form a management company but, apparently, no other form of entity. The management company must be directly owned by the entity that owns the property, it cannot manage real estate held for development, and it may receive fees only for properties in which it has an interest. A REIT that is involved in a joint venture with an outside party (such as RioCan REIT) is entitled to receive management fees because it has an interest in the property, but it cannot receive third-party fees on properties in which it has no interest. The rules may preclude the rendering of services to other entities in the REIT group.

■ As a mutual fund trust, a REIT cannot directly engage in carrying on business. For that reason, an intermediary trust was often interposed to own real estate or to be a partner in a partnership that owned real estate. In such a structure, Finance says that a mutual trust (the REIT) does not qualify because it does not directly derive rent

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from real property in Canada; it is earning income from the intermediary. Interested parties are currently attempting to obtain a reversal of that view.

■ A REIT such as IPC that owns a non-resident subsidiary is offside. However, if the REIT's only income is dividends, the income is not classified as non-portfolio earnings and the trust is not subject to the entity-level tax.

■ The revised legislation provides that a REIT that qualified on October 31, 2006, but not later, is not eligible for the four-year transition.

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Foreign Tax News

Canada's Treaties

Negotiations to update the **Canada-Spain** income tax treaty were scheduled to be held during the week of April 16, 2007 in Madrid.

United States

Proposed regulations curb abuses by artificially generated foreign tax credits. (Release IR-2007-73, March 29, 2007). The targeted transactions set out in the proposed regulations involve a US taxpayer's voluntarily subjecting itself to foreign tax, while an ordinary business transaction would attract little or no tax.

France

If certain conditions are met, a March 29, 2007 guideline says that withholding may be based on a partner's residence for passive income received through a foreign partnership that is fiscally transparent in its home country.

The Civil Code is amended to provide tax measures for a fiducie (similar to the common-law trust) for management and hedging purposes.

Russia

Tax authorities and lower courts ruled that a sale-leaseback that yielded profit levels lower than the official inflation rate was tax-motivated and had no substance. The Supreme Arbitral Court of the Russian Federation concluded that the arrangement was economically viable and not abusive, low profitability notwithstanding.

Sweden

The national net wealth tax will be abolished by the end of 2007 to encourage the retention of investments in Sweden and to increase risk capital investments.

Belgium

The European Commission extended the procedure regarding Belgian coordination centres, which were found to be incompatible state aid. Interested parties may submit their comments before transitional rules are established for those centres.

Isle of Man

The budget confirmed that exempt companies will be abolished and all other special regimes repealed effective April 5, 2007.

China

The new Enterprise Income Tax Law, applicable to resident and non-resident enterprises, takes effect after 2007.

Czech Republic

The Supreme Administrative Court applied a domestic substance-over-form rule in a treaty context. The court recharacterized consideration paid to a resident individual as dividends subject to a domestic withholding rate; the non-resident payer was said to be a mere intermediary without any business interest in the transaction, and its initial receipt of an amount characterized as dividends subject to a lower treaty rate was reduced accordingly.

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