CANADIAN TAX Highlights

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AMPS: Customs Civil Penalties

On October 7, 2002, the Canada Border Services Agency (CBSA) fully implemented the administrative monetary penalty system (AMPS), a civil penalty regime designed to encourage and sustain compliance with customs legislation, including the Customs Act, the Customs Tariff, and regulations. Former section 32.2 of the Customs Act required a mandatory correction of mistakes in customs entries, within 90 days of the time a person had "reason to believe" that the entry was incorrect. AMPS was expected to improve customs compliance, because importers would choose to correct such entry errors rather than face the automatic AMPS penalty if the 90-day-correct deadline was missed. A recent CBSA policy development may enhance the reach of AMPS penalties beyond their intended legislative scope.

In situations where errors are obvious—for example, if an importer imports a chair, but classifies it as raw fish—the CBSA has begun to take the administrative position that the importer would have had "reason to believe" that the entry was in error at the time it was made. Thus, the AMPS penalty for failure to correct errors within 90 days applies in virtually all situations where inadvertent errors are not caught within 90 days of entry. The interpretation appears to be somewhat inconsistent with the arguably objective test for ex post facto discovery of customs errors, and it appears to replace that test with a standard of perfection for completing customs entries.

The CBSA has indicated that, effective January 31, 2007, if such an error comes to its attention in the course of a customs audit and a section 32.2 correction is required, the AMPS penalty applies to the mandatory correction: "As of January 31, 2007, additional [AMPS penalties] are to be applied to directed self-corrections, at the conclusion of a compliance verification review or monitoring activity, where it was found an importer had previous 'Reason to Believe.'" The approach defines the "reason to believe" criterion not on what the importer can reasonably be assumed to have known (did the importer really know it was classifying chairs as raw fish?) but on the assumption that the importer ought to have known it was making an error (if it had focused its attention on the error).

Penalties are currently being levied on importers under audit in 2007. It is expected that test cases will be taken to the Canadian International Trade Tribunal to test the logic of this policy approach. If the CBSA is correct, and penalties apply at the date of the audit because the importer failed to correct within 90 days of having had "reason to believe," is there any further compulsion to force the importer to make the "directed self-corrections" that the CBSA says must be made? Doing nothing may not be a viable strategy for an importer: once the CBSA audit activity brings the error to the importer's attention, the importer then obviously has reason to believe that an error has occurred. The AMPS penalty undoubtedly applies if the appropriate corrections are not then made.

The monetary impact on an importer can be high. The AMPS penalty is a minimum $100 per transaction, but for each error the penalty can rise to as much as 5 percent of the value of the goods imported (to a maximum of $25,000). The impact of AMPS is much broader than its application to unmade section 32.2 corrections. AMPS penalties also apply in the case of failing to report imported goods at the prescribed time in the prescribed manner; failing to keep records at the specified place; failing to furnish proof of the origin of goods where required; and failing to correct, within the 90-day period, a declaration of origin of goods, tariff classification, or value for duty.

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Ontario PST on Software 2

In April 2006, the Ontario government released a revamped RST guide, "Computer Programs and Related Services" (no. 650), triggering industry concern that the rules were becoming still more complex. Two areas of special concern are IT service exemptions and custom software definitions. (See *Canadian Tax Highlights*, "Ontario PST on Software," July 2006.) A year of audit experience under the new guide appears to indicate that industry concerns were well founded. In the past the ministry has worked with taxpayers, acknowledging and accommodating the unique characteristics of a particular industry and product to arrive at a reasonable solution for the application of PST. It may be time for the ministry to do so again.

■ **IT service exemptions**. The guide's new conditions for exemption eligibility focus less on the service's nature and more on whether it is provided in conjunction with taxable services. For example, the legislation (Retail Sales Act Regulation, RRO 1990, reg. 1012) expressly exempts project planning, defined to include "the analysis of specifications, determination and verification of hardware and software prerequisites, scheduling, the preparation of reports, reviewing documentation and discussions of any kind." The guide suggests that such services are taxable if they must be performed to supply a taxable service; if planning services are provided throughout the project, only those provided at the initial stages can be exempt. The guide is not clear on the point, but it seems to say that the project-planning phases typical of a contract for the configuration and installation of taxable software are no longer exempt, or are exempt only at the project's outset. Such conclusions seem to run counter to the legislation and the ministry's previous interpretations, and they ignore the fact that planning for a larger implementation project may be ongoing as initial plans are fine-tuned to conform to evolving customer requirements or unanticipated setbacks.

This turn of events creates uncertainty about the fate of other exempt services. The codification of areas of exemption was presumably intended to introduce some certainty and simplicity in an otherwise complex tax regime. Many IT service providers had painstakingly developed tax matrices based on the legislated areas of exemption and taxability; they are now left wondering whether they may be liable for taxes that the new interpretation indicates should have been collected. Their customers, already overburdened with high taxes on their IT spending, may not have paid or self-assessed enough tax, according to the ministry.

■ **Custom software**. Whether software is truly custom is also developing into a troublesome audit issue. A custom computer program is designed and developed solely to meet the specific requirements of one person and is intended for its exclusive use. The ministry says that software is custom only if all rights to it are transferred to the purchaser; otherwise, the software is a taxable computer program. In practice, software can be created for one user and incorporate the latest innovations, but may still include some subroutines and strands of code to which the programmer either cannot or will not cede control. Reusable elements may include a code for standard security routines that does not reflect or compromise the true and unique nature of the program, but for convenience is used time and again. A programmer should be allowed to reuse such a code without jeopardizing the custom nature of the software: the fact that marble is commonly used in building construction does not compromise the uniqueness of the Taj Mahal.

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Get a Tax Shelter Number: Baxter

The FCA in *Baxter* (2007 DTC 5199) reversed the TCC and found that the taxpayer had acquired an interest in a tax shelter as defined in section 237.1 of the Act. (See *Canadian Tax Highlights*, "No Tax Shelter Advice," June 2006.) Because no one had obtained the necessary tax shelter ID number, no deductions were allowed for capital cost allowance in respect of the software licences acquired.

Before an investment is considered to be a tax shelter, as required in the definition's introductory paragraph (the preamble test), there must be "statements or representations made or proposed to be made in connection with the property" that "represent" that a second, numerical test will be met. The numerical test requires that at the end of any of the four taxation years ending within four years after the day the investment in the property is acquired, an amount (a loss, in the case of a partnership) that is related to the investment acquired (including rights to income) and that is represented as deductible in the year or a preceding year must equal or exceed the investment's cost (net of prescribed benefits).

At the TCC, the Crown conceded that no statements or representations were made to Baxter—they had been made to others. Baxter was a lawyer who understood the tax consequences of purchasing the computer software, and he relied on his friend in evaluating the investment opportunity. On the facts, the FCA said that Baxter had read the tax opinion issued to the promoter; the tax opinion specifically stated that it could be shown to prospective purchasers and indicated that the investment would be fully deductible over two years. (The tax opinion also said that it did not "contain any statements, representations or warranties concerning the tax consequences of the software for a taxpayer.") However, the FCA concluded that the financial projections, other promotional information, appraisals, and a tax opinion that were prepared by or for the promoter for distribution by sales agents to prospective purchasers—or that were made available to them—constituted statements or representations within the meaning of the tax shelter definition. The FCA rejected the TCC conclusion that the tax shelter rules did not deny a deduction for capital cost allowance: the TCC had said that CCA was not an "amount incurred" and thus the tax shelter definition was not met.

Even though it was generally acknowledged by tax practitioners that the wording of the preamble in the tax shelter definition was very broad, and that it included verbal as well as written communications, the conventional wisdom of many tax advisers was that the preamble test of "statements and representations" having been made required a direct linkage between the information in the representation and the ability to rely thereon by the taxpayer. This belief was based on the fact that the term "representation" has a distinct legal meaning—a "statement of fact made to induce another to enter into a contract." In *Will-Kare Paving & Contracting* (2000 DTC 6467), the SCC stated that where a phrase in the Act has a legal meaning and an ordinary meaning, the legal meaning is to be preferred. (See *Canadian Tax Highlights*, "Tax Shelter Update," January 2007.) In contrast, the FCA in *Baxter* concluded that a non-technical meaning should be given to the requirement that a statement or representation "represent" that the numerical test will be fulfilled. Thus, a tax shelter exists if the required information is made known or communicated by a promoter to prospective purchasers.

If the tax shelter rules apply, the amount of any expenditure that can be written off may be reduced under subsection 143.2(6) by a limited-recourse amount or an at-risk adjustment. An expenditure is defined to include not only an outlay or expense but also the cost or capital cost of property.

A debt's unpaid principal is deemed to be a limited-recourse amount unless bona fide arrangements in writing were made when the debt arose for its repayment within a reasonable period not exceeding 10 years and for interest; interest must be payable at least annually and at least at the prescribed rate (calculated as the lesser of the actual rate when the debt arose and the rate from time to time) and actually paid no later than 60 days after the taxation year-end. Generally, all long-term debt (or unpaid purchase price) not expected to be fully repaid within 10 years is deemed to be a prescribed benefit; an exception is made for a partnership debtor if "tangible capital property located in Canada" is involved and other tests are met.

The at-risk adjustment (similar to an at-risk amount) reduces an expenditure for any amount or benefit that the taxpayer (or a non-arm's-length person) is entitled to receive or to obtain in any form or manner whatever, granted for the purpose of reducing the impact of any loss that the taxpayer may sustain in respect of the expenditure or the property. At-risk adjustments may be made, for example, for reimbursement, compensation, revenue guarantee, proceeds of disposition, and a loan or any other form of indebtedness.

If the "numerical threshold" part of the tax shelter test in section 237.1 is expected to be met, then any investor thinking of acquiring property should carefully consider the downside of not obtaining a tax shelter identification number before investing. This caution applies even when the taxpayer makes his or her own decisions and analyses with respect to an investment, if the promoters have obtained or prepared relevant materials that are available to any (other) prospective purchaser. All bets may be off with respect to relying on what practitioners often refer to as the "organizer exemption," where each party is acting as principal and has his or her own counsel.

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ONE IN FIVE EMPLOYEES

The public sector is still the largest employer in Canada, but it has shrunk in relative importance over the past 15 years. The number of employees in government departments at all levels has increased, but the number in government-owned business enterprises has declined significantly in absolute terms. Neither category has kept pace with the growth in the labour force.

As shown in the table, departmental employees in all levels of government fell from 21.0 percent of all employed Canadians in 1991 to only 17.1 percent in 2000 and have stayed close to that level since. In absolute terms, the

Public Sector Employment as a Percentage of All Employees

	Government departments	Government business enterprises	Total public sector
1991	21.0	2.7	23.8
1992	21.4	2.7	24.1
1993	21.2	2.5	23.7
1994	20.5	2.5	23.0
1995	19.9	2.3	22.2
1996	19.2	2.0	21.2
1997	18.5	1.9	20.3
1998	17.9	1.9	19.8
1999	17.4	1.8	19.2
2000	17.1	1.8	18.9
2001	17.6	1.8	19.4
2002	17.6	1.7	19.3
2003	17.6	1.7	19.3
2004	17.4	1.7	19.1
2005	17.5	1.6	19.1
2006	17.5	1.6	19.1

numbers dropped from 2.7 million in 1991 to a low of 2.5 million in 2000, and have since climbed to nearly 2.9 million in 2006.

As a result of the federal government's privatization of several large government-owned corporations, the number of employees in government-owned businesses dropped from 351,000 in 1991 to a low of 258,000 in 1997, and has changed little since, reaching 263,000 in 2006. The decline in relative importance is illustrated in the table.

Provincial and territorial governments accounted for about one-half of all departmental employees and devoted one-half of their employees to health care and social services. Federal departmental employment ranged from 15.3 percent of total employed Canadians in 1991 to a low of 13.1 percent in 1998 and has since risen to 13.6 percent in 2006. Local government employment rose from a low of 32.9 percent of the total in 1991 to a high of 35.9 percent in 2001 and has since settled to 35.4 percent in 2006.

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Executive Not Resident; Trust Instalments

No permanent home. The TCC recently decided in favour of the taxpayer in *Salt* (2007 TCC 118). After considering both Canadian domestic law and the tiebreaker rules in the Canada-Australia treaty, the court found that the taxpayer was not a Canadian resident during 1998 to 2000 when he worked in Australia. The taxpayer's Canadian home, which was rented to an arm's-length third party while the taxpayer worked abroad, was not a "permanent home" available to him at all times in Canada.

The CRA agreed with Mr. S that he was a resident of Australia during his assignment there, but it assessed him as a Canadian resident because he was also "ordinarily resident in Canada" under subsection 250(3). The terms "resident" and "ordinarily resident" are not defined in the Act; they take their meanings from common usage. Moreover, article 4(3)(a) of the Canada-Australia treaty (the "permanent home" rule) states that when a taxpayer has dual residence under the relevant domestic laws, "he shall be deemed to be a resident solely of the Contracting State in which he has a permanent home available to him." In the CRA's opinion, Mr. S had a permanent home available to him in Canada while he was living in Australia: he had "a dwelling . . . maintained in a condition suitable for year-round occupation, leased to a non-arm's length party, or leased under an agreement that could be broken with three months' notice or less."

In determining whether the permanent home rule applied in this case, the TCC referred to the OECD model treaty commentary on article 4, which says that it is essential to the concept of "permanent home" that the dwelling be available to the individual "at all times continuously" and that it have been obtained for "permanent use as opposed to staying at a particular place under such conditions that it is evident that the stay is intended to be of short duration." The fact that Mr. S leased his Canadian home (in Quebec) to an arm's-length party for 22½ months and was unable to break that lease under Quebec civil law without providing six months' notice was sufficient evidence that he did not have a permanent home in Canada during his stay abroad. Thus, the TCC found that Mr. S was not deemed ordinarily resident in Canada during his assignment in Australia.

No instalment interest for inter vivos trusts. The CRA recently confirmed its administrative policy not to charge instalment interest to an inter vivos trust that fails to remit instalments. The CRA said in a recent letter that the requirement that an inter vivos trust remit instalment tax payments under sections 155 and 156 is not currently enforced. According to its current administrative policy, the CRA does not charge instalment interest when a trust fails to remit instalments. The CRA notes that it will not necessarily continue this policy indefinitely, but before it begins to enforce the legislation it will make sufficient information available to inter vivos trusts and the trustee community to assist them in fulfilling the requirement to remit instalments.

This position is consistent with the CRA's comments at the round table at the 2005 Conference of the Society of Trust and Estate Practitioners. The CRA noted that because T3 returns are processed manually, no instalment notices are sent; therefore, no instalment penalties or interest is applied. The CRA said that this administrative position may change if T3 returns cease to be processed manually.

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Compassionate Construction

With few exceptions, drugs and similar substances qualify for the medical expense tax credit if they meet the three conditions in paragraph 118.2(2)(n): they must be (1) used for medicinal purposes, (2) prescribed by a medical practitioner, and (3) recorded by a pharmacist. Recently, the phrase "recorded by a pharmacist" has been the subject of judicial consideration and CRA opinions. Often the decisions are characterized by "compassionate construction" of the legislation because they involve seriously ill taxpayers. It is probably impossible to wring all compassion out of the Act: unusually compelling facts often lead to compassionate decisions. The danger lies in using those decisions as precedents.

The federal government regulates the manufacture, marketing, and sale of legal drugs; provincial and territorial governments regulate the sale and place of sale of those drugs. While the Byzantine regulatory structure is difficult to navigate, it can be said that there are four broad categories of therapeutic products in Canada: (1) schedule F drugs require a prescription issued by a qualified medical practitioner; (2) behind-the-counter drugs require the intervention of a pharmacist before they can be sold, although they do not require a prescription (insulin and codeine are examples); (3) over-the-counter drugs are generally found in drugstores and are available for self-selection; and (4) unscheduled drugs are available for sale in any retail store. Pharmacists play a key role in the dispensing of legal drugs: among other things, provincial law requires them to keep records of the drugs that they dispense on prescription. The precise rules vary from province to province.

In some cases, medical practitioners write prescriptions for substances that do not require them, perhaps in an attempt to provide tax relief for the substances or to allow for coverage under private medical plans. The recent cases dealing with the phrase "recorded by a pharmacist" in paragraph 118.2(2)(n) involve substances such as vitamins, food supplements, homeopathic medicines, and even bottled water, none of which required a prescription; the substances were used for medicinal purposes on the recommendation of medical practitioners.

In *Frank* ([2001] 3 CTC 2596), the TCC held that a pharmacist's sales or purchase slips were sufficient to constitute a recording. In *Pagnotta* ([2001] 4 CTC 2613), the TCC followed *Frank* and extended the "compassionate" interpretation of paragraph 118.2(2)(n) to the meaning of the word "prescribed," effectively equating it to "recommended." In *Ray* ([2002] 4 CTC 2590), the court entirely ignored the words "as recorded by a pharmacist"; the FCA reversed the decision on appeal, holding that "compassionate construction" did not permit courts to disregard statutory requirements, even if they are difficult to rationalize on policy grounds. The FCA said that paragraph 118.2(2)(n) was intended to ensure that tax relief is not available for off-the-shelf medications, and there was no evidence that pharmacists anywhere in Canada were required to keep records for the vitamins, herbs, and foods at issue in the case. Absent such a requirement, any actual record kept by a pharmacist was not made in his capacity as a pharmacist, as dictated by paragraph 118.2(2)(n).

In the latest instalment, a Quebec taxpayer succeeded before the TCC in *Breger* (2007 TCC 254), which involved medicinal, nutritional, and herbal supplements. The court accepted the argument that a pharmacist in Quebec must record the dispensing of any medications prescribed by a medical doctor; thus, the record actually kept by the pharmacist satisfied the *Ray* test because the record was made in his capacity as a pharmacist. Interestingly, *Breger* appears to be yet another instance of compassionate construction. The word "prescription" is defined under the Quebec Pharmacy Act as an authorization to supply a medication. A pharmacist must fill prescriptions, but the medications in *Breger* did not require any authorizations before they could be dispensed. Because no authorization was required, it is difficult to see how the prescriptions that were issued met the legal definition—that they were "authorization[s] to supply a medication."

In two recent technical interpretations (document no. 2007-0223981E5, April 19, 2007, and document no. 2007-0231171E5, May 9, 2007), the CRA continues to proceed on its view of the law, which is different from that of the court in *Breger*. The CRA is unaware of any legal requirement for pharmacists to record prescriptions for vitamins, minerals, food, supplements, or similar preparations.

Many Canadians belong to employer-sponsored health plans; if the plan is a qualifying one, their participation does not generate a taxable benefit, except for Quebec income tax purposes. Under one CRA rule, a qualifying health plan cannot cover any expense that does not qualify as a medical expense under subsection 118.2(2); this rule has no legislative basis, but the CRA has uniformly imposed it for many years. Some health plans provide reimbursement for non-prescription drugs: if the expenditure for those drugs does not qualify as a medical expense under subsection 118.2(2), then the health plan ceases to meet CRA requirements.

In yet another instance of compassionate construction, the TCC in *Hoare* (2007 TCC 292) allowed medical expenses of over $55,000 for the salary paid to the private tutor of two children with severe learning disabilities. The children were taught at home in New Brunswick by the tutor and participated in a distance learning program (NIDES) offered by the British Columbia public school system. NIDES provided materials and assignments and tests, which were graded by NIDES teachers. The children's curriculum, which involved non-NIDES courses, was approved by the New Brunswick Ministry of Education. The TCC accepted the evidence that 75 percent of the schooling time was consumed by NIDES distance learning. The tutor appears to have taught lessons for 6½ hours per day.

The TCC considered two main requirements related to the tutoring services in paragraph 118.2(2)(l.91): the services must be "supplementary to the primary education" of the patient, and the patient must be certified by a medical practitioner to be a person who "requires" the services. With respect to the latter requirement, a medical practitioner had "recommended" that the children receive special needs education with a tutor. The TCC found as a fact that the tutoring services were supplementary to the children's primary education and held that the doctor's recommendation constituted a requirement for the purposes of paragraph 118.2(2)(l.91). These conclusions appear to be, respectively, compassionate readings of the facts and of the law.

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Related-Party Doubtful Debt

In *Cloverdale Paint Inc.* (2006 TCC 628), the TCC allowed the taxpayer to claim a reserve worth $4.3 million for doubtful accounts under paragraph 20(1)(l) against a non-arm's-length trade receivable from its US subsidiary corporation. The case supports the position that the collectibility of a debt is more important than the relationship between the debtor and the creditor when determining whether a Canadian taxpayer can claim a reserve for doubtful accounts.

In 1994 the taxpayer, Cloverdale Paint Inc. (Canco), expanded into the US market through a US wholly owned subsidiary corporation (Subco). By 2001 the US market had soured; Subco owed about $6.5 million in trade payables to Canco. Canco's board of directors decided to continue to fund Subco rather than close or bankrupt it.

The company's external auditors required that Canco's financial statements reflect an allowance for doubtful accounts regarding Subco trade receivables, which were reported as non-current. Applying the liquidation method to Subco's assets, the auditors arrived at a reserve of about $4.3 million. Canco followed this accounting treatment on its 2001 tax return. The CRA did not believe that Canco was entitled to deduct a reserve against the amounts owing from Subco, because "there was no debt that had been established in 2001, and in the alternative, [the taxpayer's] assumptions in calculating the amount of doubtful debt cannot support the deduction." Canco argued that it had met the requirements of subparagraph 20(1)(l)(i), which allows a taxpayer to claim a reserve that is "a reasonable amount in respect of doubtful debts . . . that have been included in computing the taxpayer's income for the year or a preceding year."

On the basis of the calculations of Canco's auditors, the TCC concluded that the reserve amount was reasonable, making the main issue whether the debt collection was doubtful. The TCC cited the FCA decision in *Rich* (2003 DTC 5115), which stated, "Whether the creditor has a non-arm's length relationship with the debtor may also be relevant in some cases. However, the predominant consideration will be the ability of the debtor to repay the debt in whole or in part. The non-arm's length relationship may justify closer scrutiny than in [arm's-length] situations. But a non-arm's length relationship alone, without more, cannot lead to a finding that the creditor did not honestly and reasonably determine the debt to be bad." The TCC noted that Canco's four witnesses were "men of integrity, who did not take the decision of claiming a reserve lightly." On the facts, disallowing the reserve "would require a finding that paragraph 20(1)(l) does not apply to a non-arm's length transaction."

Cloverdale is welcome news for the taxpayer. Historically, however, FCA decisions on the treatment of related-party debts have not been consistent. In *Rich*, a majority of the FCA allowed the taxpayer to treat a debt receivable by a father from his son's corporation as a bad debt; the writeoff created an allowable business investment loss for the father. On the other hand, the FCA decided against the taxpayer in *Flexi-Coil Ltd.* (96 DTC 6350). The court agreed with the CRA's assessment of a smaller paragraph 20(1)(p) bad debt deduction than the one claimed by the taxpayer against debts owing from foreign subsidiaries.

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Corporate Rate Update

Most provincial corporate income tax rate changes affecting 2007 fiscal years were rate cuts and were made before this year's round of provincial budgets. Only the Manitoba, New Brunswick, and Quebec 2007 budgets changed general, M & P, and small business tax rates. Manitoba reduced its rates after 2007, New Brunswick increased its small business rate and reduced its small business threshold for 2007, and Quebec increased its active rate for financial institutions and oil refining companies for 2007. Table 1 shows 2006 and 2007 combined general, M & P, and small business rates.

The general rates for 2007 decreased in Alberta, Manitoba, and the Northwest Territories; the same rate applies to M & P. In Saskatchewan, the general rate decreased for 2007, but the M & P rate stayed the same. New Brunswick's general rate, which is the same as its M & P rate, remains at 13 percent because its 2007 budget repealed a previously scheduled 1 percentage point decrease for 2007. The federal surtax is eliminated for all corporations after 2007, and the federal general rate declines in stages from 2008 to 2011; the same rate applies to M & P. As a result, the federal general rate including surtax declines from 22.12 percent in 2007 to 18.5 percent after 2010. General rate decreases

Table 1 Combined Corporate Income Tax Rates (December 31 Year-End)

	General (M & P)		CCPC small business	
	2006	2007	2006	2007
	percent			
Federal	22.12	22.12	13.12	13.12
Alberta	32.49	32.12	16.12	16.12
British Columbia	34.12	34.12	17.62	17.62
Manitoba	36.62	36.12	17.62	16.12
New Brunswick	35.12	35.12	14.87	18.12
Newfoundland & Labrador	36.12 (27.12)	36.12 (27.12)	18.12	18.12
Northwest Territories	34.86	33.62	17.12	17.12
Nova Scotia	38.12	38.12	18.12	18.12
Nunavut	34.12	34.12	17.12	17.12
Ontario	36.12 (34.12)	36.12 (34.12)	18.62	18.62
Prince Edward Island	38.12	38.12	18.79	17.69
Quebec	32.02*	32.02*	21.23	21.12
Saskatchewan	37.61 (32.12)	35.62 (32.12)	18.12	17.62
Yukon	37.12 (24.62)	37.12 (24.62)	17.12 (15.62)	17.12 (15.62)

* For 2007, the rate is 33.19 percent for financial institutions and oil-refining companies.

Table 2 CCPC Small Business Taxable Income Threshold

	From	To	Effective date
	dollars		
Federal	300,000	400,000	January 1, 2007
Alberta	400,000	430,000	April 1, 2007
	430,000	460,000	April 1, 2008
	460,000	500,000	April 1, 2009
British Columbia	400,000	400,000	Unchanged
Manitoba	400,000	400,000	Unchanged
New Brunswick	450,000	475,000	July 1, 2006
	475,000*	400,000*	January 1, 2007
Newfoundland & Labrador	300,000	400,000	January 1, 2007
Northwest Territories	300,000	400,000	January 1, 2007
Nova Scotia	350,000	400,000	April 1, 2006
Nunavut	300,000	400,000	January 1, 2007
Ontario	400,000	400,000	Unchanged
Prince Edward Island	300,000	400,000	January 1, 2007
Quebec	400,000	400,000	Unchanged
Saskatchewan	300,000	400,000	July 1, 2006
	400,000	450,000	July 1, 2007
	450,000	500,000	July 1, 2008
Yukon	300,000	400,000	January 1, 2007

* New Brunswick's 2007 budget repealed a $25,000 increase to its small business threshold (previously scheduled for July 1, 2007) and reduced the threshold to $400,000 on January 1, 2007.

are also expected after 2007 in Manitoba and Saskatchewan; Quebec's active income rate increases in 2007 for financial institutions and oil-refining companies and will increase in stages starting in 2008 for all other corporations. Alberta has stated that its general rate will drop by 2 percentage points at a date yet to be specified.

In 2007, provincial small business rates declined in four provinces and increased in one. Manitoba's small business rate fell from 4.5 to 3 percent on January 1, 2007 and will decline further to 2 percent on January 1, 2008 and, subject to balanced budget requirements, to 1 percent on January 1, 2009. Prince Edward Island's small business rate declined from 6.5 to 5.4 percent on April 1, 2006 and will decrease by 1.1 percentage points on April 1 of each year until it reaches 1 percent on April 1, 2010. Quebec's preferential rate fell from 8.5 to 8 percent on March 24, 2006; Saskatchewan's declined from 5 to 4.5 percent on January 1, 2007. A previously scheduled 0.5 percentage point reduction to New Brunswick's small business rate was repealed by the province's 2007 budget; that rate had decreased to 1.5 percent on July 1, 2006, but it increased to 5 percent on January 1, 2007. The federal small business rate including surtax will decline from 13.12 to 11.5 percent on January 1, 2008 and to 11 percent on January 1, 2009. Starting after 2006, the federal, provincial, and territorial small business taxable income thresholds will each be a minimum of $400,000. During 2007 and subsequent years, Alberta's and Saskatchewan's thresholds will increase above $400,000. Table 2 outlines the changes to small business thresholds.

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Anti-Tax-Haven Initiative

The 2007 federal budget proposed to restrict deductions for interest on equity or debt investments in an FA. In response to criticism from the tax and business communities that the proposal was too broad and would significantly disadvantage Canadian companies globally, Finance issued an amended resolution on May 14, 2007 (*News Release* 2007-041) with application after 2012. Finance will work with a technical round table of tax experts to advise on enabling legislation; the draft legislation is expected to be released this fall.

The budget's tax fairness initiative has been rebranded as an anti-tax-haven initiative that uses the same broad tracing language to capture debt-funded FA investments but is significantly circumscribed by a focus on double-dip financing arrangements, in which interest expense is deducted both in Canada and in the place where the FA carries on active business. The Canadian borrowing must be traced (broadly speaking) to an FA's indebtedness if the income therefrom is recharacterized as active business income (taxable or exempt surplus) under paragraph 95(2)(a). Presumably to narrow the scope to so-called tax havens, any foreign tax on recharacterized income is grossed up by the relevant tax factor and deducted from the recharacterized income; the net is double-dip income. A corporation generally can deduct only its FA-related interest expense in excess of its double-dip income for the year. As in the budget proposal, the basic rule assumes that a corporation borrowed money to invest in an FA that onlends to another FA. More complex structures are captured by limiting a borrowing corporation's interest expense by reference to a related corporation's double-dip income. The revised proposal's application to partnerships will adversely affect the most commonly used tower structures.

The revised proposal continues many of the budget proposal's technical uncertainties and traps. A specific anti-avoidance rule was dropped, but as yet taxpayers have no guidance on what might be acceptable tax planning. Taxpayers may also be concerned with an apparently newly aggressive attitude to cross-border tax arbitrages, evidenced by comments in the backgrounder accompanying the revised measure (for example, "[t]he Government is committed to shutting down inappropriate tax avoidance structures"). It remains to be seen whether Finance's new attitude will influence the CRA's views on this proposal and on subsection 95(6) and GAAR.

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Hedge Funds

Hedge funds are pooled investment vehicles that pursue alternative investment strategies in order to provide an absolute return to investors even in a declining market. Canadian tax issues include the treatment of carried interests for promoters or advisers; the calculation and character of fund income; investment in the fund or in a master feeder; and whether a fund in Cayman can be regarded as carrying on business in the jurisdiction where the manager resides.

■ **Carried interest.** In lieu of fully taxable fees, promoters and advisers may prefer to have a carried interest in the fund in order to claim capital gains treatment and to defer tax. A general partner often takes a carried interest in the limited partnership in lieu of fees therefrom. For example, after meeting certain performance thresholds, at the end of each fiscal period the limited partnership allocates taxable income to the general partner's account (if it has a positive balance). Any taxable capital gains so allocated are taxed at capital gains rates (from 19.5 percent in Alberta to 24.32 percent in Ontario) rather than fully taxable as fee income. GST, which is applicable to fees, does not apply to the allocations. Arguably, granting a carried interest is not a taxable event when the partnership has no value prior to its funding.

Typically, a fund manager is paid a fee of 2 percent of the assets under administration and 20 percent of fund profits (the 2-and-20 formula), structured as a partnership allocation. Fee payments (and tax) may be deferred for many years. A 20 percent carried interest performance fee on investments held by a foreign feeder corporation may be included. Alternatively, a fund manager may receive a 1 percent fee, offset by expenses; the other 1 percent is converted to a tax-deferred capital gain. That other 1 percent may be loaned to the fund, invested, and then paid along with investment income as a capital gain.

■ **Calculation and character of fund income.** Gains and losses of a taxpayer who is a trader or dealer in securities or who carries on a business of trading in securities are on income account, but they are on capital account for a taxpayer who holds securities as an investment, particularly to earn income such as dividends or interest. Partnership funds generally take the position that they are not carrying on business and treat gains and losses as capital; the CRA has not taken issue with that position. The CRA says that whether a gain or loss is on income or capital account is a question of fact, but some securities transactions are always on income account (for example, a short sale of shares). The case law appears to support this position: see *Interoceanic Investments Corp. Ltd.* (68 DTC 18 (TAB)) and *Schultz* (95 DTC 5657 (FCA)). However, a trading or investment activity that is a hedge for another investment may assume the character of the hedged assets: the CRA has said that a short sale hedge for shares held on capital account is itself on capital account.

If a non-trader or dealer in securities makes an irrevocable election under subsection 39(4) in the year it disposes of a Canadian security, every Canadian security it owns or disposes of in that year or a later year is deemed to be capital property or a disposition of capital property, respectively.

The trader-or-dealer exception does not apply to a mutual fund trust or corporation. A partnership cannot elect, but a partner, regardless of its trader or dealer status, may elect in the year the partnership disposes of the securities. Although the definition of "Canadian security" does not include a short seller's obligation to return an identical security, the CRA says that the election applies.

■ **Lending activity.** In Canada, lending activities are on income account; repo transactions are not recharacterized.

■ **Master fund or foreign corporate feeder.** Canadian pensions prefer to invest in the master fund in the master-feeder structure to avoid withholding tax on dividends, as do Canadian taxable investors to reduce withholding. Foreign investment entity reporting rules in Canada now require either imputed income based on a prescribed rate of designated cost or annual mark-to-market reporting.

■ **Derivatives.** Total equity swaps are often used by funds to avoid Canadian withholding tax on dividends or on distributions from income trusts; withholding is not exigible on compensation payments.

■ **Carrying on business.** A manager in Canada may make investment decisions and perform other services for a feeder fund located in a tax haven such as a Cayman exempt corporation. A non-resident is not considered to be carrying on business in Canada by virtue of the designated investment services provided by a Canadian service provider (a Canadian-resident corporation, trust, or partnership). Protected services include investment management and advice with respect to qualified investments (including publicly traded shares, indebtedness, annuities, commodities, currency, options, and forward and future agreements), whether or not the manager has the discretion to buy and sell; purchasing and selling qualified investments; and the provision of investment administration services (commonly known as back-office services).

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Acquiring an S Corp

A Canadian corporation may make a Code section 338(h)(10) election to treat the acquisition of an S corporation's stock as an asset acquisition for US federal income tax purposes. Absent an election, the basis of the assets acquired is not affected by the sale, and the assets must continue to be depreciated using historical depreciation methods and lives. The portion of the sale price representing goodwill cannot be amortized or otherwise recovered before the target stock's ultimate disposition.

A section 338(h)(10) election generally allows the acquiring corporation to step up to FMV its basis in the acquired company's assets, resulting in larger tax deductions for depreciation. Any residual purchase price is allocated to goodwill, which generally may be amortized over 15 years for tax purposes.

Mechanically, the election creates a hypothetical sale transaction in which the target is deemed to have sold its assets to a new corporation (Newco) at the close of the acquisition date; the sales proceeds are deemed to have been distributed in a liquidation of the target to its shareholders. The gain on the sale of the assets passes through to the target's shareholders, thereby increasing their basis in the target stock before the liquidation of their shares. As a result, if the gain on the deemed asset sale increases the basis of the target stock to an amount that equals or exceeds the amount paid for that stock, then the target's shareholders only recognize a gain in connection with the deemed asset sale and not in connection with the deemed liquidation of the target. Although the amounts of income recognized at the shareholder level may be relatively equal in a stock sale whether or not a section 338(h)(10) election is made, the character of the amount—capital versus ordinary income—may differ.

Without the election, the shareholders generally recognize a capital gain on the difference between their portion of the sale proceeds and their basis in the target stock. If the parties make an election, the character of the income or loss depends on the character of the income or loss that the target recognizes on the deemed sale of its assets. As a consequence, if the S corporation realizes ordinary income (such as depreciation recapture or a gain from the sale of inventory), that income flows through to the shareholders as ordinary income. Because ordinary income is likely to be taxed at a higher rate than long-term capital gains, the election may result in the shareholders' owing additional taxes. Therefore, depending upon the overall benefit of the election, the buyer may need to discuss methods for compensating the shareholders for any additional tax caused by the election.

The section 338(h)(10) election is made by filing form 8023-A, "Corporate Qualified Stock Purchases," with the IRS. The election requires the consent of the acquiring corporation and each of the S corporation shareholders. According to the Treasury regulations, the election must be made not later than the 15th day of the ninth month beginning after the month of the acquisition. Once made, the election is irrevocable.

Most states follow the federal tax treatment of acquisitions for which the election is made and increase the basis of the target's assets for state tax purposes accordingly. However, a few states do not follow the federal treatment.

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As in the case of any acquisition, state and local tax consequences must be identified and carefully weighed.

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FOREIGN TAX NEWS

WCO-OECD

A World Customs Organization and OECD conference discussed the possibility of convergence in transfer-pricing and customs-valuation methods for transactions between related parties.

United Kingdom

The United Kingdom is the 15th country to sign the OECD-Council of Europe Convention on Mutual Administrative Assistance in Tax Matters; Canada has signed but not yet ratified the convention.

Germany

Finance issued guidance on anti-treaty-shopping rules. The law as amended in 2007 requires a business or other good reason for interposing a foreign corporation, specifically excluding mere asset securitization or shareholders' pensions in times of economic crisis and concerns relating to the entire corporate group, such as cost reductions or location preferences.

Thin capitalization rules reclassifying excess interest as profit distributions were held not to be incompatible with EC law: *Lasertec Gesellschaft für Stanzformen GmbH v. Finanzamt Emmendingen* (C-492/04), May 10, 2007.

Netherlands

Finance proposes to encourage the use of environmentally friendly vehicles with a tax increase based on CO_2 emissions. Also, an individual who leases a car and drives it more than 500 kilometres per year for private purposes must increase his or her taxable income by 22 percent of its catalogue value; a reduced inclusion rate is proposed for cars with low emission rates.

The advocate general of the ECJ gave his opinion that the Dutch withholding tax on outbound dividends is incompatible with the EC treaty's free movement of capital: *Amurta SGPS v. Inspecteur van de Belastingdienst* (C-379/05), June 7, 2007.

Sweden

An individual can now claim a 50 percent deduction for services for work performed in or in relation to a dwelling, including cleaning, cooking, certain gardening, and child care.

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