CANADIAN TAX Highlights

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2008 China Tax Reform

China's new Enterprise Income Tax Law (EITL), enacted March 16, 2007 and effective after 2007, unifies the income tax treatment of domestic and foreign enterprises, including foreign-invested enterprises. The primary goal of the tax reform, which eliminates preferential regimes and incentives for foreign investors, is to level the tax playing field and standardize the tax system to promote fair competition for all enterprises in China. The reform creates both new challenges and new opportunities for existing enterprises and investors.

The EITL is based largely on the existing tax system, but some international tax concepts—wholly or partly new to China—require extra attention from tax planners.

Tax residence. The "managed or controlled" definition of tax residence allows China to tax the worldwide income of any foreign company managed or controlled in China. A multinational corporation that invests in China through a low-tax-jurisdiction intermediary holdco must ensure that it has sufficient substance in its country of origin.

Controlled foreign corporations (CFCs). A Chinese shareholder in a low-taxed CFC must include its share of the CFC's profits in its taxable income.

Thin capitalization. All enterprises are covered by a single new thin capitalization rule.

Transfer pricing. Transfer-pricing administration is strengthened. A Chinese company must provide information on related-party transactions in its annual income tax filing to the tax authorities. In transfer-pricing audits, both the audited company and its related party must provide information.

Cost-sharing agreements. A Chinese company and related parties may enter into a cost-sharing agreement for the joint development of intangibles.

Foreign tax credits. A resident enterprise that directly or indirectly holds shares of a foreign enterprise that pays foreign-source dividends may claim tax credits for its share of the foreign enterprise's underlying taxes.

General anti-avoidance rules. Broadly worded rules allow the tax authorities to disregard contracts and other arrangements lacking commercial viability.

The new rules set the base corporate tax rate at 25 percent; certain technology companies enjoy a 15 percent rate, and certain small companies a 20 percent rate. Tax holidays for foreign investors are eliminated, subject to some grandfathering, as are the existing tax incentives for foreign-invested entities in special regions. A foreign company with Chinese-source income may also suffer some increased withholding tax rates. No official increases have been announced, but there are several potential targets: (1) A 20 percent withholding tax may be imposed on gross dividends, although a reduction to 10 percent or less is likely. The EITL does not include a dividend reinvestment tax refund. (2) A 20 percent withholding tax may be imposed on gross interest, royalties, rentals, and service fees, with perhaps a concessionary 10 percent rate. (3) A 25 percent withholding tax may be imposed on net income from engineering and labour services.

The foreign investor may thus suffer an increase in income tax and withholding tax rates and the elimination of tax holidays. In contrast, the income tax rate applicable to domestic enterprises drops from 33 to 25 percent. The reduced rate, in combination with the elimination of deduction limits on certain costs and expenses—significant items such as wages and advertising—that previously applied only to domestic enterprises, represents a major reduction in the tax burden of many domestic companies. Foreign investors, including Canadian multinationals, should consider the implications for their tax-planning strategies and take appropriate action. Tax benefits available under the existing preferential tax policies should be maximized before the EITL's effective date.

Foreign multinationals should also review their Chinese inbound investment structures that use intermediaries in low-tax jurisdictions such as Barbados and Mauritius, traditionally popular holdco jurisdictions. In September 2006, China and Mauritius signed a protocol to their 1994 tax treaty that after 2007 allows China to tax a Mauritian company's gain from the sale of equity interests of a Chinese company if it owns at least 25 percent of the Chinese company's shares in the 12 months before the sale. The use of Mauritius as a holdco jurisdiction may thus need to be reconsidered. China also announced plans to renegotiate its Barbados treaty; the capital gains provisions in that

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treaty may be the target of an amendment similar to that in the China-Mauritius treaty, and the treaty renegotiations should be monitored.

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ANCHOR POINTE

The FCA in *Anchor Pointe Energy Ltd.* (2007 FCA 188) reversed the TCC and found that a taxpayer bears the onus to disprove new assumptions of fact made by the minister at the objection stage, even though the assessment's confirmation was issued after the normal reassessment period's expiry. (See *Canadian Tax Highlights*, "No Reverse Onus," August 2006.)

The 2007 FCA decision is the fourth procedural review of Anchor Pointe's 1991 taxation year; the substantive issues in the case have yet to be heard. In 1991, Anchor Pointe's predecessors each purchased seismic data for cash and a promissory note and claimed the purchase price as Canadian exploration expense (CEE). On audit, the minister reduced the CEE claimed on the basis that it exceeded the seismic data's FMV. The minister held in abeyance the objections filed by the taxpayer in 1994 pending the FCA's decision in *Global Communications Limited* (99 DTC 5377); the latter decision was rendered in 1999 and confirmed that seismic data purchased for resale or licensing do not qualify as CEE.

Nine months after the FCA judgment was rendered in *Global* and almost a decade after the 1991 taxation year in issue, the minister confirmed Anchor Pointe's reassessments on two grounds: (1) relying on *Global*, that none of the seismic data qualified as CEE because they were purchased for resale or licensing, and alternatively (2) that the taxpayer failed to establish that the seismic data had the FMV claimed. In confirming the reassessments, the minister relied on *Global* but did not increase the taxpayer's taxable income because the normal reassessment period had expired. The taxpayer appealed to the TCC.

In 2006, the parties brought a motion to the TCC on consent to determine which party bears the onus of proof of assumptions of fact that the minister first raised on the reassessments' confirmation. The TCC reviewed the reasons for shifting the onus of proof between the minister and a taxpayer and concluded that the minister bears the onus: it was inappropriate to impose on the taxpayer the additional burden of disproving new assumptions made by the minister at the objection stage. The TCC said that the system already favours the minister by presuming assessments to be correct; by authorizing the Crown to plead unproved assumptions; by imposing the burden of proof on the taxpayer; and by granting the minister as much time as necessary to process an objection. Ultimately, the TCC found that placing the onus on the minister for new factual assumptions and arguments made at the objection stage is fairer from a procedural standpoint.

On May 15, 2007, the FCA allowed the minister's appeal. The FCA said that in a self-reporting tax system such as Canada's, the minister must make assumptions of fact in determining a taxpayer's tax liability. The taxpayer bears the initial onus of disproving the facts assumed by the minister at the objection stage because only the taxpayer possesses the information necessary to refute the minister's assumptions. In some circumstances the result may be unfair, but on the facts the taxpayer had the exclusive knowledge of the purpose for which the seismic data were purchased and used.

The FCA acknowledged that a large body of case law establishes that the taxpayer bears the onus of proof only with respect to assumptions of fact made by the minister at the time of assessment. However, the FCA said that the term "assessment" in the Act has two meanings: (1) the process by which tax is assessed (that is, the issuing of an assessment or reassessment); and (2) the product of that process (that is, the amount of tax initially determined as owing and subsequently confirmed). The FCA adopted the latter meaning in this context, effectively extending the meaning of "assessment" to include the confirmation of an assessment. The FCA concluded that an assessment cannot create two sets of factual assumptions for which different parties bear the onus of proof. Unlike the TCC, the FCA concluded that it was inappropriate to require the minister to prove factual assumptions in the negative when the taxpayer has all the evidence. Consequently, the minister may assume new facts for which the onus rests on the taxpayer, right up to the time the notice of confirmation is issued, regardless of how much time has elapsed. The FCA also rejected the argument that the taxpayer was prejudiced by the delay of six years between the filing of the notice of objection and the reassessment's confirmation. The FCA said that the taxpayer could have avoided the delay and expedited the process pursuant to paragraph 169(1)(b) by filing an appeal to the TCC before the minister confirmed the notice of objection.

The FCA's decision blurs the traditional distinction between the audit phase, in which factual assumptions are made to determine a taxpayer's tax liability, and the objection phase, in which a taxpayer's tax liability is confirmed or reassessed in an administrative appeals framework. A taxpayer normally has an opportunity to disprove the auditor's factual assumptions in an administrative setting by filing a notice of objection and making submissions to an appeals officer. This opportunity is lost if the appeals officer introduces new arguments and factual assumptions when confirming the assessment. The taxpayer can only refute the new facts and arguments on an appeal to the TCC, thus extending what was formerly an administrative process into a judicial setting that is too costly, daunting, and time-consuming for many taxpayers. On the other hand, a taxpayer with adequate resources may be encouraged to proceed directly to the TCC and skip the CRA's administrative appeals process altogether in an effort to minimize the risk that an appeals officer may adopt new arguments and factual assumptions that the taxpayer must later disprove.

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Are Mistakes Misrepresentations?

Paragraph 152(4)(a) of the Income Tax Act allows the CRA to reassess at any time if the taxpayer or person filing a return made "any misrepresentation that is attributable to neglect, carelessness or wilful default or has committed any fraud in filing the return or in supplying any information." *Ridge Run Developments Inc.* (2007 TCC 68) held that the provision includes an earlier year's "incorrect" tax return whose error affects only a noncapital loss carryforward amount.

The facts in *Ridge Run* were complex. Essentially, Ridge Run was a real estate project that went wrong, arguably because a principal of Ridge Run misapplied funds, and lawsuits were threatened against a number of individuals and corporations. Protracted negotiations eventually resulted in many parties executing a mutual release in 1994, settling all claims and potential claims between them. Ridge Run's accountant prepared its 1994 income statement for financial statement purposes identifying a "debt forgiveness" of $1.7 million, to reflect the results of the release. (No accounting was ever made to establish the exact amount, if any, forgiven by the release.) In preparing the 1994 tax return, he backed out the debt forgiven for book purposes on form T2S(1) ("Net Income (Loss) for Income Tax Purposes") from taxable income, but he neglected to reduce the company's loss carryforward position for that amount. The facts were disclosed by the taxpayer in the return because the financial statements showing the forgiven debt were filed as required with the return. The 1994 taxation year was a loss year resulting in a nil assessment.

In 1997, the taxpayer applied its loss carryforwards—not reduced by the debt forgiveness—against taxable income. The CRA reassessed and reduced the loss carryforward applied from 1994 by $1.7 million to reflect the section 80 treatment of the debt forgiveness in that year. The limitation period for 1997 expired, and after considerable discussion with CRA audit and appeals, a reassessment was issued for 1997 in 2003. During the discussions, the information provided by the taxpayer to the CRA was determined to be incomplete and confusing—the CRA thought that the debt forgiveness was in 2000—but eventually, when all the facts were made available to the CRA, it determined that 1994 was the appropriate year for the debt forgiveness.

The court managed to sort through the labyrinth of facts, and focused on the main questions: to what extent did the incorrect 1994 tax return filed result from "a misrepresentation that is attributable to neglect, carelessness or wilful default" and did paragraph 152(4)(a) apply? The court noted that prior cases such as *Nesbitt* (96 DTC 6045 (FCTD)) and *Taylor* (61 DTC 1139 (Ex. Ct.)) decided that all "incorrect" tax returns were "misrepresentations," but no precedent was on all fours with *Ridge Run*. Although the taxpayer argued that there was a basis for not applying section 80 in 1994, it foundered on the lack of evidence that any such basis was even considered in preparing the 1994 tax return. The taxpayer failed to discharge its onus to disprove the minister's position that section 80 applied in 1994.

Ridge Run illustrates that any material error in a tax return is sufficient to suspend the limitation period, by virtue of its and previous decisions' generous interpretation of paragraph 152(4)(a). On the other hand, a well-considered filing position, based on a careful analysis of the facts and law, still appears to allow taxpayers to take advantage of the relevant limitation period for reassessments.

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Changing Priorities: Surplus

Statistics Canada recently released information on government finance in Canada, showing the dramatic turnaround in the overall fiscal position of the public sector. Detailed analysis shows how this result emerged.

The figures, summarized in *The Daily* for June 14, 2007 (http://www.statcan.ca/Daily/English/070614/td070614.htm), show that for the fiscal year 1997-98 for the senior levels and the calendar year 1997 for local governments, the three levels incurred a deficit of $1.1 billion. By 2006-7 (2006 for local governments), the surplus amounted to $28.6 billion. While much of the improvement can be attributed to the improvement in the federal fiscal performance and the restoration of balance in the Canada and Quebec pension plans, the changes in the relative importance of spending functions show that all levels revised their spending patterns. The numbers are based on Statistics Canada's financial management system of analyzing government finances, embracing a wide range of public sector agencies, including the Canada and Quebec pension plans.

As shown in the table, total revenue of all levels of government declined from 45.4 percent of GDP in 1998 to 41.7 percent in 2007. Collections of personal income tax dropped

Revenue and Expenditure of All Levels of Government as a Percentage of GDP, 1998 and 2007

	1998	2007
Total revenue	45.4	41.7
Personal income taxes	14.3	12.5
General sales tax	5.2	4.7
Gasoline and motive fuel taxes	1.3	0.9
Corporation income taxes	3.9	4.0
General property taxes	3.5	3.0
Contributions to social security plans	5.3	5.1
Sales of goods and services	3.2	3.2
Investment income	3.1	3.3
Total expenditures	45.5	39.7
Health	6.6	7.4
Social services	14.2	11.9
Education	6.4	6.2
Debt charges	6.5	3.2
Surplus (+) / deficit (–)	–0.1	+2.0

from 14.3 percent to 12.5 percent over the same period; they also declined as a percent of all revenue, from 31.5 percent to 30.0 percent. Of the major income items shown, only corporate income tax collections, sales, and investment income held their position relative to GDP over the period.

Dramatic changes in spending patterns enabled the public sector to reduce the relative importance of revenue and produce a significant surplus. As shown, health-care spending increased from 6.6 percent of GDP in 1998 to 7.4 percent in 2007; its share of all spending rose from 14.5 percent to 18.6 percent over the period. All forms of education spending dropped from 6.4 percent to 6.2 percent over the period. Spending on social services dropped from 14.2 percent of GDP to 11.9 percent over the period, and from 31.2 percent of combined budgets to 30.0 percent. Not surprisingly, debt charges dropped from 6.5 percent of GDP to 3.2 percent, and from 14.3 percent of all budgets in 1998 to only 8.0 percent in 2007.

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USSC Refuses Economic Nexus Cases

The US Supreme Court (USSC) recently refused to hear taxpayer-initiated appeals of New Jersey and West Virginia supreme court decisions that upheld the states' jurisdictional ability to impose an income tax on out-of-state businesses whose in-state business activities did not involve a physical presence in the state.

By denying the petitions for appeal in these two cases, the USSC missed an opportunity to clarify whether a state may constitutionally impose an income tax on an out-of-state taxpayer with no in-state physical presence. The issue has widespread implications, particularly for Canadian companies that have business activities—including the receipt of interest or royalty income from an in-state affiliate—but no physical presence in a state.

The two cases are *Lanco, Inc. v. Director, Division of Taxation* (908 A. 2d 176 (NJSC 2006)), in which the taxpayer's sole contact with New Jersey was the licensing of trademarks to an affiliate in the state, and *MBNA America Bank, N.A. v. Tax Commissioner of the State of West Virginia* (640 S.E. 2d 226 (WVSC 2006)), in which the only contact with West Virginia was the solicitation, issuance, and servicing—all done from outside the state—of credit cards to West Virginia customers.

In a previous case, *Quill Corp. v. North Dakota* (504 US 298 (1992)), the USSC concluded that physical presence was required before a state could impose its sales and use taxes on an out-of-state taxpayer. The court did not discuss whether "physical presence" was a requirement for all types of taxes or whether it was limited to sales and use taxes, leaving the issue open to interpretation. Since *Quill*, the USSC has not addressed whether physical presence is required to establish nexus for other types of taxes, including income and franchise taxes.

Following its decision in *Quill*, the USSC denied a petition for appeal in *Geoffrey I v. South Carolina Tax Commission* (437 S.E. 2d 13 (SCSC 1993)), in which the South Carolina Supreme Court upheld the imposition of an income tax against a non-resident corporation that had no physical presence in South Carolina, but derived income from licensing trademarks to an in-state affiliate. Since the USSC refused to hear *Geoffrey*, US states have split on the question of whether it is constitutional to impose income and franchise taxes on an out-of-state taxpayer with no in-state physical presence.

Lanco and *MBNA* were two thoughtfully litigated state court decisions that represented the best opportunity since *Geoffrey* for the USSC to settle the issue. In both *Lanco* and *MBNA*, the two states' highest courts interpreted the *Quill* decision narrowly and held that the physical presence requirement applied only to sales and use taxes. Thus, the highest court in each of West Virginia and New Jersey has allowed its state to assert taxing jurisdiction over a taxpayer that has no physical presence in the state. The USSC's denial of a petition for appeal has no precedential value; it simply means that the court refused to review the case presented. (The USSC grants less than 5 percent of petitions for appeal.) For West Virginia and New Jersey taxpayers, the denial by the USSC in *Lanco* and *MBNA* means that their respective highest court decisions are good law in each state.

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Statute-Barred Rollover Valuation

A recently released technical interpretation (TI 2006-0196001C6, October 6, 2006) says that the CRA can reassess an individual taxpayer beyond the normal reassessment period on a rollover of shares from the individual to his or her holdco (1) if there was a substantial difference between the shares' FMV and the value attributed to them by the individual and (2) if the taxpayer misrepresented the facts by neglect, carelessness, wilful default, or fraud. The TI also says that the CRA can impose a third-party civil penalty on the professional who prepared the taxpayer's rollover form and/or income tax return. The TI addresses a question asked at the October 2006 APFF round table.

In the TI, the taxpayer, Mr. X, purported to roll personally owned public corporation shares to his holdco under section 85, but he established the shares' value using a method that was not consistent with the CRA's position on share valuation in *Information Circular* 89-3, "Policy Statement on Business Equity Valuations" (August 25, 1989). Mr. X then provided the share value to his tax professional, who prepared the rollover form on Mr. X's behalf. There was a significant difference between the shares' FMV and the value attributed to them by Mr. X. The normal reassessment period for the taxation year of the transfer had expired.

Subparagraph 152(4)(a)(i) allows the CRA to reassess beyond the normal reassessment period if a taxpayer made a misrepresentation attributable to neglect, carelessness, wilful default, or fraud. Subsection 163.2(4) allows the CRA to impose a third-party civil penalty if it can show that the professional who prepared the taxpayer's rollover form and/or income tax return participated in, assented to, or acquiesced in making a false statement.

The TI says that determining whether a person misrepresented the facts by neglect, carelessness, or wilful default can be resolved only by considering all the facts of a particular case. The CRA says that it could prove that Mr. X made such a misrepresentation because of the substantial difference between the shares' FMV and the value he attributed to them and because he did not consider the CRA's position on the valuation of shares in IC 89-3. The CRA says that a prudent and conscientious person exercising due diligence would, among other things, consider the CRA's valuation principles, practices, and policies. The TI says, "In this case, the CRA could, without a doubt, issue a reassessment for Mr. X's taxation year in which the shares of the public corporation were disposed of, pursuant to subparagraph 152(4)(a)(i)."

The TI also cites *Information Circular* 01-1, "Third-Party Civil Penalties" (December 18, 2001), and says (at paragraph 64) that to impose third-party penalties under subsection 163.2(4), the CRA must "prove, on the balance of probabilities, that an advisor or a tax return preparer knew of the false statement or that culpable conduct existed in a given situation." On the facts of the TI, the CRA says that it could possibly prove that the professional who prepared the rollover form was aware of the substantial difference between the shares' FMV and value attributed to them, or that he engaged in culpable conduct in the circumstances. Thus, the CRA could be justified in imposing a penalty under subsection 163.2(4). The TI notes that in such a situation the Third-Party Penalty Review Committee examines the facts and makes the final decision whether to impose the third-party civil penalty on the tax preparer.

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CRA To Help Small Businesses Reduce the Compliance Burden

The CRA Action Task Force on Small Business Issues was created (1) to identify which of the CRA's administrative practices imposed the greatest burden on small businesses; (2) to develop solutions to reduce the burden; and (3) to introduce a systemic approach to burden reduction across the CRA. The task force was made up of senior CRA officials, small-business owners, and representatives from Industry Canada and business organizations. The task force's report, *Helping Small Businesses by Reducing the Compliance Burden* (March 2007), found that employment- and tax-related information obligations imposed by various levels of government—in particular, GST/HST, payroll taxes, and income taxes—are most burdensome to small businesses. The report identifies three key objectives and over 50 CRA initiatives that have been or will be undertaken to achieve these objectives. These objectives and key initiatives are noted below.

Objective 1: Simplify, improve, and where appropriate reduce the frequency of small business interactions with the CRA.

- Reduce tax filings and remittances. For example, 2007 federal budget measures reduce the frequency of tax instalments, source deductions, and GST/HST filing and remitting requirements for qualifying small businesses, starting in 2008.
- Periodically review administrative thresholds.
- Coordinate compliance activities, such as combining income tax and GST/HST audits.
- Enhance the functionality of the CRA's "My Business Account" online service.
- Allow electronic filing of debit GST/HST returns.

■ Introduce a simplified SR & ED claim form and self-assessment tool.

■ For late payroll remittances, determine whether changes are required to graduated penalties, and review and update the fairness provision guidelines that provide relief from penalties and interest.

■ Reduce the provincial and territorial compliance burden and harmonize federal and provincial business programs.

■ Administer Ontario's corporate income tax and corporate minimum tax, starting with taxation years ending after 2008, resulting in combined income tax instalments and one corporate tax return.

■ Expand adoption of the federal business number by the provinces and territories. For example, Ontario's retail sales tax program adopts the federal business number in 2007.

Objective 2: Improve how and when the CRA communicates with small businesses.

■ Ensure that the CRA's forms and publications are relevant, appropriate, and written in plain language.

■ Present information in a variety of formats, such as a question-and-answer format to communicate legislative changes.

■ Analyze common errors made by small businesses and take steps to reduce them.

■ Identify the sources of the compliance burden through surveys and discussions with small businesses and work on their elimination.

■ Hold small-business seminars on a variety of topics.

■ Provide accurate and consistent responses to telephone queries—for example, by implementing centres of expertise to deal with complex issues and by enhancing and standardizing the training of CRA telephone agents.

■ Improve the content and organization of the CRA Web site—for example, by providing links between relevant Web pages.

■ Introduce "Smartlinks" and expand to other secure Web pages such as "My Business Account." "Smartlinks" is a utility that allows users to access a CRA agent directly from the CRA Web site.

■ Increase awareness and knowledge of CRA electronic products and services for small businesses by advertising and distributing the "CRA Electronic Services for Businesses and Individuals" CD-ROM.

■ Conduct surveys on how to improve CRA electronic products and services.

Objective 3: Make burden reduction systemic within the CRA.

■ Develop a performance measurement framework for compliance burden reduction to measure the CRA's progress in burden reduction and report thereon to Parliament annually.

■ Review initiatives in other countries and at other levels of government to identify potential burden-reduction strategies.

■ Conduct research and review other studies to better understand the needs of small business.

■ Inventory the CRA's administrative requirements and information obligations with which small businesses must comply.

■ Make compliance burden reduction fundamental to the CRA's forms-review process and to the development of its administrative procedures.

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US Tax Advice Penalty Standard

Legislation effective May 25, 2007 (Small Business and Work Opportunity Act of 2007, Pub. L. no. 110-28) establishes a "more likely than not" standard for tax advisers to avoid Internal Revenue Code section 6694 understatement penalties for advice on a US tax return position that is not separately disclosed. A monetary penalty of up to 50 percent of the income derived by the adviser may be imposed if a US federal return or claim for refund that is filed does not disclose a position for which the adviser did not reach a more-likely-than-not opinion.

The more significant changes are as follows. (1) The standard for a position on a return without form 8275 ("Disclosure Statement") disclosure has been raised from "realistic possibility" to a reasonable belief that the position would "more likely than not" be sustained on its merits. (2) The former "not frivolous" standard for a return with disclosure increases to a "reasonable basis" standard; thus, the preparer cannot under any circumstances sign a return if he or she knows that the return contains a position that is not supported on a reasonable basis. (3) The section 6694 penalty is expanded to apply to estate tax, gift tax, and information and other returns. (4) The amount of the penalty has been increased.

Under prior law, an income tax adviser was open to penalty if he advised vis-à-vis a position that resulted in an understatement of tax on a return and if (1) there was no "realistic possibility" of its being sustained on its merits, (2) the position was undisclosed or was frivolous, and (3) the adviser knew or reasonably should have known of the position. The penalty was $250 if the adviser knew or reasonably should have known of the position taken; a second-tier penalty of $1,000 was imposed if the adviser engaged in specific wrongful or reckless conduct.

Both the prior and the new penalty provisions apply specifically to a "return preparer," but the definition of that phrase is broad enough to include, for example, a person who gives advice on specific issues of law before a transaction occurs. Thus, an individual who provides tax-planning advice may be subject to the penalty provision.

The new rules broaden the scope of the penalties to capture advisers with respect to returns for estate and gift tax, employment tax, and excise tax returns, and returns of tax-exempt organizations. The new rules also alter the standards of conduct sufficient to avoid penalty with respect to a return that understates tax. Thus, the provision replaces the "realistic possibility" standard for an undisclosed position with a requirement that the adviser hold a reasonable belief that the position's tax treatment was more likely than not the proper treatment. Moreover, the "not frivolous" standard that previously applied to a disclosed position is replaced with the requirement that there must be a reasonable basis for the tax treatment of the disclosed position. Under the new rules, the first-tier penalty increases from $250 to the greater of $1,000 and 50 percent of the income derived or to be derived from the preparation of the relevant return (or refund claim); the second-tier penalty, formerly $1,000, increases to the greater of $5,000 and 50 percent of the income derived by the tax adviser.

The legislation does not provide for transitional relief, but new Notice 2007-54 (2007-27 IRB 12) addresses various questions regarding the penalty's scope and application. The notice acknowledges that the amendments raise questions: What activities represent preparation of a tax return? Who is the return preparer? How does the statute apply to signing and non-signing preparers? Under the transitional relief, income tax return preparers are subject to the existing regulations for returns due before 2008; for non-income tax returns due before 2008, a "reasonable basis" standard applies.

Treasury Department Circular 230 requirements that govern professional conduct apply the same standard for avoiding a penalty as the old Code section 6694: a return position must have a "realistic possibility of being sustained on its merits" (a 33⅓ percent likelihood of success) or must be disclosed and not be frivolous (a 5-10 percent likelihood of success). IRS Notice 2007-30 (2007-14 IRB 883) establishes that any violation of the circular may trigger a monetary penalty. An adviser who fails to meet the standards in both the circular and the new Code section 6694 may be exposed to a penalty as high as 150 percent of his or her fees from the engagement.

More than ever before, an adviser on a US tax return position has a significant incentive to communicate clearly with the client to ensure proper reporting and disclosure. The new "more likely than not" standard for advisers under the new Code section 6694 is higher than the standard for taxpayers, unless the issue involves a tax shelter. An understatement penalty is imposed on a taxpayer with a substantial understatement of tax attributable to an undisclosed position only if it lacks "substantial authority." The "substantial authority" standard is less stringent than the "more likely than not" standard, but more stringent than the previous "reasonable basis" standard for advisers.

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GAAP: Substantive Enactment

Two major federal tax bills received third reading in Parliament in June 2007, making the tax measures included in these bills "substantively enacted" for Canadian GAAP purposes. One of the bills also received royal assent before Parliament's summer recess. Corporations, income trusts, and other organizations may need to reflect future tax changes under Canadian and US GAAP in interim or other financial statements.

Bill C-52 received third reading on June 12, 2007 and royal assent on June 22, 2007, meaning that the tax measures in the bill are now also considered to be "enacted" for the purposes of US GAAP. Bill C-33 received third reading on June 15, 2007. The table shows the measures included in these two bills.

The changes in the two tax bills were considered substantively enacted on June 12 or 15, 2007, respectively, for the purposes of Canadian GAAP. Thus, public companies and trusts with calendar year-ends must account for the

Tax measure	"Substantially enacted" under Canadian GAAP
Certain 2007 budget proposals	Bill C-52, June 12, 2007
Reduction of the general corporate tax rate to 18.5% (from 19%) after 2010	Bill C-52, June 12, 2007
New tax on distributions from specified investment flowthrough entities (SIFTs), effective in 2011 for previously existing income trusts and partnerships, and in 2007 for new trusts and partnerships	Bill C-52, June 12, 2007
Changes to the proposed definition of expenditure, and limitations on the use of stock option expenditures, in R & D investment tax credit claims	Bill C-33, June 15, 2007
New tax rules affecting foreign investment entities and non-resident trusts, effective for tax years starting after 2006	Bill C-33, June 15, 2007
Tax measures affecting restrictive covenants, non-compete payments, and similar payments	Bill C-33, June 15, 2007
Technical tax amendments previously released in draft form on July 18, 2005	Bill C-33, June 15, 2007

tax changes in their June 30, 2007 interim reporting period under Canadian GAAP; under US GAAP, they must also account in that period's reporting for the changes in Bill C-52. When measuring the effect of these changes in tax law and tax rates, estimated temporary differences should be identified and future tax assets and liabilities should be calculated as of the date of substantive enactment. The SIFT legislation now triggers recognition of future income tax assets and liabilities with a corresponding impact on future tax expense, based on the temporary differences that are expected to reverse after the changes' effective date (but excluding existing temporary differences that reverse before that date).

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Right To Assert Privilege

A person served by the CRA with a request for information (RFI) under section 231.2 of the Income Tax Act (ITA) or section 289.1 of the Excise Tax Act (ETA) must provide any information requested. If the person fails to comply, the CRA may apply to a court for a compliance order requiring him or her to provide the information (ITA section 231.7 and ETA section 289.1). An RFI or compliance order application is frequently served on the taxpayer being audited or investigated, but it may also be served on third parties, including lawyers and accountants. Documents protected by solicitor-client privilege need not be disclosed. But procedural issues arise on the issuance of a compliance order because a taxpayer—the only party who can waive privilege—is not party to the application and thus receives no immediate rights to assert a claim for privilege. In *Cornfield* (2007 FC 436), the Federal Court concluded that a taxpayer need not be served with notice that a compliance order has been issued.

In *Cornfield*, the CRA issued an RFI under the ETA, requiring that a taxpayer's lawyer provide a statement of adjustments and other accounting documentation relating to a real estate transaction. The lawyer refused, saying that the disclosure requirement conflicted with the *Professional Conduct Handbook* of the BC Law Society, which governs lawyers in the province and requires them to claim solicitor-client privilege for documents "which [are] or may be privileged" (unless the client waives that privilege). The CRA applied for a compliance order under ETA section 289.1. The Federal Court reviewed (1) whether the documents were subject to solicitor-client privilege, (2) whether section 289.1 adequately protected the rights of a lawyer's client to claim solicitor-client privilege, and (3) whether the Federal Court should add procedural safeguards such as a requirement to serve notice on the taxpayer-client.

The Federal Court set out the statutory framework governing the issuing of a compliance order and the relevant case law. The court concluded that notice need only be served on "the person against whom the order is sought." The court also determined that the documents in question were not subject to solicitor-client privilege: they were "an accounting record of a lawyer, including any supporting invoice, voucher or cheque," all of which are statutorily excluded from the definition of "solicitor-client privilege" (as well as by common law).

In considering whether the current procedure should be amended to require that the taxpayer be added to the application to give it the immediate right to assert privilege, the court said that the *Professional Conduct Handbook* did not apply if the documents were not privileged. The documents in question were merely confidential communications, altogether different from communications that satisfied the test for solicitor-client privilege under the ETA or the ITA, and there was nothing for the client to waive. The court also considered an interesting hypothetical scenario involving financial or accounting records (normally not within the ETA or ITA definition of "solicitor-client privilege"). If such records contained notations or other information that might be privileged, the court said that although they did not satisfy the definition of non-privileged information, the statute and court procedures provided the necessary protection. The court also said that the procedure for issuing a compliance order need not be amended, because service on the taxpayer was not necessary given the previous jurisprudence and the procedure set out in the legislation.

Unfortunately, the court concluded that a taxpayer may not be given a right to assert his or her claim of privilege when a compliance order application is made in respect of a third party. A lawyer may be sufficiently knowledgeable to assert this right on the client's behalf, but there may be practical problems if the documents that are potentially privileged at common law are in the possession of a non-lawyer third party served with a compliance order application.

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Canadian Tax Traps

The following real-life fact situations presented tax traps, either because of a lack of foresight or simply owing to technical errors.

Loss utilization. A husband sells publicly traded shares in order to crystallize his loss. Without his knowledge, his wife buys the same shares two weeks later, triggering the superficial loss rules to deny the husband's capital loss.

An individual intends to sell his company for a substantial gain. A friend owns a company with a substantial capital loss carryforward. If the individual tries to roll his shares to the lossco and have the lossco sell his company, subsection 69(11) denies the rollover and a capital gain is realized. A rollover is also denied on a transfer to a lossco that the individual owns equally with a parent: the lossco is not affiliated with the individual.

Capital dividend account. Following their parents' death, two siblings—one Canadian-resident and one US-resident—each own 50 percent of a Canco's shares; a capital dividend declared is paid equally to them. The capital dividend attracts 15 percent Canadian withholding tax for the US shareholder and is taxable in the United States. A deemed dividend on a repurchase by Canco of the US shareholder's shares for cancellation would have attracted Canadian withholding tax, but the Canadian shareholder could have received the entire capital dividend account tax-free.

Employee stock options. An individual rolls unexercised employee stock options to his holdco, which has business losses, so that it may exercise the options, but the subsequent exercise triggers the taxable benefit to the employee.

An individual exercises employee stock options in a private company representing 10.1 percent of the shares for nominal consideration. He rolls the shares to a holdco to defer tax on any dividends, but the deferral of the stock option benefit is lost on any disposition or exchange of the stock.

An individual exercises a stock option of a US public company and subsequently sells the shares at a loss. The resulting capital loss cannot be carried back to offset the previous income inclusion (the stock's FMV less the option price).

Paid-up capital (PUC). Mr. A incorporates Opco and subscribes for 100 common shares at $100. Two years later, Mr. B subscribes for 100 commons at $400,000. Mr. B's adjusted cost base (ACB) is $400,000, but his PUC is only $200,000, because PUC is averaged over all shares of the class. Mr. B cannot take out more than $200,000 as a return of capital unless he originally acquired a separate class of shares.

Rollovers. A general partnership owns an apartment building; each partnership interest has a negative ACB. The land has a capital cost of $1.2 million. The building has a capital cost of $6 million, an undepreciated capital cost (UCC) of $1.8 million, a mortgage of $8 million, and an FMV of $16 million. The partnership cannot roll the building to a newco for common shares and the assumption of the mortgage so that a purchaser can acquire the shares and trigger a capital gain to the partnership: the deemed proceeds cannot be less than the mortgage assumed, and recapture is triggered.

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Foreign Tax News

IBFD

A joint conference with the European Chartered Institute of Taxation discussed the taxation of foreign income in Europe, tax relief for financing costs, tax planning for international accounting standards, and attribution of profits to PEs.

United States

Treasury says that it will not apply the authorized OECD approach for the attribution of profits to a PE to most of its treaties, although the approach was recently incorporated into a few US treaties (such as those with Japan and the United Kingdom). Treasury disagrees with the symmetry requirement (although it says that the overall US foreign tax credit limitation makes double taxation unlikely); it says that relief from double taxation is an article 23 issue and that the amount of a PE's income that is exempt from tax is to be computed according to the home state's domestic law.

United Kingdom

As the next stage in its review of links with large business, HMRC issued two consultation documents regarding the improvement of its dealings with transfer-pricing inquiries and the provision of certainty to business through rulings and clearances. HMRC is looking at an 18-month timetable for resolving transfer-pricing issues and at giving pre- and post-transaction rulings within 28 days and across all relevant taxes.

European Union

The European Commission published a summary of the results of public consultation on VAT modernization for financial and insurance services.

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