CANADIAN TAX Highlights

Editor: Vivien Morgan, LL.B.

Volume 15, Number 8, August 2007

GST ITCs: Agency and Claim Info

Agency. In business dealings, several taxpayers often work together toward a common goal, but they may not take the time to accurately define their legal relationships. That absence of clarity can create problems for tax purposes, particularly with respect to the transaction-based GST, as it did initially on the facts in *YSI's Yacht Sales International* (2007 TCC 306). Fortunately, the TCC was able to conclude that YSI was entitled to claim input tax credits (ITCs).

YSI was a yacht broker retained by a client to find financing to rebuild a ship and ultimately to find a purchaser for the rebuilt ship. YSI found financing and a prospective purchaser, but the relationship between the client-vendor and the prospective purchaser broke down before the ship's reconstruction was complete. YSI stepped in to complete the project, and the purchaser agreed to provide the funds to pay the amounts owed by YSI (including GST) on suppliers' invoices for goods and services issued in YSI's name.

Initially, the purchaser claimed the ITCs by filing a GST rebate application, which the CRA disallowed because the invoices were in YSI's name. Then YSI's attempts to claim the ITCs on its own account were denied because (1) it did not qualify for ITCs because it purchased the goods as an agent, and (2) the GST was not payable by it.

The central issue was whether YSI was entitled to recover the ITCs. The TCC divided the issue into two questions: (1) Did YSI acquire the goods and services from the suppliers for consumption, use, or supply in the course of its commercial activities? (2) Was GST payable by YSI? On the first question, the Crown argued that YSI was acting as an agent when it entered into agreements to acquire the goods and services: thus, YSI did not acquire goods or services for consumption, use, or supply in the course of its own commercial activities. (This position seems to contradict the CRA's initial denial of the purchaser's GST rebate claim in its capacity as principal.) The TCC disagreed, saying that YSI acquired the goods and services on its own account and not on behalf of the purchaser; the parties did not intend an agency relationship, and their relationship was more one of buyer and seller. The essential question was whether the purchaser agreed to be bound by YSI's agreements with suppliers, and the clearest expression of its intention was found in a memo that was never formalized in a written agreement; the memo provided that YSI would contract with suppliers and charge the purchaser a 5 percent markup to the extent that YSI's wholesale accounts were used.

On the second question, the Crown said that YSI was liable for the GST payment, but the purchaser was ultimately liable for the payment because the funds were drawn from the purchaser's bank account. The TCC disagreed: YSI was the only person liable to pay the consideration under the agreements with suppliers and was thus the "recipient" of the supplies as defined. The use of the purchaser's bank account was merely a convenient funding mechanism.

YSI could have avoided the denial of ITCs if it had executed a straightforward agreement defining the legal relationship between the parties, and, although not necessary, perhaps even setting out how the parties intended to account for the GST. *YSI* confirms that notwithstanding the source of funds used to pay for supplies and GST, if the person making the payment for the supply is legally liable to do so and is also the supply's recipient, it can claim the related ITCs. A more difficult question arises if the person making the payment in fact acts as an agent. In that situation, both the agent and the principal may be liable to pay the GST, and perhaps either agent or principal can claim the ITCs because they are both "recipients" under the legislation. The CRA policy has generally been to deny the agent an ITC claim, but that policy might not carry the day.

Documentation requirements mandatory. A recent landmark FCA decision definitively concluded that the documentation requirements for ITC claims in subsection 169(4) are mandatory. In a decision delivered from the bench in the *Systematix Technology Consultants* (2007

In This Issue

FCA 226), the FCA rejected prior TCC jurisprudence that suggested that the subsection 169(4) documentation rules may not be mandatory. The FCA concluded that if the GST registrant claiming ITCs does not have the information required to support the ITC claim—in this case, a valid GST registration number from the supplier, but also including its proper name—then the registrant cannot claim an ITC, regardless of whether all other requirements in the ETA are met. The wording of the decision appears to impose an absolute liability on the claimant to provide accurate information, regardless of whether due diligence was exercised.

The CRA recently introduced an Internet-based GST registry system, which allows a user to confirm a registrant's GST number by entering the registrant's name, GST number, and the date of the transaction in question. However, the process may be too cumbersome for all but the largest transactions. Perhaps the day-to-day practical difficulties inherent in the real-time collection of full and accurate information from or about third parties should be reflected in a legislative change that grants discretion to either the CRA or the TCC to determine whether it is fair to impose the requirements in particular circumstances.

Robert G. Kreklewetz and Vern Vipul
Millar Kreklewetz LLP, Toronto

Administrative Relief for 2006 Eligible Dividend Filings

The CRA recently announced its administrative policy on due dates for two 2006 eligible dividend filings. (1) The election (or revocation of an election) not to be a CCPC under subsection 89(11) for the 2006 taxation year is considered filed on time if it is filed before 2008. (2) A corporation may have paid a dividend exceeding its eligible general-rate income pool (GRIP) amount because it relied on the incorrect version of schedule 53 ("General Rate Income Pool (GRIP) Calculation"). To avoid part III.1 penalty tax, the corporation should send details (identifying steps to restore the proper balance) to the Director General of Income Tax Rulings before December 31, 2007.

1) Elections to be a non-CCPC. Subsection 89(11) allows a CCPC to elect not to be a CCPC at any time in the year and thereafter for purposes of the eligible dividend rules; the corporation may thus pay eligible dividends unrestricted by its GRIP balance, but limited by any low-rate income pool (LRIP) balance. (New subsection 249(3.1) deems the CCPC to have a year-end immediately before the election.) The election is due on or before the corporation's income tax filing due date. The CRA has orally confirmed that a corporation that filed its 2006 tax return before the release of the new eligible dividend forms (including form T2002, "Election, or Revocation of an Election, Not to be a Canadian-Controlled Private Corporation") must now file the forms.

2) GRIP calculation. On June 13, 2007, the CRA released a revised version of schedule 53 that corrects an earlier version's calculation error. In making the GRIP calculation for 2001-2005, the originally released schedule 53 calculated a GRIP amount year by year and then added each year's total to arrive at a CCPC's 2006 opening GRIP balance. Thus, taxable dividends paid in a year reduced GRIP for that year only, and the 2006 opening GRIP balance could be overstated—an error that could cause a taxpayer to pay an excessive eligible dividend and trigger a 20 percent penalty (part III.1, a tax on excessive eligible dividend designations).

Paul Hickey
KPMG LLP, Toronto

Canada-US Protocol

On August 13, 2007 Finance Minister Flaherty indicated that the Canada-US treaty protocol will be signed on September 10, 2007 in British Columbia. This is a positive development, but it is not clear that the protocol will be ratified in 2007.

Once the protocol is signed, it must be ratified by both countries. In the United States the protocol must be submitted for advice and consent, which generally involves a hearing of the Senate Foreign Relations Committee. That committee convened on July 17, 2007 to consider various proposed treaty revisions and protocols, but not the Canada-US protocol. The committee is apparently not inclined to hold more than one tax treaty hearing annually, and thus ratification of the new protocol this year seems unlikely. Occasionally a treaty is effective before its ratification, and thus there may be room to lobby for a special effective date for the new protocol.

Sandra Slaats
Deloitte & Touche LLP, Toronto

Michigan Replaces Single Business Tax

The recently enacted Michigan business tax (MBT) will soon replace the state's troublesome single business tax (SBT), which often triggered a disproportionate amount of tax for Canadian-based companies with very little in-state activity. The MBT is effective after 2007 for all post-2007 business activities in Michigan; SBT applies to pre-2008 activities in straddle fiscal years.

The SBT is a modified value-added tax based on US federal taxable income with substantial modifications, including the disallowance of deductions for compensation, interest expense, and depreciation. Although US federal law prohibits a state from imposing an income-based tax on an out-of-state taxpayer whose in-state activities are limited to the solicitation of tangible personal property sales (Public Law 86-272), the SBT is not considered an income-based tax. Under Michigan's jurisdictional rules (nexus), the presence in Michigan of a person or property for more than two days a year can create SBT exposure. The Canada-US treaty does not determine tax status for SBT purposes.

The MBT replaces the SBT with four tax regimes: (1) a business income tax (BIT); (2) a modified gross receipts tax (GRT); (3) a premiums tax on insurance companies; and (4) a capital-based franchise tax on financial institutions. A taxpayer can be subject to both the BIT and the GRT. The MBT nexus threshold is met if an out-of-state company has a presence in Michigan for one day or if it actively solicits sales and has Michigan-source gross receipts exceeding $350,000 per year. The MBT expressly acknowledges that Public Law 86-272 applies for the BIT, but not the GRT.

The MBT requires unitary business groups to file combined tax returns, which generally will not affect Canadian companies. A unitary business group has three characteristics:

1) Water's edge: the group includes all US-organized entities except those with substantial non-US operations and at least 80 percent active foreign business income as defined in the Code.

2) 50-percent ownership: the group includes any entity and all others in which it owns or controls, directly or indirectly, more than 50 percent of the ownership interest with voting rights.

3) Unitary: group members have business activities or operations that result in a flow of value between such members, activities, or operations that are integrated with, are dependent upon, or contribute to each other. Flow of value is determined by reviewing all the facts and circumstances of business activities and operations. Combined group members are treated as one.

The BIT applies to a taxpayer's apportioned business income tax base at a 4.95 percent rate. The BIT base is similar to many states' income tax base: federal taxable income is modified, including the addback of certain royalties, interest, or other expenses paid to a non-unitary-group related person for the use of an intangible asset. The addback may apply, for example, to interest paid by a Michigan combined group to a Canadian affiliate. SBT business loss carryovers cannot offset the BIT base.

The GRT is based on gross receipts less purchases from other firms and is imposed on the apportioned net amount at 0.80 percent. The GRT base of a unitary business group is the sum of the modified gross receipts of each group member, excluding inter-member transactions.

A taxpayer with business activity outside Michigan apportions the BIT and GRT tax bases using a single-factor (sales) apportionment formula that excludes a unitary group's inter-member transactions. The *Finnigan* rule (*Appeal of Finnigan*, docket no. 88-SBE-022-A (Cal. State Bd. of Equilz. 1990)) is adopted to determine sales included in the factor's numerator—Michigan sales from each unitary business group member whether it itself has nexus with Michigan.

A number of credits can reduce BIT and GRT. Several credits are carried over from the SBT, but many are new, designed to reward companies that invest in Michigan, including a compensation and investment credit, a research and development credit, and a personal property tax credit. A taxpayer that reasonably expects its liability for the tax year to exceed $800 must file estimated returns and make estimated payments quarterly.

Jeffrey Brown and Barry Nussbaum
KPMG LLP, Toronto

Fees Not Earned by Corporation

Subsection 56(4) is an anti-avoidance provision that deals with the indirect receipt of income: generally, where a taxpayer transfers or assigns rights to income in a non-arm's-length transaction, the income is attributed back to the transferor. The provision applies, for example, if a taxpayer assigns the right to receive salary from his employer to a corporation controlled by him (*No. 594* (59 DTC 78 (TAB)). The rule was recently considered in *Robert Boutilier* (2007 DTC 479 (TCC)).

The taxpayer was a financial planner, an independent contractor, who sold mutual funds. As is normal with such sales, he earned a sales commission on the sales and was entitled to trailer fees payable quarterly for as long as the purchaser held the mutual funds. Trailer fees are designed to compensate the investment sales party for providing continuing future services and advice to the client in order to encourage the retention of the fund units. Initially, such trailer fees were paid to the taxpayer but within a year a different procedure was adopted. A new corporation was formed, and its common shares were held by a trust for his family members. The taxpayer was a director and officer of the corporation and a trustee of the trust. He rolled the service part of his business into the company under section 85 in exchange for preference shares. The trailer fees were paid to the corporation and dividended to the family trust, and then (by means and for reasons not clear) they found their way back to the taxpayer.

The taxpayer was reassessed by the CRA under subsection 56(4). At the TCC, he argued that the rule did not apply because no right to income was assigned, only the "opportunity" to earn income in the future by providing services to clients to whom he had sold mutual funds. However, the court said that the section 85 transfer agreement did not refer to an opportunity to earn those trailer fees.

The court agreed that there is a distinct line between the commission earned on sales and fees earned in the future for services, and it also agreed that is possible for a corporation to provide such services. But on the facts, no evidence supported the proposition that the corporation was anything more than a conduit: it had no employees and no formal office, and it incurred minimal expenses in comparison with the taxpayer's expenses incurred to earn his initial sales commissions. Even the services provided to the corporation by the taxpayer (there were no other employees) were not remunerated. The corporation merely reported the income but did nothing to earn it. Accordingly, the TCC held that subsection 56(4) applied and that the income belonged to the taxpayer, at least for tax purposes. A similar analysis has been used in many decisions, including a long line of cases starting with *Sazio* (69 DTC 5001 (Ex. Ct.)), which held that the rule does not apply if a corporation earns income from services provided by an individual as its sole employee. (That case prompted the introduction of the personal service business rules in section 125.) However, the corporation must actually earn the income. (See, for example, *Burns*, 73 DTC 5219 (FCTD) and *Connor*, 75 DTC 85 (TRB).)

The taxpayer also argued that the corporation had paid tax on the income, and thus he should not have to do the same. The court distinguished the cases cited and concluded that "whether the corporation here has been properly assessed has little bearing on the appeal and it remains an issue the corporation must deal with." Although it is not clear from the facts, the corporation's tax years may have been statute-barred.

In *Boutilier*, the court found that the corporation did not earn the income. However, the court noted that neither subsection 56(4) nor the Act deals with the situation in which the transferee has already paid tax. (Subsection 248(28) does not apply.) The court referred to paragraph 10 of IT-440R2, which states that where subsection 56(4) applies, but where there has been no deliberate attempt to evade or avoid tax, the income is included as income in the transferor's hands only. In the absence of a statutory rule addressing this type of double taxation, the CRA "would, and probably should," tax only the transferor.

John Jakolev and Graham Turner
Jet Capital Services Limited, Toronto

ITTN No. 36: Paragraph 95(6)(b)

On July 26, 2007 the CRA released its long-awaited *Income Tax Technical News* (ITTN no. 36) on its interpretation of paragraph 95(6)(b), following its promise at the Foundation's 2004 annual conference round table to provide clarification of the rule, including examples. The ITTN is believed to take into account comments from the tax community on a draft that was not widely circulated.

The ITTN provides little new guidance on the CRA's interpretation of paragraph 95(6)(b); its views and approach appear to be unchanged. The ITTN says, "The words of paragraph 95(6)(b) are broad and could be considered to apply to a wide range of transactions," seeming to inform the rule with GAAR-like status if (1) shares or interests are acquired or disposed of (2) with the principal purpose of permitting a person to avoid, reduce, or defer the payment of tax, etc. Five examples are used to discuss the rule's application. In each example, the analysis focuses on the test for the transaction's or series' principal purpose. The first example is one that appeared in Finance's technical notes to the rule's 1994 amendment: a Canadian lender acquires a temporary and threshold 11 percent share interest in an FA of an arm's-length Canco to facilitate the lender's earning exempt surplus (not FAPI) when it books the loan through its wholly owned FA. The issuance of the 11 percent FA interest to the lender directly converts its would-be FAPI to deemed active business income, and thus paragraph 95(6)(b) applies. Another example, in which a Canadian vendor corporation acquires a nominal and threshold preferred share interest in an unrelated FA to avoid the application of subsection 85.1(4), echoes the same theme.

The other three examples—related-group transactions—appear to demonstrate a much broader application for paragraph 95(6)(b), because they involve an issuance or acquisition of shares that does not by itself create a new relationship. It thus seems that any combination of tax benefit (as principal purpose) and share or interest transaction may trigger the rule.

Because the rule does not carve out transactions that do not result in an abuse or misuse, the CRA's view could make the rule more powerful than GAAR. The CRA does not assess the rule's application on policy grounds, but rather measures the tax benefit against other possible benefits to ascertain the principal purpose. One Canadian outbound example involves a Canco borrowing to equity capitalize an FA Finco; Finco lends to FA2, which carries on an active business. (The CRA says that Canco's interest deduction is the tax benefit from the share issuance.) It may be that the CRA can conclude that the rule does not apply if Canco expected enhanced dividend distributions from FA2, which uses the borrowing, for example, to fund an acquisition. The ITTN's logic leads one to expect the CRA to invoke the rule if Canco did not own FA2—for example, if Canco's parent owned it—or if FA2 borrowed simply to refinance.

The Canadian inbound example involves a Cansub of a foreign-owned parent that borrows funds to subscribe for fixed-rate preferred shares of a foreign operating company (through an FA sub) owned by the foreign parent. Like the Canadian outbound example, the Cansub is said to enjoy a tax benefit from the interest expense deduction, but because it has no upside entitlement through common shares, paragraph 95(6)(b) applies.

The other outbound example involves the elimination of a surplus deficit on an FA liquidation under current regulations, a result that does not follow under proposed reg amendments.

Paul L. Barnicke
PricewaterhouseCoopers LLP, Toronto

Provincial Residence

The Supreme Court of British Columbia recently decided in favour of the taxpayers in two cases involving provincial residence. Both taxpayers were held to be resident in Alberta and not British Columbia, but the decisions confirm that residence cases are highly fact-specific.

A taxpayer is liable for income tax in Alberta if he or she "was resident in Alberta on the last day of the calendar year" ("taxation year" in the case of British Columbia residence). Federal regulation 2607 provides a tie-breaker for an individual resident in more than one province on the taxation year's last day: the individual is deemed resident in the province "reasonably . . . regarded as his principal place of residence."

In *Mandrusiak* (docket no. L051824, May 31, 2007), the taxpayer and his wife lived on a farm in Alberta that they had owned since 1980. Mr. Mandrusiak was employed in Alberta and in 1987 began working at his employer's new Vancouver office. He bought a home in Vancouver that he owned during the years in question (2000-2002). He retired in 1997, but consulting activities for his former employer required him to spend time in British Columbia. His Alberta farm was his primary source of income in 2000 and thereafter.

The BC Supreme Court found that although the taxpayer spent the last day of each relevant taxation year in Alberta, he was at the same time a BC resident because in 2000-2002 he spent considerable time in British Columbia, and he worked, owned a home available for his occupancy, received mail, had use of a vehicle, was medically insured, attended church, made charitable donations, and made day-to-day purchases there. The court said that the amount of time he spent in each province must be considered in light of all the evidence, particularly the history of his connection to each province and the context in which he came to British Columbia and resided there in the years in question. The court found that his principal place of residence was Alberta because, inter alia, he owned his Alberta home longer than he owned his BC home; his family resided in Alberta; his Alberta social ties were stronger; his chief source of income was his Alberta farm; and his RRSP, pension plan, and family holdco and trust were in Alberta.

In *Waring* (docket no. S98635, December 15, 2006), Mr. and Mrs. Waring moved from Victoria to a home they purchased in October 2002 in Calgary, where their sons lived and where their daughter intended to move when she found a job. The taxpayer still owned his BC residence, in which his wife sometimes resided and his daughter continued to reside while she sought employment in Alberta. Mr. Waring remained in Calgary. In January 2003, he and his wife decided to move back to British Columbia because their daughter had accepted employment there and the Alberta weather had worsened Mrs. Waring's health.

The court accepted Mr. Waring's evidence that he purchased the Calgary home because he had planned to move there permanently. Despite Mr. Waring's continuing ties to British Columbia, the BCSC said that the evidence weighed heavily in favour of finding that he was ordinarily resident in Alberta on the last day of 2002.

Jim Yager
KPMG LLP, Toronto

Capital Taxes Eliminated by 2012

Corporate capital taxes have long been under attack by Canadian businesses and investors because they are based on balance sheet amounts—such as share capital and debt—not on profitability. The federal government responded by eliminating its large corporations tax (LCT) for all corporations after 2005. ("LCT Still Relevant," *Canadian Tax Highlights*, May 2007, discusses the LCT's continuing relevance.) To encourage the demise of general capital taxes, the 2007 federal budget promised financial incentives to provinces that enact legislation to eliminate their capital taxes before 2011. The six provinces (Manitoba, New Brunswick, Nova Scotia, Ontario, Quebec, and Saskatchewan) that impose general capital taxes in 2007 will follow suit and gradually reduce and then entirely eliminate them. Only Nova Scotia will not meet the federal

Table 1 General Corporate Capital Tax Rates and Exemptions/Deductions (December 31 Year-End)

		Rate (exemption/deduction)[a] 2006	Rate (exemption/deduction)[a] 2007	Eliminated in stages before:
Federal		No capital tax		na
Alberta		No capital tax		na
British Columbia		No capital tax		na
Manitoba	On first $15 million taxable capital	0.3% ($5 million)[b]		2011[c]
	On taxable capital > $15 million	0.5%		
New Brunswick		0.25% ($5 million)	0.2%	2009
Newfoundland and Labrador		No capital tax		na
Nova Scotia	If taxable capital < $10 million	0.52% ($5 million)	0.475%	July 1, 2012
	If taxable capital ≥ $10 million	0.26% (nil)	0.237%	
Ontario		0.3% ($10 million)	0.285% ($12.5 million)[b]	July 1, 2010
Prince Edward Island		No capital tax		na
Quebec		0.525% (Up to $1 million)[e]	0.49%	2011
Saskatchewan[d]		0.449% (Up to $20 million)[f]	0.224%	July 1, 2008
Northwest Territories		No capital tax		na
Nunavut		No capital tax		na
Yukon		No capital tax		na

[a] Associated or related corporations generally share exemptions and deductions.

[b] Manitoba's and Ontario's capital tax deductions will increase; see table 2.

[c] The elimination of Manitoba's capital tax is subject to balanced budget requirements and does not apply to Crown corporations.

[d] Saskatchewan's capital tax is eliminated on new capital invested in Saskatchewan after June 30, 2006 and on other capital in stages by July 1, 2008. (The rate remains 0.6 percent for Crown corporations, 1.5 percent for telecommunications Crown corporations.)

[e] Quebec's exemption is reduced by $1 for every $3 of the previous year's paid-up capital (of the associated group) exceeding the exemption; taxable capital exceeding $4 million attracts the full rate.

[f] A basic Saskatchewan exemption ($10 million) applies to all corporations; corporations in an associated group share an additional $10 million exemption in proportion to each company's salaries and wages paid in Saskatchewan relative to the group's total salaries and wages paid.

Table 2 Changes in General Corporate Capital Tax Deductions After 2006

	From	To	Effective date
Manitoba	$5 million	$10 million[a]	Taxation years commencing after January 1, 2007
Ontario	$10 million	$12.5 million	January 1, 2007
	$12.5 million	$15 million	January 1, 2008

[a] Manitoba's increased capital tax deduction coincides with a change in the calculation and rates of tax: generally for taxation years commencing after January 1, 2007, the tax is nil on the first $10 million of taxable capital employed in Manitoba, and graduated rates apply on any excess.

2011 deadline; its general capital tax will be eliminated by July 1, 2012. Manitoba will meet the deadline subject to balanced budget requirements.

General capital taxes are imposed on corporations (other than financial institutions and insurance companies) that have a permanent establishment in the jurisdiction. Table 1 shows 2006 and 2007 general capital tax rates; table 2 shows capital tax deduction increases after 2006.

Louis Provenzano and Ruby Lim
PricewaterhouseCoopers LLP, Toronto

Sheltering US Branch Profits

Non-US banks, insurance companies, and other businesses have been given the green light by the IRS to prospectively shelter branch operations' profits with losses incurred in other US entities (PLR 200720010 (February 13, 2007; 2007 PLR Lexis 250)).

In the ruling, a parent corporation conducts a profitable US banking business through a branch. The parent's wholly owned subsidiary—a securities brokerage and investment banking business—annually generates losses. The parent plans to convert its sub under state law into a single-member LLC and will prospectively combine and report its US banking operations and the LLC's operations in its annual US corporate tax return. The conversion is intended to allow annual consolidation of the two businesses' taxable income or losses.

The IRS ruled that the conversion itself was a partially tax-free complete liquidation transaction, so long as the parent continued to operate its sub's US business for 10 years afterwards and made required disclosures. The only taxable gains to the sub (or the parent) are any gains attributable to intangible assets (excluding goodwill, but including patents, trade names, customer lists, and similar items). The parent succeeds to the sub's losses carried forward and may use them prospectively.

It is significant that the IRS did not invoke a general anti-abuse rule that renders the conversion fully taxable if the IRS deems the liquidation to be carried out for the principal purpose of avoiding US tax. It is likely that the IRS permitted the future consolidation, because on the facts the parent had owned its sub during the entire period in which the losses were incurred. Foreign persons that conduct profitable US branch businesses should review their other US operations to see whether a similar beneficial sheltering can be achieved.

Steve Jackson
Ernst & Young LLP, New York

Thin Cap: ECJ Decisions

Article 56 of the Treaty Establishing the European Community prohibits tax and all other restrictions on the movement of capital between member states and between member states and third countries. The treaty also prohibits restrictions on the right of establishment—but only between member states—including the right to incorporate and finance a controlled subsidiary or a branch in another member state. Recent cases shed light on the balance between the two guarantees and third-country beneficiaries.

In *Lankhorst-Hohorst* ([2002] ECR I-11779, Case C-324/00) the European Court of Justice (ECJ) ruled that the German thin cap rules were not compatible with the right of establishment. Those rules deemed interest paid by a German sub to its Dutch parent to be a "covert distribution of profits" or a non-deductible dividend; the denial of a deduction obstructed the establishment of German subs by an EC-member-state parent. The decision sparked challenges to other member states' thin cap rules; some member states changed their tax laws to fend off challenges.

On March 13, 2007 the ECJ issued its judgment in *Test Claimants in the Thin Cap Group Litigation* (Case C-524/04). Some claimants in a class action challenge to the UK thin cap rules (1994 to present)—including Volvo, Lafarge, Caterpillar, and PepsiCo corporate group members—were chosen to represent the litigation participants. In each test case, the UK-resident borrower was at least 75 percent owned (directly or indirectly) by a non-resident parent and had received a loan from the parent or from another non-resident company similarly owned by that parent. The UK sub in the Caterpillar test case borrowed from Irish and Swiss subs of a US-resident parent and, in the PepsiCo test case, from a Luxembourg-resident sub of the US parent operating through a Swiss branch. Because the United States is not an EC member, the UK subs borrowing from lenders whose parents were resident there could not invoke the right of establishment; thus, these test cases were based on the EC treaty's guarantee of free movement of capital to and from third countries. (Annex I of EC Directive 361/88 lists cross-border loans between corporations as movements of capital; the directive is no longer in force, but it is still the ECJ's primary reference for that determination.)

The ECJ in the *Thin Cap* test case ruled that the right of establishment generally precludes thin cap rules that restrict the deductibility of interest paid to a resident of another member state or to a member-state resident controlled by a parent that is resident in a member state. However, if the particular legislation permits an objective assessment of whether the loan structure is purely artificial and entered into for tax-avoidance reasons, and if the taxpayer is given an opportunity to demonstrate a commercial purpose for the transaction, then the denial of a deduction for interest exceeding an arm's-length amount may be compatible with the right of establishment. The *Thin Cap* decision goes against the third-country test cases of Caterpillar and PepsiCo. The thin cap rules apply only within corporate groups and thus affect primarily the freedom of establishment. The treaty's guarantee of freedom of establishment protects only the right to establish and finance controlled subsidiaries across member state borders within the EC and does not apply to relationships between companies resident inside and outside the EC. The effect of the thin cap rules on the movement of capital is only indirect—an unavoidable consequence of the restriction on establishment—and thus the treaty guarantee of free movement of capital does not apply. The High Court of Justice of England and Wales must now apply the decision to each test case in light of the legislation in force at the relevant time, but clearly the Caterpillar and PepsiCo test cases will fail.

On May 10, 2007, the ECJ ruled in *Lasertec* (C-492/04), which challenged the same German thin cap rules as *Lankhorst*. Interest paid by Lasertec to its Swiss parent, which held two-thirds of its shares, was reclassified by German tax authorities as a non-deductible covert distribution of profits. The thin cap rules applied if the lender had a "significant holding" in the borrower, which the court said indicated an intention that the rules should apply where the borrower effectively controlled the lender; thus, the relevant freedom was freedom of establishment, which did not apply because the parent resided in a third country. As in *Thin Cap*, any restrictive effects on the free movement of capital were merely an indirect and unavoidable consequence of the restriction on the freedom of establishment; separate consideration of article 56's guarantee of free movement of capital was not justified.

Thin Cap and *Lasertec* confirm ECJ jurisprudence that the purpose or subject matter of the challenged tax law determines which treaty freedom is primary. If the right of establishment or the freedom to provide services is most directly affected, then a resulting indirect restriction on the free movement of capital is not sufficient to invoke article 56. However, in *Holböck* (Case C-157/05, May 24, 2007) the ECJ indicated that article 56 may apply if a general tax rule restricts free movement of capital and freedom of establishment equally. Mr. Holböck, an Austrian resident, held a controlling interest in a company resident in Switzerland, not an EC-member state. Under Austrian tax law, dividends from Austrian companies were treated more favourably than those from a foreign company, whether or not the recipient controlled it. (The ECJ in *Lenz* (C-315/02, 2004ECR I-7063) had held that the rules were incompatible with article 56 for an EC-resident payer.) Even though Mr. Holböck controlled Swissco, the court did not treat the rules as directly and primarily affecting the freedom of establishment and considered the application of article 56. On the facts, however, the rules were in place before 1994 and were thus grandfathered.

Holböck appears to confirm that the ECJ's restrictive approach in *Thin Cap* and *Lasertec* does not exclude article 56's application if the impugned tax law affects freedom of establishment and free movement of capital equally. However, the uncertainty inherent in determining whether a measure affects one freedom more directly than another will undoubtedly allow the court other opportunities to refine its position.

Martha O'Brien
University of Victoria

Earnings and Profits Attributable to CFC Stock

IRS final regs of July 27, 2007 under Code section 1248 provide guidance for determining earnings and profits (E & P) attributable to the stock of a controlled foreign corporation (CFC) in certain non-recognition transactions, and they clarify the section 1248 treatment of a foreign partnership's sale of CFC stock. The final regs modify somewhat the proposed regs of June 2, 2006 and are generally effective after July 29, 2007.

A foreign corporation is a CFC if US shareholders own more than 50 percent of the stock's votes or value on any day during the corporation's tax year. A US shareholder is a US person that owns—directly, indirectly, or by attribution—at least 10 percent of the forco's total combined voting power. Under Code section 1248, if a US person sells or exchanges CFC stock, the gain is generally recharacterized as a dividend if the person owns at least 10 percent of the forco's combined voting power at any time when forco was a CFC during the five years ending on the date of sale. Under Code section 964(e)(1), a CFC that sells or exchanges forco stock must generally recognize any gain as a dividend as it would under section 1248(a) if it were a US person.

The final regs clarify (where the proposed regs did not) the attribution of E & P to non-exchanging shareholders in certain non-recognition transactions. Language from the proposed regs' preamble is incorporated into the final regs: generally, the E & P attributable to an acquiring corporation's stock held by a non-exchanging shareholder immediately before a restructuring transaction will continue to be attributable to the stock, but E & P attributable to the acquired corporation's stock and accumulated before the restructuring will not be attributed to the non-exchanging shareholder's stock in the acquiring corporation.

The proposed regs treated a foreign partnership's sale or exchange of CFC stock as a sale or exchange by the partners of their proportionate share of the stock, and applied Code section 1248(a) to tiers of foreign partnerships; however, it was unclear whether section 1248 applied to a partner's sale of its interest in a partnership that held corporate stock. The final regs clarify that section 1248 does not apply: the sale or exchange of the partnership interest generates ordinary income under Code sections 751(a) and 751(c) if attributable to stock in a forco described in section 1248, and thus the operation of section 1248 is pre-empted (section 1248(g)(2)(B)). The final regs thus clarify that a foreign partnership is treated as an aggregate only when it sells or exchanges corporate stock (Treas. reg. section 1.1248-1(a)(4)); a partner may apply that aggregate rule to open years, provided that it does so consistently in all such years, by treating its distributive share of gain attributable to a sale of CFC shares as recognized on the sale or exchange of a forco's stock under section 1248(a).

The final regs also clarify the application of Treas. reg. section 1.1248-8: the CFC definition now includes a corporation described in either Code section 953(c)(1)(B) (certain captive insurance companies) or Code section 957. A new example in Treas. reg. section 1.367(b)-4(d) clarifies that E & P attributable to certain lower-tier subs are not taken into account in determining the E & P attributable to transactions described in Treas. reg. section 1.367(b)-3—for example, when a USco acquires a Canco's assets in a section 332 liquidation or an asset acquisition under section 368(a)(1).

The final regulations provide needed clarification for some tax consequences under Code sections 1248 and 367 that may affect a US shareholder that sells its stock in a Canco CFC or engages in certain non-recognition transactions involving the CFC. A US partner in a Canadian partnership that sells a CFC interest (held directly or through tiers of partnerships) may also be affected.

Marla Waiss
Hodgson Russ LLP, Buffalo

CANADIAN TAX Highlights

The editor of *Canadian Tax Highlights* welcomes submissions of ideas or of written material that has not been published or submitted elsewhere.
Please write to Vivien Morgan in care of the Canadian Tax Foundation.

Published monthly
Canadian Tax Foundation
595 Bay Street, Suite 1200
Toronto, Canada M5G 2N5
Telephone: 416-599-0283
Facsimile: 416-599-9283
Internet: http://www.ctf.ca
E-mail: vmorgan@interlog.com
ISSN 1496-4422 (Online)

More Canadian Tax Traps

This article continues with further real-life situations that created tax traps due to lack of foresight or simply technical errors.

Non-arm's-length transfers. A widow anxious to avoid Ontario probate fees on death changes her brokerage account and the title on vacant land and the family residence to joint ownership with her daughter. There is a deemed sale of half of the assets to the daughter at FMV, accelerating gains on the brokerage account and vacant land.

A son who is active in the family business is given an option in writing to purchase his father's shares over 10 years at today's FMV. Nothing is paid for the option, which contains no price adjustment clause. The business appreciates in value and over time the son purchases all the shares. The CRA says that section 69 deems each sale by the father to occur at FMV, not at the option price. The father's deemed proceeds exceed the actual sales price, but the son's cost is not increased.

Over the last three years, a professional partnership has fallen behind on payments of management fees (a 15 percent markup) accrued to a company owned by the three partners' spouses. The CRA may argue that a shareholder loan should be included in income and that the management fees should be added back as unpaid amounts.

Foreign business. An individual owns all the shares of a Canadian manufacturer, Opco. Opco's US sub accounts for 60 percent of total profit. When the US sub's shares exceed 10 percent of Opco's value, Opco is not a QSBC and the capital gains exemption is not available on the sale of its shares.

Mr. A, a developer, decides to start building homes at his favourite US ski resort. His Canco forms a US sub, of which Mr. A is the sole officer and director. Because construction can only proceed in the summer, only independent contractors are hired to build the homes. The US sub thus has fewer than six full-time employees and carries on an investment business: FAPI is attributed to the Canco. The sub is deemed to be a US resident under the Canada-US treaty; but it may have a Canadian place of management and thus a Canadian PE, and it should file a Canadian return.

A Canadian individual is entitled to a commission on a sale of goods between a South American company and a European company. The individual forms an offshore company to receive the fee, but income received by a controlled foreign affiliate from services rendered by a shareholder is FAPI; no deferral or saving is available.

Trust for family cottage. A discretionary family trust is formed to own a cottage. The beneficiaries are Albert, Ben, and Carol (who are adult siblings). The cottage was purchased in 1990 and sold in 2006. The gain is allocated to Albert, who has no other residence, and the principal residence exemption is claimed by the trust. Carol is selling her principal residence, which she has lived in since 1995, but is precluded from designating her house as a principal residence for the years in which a principal residence was designated by the trust. A designation by the trust is a designation for that year by each beneficiary of the trust.

Jack Bernstein
Aird & Berlis LLP, Toronto

Foreign Tax News

European Union

A conference hosted in Austria focused on issues connected with the introduction of a general EU tax.

United States

The IRS Large and Midsize Business Division released an industry directive to field auditors regarding international hybrid instrument transactions, financial arrangements where the taxpayer treats the transactions differently (as debt or equity) for US and foreign purposes.

Russia

The federal tax service publicized its internal criteria for tax audit selection, including a lower tax burden, monthly salary payments, and profits relative to industry (or regional) averages; losses in two consecutive periods; growth in expenses relative to income; entering into a series of non-business-motivated transactions; borderline qualification for special tax benefits; failure to clarify accounting discrepancies; and repeated migration to different tax inspectorates.

Vivien Morgan
Canadian Tax Foundation, Toronto