CANADIAN TAX Highlights

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Section 160: Undue CRA Delay

In *Addison & Leyen Ltd.* (2006 FCA 107), the FCA held that a taxpayer may apply to the Federal Court for judicial review of the CRA's conduct in the context of a section 160 assessment. If the decision withstands appeal to the SCC, it will provide taxpayers with a new and potentially powerful method of challenging section 160 assessments.

Broadly speaking, section 160 permits the CRA to collect the tax debt of a debtor from another person if (1) the parties are not at arm's length; (2) the tax debtor transferred property to the second person for less than FMV consideration; and (3) the tax debtor has an unpaid tax debt that arose in the year when the transfer occurred, or in a prior year. The tax debtor and the second person are then jointly and severally liable to pay the tax debt (up to the transferred property's FMV net of any consideration given).

In *Addison*, the taxpayers as shareholders and directors had liquidated most of the assets of York Beverages (1968) Ltd. and distributed the proceeds among themselves—as dividends, loan repayments, fees, and retiring allowances—before September 30, 1989 (its year-end), but leaving adequate funds to cover its estimated 1989 tax liability. The taxpayers resigned as directors and the new director, a representative of an unrelated company, Senergy Inc., caused York to acquire seismic data in hope of eliminating York's tax liability for 1989. York's shares were then sold on September 28, 1989 to Senergy; thus, the taxpayers were still shareholders of and related to York when the seismic data were purchased.

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In 1992, York was reassessed on the seismic data purchase for $3.2 million in tax and penalties; York filed a notice of objection in 1993. The CRA said that the seismic data had been overvalued. (The minister had not responded to the objection, and York had not taken further steps to appeal even at the time of the FCA hearing in 2006.) The file sat dormant until 1997, when the CRA realized that it had not determined whether it could collect the tax debt from York; by mid-1998, the CRA had concluded that it could not. In late 1998 or early 1999, the CRA issued information requests regarding York to the taxpayers, who had had no involvement with York since its sale to Senergy in 1989 and were unaware of the 1992 reassessment. The taxpayers responded to the requirements, and the CRA used the information supplied to trace York's 1989 distributions to the taxpayers. The CRA did not notify the taxpayers of York's situation, which a note in the CRA's file suggested it had deliberately concealed in order to aid collection of the debt from the taxpayers. In February 2001, approximately 12 years after the taxpayers sold York and 9 years after York was reassessed for the tax debt, the CRA issued section 160 assessments to the taxpayers. By that time, accrued interest had caused York's total tax liability to grow from the initial $3.2 million to $6.7 million.

The taxpayers brought an application in Federal Court for judicial review of the section 160 assessments, alleging that they should be quashed on grounds including delay, unfairness, and abuse of process. The Federal Court trial judge struck out the application, saying that the remedy sought was not within the Federal Court's jurisdiction. On appeal to the FCA, the majority disagreed: section 18.5 of the Federal Courts Act provides only that the Federal Court does not have the jurisdiction to hear judicial review applications for matters for which an appeal lies to the TCC, "to the extent that it may be so appealed." The majority noted that in an income tax appeal the TCC considers only whether an assessment is correct; it does not consider unreasonable delay or other improper conduct on the part of the CRA (except for the application of the Charter of Rights and Freedoms to evidentiary issues), because those matters are not relevant to the determination of the correct tax liability.

The court noted that a section 160 assessment is issued at the minister's discretion, a discretion not circumscribed by any statutory time limit. The rule thus creates a potentially unfettered assessment mechanism to which the taxpayer can plead neither due diligence nor a lack of control or knowledge of the primary tax debtor's affairs.

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In view of the scope of the minister's discretion, the fact that section 160 is primarily a collection tool and not an assessment tool, and the limits on the TCC's jurisdiction to supervise the minister on a section 160 assessment, the majority allowed the taxpayers' appeal. The court concluded that section 18.5 of the Federal Courts Act was not sufficiently explicit to deprive a taxpayer of the right to seek judicial review of the minister's exercise of discretion in issuing a section 160 assessment.

The minority issued a strong dissent. The minister's delay in issuing the section 160 assessment was not reviewable in the Federal Court: subsection 160(2) specifically allows the minister to assess at "any time," an indication that Parliament clearly intended that section 160 assessments could not be challenged on the basis of delay. While agreeing that the result seemed harsh in this case, the minority suggested that only Parliament has the authority to address the overbreadth of section 160 (and perhaps also the scope of the minister's discretion with respect to the interest and penalties). An appeal to the SCC was scheduled to be heard on May 24, 2007. The FCA minority, Rothstein J, is now a member of the SCC and will have to sit out the appeal.

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Going Dutch

The Netherlands has a long history of providing an attractive locale for establishing holding, financing, and royalty companies. A new vehicle, the Dutch cooperation (co-op; in Dutch, *coöperatie*), has surfaced in response to changes in ruling practice that temporarily chilled interest in the Netherlands.

To attract international holding or financing structures, the Netherlands has offered many advantages, including its extensive and favourably negotiated treaties, the participation exemption, the absence of withholding taxes on interest and royalties, and a cooperative tax authority. In 2001, the favourable ruling practice was changed in response to external pressure. (See "Dutch Double Under Pressure," *Canadian Tax Highlights*, May 2001.) Multinational companies started to look more seriously at other jurisdictions such as Luxembourg.

The Netherlands has been working hard on a solution to once again attract foreign interests. Capital duty tax was abolished in 2006, and the 2007 Dutch corporate income tax reform, inter alia, streamlined the participation exemption and interest deductibility rules. However, Dutch withholding tax on dividends remained a hurdle. A 2005 Ministry of Finance announcement promised the dividend withholding tax's eventual demise, but the 2007 tax reform only reduced the basic withholding tax rate from 25 to 15 percent. A 15 percent rate—even a 5 percent rate—is usually possible under tax treaties, and thus the reform fell short of solving the tax impediment to locating in the Netherlands.

A solution materialized in the co-op, which is now commonly used in international structures. The co-op's main benefits are its access to the Dutch participation exemption and the absence of Dutch dividend withholding tax on profit distributions. Currently, the Dutch Dividend Tax Act does not apply to distributions by the co-op. Interposing a Dutch co-op thus eliminates the need for other exit strategies such as interposing a top holding company in Cyprus, Hungary, or Luxembourg.

Co-ops developed in the mid-18th century to permit farmers to collectively purchase and sell goods. The co-op was adopted into Dutch law in 1876 as a species of association; in 1988, the co-op became a separate legal entity.

A co-op is an association, a cooperative established by a notarial deed. Its articles must state that its object is to provide for certain economic needs of its members. A co-op must have at least two members. The co-op's members are not liable for its debts during its existence, and their joint liability upon dissolution or bankruptcy can be specifically excluded in whole or in part in the articles of incorporation. Due to the co-op's flexibility, its articles can be shaped so that the co-op resembles either a corporation or a partnership for foreign purposes. The co-op does not require a minimum capital; capital contributions are allocated to the members' capital account, and profits are allocated to the members on the basis of their contribution.

A co-op is considered a separate taxpayer for Dutch corporate income tax purposes and is thus subject to the basic corporate tax rate of 25.5 percent. The co-op can apply the Dutch participation exemption to its income derived from subsidiaries; the co-op can also be used for Dutch financing structures. To avoid concerns over whether foreign tax authorities might view the nature of the entity differently, in some circumstances it may be useful to create a double Dutch structure with a co-op on top of a Dutch corporation (BV).

The CRA announced in November 2006 that it was reviewing whether it considered a Dutch co-op to be a corporation. A CRA ruling (2006-0208571R3) concluded that the particular co-op examined therein could be treated as a corporation for Canadian income tax purposes. The ruling rested on the fact that the co-op was characterized in the Netherlands as a separate legal entity, and its board of directors was charged with the authority to legally commit and bind the co-op. The co-op's articles provided that (1) it was incorporated for an indefinite period; (2) admission and transfer of membership were subject to members' approval; (3) members were entitled to one vote, and the total number of votes was in proportion to the capital accounts; (4) members should have separate capital accounts whose repayment was subject to the approval of all members; (5) profits were available to the entity and could be retained unless the members voted in favour of distribution; (6) the board of directors had authority to represent the co-op; and (7) the members were completely excluded from any liability for any of the co-op's debts or losses. Although the ruling does not confer the status of corporation on every co-op, it does make it possible for a Canadian parent to structure a co-op as a corporation and avoid Dutch withholding tax.

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GST Harmonization Strategies

Sales tax harmonization was always Finance's goal, even before the GST's introduction in 1991. Apart from the harmonized sales taxes of three Atlantic provinces (bought with a federal one-time incentive of $1 billion) and Quebec's own partial move toward a harmonized tax, the goal has proved elusive.

Recent rumblings from Finance suggest a renewed initiative to bring under the GST tent the five remaining provinces with retail sales taxes: Ontario, British Columbia, Saskatchewan, Manitoba, and Prince Edward Island. The 2006 *Advantage Canada* document suggested "a stronger Canadian economic union . . . by encouraging the provinces to move ahead with the harmonization of sales taxes with the GST." That theme reverberated in the March 2007 budget, which committed the federal government to "[p]ursuing a more competitive business tax system [through harmonization] . . . effectively eliminating retail sales taxes on business inputs and capital goods." In addition to gains in economic efficiency and investment growth, harmonization reduces complexity for consumers, compliance costs for business, and tax collection costs for governments.

Provincial RST is supposedly a direct tax on the consumer, but in practice 40 percent of RST revenue derives from businesses. The importance of harmonization in making Canada's business taxation system more efficient and more conducive to investment is brought into focus by comparing the burden of RST on capital with the burden of corporate income taxes. For each province that imposes an RST, the table shows the impact of these two forms of taxes on the marginal effective tax rate (METR) on investment, as projected for 2011. METR is the most comprehensive measure of the investment-hindering effects of taxation. The table shows a striking result. Harmonizing the RST of those five provinces on average reduces their METR fully as much as eliminating their provincial corporate income taxes. Either tax change reduces Canada's overall METR on investment by 5.5 percentage points (more than four times the impact of eliminating the remaining provincial capital taxes). Harmonization in Ontario alone would shave 4.1 percentage points off the country's METR. In short, sales tax harmonization lowers Canada's tax burden on capital from one of the world's highest to a more investment-friendly level.

Impacts on METR of Harmonization Versus Provincial Corporate Tax Abolition, 2011[a]

		METR impact (percentage points)		
	Base case METR, %	GST-PST harmonization	Provincial CIT abolition	Ratio of impacts (harmonization/ CIT cut), %
British Columbia	32.9	−8.1	−8.4	95.8
Saskatchewan[b]	28.0	−4.9	−8.3	58.7
Manitoba	33.1	−8.7	−9.6	90.5
Ontario	36.0	−9.1	−8.7	104.2
Prince Edward Island[c]	31.3	−19.3	−13.6	141.8
Canada (total)	31.1	−5.5	−5.5	100.6

[a] Excludes resources, financial services, and R & D assets. [b] The investment tax credit designed to offset the RST burden on investment has been eliminated. [c] The impact of harmonization is affected by large investment tax credits.
Source: Canada, Department of Finance, communication with author.

Despite the major economic gains from harmonization and Finance's best intentions, no one has produced a roadmap or strategy on how to achieve that goal. Harmonization's Achilles' heel continues to be the visibility of the large tax-burden shift from business to consumer. Economists Michael Smart and Richard Bird computed the shift at $6.2 billion in 2002, equal to about $7.5 billion in 2007. In Ontario alone the shift is computed at nearly $5 billion annually. The federal government does not have $7.5 billion annually to induce harmonization. Other incentives to spark reform must be developed, drawing on federal flexibility and fiscal incentives and provincial policy ingenuity.

■ The starting point for reform should be the Quebec sales tax (QST) model, under which each harmonizing province continues to set its own tax rate and taxable base. Unlike the GST, which provides businesses with full input tax credits (ITCs) to offset tax paid on capital and other inputs, the QST offers only partial ITCs and thus reduces the visible tax burden shift from business to consumers. The CRA could enter into a tax collection agreement requiring a province to provide at least 70 percent ITCs for business capital purchases initially (rising to 100 percent over several years) and at least 50 percent credits for intermediate input purchases. This scheme emphasizes a reduced tax burden on capital relative to other business costs.

■ The federal government could rebate to the harmonizing provinces the incremental business income taxes arising from the reduced business deductions for sales tax incurred on inputs. This rebate, in addition to the partial ITCs, would substantially reduce the tax shifted onto consumers and ultimately lift the tax burden from investment. The 2007 federal budget offered the provinces a similar rebate as an incentive for eliminating their capital taxes.

■ If the harmonizing provinces raised corporate income tax rates by up to 2 percentage points in order to cushion their revenue losses, the net METR effect on business taxation would still show much greater efficiency than not harmonizing. Recouping the lost revenue from the corporate taxes would also make the process more politically palatable to consumer-voters.

■ The GST tax treatment of new housing might need to be changed. Currently, GST applies to the full construction cost, including land value, while provincial sales tax strikes only the materials and not the on-site labour or land. A 13 or 14 percent harmonized tax on the full cost of new homes and condos would be politically problematic. The exclusion of land value from the taxable base generates the greatest relief to home purchasers in Ontario and British Columbia, the two provinces critical to harmonization.

■ As in the Quebec model, harmonizing provinces should be allowed to depart from the federal GST base. Some provinces may wish to continue current sales tax exemptions, such as books and meals in British Columbia, under a harmonized tax. Others may wish to exempt home repair and maintenance, an industry in which GST evasion is already rampant; trying to apply the higher harmonized rates might prove futile in any event.

■ Accelerating the second GST rate cut from the government's 2011 target could lubricate the harmonization process. That 1 percent cut could allow room for a rate hike of 0.5 percent in the harmonizing provinces, giving the provinces $2 billion annually to buffer the business-to-consumer tax shift. Consumer-voters in the harmonizing provinces would still see a net cut of 0.5 percent in their total sales tax rate; all other provinces would experience a full 1 percent cut.

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Disclosure Not Voluntary

The Federal Court recently held in *L'Heureux* (2006 FC 1180) that a CRA decision maker had arrived at a reasonable conclusion when he rejected the taxpayer's voluntary disclosure application for unreported consulting income from his major client: the application was made after the CRA initiated an audit of that client.

The CRA's voluntary disclosure program is intended to provide taxpayers with an opportunity to correct omissions of taxable income from past returns without attracting interest and penalties imposed under the Act and other Canadian tax legislation. The empowering legislation contains no specific requirements, saying only that "the Minister may at any time waive . . . all or any part of penalty or interest otherwise payable." Four criteria for valid disclosure are listed in *Information Circular* 00-1R, "Voluntary Disclosures Program," at paragraph 6, including the requirement that the taxpayer initiate the disclosure. Thus, a disclosure is not considered voluntary if it is made with the knowledge that an audit, investigation, or other enforcement action had been initiated by the CRA.

The taxpayer in *L'Heureux*, Mr. L, was a consultant who had advised a client corporation (Canco) about its SR & ED expenditures since September 2001. On April 13, 2004, Canco received notice from the CRA that its SR & ED claim would be "subject to a financial and scientific audit." Until May 24, 2004, the CRA reviewed Canco's financial records, met with Canco's accountants and Mr. L in his capacity as Canco's consultant, and requested further information from Canco's accountants, including cheques paid to Mr. L. On May 28, 2004, Mr. L filed a voluntary disclosure application regarding unreported income, including income from Canco. He claimed that this voluntary disclosure was made on his behalf by his accountant, whom he had directed "in the winter of 2004" to "straighten out" his affairs, and was not related to the CRA's review of Canco's SR & ED claim.

The chief of appeals in the Montreal Taxation Services Office rejected the application, and Mr. L applied for judicial review of that decision. The Federal Court stated that the appropriate standard for its review of the CRA decision was one of reasonableness only. The court cited an SCC decision in *Law Society of New Brunswick v. Ryan* ([2003] 1 SCR 427), which said, "When deciding whether an administrative action was unreasonable, the court should not at any point ask itself what the correct decision would have been. . . . [A] decision may satisfy the reasonableness standard if it is supported by a tenable explanation even if [it] is not one that the reviewing court finds compelling." On the facts in *L'Heureux*, the Federal Court said that "[t]he notion of 'audit' within the meaning of paragraph 6(a) of the Circular cannot be limited to a direct and immediate review of the tax return or the financial statements of an individual, but includes audits of third parties when it is reasonable to believe . . . that the purpose and the impact of the audit are sufficiently related to the object of the disclosure, in this case, the [taxpayer's] income." The Federal Court said that it was a reasonable inference from the evidence before the CRA decision maker that the disclosure was not voluntary because Mr. L's application resulted from his knowledge of the CRA's ongoing audit of Canco's SR & ED claim.

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Settlement Payments: GST

Section 182 of the Excise Tax Act (ETA) ensures that certain amounts paid in respect of a breach of a contract are subject to GST. In practice, settlement negotiators frequently overlook the rule, creating a windfall to the person defaulting under the contract and a shortfall to the settlement's recipient. A case in point is *Mi Sask Industries Ltd.* (2007 TCC 73).

Mi Sask contracted with the city of Medicine Hat to build pipeline crossings on certain waterways in Alberta, providing services that attracted GST. The agreement required the city to maintain construction insurance. The city did not obtain third-party insurance, but chose to self-insure. When damage was sustained during construction, Mi Sask pursued the city directly for compensation. The ultimate settlement required the city to pay $200,000 to Mi Sask. Apparently the GST's application was not discussed. The CRA subsequently assessed Mi Sask for $13,084.11—7⁄107 of the gross settlement—on the basis that section 182's deeming rule applied.

The rule essentially provides that amounts paid by a recipient to a supplier for the breach, modification, or termination of an agreement are deemed to be GST-included amounts if the underlying supply is taxable. Certain conditions must be met to trigger the rule's application: (1) there is an agreement for a taxable supply (not zero-rated); (2) the agreement is breached, modified, or terminated after 1991; (3) an amount is paid or forfeited by the recipient to the registrant supplier; and (4) that amount is not consideration for the supply. Paragraph 182(1)(a) of the ETA deems the supplier to have made a supply equal to 100⁄107 of the amount paid or forfeited: that amount is deemed to include GST equal to 7⁄107 of the amount. Paragraph (b) deems the recipient of the damages payment to have collected GST, which it must remit; the payer of the damages is deemed to have paid GST on the deemed consideration and may claim an input tax credit of that amount.

The *Mi Sask* facts fulfilled section 182's conditions: there was a prior agreement for a taxable supply and a breach by the recipient, and the city paid Mi Sask an amount that was not consideration for the supply. The TCC found that the $200,000 paid to Mi Sask was deemed to include $13,084.11 of GST (7⁄107 × $200,000), which Mi Sask was required to remit.

Section 182 can catch parties off guard. Mi Sask netted $13,084.11 less than it thought it had negotiated. Conversely, the city was out of pocket for only $186,915.89 on the settlement after claiming an input tax credit for the $13,084.11 GST it was deemed to have paid. To add insult to injury, if the city had obtained the third-party insurance the agreement required, the payment to Mi Sask would not have been subject to GST: payment or receipt of an amount in satisfaction of a claim arising under an insurance policy is GST-exempt. *Mi Sask* serves as a reminder that the GST's application should be specifically addressed in the course of settlement negotiations. Usually the non-defaulting supplier should ensure that the damage payment is grossed up to include the deemed GST.

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Dunne like Dinner

In *Dunne v. Quebec (Deputy Minister of Revenue)* (2007 SCC 19), on appeal from the Quebec Court of Appeal, the SCC concluded that the Quebec Taxation Act was not ultra vires the province's taxing power under section 92(2) of the Constitution Act. Retired non-Quebec partners with similar fact patterns receiving retirement stipends from national professional firms operating in Quebec may need to reconsider their prior Quebec tax-filing positions.

Dunne, an Ontario resident, was an active member of a national accounting firm partnership until 1994, when he began to receive retirement benefits from that partnership. In 1997, Revenue Quebec determined that 20 percent of that retirement income was taxable in Quebec, reflecting the partnership's income allocated to Quebec that year. Dunne, who neither resided in Quebec nor carried on business in Quebec, argued that he had received no business income from Quebec; he appealed and challenged the constitutionality of Quebec's taxing provisions.

In 2003, the Court of Quebec vacated the assessment, saying that Dunne was deemed a partner of the accounting firm carrying on business in Quebec, but only for limited purposes. A Quebec Taxation Act regulation provided that an individual's income was deemed to have been earned totally outside Quebec if he or she had no Quebec establishment; the court said that in the absence of a rule deeming the partnership's establishment to be Dunne's, all his income was deemed earned outside Quebec. The Court of Appeal set aside that decision.

On the basis of the partnership agreement, the SCC said that it was clear that the allowance stipend paid to Dunne as a retired partner was a share in the partnership profits, although perhaps intended as consideration for past services and for agreeing to a no-competition clause.

The partnership agreement defined the partnership net profit as the gross profit less, inter alia, retirement allowances. If gross profit was insufficient, retirement allowances to former partners could be reduced proportionately. The payments were also capped at 15 percent of gross profits and could be reduced pro rata to keep within the cap. The agreement also stated that retirement allowances were a share of partnership income for tax purposes. The Quebec Taxation Act's deeming provisions (sections 608, 609, and 612.1) determined the portion of Dunne's income that was allocated to the partnership's Quebec activities and taxable in Quebec, and did not improperly expand the scope of provincial taxing power.

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New York Tax Changes

The 2007-8 New York state budget bill enacted on April 1, 2007 includes several changes that may affect Canadian companies conducting business there.

■ The new bill moves New York closer to adopting mandatory unitary combined reporting for corporations. In essence. a unitary business exists when one or more members of a group of affiliated entities engage in a common enterprise. A combined report is a tax return for a group of affiliated corporations engaged in a unitary business, reporting a multiple-entity unitary business as one business unit. Previously, New York law required a corporation to file a combined report only if the following three factors were satisfied: (1) there was common stock ownership of affiliated group members, (2) a unitary business existed, and (3) filing on a separate-entity basis would result in a distortion of tax reported. Distortion was presumed to exist when there were substantial intercorporate transactions between affiliated group members: at least 50 percent of expenses or receipts resulted from such activities. Relevant transactions included selling, manufacturing, or acquiring goods or property or performing services for other group members; financing other group members; and using common facilities and employees. A taxpayer could rebut the presumption of distortion by showing that the transactions were conducted at arm's length.

The new law mandates combined reporting in the mere presence of substantial intercorporate transactions, regardless of whether they were at arm's length. Alien corporations such as Canadian entities cannot be required to file combined returns with US domestic corporations, but they may still be taxable in New York on a separate-entity basis. US affiliates of a Canadian parent can be required to file a combined return.

■ The budget bill also lowers corporate tax rates for tax years beginning after 2006. The general corporate tax rate is reduced to 7.1 percent from 7.5 percent; the alternative minimum corporate tax rate is reduced to 1.5 percent from 2.5 percent. For tax years beginning or after January 31, 2007, a preferential corporate tax rate of 6.5 percent applies for a New York manufacturer as defined, including the manufacturer's having property present in New York that is eligible for an investment tax credit and has an adjusted basis of at least $1 million, or having all its real and tangible property located in New York and used principally (more than 50 percent) in manufacturing. The budget also accelerates the shift from a three-factor apportionment formula (receipts, property, and payroll) to a single factor (receipts) for years beginning after 2006. To attract jobs and investment, many states have moved to the single-factor method, which reduces the apportionment in states where the business's main activities are labour- and capital-intensive.

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GAAR on Interspousal Interest Conversion

The FCA recently upheld the TCC's decision in *Lipson* (2007 FCA 113) that GAAR applied to a series of transactions designed to convert non-deductible home mortgage interest payments into deductible interest payments on money borrowed to purchase shares. The FCA agreed with the TCC's analysis, which relied heavily on the concepts of economic purpose and economic reality.

In April 1994, Mr. L, the taxpayer, and Ms. L, his spouse, agreed to purchase a personal residence for $750,000. As part of the tax plan, Ms. L borrowed $560,000 from a bank (the share loan) in August 1994, provided the bank with an interest-bearing demand promissory note, and used the funds to buy Mr. L's shares in a family corporation. Mr. L forwarded the funds to the trust account of the solicitor handling the home purchase. In September 1994, Mr. and Ms. L borrowed another $560,000 from the bank (the replacement loan), which was secured by a mortgage on the new home; the funds were used to repay Ms. L's share loan.

Mr. L did not elect out of the rollover in subsection 73(1): even though Ms. L purchased Mr. L's shares for fair market value, the transfer was deemed to occur at his adjusted cost base, and he realized no gain or loss on the sale. Any of Ms. L's income or loss on the shares was attributed back to Mr. L under subsections 74.1(1) and 74.2(1).

The CRA reassessed Mr. L for his 1994, 1995, and 1996 taxation years to disallow about $105,000 in interest expense paid on the replacement loan. The TCC found that the purpose of the series of transactions was to make that interest deductible: interest on money used to buy a house would not be deductible. As a result, the transactions resulted in a misuse and abuse of paragraph 20(1)(c) and subsection 20(3). The TCC also concluded that subsection 73(1) and section 74.1 were misused to execute the scheme.

Mr. L argued that the TCC erred by "improperly importing into the GAAR analysis the concepts of economic purpose and reality and by recharacterizing the transactions in issue. [The TCC] conducted the abuse and misuse analysis on the basis that the borrowings were used to buy the home rather than by reference to the transactions as they actually took place and the legal relationships which were created." The taxpayer cited *Singleton* ([2001] 2 SCR 1046), *Shell Canada* ([1999] 3 SCR 622), and *Canadian Pacific* (99 DTC 5132 (FCA)), arguing, "We should reject any analysis under s. 245(4) that depends entirely on 'substance' viewed in isolation from the proper interpretation of specific provisions of the *Income Tax Act* or the relevant factual context of a case" (quoting *Canada Trustco* ([2005] 2 SCR 601, at paragraph 30 of *Lipson*).

Mr. L argued that the first task in a misuse analysis is to construe the object, spirit, and purpose of the provisions that gives rise to the tax benefit. Then it must be determined whether the transactions, as they actually took place, fall within or frustrate the object, spirit, and purpose of the provisions; Mr. L said that the TCC erred by basing its decision on the overall purpose of the transactions rather than on the actual transactions and the legal relationships they created.

The FCA agreed with Mr. L that without considering the overall purpose identified by the TCC and by looking at the object, sprit, and purpose of the provisions that gave rise to the tax benefit, it was difficult to find that there was a misuse or abuse of those provisions. However, the FCA said that the TCC was entitled to consider the transactions as a whole and to give considerable weight to their overall purpose in its misuse-and-abuse analysis. The TCC found that, factually, the transactions formed part of a series of transactions whose purpose was to make the mortgage interest tax-deductible.

The FCA noted that both subsection 245(2) and paragraph 245(3)(a) refer to a "series of transactions"; in *Canada Trustco*, the SCC confirmed that "series of transactions" refers to transactions "pre-ordained in order to produce a given result" with "no practical likelihood that the planned events would not take place in the order ordained."

The FCA also noted that subsection 248(10) extends the meaning of "series of transactions" to include "related transactions or events completed in contemplation of the series." Therefore, according to the FCA, when a tax benefit results from a series of transactions, that series becomes relevant in determining whether any transactions within the series constitutes an abuse of the relevant provisions. The FCA upheld the TCC's decision that Mr. L engaged in abusive tax avoidance.

Unfortunately, *Lipson* and other cases since the SCC's 2005 decisions in *Canada Trustco* and *Mathew* ([2005] 2 SCR 643) do not seem to further the SCC's goal of interpreting the Act consistently, predictably, and fairly. The interpretation of GAAR has apparently not yet achieved a balance between preventing abusive tax avoidance and preserving certainty in tax law so that taxpayers can manage their affairs intelligently. The taxpayer has applied for leave to appeal to the SCC. It is hoped that the SCC will hear the appeal and provide greater clarity.

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US Estate Tax on US Realty

Many Canadians are seeking to purchase vacation properties or second homes in the United States. The warmer climate, beautiful locales, and only occasional hurricanes make US-situs real estate attractive, but unfortunately Canadian owners are exposed to US estate tax. With proper planning, estate tax may be completely avoided.

A Canadian citizen and resident is subject to US estate tax on his or her US-situs assets at death. Under the Code, a non-US citizen and non-US resident is entitled to an estate tax credit of US$13,000; thus, US$60,000 of US-situs assets may pass free of US estate tax on the individual's death. The Canada-US treaty's 1995 protocol affords additional relief to a Canadian citizen and resident, potentially providing a larger US estate tax credit that exempts an amount bearing the same ratio to a US citizen's exemption that the value of the Canadian's US-situs assets bears to the value of his or her worldwide estate (the prorated exemption). The prorated exemption is determined by multiplying a US citizen's estate tax exemption (currently $2 million) by a fraction whose numerator is the value of the decedent's US-situs assets and whose denominator is the value of the decedent's worldwide assets.

$$\text{Estate tax exemption for a US citizen} \times \frac{\text{Value of decedent's US-situs assets}}{\text{Value of decedent's worldwide assets}}$$

$$= \text{Prorated exemption}$$

The treaty also allows a marital exemption equal to the prorated exemption. If a Canadian citizen dies owning US-situs assets and leaves them to his or her spouse in a manner that would qualify for the US marital deduction if the surviving spouse were a US citizen, the exemption amount is effectively doubled. In some cases, use of the prorated exemption and marital exemption eradicates most or all of the US estate tax exposure at the Canadian's death, although special estate planning may still be required to minimize the taxation of the assets in a surviving spouse's estate.

Assume, for example, that Mr. and Mrs. C are both Canadian citizens and residents. Mr. C dies owning a house in Florida worth US$1 million, his only US-situs asset; his worldwide estate totals US$10 million. His will creates a credit shelter (or bypass) trust; the remaining assets pass outright to Mrs. C. Mr. C's prorated exemption under the treaty allows $200,000 of assets to pass free of estate tax.

$$\text{\$2,000,000 (2007 estate tax exemption for a US citizen)} \times \frac{\text{\$1,000,000 (Mr. C's US-situs assets)}}{\text{\$10,000,000 (Mr. C's worldwide estate)}}$$

Even though Mr. C's exemption can be doubled to $400,000 by virtue of the treaty's marital exemption, $600,000 of his US property remains exposed to US estate tax at a top rate of 45 percent. Furthermore, if Mrs. C owns all or a portion of the property at her death, it is likely to attract US estate tax again in her estate.

US estate tax exposure in both Mr. C's and Mrs. C's estates may be avoided through the use of a residence trust. A residence trust can be used in many situations, but it works most effectively for a married couple. The structure avoids the inclusion of the US real property in either spouse's estate for US estate tax purposes if specific requirements are met. One spouse (the grantor) creates the residence trust and contributes funds; neither event is taxable for US gift tax purposes. To avoid the trust's inclusion in the grantor's estate, the grantor cannot be a beneficiary or a trustee. Instead, the grantor's spouse and descendants can be the trust beneficiaries and the grantor's spouse can be the trustee, so long as distributions of income and capital are limited by an ascertainable standard. The trust then purchases the US-situs realty with the assets that the grantor contributed to the trust. It is essential that the purchase contract be in the name of the trust and that the funds for closing come from a trust account.

The grantor's spouse and descendants, as trust beneficiaries, can use the property rent-free during their lifetimes. Under certain provisions of US law, the grantor may use the property rent-free during his or her spouse's lifetime and can contribute funds to the trust to cover any related costs. Upon the grantor's death, the trust property is not included in his or her estate for US estate tax purposes, nor is it included in the spouse's estate at the spouse's death, even if he or she is the trustee, provided that trust distributions are limited by an ascertainable standard. If Mr. and Mrs. C had purchased the Florida property within a residence trust, the entire $1 million value of that property could have passed to their children without the imposition of any US estate tax. In Mr. C's estate, $270,000 of US estate tax would have been saved, and additional savings realized in Mrs. C's estate. Moreover, Mr. and Mrs. C's US estate tax exemptions would remain available to shelter any other US-situs assets.

The residence trust protects the property held in the trust from creditor claims, and if the property is held for more than one year the US long-term capital gains rate applies on a sale. At present, this rate is 15 percent federally, versus the 34 percent capital gain rate for real property held by a corporation.

The residence trust has a few disadvantages. If the grantor's spouse predeceases the grantor, the grantor must pay rent to continue to use the property. Moreover, if the grantor and his or her spouse divorce, the spouse can continue to use the property to the exclusion of the grantor. Nonetheless, for wealthy Canadian citizen and resident couples contemplating the purchase of US real property, the residence trust may be an effective mechanism to completely avoid US estate tax exposure on the property and preserve US estate tax exemptions.

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LCT Still Relevant

The federal large corporations tax (LCT) was eliminated for all corporations after 2005. Despite its demise, the LCT remains relevant for the purposes of computing unused surtax credits and a CCPC's small business limit and SR & ED expenditure limit. The definition of "large corporation" also has continuing relevance for filing and remittance requirements such as filing a notice of objection, paying one-half of disputed taxes when appealing, and objecting to an assessment notice. In addition, for taxation years ending after 2008, Ontario's general capital tax base is harmonized with the LCT, which requires the calculation of LCT values for Ontario purposes for taxation years ending after 2008, until Ontario eliminates its general capital tax on July 1, 2010.

■ The LCT was not deductible in computing income for income tax purposes, but it was reduced by the portion of the federal surtax liability that was the corporation's "Canadian surtax payable." Any unused Canadian surtax liability could reduce LCT for the previous three years (and, before 2006, for the next seven years). Starting with the 2004 taxation year, the unused surtax credits (generally the excess of a corporation's Canadian surtax liability for a taxation year over that year's LCT) are calculated as if a notional LCT applied, using a $10 million capital tax threshold and a 0.225 percent rate. Although after 2005 a corporation cannot carry forward unused surtax credits, a corporation can still carry back those credits, including any credits arising after 2005, against an LCT liability for

Table 1 Carryback of Unused Surtax Credits

	Year in which unused surtax credits arose		
Carryback to year LCT paid?	2006	2007	2008
2003	Yes	No	No
2004	Yes	Yes	No
2005	Yes	Yes	Yes

the three previous taxation years. Consequently, the corporation's unused surtax credits can be carried back as shown in table 1.

Thus, for each of 2006, 2007, and 2008 a corporation's unused surtax credits can reduce or eliminate its LCT liability for the three prior years. After 2008, unused surtax credits cannot be carried back.

■ The federal small business limit and small business rate are enhanced (see table 2). The small business limit is reduced on a straight-line basis for a CCPC that in the preceding year employed in Canada (on an associated basis) taxable capital of between $10 million and $15 million; at $15 million or more, the limit is nil. After 2003, the reduction is based on a notional LCT calculation (as above, at a 0.225 percent rate with a capital tax threshold of $10 million). Therefore, although the LCT is eliminated, a CCPC may still need to compute its notional LCT. The reduction to the small business limit applies to all provincial and territorial small business deductions (except in Ontario, which has its own clawback).

■ A notional LCT must also be computed to determine a CCPC's enhanced federal SR & ED investment tax credits (ITCs) and refund rates. Table 3 shows that, generally, a qualifying CCPC's access to enhanced ITCs and refund rates depends on its expenditure limit.

Table 2 Small Business Limit and Rate Changes

	From	To	Effective date
Small business rate	12%	11.5%	Jan. 1, 2008
Small business rate	11.5%	11%	Jan. 1, 2009
Small business limit	$300,000	$400,000	Jan. 1, 2007

Table 3 A CCPC's Enhanced SR & ED ITCs and Refund Rates

	ITC rate	Refund rate
Annual qualified expenditures		
Up to expenditure limit	35% of expenditures	100% of ITCs on current expenditures, plus 40% of ITCs on capital expenditures
Over expenditure limit	20% of excess expenditures	40% of ITCs on excess expenditures

To determine the expenditure limit, the maximum expenditure limit ($2 million) is reduced by an amount calculated for the prior year of the CCPC's associated group: the sum of $10 for each $1 of taxable income above $400,000 up to $600,000 (above $300,000 to $500,000 for taxation years ending before 2007), plus $0.40 for each $1 of taxable capital employed in Canada above $10 million up to $15 million. The reduction for taxable capital exceeding $10 million requires the computation of the CCPC's small business limit, which is based on its notional LCT.

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Income Trusts for Sale

On October 31, 2006, Canada had about 170 publicly traded income trusts structured to avoid entity-level taxation on the underlying business profits. The announcement of major changes to the taxation of income trusts resulted in a precipitous drop in their value. The aggregate market capitalization of the income trust market fell $26 billion, or 13 percent (some as much as 20 percent), in the first week of November 2006. Access to additional capital is restricted, and there is no retail appetite for units: many income trusts have been privatized and sold principally to foreign corporations and private equity funds. Newspaper articles indicate that income trust deals with a total enterprise value of more than $7 billion were pending or closed between October 31, 2006 and April 16, 2007; an additional fourteen business trusts, five REITs, two energy funds, and one oil and gas fund were considering sales.

Early income trusts held loans and shares of a Canco that carried on the business. In later structures, an income trust was the beneficiary of a holding trust that was the limited partner in a partnership to avoid corporate tax. Some cross-border income trusts with Canadian and US operations owned shares of a Canco that owned a US C corp that carried on the US business. In some cases, the US C corp owned a Nova Scotia ULC funded by a loan from the income trust; in other cases, the income trust owned shares of a US limited liability company (LLC) that invested in the US opco or that owned shares and debt of a Canco that owned an LLC that carried on the US business.

The acquisition of publicly traded income trust units is subject to the same laws and rules applicable to takeovers of any business entity. Provincial securities law regulates takeover bids in a public context—for example, by requiring a formal offer to all unitholders, held open for acceptance for 35 days and not subject to any financing conditions. The rules and policies relating to related-party transactions, going-private transactions, insider bids, etc. also apply. The trust declaration may permit the compulsory acquisition or redemption of remaining units when at least 90 percent are acquired pursuant to the formal offer. Unitholders may amend the trust declaration to allow a squeeze-out when 66⅔ percent of units have been acquired; approval by 66⅔ percent of unitholders may be required.

Post-acquisition planning depends on the structure and the type of purchaser, such as a foreign equity fund or a foreign or Canadian corporation. In an income trust, trust, and partnership structure, the income trust distributes the holding trust's debt and equity to the purchaser as a return of capital; the holding trust then distributes its limited partnership interest to the purchaser as a return of capital, and the partnership may then be dissolved. A capital gain on the redemption may be offset by a capital loss.

Acquisition of the income trust's business may entail the purchase of the operating entity's assets, the shares of the operating entity, the interest of the limited partnership carrying on the business, and the purchase of any holding trust. In a negotiated (not hostile) transaction, the purchase price may be designed to result in specified per-unit distributions to unitholders plus a fixed contribution to the income trust's transaction costs, ensuring that the buyer acquires all operations as quickly as possible. The income trust's existing trustees will likely be responsible for winding up the income trust and any other entities not acquired. Approval of 66⅔ percent of unitholders is required.

For tax purposes, the tax cost of each entity—including the holding trust, partnership, and corporation—and of each of the underlying assets must be determined. Usually, the trust is an attractive target because the operating assets have a value exceeding that of the trust units. The purchaser wants to minimize triggering capital gains on winding up the structure and to step up the assets' tax cost, which may be possible if the tax cost of the various entities exceeds the tax cost of the underlying assets and in the business.

The structuring of an acquisition also depends on the purchaser's governing tax rules. For example, some income trusts have elected to be US corporations for US tax purposes in order to reduce the tax for US unitholders. A US fund purchasing the income trust may wish to form a Luxembourg company to acquire the trust units and use the Code section 338(g) election to avoid US tax on the income trust's dissolution and to achieve a step-up in the business assets' tax cost for US tax purposes. The holding trust is ignored for US tax purposes. A foreign purchaser may use a foreign or a Canadian corporation (perhaps a ULC for a US purchaser) for the acquisition.

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FOREIGN TAX NEWS

Treaties

A new **Canada-Mexico** treaty, signed on September 12, 2006, entered into force on April 18, 2007. The first **Netherlands-United Arab Emirates** treaty, signed on May 8, 2007, generally follows the OECD model treaty. The English text prevails in case of conflict.

European Commission

The European Commission has asked nine member states—Czech Republic, Denmark, Lithuania, the Netherlands, Poland, Portugal, Slovenia, Spain, and Sweden—to provide information on discriminatory taxation of pension funds.

OECD

Comments on proposed changes in a discussion draft on the application and interpretation of OECD model treaty article 24 (non-discrimination) should be submitted by July 31, 2007. A discussion draft was also issued on a revised commentary on article 7 (business profits). A PE's profits on a separate-entity basis are determined using a two-step approach requiring a functional and factual analysis and the application of transfer-pricing principles to the functions performed, assets used, and risks assumed in the PE and the rest of the enterprise. Domestic laws in the PE state determine the deductibility of expenses attributed to the PE. Several exceptions to the arm's-length principle in the existing commentary are eliminated. No deductions are allowed for internal debts and receivables, except for financial enterprises. A PE requires funding by free capital and interest-bearing debt to support the functions, assets, and risks; different approaches may be used to attribute free capital and to achieve an arm's-length result. Relief for double taxation caused by different capital attribution methods may be available. Comments should be sent before June 15, 2007 to jeffrey.owens@oecd.org.

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