CANADIAN TAX Highlights

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IRS Scrutiny Intensifies

Many non-US residents are unaware of their actual or potential US tax liabilities. A US-citizen Canadian resident remains liable for US income tax on worldwide income and for US gift, estate, and generation-skipping transfer tax on worldwide assets. And a Canadian-citizen Canadian resident who owns US-situs property may be exposed to US income, gift, or estate tax. Clients should be advised that regardless of the likelihood of detection, the US tax obligation exists. Recent developments in information sharing increase these taxpayers' transparency.

Homeland Security and the IRS apparently now share information. A border crossing guard may have information readily available in his or her booth computer concerning a traveller's unpaid US tax liabilities and may bar the traveller's entry into the United States. In addition, anecdotal evidence indicates that Homeland Security agents may be acquiring US tax sophistication and, for example, a border guard may ask a traveller with a green card or a non-resident US citizen whether he or she has been filing US tax returns. Even if a non-US passport is used at the US point of entry, most countries' passports list the place of birth, allowing Homeland Security to easily identify a traveller who is a US citizen by reason of his or her birth in the United States.

It has been known for years that the CRA and the IRS exchange large quantities of information, and now US and Canadian governmental agencies engage in other information-sharing initiatives, such as the Joint International Tax Shelter Information Center formed by the tax administrations of the United Kingdom, the United States, Australia, and Canada. The US tax system applicable to US taxpayers with assets outside the United States is very expansive, and affected taxpayers are continually targeted by promoters of complex and significantly aggressive strategies—which may be tax shelters for US tax purposes or simply fraudulent—that purport to reduce or eliminate US tax exposure for foreign assets. By entering into cooperative governmental initiatives, the United States seeks to discover whether US taxpayer activity abroad is depriving the US Treasury of its rightful due.

Perhaps the most common situation, and the most troubling for an adviser, is that of the US-citizen Canadian resident—often a person who acquired citizenship by being born in the United States and who lived there only briefly—who has not been filing US income tax returns. He or she may have never filed a US tax return and may be unaware of the obligation to do so. But even if the failure to file is not detected during his or her lifetime, the estate's administrators and heirs face difficult issues because the US income tax liability passes to the estate; there may also be US gift and estate tax exposure and a return to file. The administrators and the beneficiaries face the dilemma of whether to file a US estate tax return, and whether to come clean to the IRS over the failure to file income tax returns or keep silent and hope the IRS does not learn of the situation. Even if the estate administrators decide to take the position that the decedent relinquished US citizenship at some point, a US estate tax return must be filed if, for example, the decedent died owning US stocks or US real property. The non-resident estate tax return (form 706-NA) requires disclosure of the place where the decedent was born and may thus trigger scrutiny.

Experience is revealing that it is becoming much easier for the IRS to discover neglected filing and tax liability obligations. And a US citizen who ignores the issues before death leaves the estate's administrators and heirs in an extremely difficult position. Not only can the IRS seek to collect against the decedent's US assets, but the administrators and heirs are exposed to transferee liability: the IRS can proceed relatively easily to collect against any US-situs assets they may hold. Even Canadian assets may not be difficult to find or to proceed against, given the Canada-US treaty mechanisms for the CRA's sharing of information and assistance in collections.

Many non-US-citizen Canadians are surprised to find that their US assets carry US tax exposure. For example, a Canadian who owns stock in a US corporation—even stock held in "street name" at a brokerage firm—holds a US-situs asset and is exposed to US estate tax. (To add to the confusion, there is no US gift tax exposure on an inter vivos transfer of the shares to a family member.) A Canadian spouse

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who purchases US real property as "husband and wife," or otherwise as a joint tenant with right of survivorship, may expect to receive US estate tax deferral until the death of the survivor, as in Canada. However, this is generally not the case in the absence of significant planning (such as the creation of a qualified domestic trust), and often only the surviving spouse's death reveals the US estate tax considerations related to the other spouse's death.

Moreover, many US states have even more sophisticated systems than the IRS to discover information about taxpayers who may be exposed to state income or other taxes. For example, if a Canadian citizen and resident dies owning New York state real estate, it may be impossible to transfer title without alerting the New York State Department of Taxation and Finance to the state estate tax exposure. Moreover, New York income tax may be owing if the property was rented during the decedent's lifetime and no related state tax returns were filed. The US states tend to be even more aggressive than the IRS in finding—and pursuing—these tax liabilities.

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US Transfer-Pricing Report

In a recent state franchise tax case, ***Hallmark Marketing Corporation*** (DTA no. 819956, July 19, 2007), the New York Tax Appeals Tribunal found that transfer-pricing documentation prepared by a US accounting firm for (and followed by) the taxpayer was adequate support for intercompany pricing for the purposes of New York state franchise tax, despite the government's argument that the documentation had numerous shortcomings.

Although it is not an income tax case, ***Hallmark*** demonstrates the benefits of being well prepared for a transfer-pricing challenge. The tribunal concluded that Hallmark had diligently complied with the arm's-length principle, including having prepared contemporaneous documentation and effective agreements governing its transactions with related entities. The taxpayer successfully argued against a US$1.6 million assessment of corporate franchise tax and related interest and penalties.

A Delaware incorporated entity (Subco) was a wholly owned subsidiary of the Hallmark group Parentco, which also had an indirect investment through a holding company (Holdco) in another wholly owned subsidiary (Fundco), which was incorporated in the Cayman Islands. Subco was a distributor for Parentco, purchasing goods for resale to third-party retailers; the two companies also provided each other with general and administrative services. Subco also sold its accounts receivable to Fundco at a discount in exchange for interest-bearing notes; the discount was intended to reflect Fundco's assumption of the risk of bad debts, returns, and discounts, and the time value of money.

Parentco hired a large accounting firm to prepare a transfer-pricing study to provide comfort that its transactions with Subco were appropriate for US tax-reporting purposes—that is, that they reflected arm's-length pricing. The study applied the comparable profits method (similar to the transactional net margin method used in many Canadian income tax transfer-pricing reports) using a Berry ratio (gross profit/operating expenses, also commonly used in Canadian reports) as a profit level indicator to compare Subco's financial results with those from a sample of nine similar distributors.

Experts for the government testified that the study was "fatally flawed" because, inter alia, (1) the study's comparable companies had materially less annual revenue than Subco; (2) the comparable companies performed different functions than Subco, or participated in different markets than Subco, and therefore were not "sufficiently similar"; (3) Subco had valuable intangibles that were not properly considered; and (4) the use of the Berry ratio and other assumptions was technically inappropriate or not supportable. The tribunal concluded, however, that these differences or facts either were appropriately factored into the study or were "not so significant as to defeat the comparability" of the sample distributors. The tribunal also recognized that "the reason for having a sufficiently large sample is the expectation that the differences among the members will average out." The tribunal said that although "the nine comparable companies used in the transfer pricing report are not identical to" Subco, they were sufficiently similar to permit a finding favourable to Subco. The government's appeal was rejected.

Although ***Hallmark*** is not a precedent for income tax purposes, it may still be important and helpful to US and Canadian taxpayers because it is one of the few cases in which the decision-making body clearly states that the comparable companies in a transfer-pricing study need only be "sufficiently comparable," not "identical," to the tested party. In each line of attack by the government, the tribunal ruled that the numerous differences between each comparable company and Subco were not sufficiently material to eliminate even one of the nine comparables.

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US Anti-Treaty-Shopping Legislation

On July 24, 2007, a House Ways and Means Committee member introduced HR 3160 in the US House of Represen-

tatives to restrict the use of US income tax treaties for treaty-shopping purposes. The legislation limits treaty benefits on some cross-border interest and royalty payments from a US sub to another multinational group member by amending the withholding tax rules in Code section 894.

The proposal applies to any direct or indirect payment that is deductible for US federal income tax purposes, and both payer and payee corporations are controlled (a "more than 50 percent" threshold) by the same foreign parent. The proposed withholding tax rate on the deductible payment is the greater of the otherwise applicable treaty rate and the rate applicable if the payment had been made directly to the ultimate parent. The proposal overrides a reduced withholding rate under a US treaty with the jurisdiction of the actual payee if the foreign parent would have suffered a higher rate had it received the payment itself.

Assume that a Canadian parent corporation invests in the United States through a Hungarian subsidiary with a Swiss or Luxembourg finance branch. The Hungarian sub contributes to its branch the funds it received from its Canadian parent, and the branch onlends to the US sub. The US sub pays loan interest that qualifies for 0 percent withholding under the US-Hungary treaty. The proposal requires the US sub to withhold at the 10 percent rate under the current Canada-US treaty.

Once the pending Canada-US treaty protocol eliminates withholding tax on non-arm's-length interest, HR 3160's direct impact potential is decreased for a Canadian-controlled multinational group. (However, the 2007 Canadian federal budget proposals restricting interest deductibility must also be taken into account; draft legislation is expected to be released in September 2007.) Nonetheless, if enacted, the proposal's effect will be far-reaching, preventing a foreign corporation in a jurisdiction with no US treaty, or with a treaty with a higher withholding tax rate on interest or royalties, from establishing an intermediary in a jurisdiction with a more favourable US treaty that has no limitation-on-benefits provision.

The proposal is a domestic-law-based treaty override and thus a departure from the favoured US approach of combatting treaty shopping via the inclusion of a limitation-on-benefits clause in its bilateral tax treaties. The CRA takes a more general domestic-law-based approach, relying on the beneficial ownership concept (or GAAR) to challenge cross-border structures that tap into the Canadian treaty network to reduce or eliminate withholding tax on outbound dividends, interest, or royalties. The TCC was scheduled to hear *Prevost Car*, which addresses the beneficial ownership issue, in early September 2007.

HR 3160 is intended to offset spending increases of US$4 billion over five years under the Farm, Nutrition and Bioenergy Act of 2007 (HR 2419). The HR member who introduced the proposal says it is a "loophole closer" that will curb treaty-shopping abuses and raise an estimated US$7.5 billion over 10 years. The proposal's status is uncertain. The House passed the farm bill incorporating the offsetting tax measure on July 27, 2007, but Senate approval and the president's ratification are still required before it can enter into force. The chair of the Senate Finance Committee indicates that the Senate's version of the bill will not include the tax proposal. The proposal has generated considerable controversy, and some senators are concerned in particular that the proposal violates the network of tax treaties negotiated by the Treasury and affirmed by the Senate. Another senator suggested that the proposal may reduce US revenue by impeding the cooperation of treaty partners' tax authorities required for the efficacy of information exchange and other transparency provisions and thus compromising the IRS's ability to track the activities of "tax cheats" sending money to other countries. A strong statement released by the president's office says that the proposal threatens to raise taxes on payments by US subs to foreign affiliates, to discourage foreign investment in the United States, to override US tax treaties with many nations, to adversely affect job creation in the United States, to undermine other international agreements and relationships with major trading partners, and to provoke retaliation in the form of higher foreign taxes on US firms. A number of business leaders and interest groups have expressed similar concerns. If the Senate passes a version of the farm bill that excludes the proposal, a House-Senate conference must reconcile the differences between the House and Senate bills. If the tax proposal survives that process, the president may veto the legislation, given the administration's stated opposition.

If the tax proposal endures the rigours of the legislative process, it will emasculate many structures for financing US subs of Canadian and other foreign parents. It may be time for Canadian-controlled multinationals to consider other double-dip alternatives that could accommodate both the potential US changes and the new Canadian interest-deductibility draft legislation expected in the fall of 2007.

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A Rich Source of Tax: PIT Stats

Recently released personal income tax statistics on the CRA's Web site provide details for the 2005 taxation year. Once again, the top 1 percent of all taxpayers provided nearly one-fifth of the federal tax collected for that year.

Taxpayers with Incomes of $250,000 or More, Taxation Years 2000 to 2005

	As a percentage of		
	All taxpayers	All income	Federal tax payable
2000	0.67	9.11	16.36
2001	0.65	8.58	16.03
2002	0.66	8.13	15.47
2003	0.70	8.32	15.75
2004	0.77	9.01	16.85
2005	0.85	9.66	18.56

The table shows that in the period 2000 to 2005, the number of high-income taxpayers—those with incomes of $250,000 or more—grew faster than the total for all taxpayers and over the period rose from 0.7 to 0.9 percent of all returns. Their share of total income amounted to 9.7 percent in 2005, up slightly from the 9.1 percent recorded in 2000, but well above the 8.1 percent shown for 2002.

Taxpayers with incomes of at least $250,000 in 2005 provided 18.6 percent of all federal income tax payable. (Because Quebec imposes and collects its own personal income taxes, the federal publication shows no data for provincial taxes collected in that province.) The increase in the share of income attributed to the high-income taxpayers is reflected in a commensurate increase in their share of federal tax payable: in 2000, 16.4 percent of federal tax came from this group, but the share fell to 15.5 percent in 2002, before rising to the 18.6 percent shown for 2005.

The changes in the federal system over the period were not critical in changing the share of federal tax collected from the high-income taxpayers. As a percentage of reported income, federal tax payable by all taxpayers dropped from 13.0 percent to 11.3 percent from 2000 to 2005. For taxpayers reporting at least $250,000 of income, federal tax dropped from 23.3 percent of income in 2000 to 21.8 percent in 2005.

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Non-Resident Service Providers

The compliance rules applicable to a non-resident who provides services in Canada should be simplified. They are cumbersome, and they do not generate substantial tax revenue.

Recently, a large US law firm representing a Canadian client on a US matter concluded that about 10 percent of the related fees were attributable to services rendered in Canada at client meetings. The client withheld 15 percent of the fees so attributable. The CRA demanded that the professional-corporation partners file Canadian corporate tax returns, and it assessed a late-filing penalty of $2,500 per corporate partner. (A non-resident individual must file only if tax is owing.) A waiver from withholding might have been obtained, but a waiver does not eliminate the corporate filing requirement; moreover, any non-resident must file to obtain a refund of the tax withheld.

The CRA also argued that the firm was carrying on business in Canada merely because the firm performed some services in Canada. The firm argued that the services were ancillary to the US business and not an independent business: the US firm had no office, employees, bank account, or assets in Canada and had not solicited the particular business. It is interesting that in the GST context *GST/HST Policy Statement* P-051R2 (“Carrying On Business in Canada,” April 29, 2005), example 18, concludes that a non-resident corporation whose non-resident employee performs engineering services for one week on an oil rig in a Canadian port is not carrying on business in Canada for GST purposes. The CRA agreed that there was no Canadian PE and that the Canada-US treaty thus eliminated tax exposure.

Withholding is required on the remuneration (including taxable benefits) of a non-resident employee who provides services in Canada, including income tax, CPP, and EI. (A CPP exemption may apply if Canada has a reciprocal agreement with the relevant foreign country.) The employer must acquire a CRA business account number and file a T4 information return; failure to withhold may attract Canadian tax, interest, and penalties. A non-resident employee employed in Canada should have a SIN and a valid work visa and must file a Canadian return by April 1 of the following year. A withholding tax waiver (for treaty-country residents) may be available.

Because regulation 105 requires withholding “in respect of” services rendered in Canada, withholding may apply on a payment to a person not performing the services, and withholding may be required on a payment for items in addition to the services. Assume, for example, that a US company with no Canadian PE sells its product into Canada, and installation included in the contract is outsourced to another non-resident. If there is no reasonable allocation of the services rendered in Canada, the Canadian payer must withhold 15 percent of the total contract. The USco must also withhold 15 percent from the non-resident subcontractor of the Canadian service component.

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Quebec Corporate Rates Status

The election of a minority government in Quebec on March 26, 2007 further complicated the status of Quebec's corporate tax rate changes for accounting purposes. For Canadian GAAP purposes, the implementing legislation must be substantively enacted: it must have passed first reading in the legislature for a majority government, and it must have passed third reading for a minority government. Recognition for US GAAP requires enactment.

Corporate income and capital tax rates. The February 20, 2007 budget (introduced by a majority government and renewed on May 24, 2007 by the minority government) eliminated the difference between Quebec's corporate active income rate and its passive income (inactive) rate, which now decreases from 16.25 to 9.9 percent on February 21, 2007, and increases in stages to 11.9 percent by 2009. However, on June 1, 2007, the newly elected minority government accelerated the corporate active income rate increase to 11.9 percent for financial institutions and oil-refining companies, effective immediately. Affected financial institutions include banks, savings and credit unions, loan and trust companies, and corporations dealing in securities, but not insurance companies. The May 24, 2007 budget also further decreases capital tax rates and eliminates the tax by 2011. None of the rate changes announced in 2007 (see tables 1 and 2) are substantively enacted for Canadian GAAP until the implementing legislation is tabled in the Quebec National Assembly (expected in the fall of 2007) and passes third reading.

Flowthrough entities. On December 20, 2006, Quebec said that it would harmonize its rules for flowthrough entities with the new federal tax rules, with some modifications. Quebec *Information Bulletin* 2007-5 (June 26, 2007) provides that a flowthrough entity in Quebec will attract a distribution tax at Quebec corporate income tax rates (as per table 1), and that a business allocation formula (based on the entity's gross income and wages and salaries) determines the Quebec tax payable for an entity with establishments both inside and outside Quebec. The Quebec rules are not substantively enacted for Canadian GAAP purposes; the legislation is likely to be tabled in the National Assembly this fall. These rules are effective on the same dates as the federal legislation, which applies a 13 percent tax in lieu of provincial tax to flowthrough entities. Because Quebec is introducing its own flowthrough entity tax, it is uncertain if, how, and when the federal government will apply the 13 percent tax to Quebec flowthrough entities.

Research and development (R & D). Under Quebec's 2007 budget, a taxpayer need no longer carry on business through a Quebec PE to qualify for the province's refundable R & D tax credits, retroactive to expenditures incurred in fiscal years starting after April 21, 2005. Quebec *Information Bulletin* 2006-5 (December 4, 2006) notes the increased asset thresholds used to determine the refundable R & D wage tax credit rate (from $25 million and $50 million to $50 million and $75 million) for R & D wages incurred after December 4, 2006. These R & D changes are not substantively enacted for Canadian GAAP.

75 percent tax holiday. Quebec *Information Bulletin* 2007-5 (June 26, 2007) restores a reference to the 10-year tax holiday for small and medium-sized enterprises (SMEs) that carry on manufacturing and processing activities in remote resource regions of Quebec. The province's 2007 budget gradually reduced the tax holiday from 75 to 25 percent by 2009. However, no related legislation has been drafted, and thus an SME can continue to benefit from

Table 1 Quebec Corporate Income Tax Rate

	Changes effective after Jan. 1/06			Date recognized for GAAP	
	From	To	Effective	Canada	US
	percent				
Active income (including M & P)					
Financial institutions* and oil-refining companies	9.9	11.9	June 1/07	not yet	not yet
Other	9.9	11.4	Jan. 1/08	Nov. 8/05	Dec. 13/05
Other	11.4	11.9	Jan. 1/09	Nov. 8/05	Dec. 13/05
Inactive income	16.25	9.9	Feb. 21/07	not yet	not yet
Inactive income	9.9	11.4	Jan. 1/08	not yet	not yet
Inactive income	11.4	11.9	Jan. 1/09	not yet	not yet
CCPC small business rate	8.5	8.0	Mar. 24/06	Nov. 8/06	Dec. 6/06

* Excluding insurance companies.

Table 2 Quebec Capital Tax Rate Changes

	Changes effective after Jan. 1/06			Date recognized for GAAP	
	From	To	Effective	Canada	US
	percent				
General rate	0.525	0.49	Jan. 1/07	Nov. 8/05	Dec. 13/05
General rate	0.49	0.36	Jan. 1/08	Nov. 8/05	Dec. 13/05
General rate	0.36	0.29	Jan. 1/09	Nov. 8/05	Dec. 13/05
General rate	0.36	0.24	Jan. 1/09	not yet	not yet
General rate	0.24	0.12	Jan. 1/10	not yet	not yet
General rate	0.12	nil	Jan. 1/11	not yet	not yet
Financial institution rate	1.05	0.98	Jan. 1/07	Nov. 8/05	Dec. 13/05
Financial institution rate	0.98	0.72	Jan. 1/08	Nov. 8/05	Dec. 13/05
Financial institution rate	0.72	0.58	Jan. 1/09	Nov. 8/05	Dec. 13/05
Financial institution rate	0.72	0.48	Jan. 1/09	not yet	not yet
Financial institution rate	0.48	0.24	Jan. 1/10	not yet	not yet
Financial institution rate	0.24	nil	Jan. 1/11	not yet	not yet

Shaded areas represent changes effective for GAAP.

the tax holiday—75 percent on income tax, capital tax, and employer health services fund contributions—until it expires on December 31, 2010.

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CRA Delay and Section 160

In *Addison & Leyen Ltd.* (2007 SCC 33), the SCC held that a lengthy delay by the minister in exercising its discretion to assess under section 160 is not a sufficient ground for judicial review.

In *Addison*, the taxpayers held shares directly or indirectly in York Beverages when it liquidated most of its assets. In 1989, York distributed the proceeds to the taxpayers as dividends, loan repayments, directors' fees, or retiring allowances, but it retained sufficient proceeds to cover its 1989 tax liability. Before its 1989 year-end, York's newly constituted board approved the use of its cash to purchase seismic data in order to generate a deduction eliminating the tax liability, and York's shares were sold to the third party that directed the seismic data's purchase. In 1992, the minister reassessed York, saying that the seismic data were overvalued, and reduced the deduction. In 1993, York filed a notice of objection; the minister never responded and York never appealed to the TCC. At some point the minister determined that it could not collect the tax from York and in February 2001 issued section 160 assessments against the taxpayers. The taxpayers filed notices of objection; the minister did not respond and the taxpayers never appealed to the TCC.

In 2005, the taxpayers applied to the Federal Court for judicial review of the section 160 assessments on the grounds that the long delay before their issue was unfair and an abuse of process, prevented them from mounting a proper challenge to the assessments' validity in the TCC, and deprived them of any possible indemnification by the primary taxpayer. The taxpayers sought, inter alia, an order quashing the section 160 assessments, but the Federal Court said that it had no jurisdiction to grant the relief.

The FCA majority reversed the lower court. Section 18.5 of the Federal Courts Act provides that the Federal Court has no jurisdiction to hear a judicial review application for which an appeal lies to the TCC, "to the extent that it may be so appealed." The majority said that the rule was not sufficiently explicit to deprive a taxpayer of the right to seek judicial review of the minister's exercise of discretion in issuing a section 160 assessment. In contrast, the TCC can consider only the assessment's correctness, not unreasonable delay or improper conduct by the minister or the minister's agents in its issue; those matters can be considered on a judicial review in the Federal Court and a remedy granted. The majority said that delay alone is normally an insufficient basis for a remedy, unless the delay was not justified and caused demonstrable loss that could not be foreseen or mitigated by the taxpayer's due diligence. Rothstein J (as he then was), dissented: Even if the majority's interpretation of the words "to the extent that it may be so appealed" was correct and opened the

door to judicial review, a delay in the issuance of a section 160 assessment was not reviewable. The section specifically allows the minister to assess "at any time": no limitation period applies. Without those words, delay might have been reviewable on fairness or other grounds.

The SCC agreed with Rothstein J's dissent. The majority's interpretation amounted to reading in a limitation period in section 160 that clearly did not exist, although delay may allow "for a remedy like mandamus to prod the Minister to act with due diligence once a notice of objection has been filed." The SCC said that the facts alleged did "not disclose any reason why it would have been impossible to deal with the tax liability issues relating to either the underlying tax assessment . . . [or those against the taxpayers] through the regular appeal process. . . . [I]n such circumstances," review powers should be authorized cautiously to preserve the "integrity and efficacy of the system of tax assessments and appeals. . . . Judicial review should not be used to develop a new form of incidental litigation designed to circumvent the system of tax appeals established by Parliament and the jurisdiction of the Tax Court. Judicial review should remain a remedy of last resort in this context." The SCC decision in *Addison* ends what would otherwise have become a significant means to challenge section 160 assessments and confirms that section 160 assessments remain a powerful tool for the minister to use at any time.

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Sham Capital Dividends

The recent case of *Ralph Faraggi* (2007 TCC 286) involved a tax scheme to enable the sale of synthetically generated tax-free capital dividends. The TCC concluded that the transactions were business transactions of an income nature; that the taxpayers received taxable dividends, not tax-free capital dividends; and that the scheme was a sham.

The transactions occurred in 1987, before subsections 83(2.1), (2.3), and (2.4) were introduced to curtail this type of plan and similar schemes. For example, a 100 percent US-owned Canco might pay out its CDA to another Canco that wanted to pay its shareholders capital, rather than taxable, dividends.

The two individual taxpayers developed a very creative and complex plan to create substantial CDAs through the incorporation of numerous new corporations with nominal assets under part 1A of the Quebec Companies Act, which permitted a corporation to have par value shares without immediate payment by the subscribing shareholder. A number of sequenced transactions involved share subscriptions of "alphabet stock" by the first group of new corporations with nominal assets to a second group of new corporations for their alphabet stock using a daylight loan from a bank. The shares' par value was initially set low; dividends could not exceed the low threshold amounts. After share values were shifted from one class to another via stock dividends, share redemptions and sales that generated capital gains were followed by subsection 83(2) elections on the crystallized capital dividends. Amending articles increased paid-up capital to purposely trigger deemed dividends under subsection 84(1). Throughout all the transactions the bank maintained control of the funds loaned, from cradle to grave. All transactions were completed within a scintilla of time.

Third-party corporations with surplus were targeted as buyers of an opportunity to distribute tax-free capital dividends to their shareholders. Participants subscribed for shares in the new corporations "seeded" with synthetic CDA; the shares were redeemed at a discount using the CDA and subsection 83(2) elections. A sharing of the benefit resulted in a premium received by the taxpayer corporations owned by the individual taxpayers. The amounts were paid out to the individuals using a subsection 83(2) election, and they filed on the basis that several million dollars were received as tax-free capital dividends.

The CRA reassessed each of the corporate taxpayers as having received business income (the premium between the third-party share subscription and the corresponding stock redemption) and each of the individual taxpayers as having received taxable, not capital, dividends. Penalties were imposed against the individuals under subsection 163(2) alleging that they had knowingly made false statements (the purported subsection 83(2) elections) in their returns. At trial, the Crown argued that the transactions creating the CDAs were shams and should be ignored. (The transactions preceded the enactment of GAAR.) The classic definition of sham was met: "acts . . . which are intended . . . to give . . . the appearance of creating between the parties the legal rights and obligations different from the actual legal rights and obligations . . . which the parties intend[ed] to create" (*Snook v. London & West Riding Investments, Ltd.*, [1967] 1 All ER 518, at 528 (HL)). The taxpayers countered that the legal form and substance of the documents conformed exactly to the transactions the parties intended to create and that the results were governed by specific provisions of the Act.

The TCC thoroughly reviewed the relevant jurisprudence, including *Snook* and *Stubart*, where Estey J added that "deceit . . . is the heart and core of sham," and said that the transactions were indeed shams. The bank loans were not really true loans involving transfers of property, since the bank could pull the funds from their circulation at

any time and the borrower had no control and possession of the funds. The bank manager testified that the bank never intended to lend funds to the taxpayers. The taxpayers intended to deceive: each step was planned in advance, and an "appearance was given of legal relations and this masked the purpose of the real intended transactions: to carry on a business for profit." The profits were camouflaged as dividends out of CDAs. It was clear to the TCC that specific provisions of the Act were abused, used contrary to their object and spirit; the taxpayers—highly skilled tax and corporate lawyers—knowingly carried out and promoted a series of transactions that they knew were artificial.

The finding of sham in *Faraggi* will no doubt be subject to considerable analysis within the tax community; some feel that the court strained the boundaries of the sham doctrine to compensate for the absence of legislative tools. It is also sobering to note that the case took 20 years to get to the TCC; *Stubart* took 18 years to reach the SCC.

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No GST Supply

The concept of "supply" is fundamental to the GST. GST applies to a taxable supply: "a supply . . . made in the course of a commercial activity." "Supply" is defined to mean the "provision of property or a service in any manner." Although "supply" is defined broadly, the passing of property or services between persons does not always constitute a supply—for example, when an agent acquires property or services on behalf of a principal. The TCC recently concluded in *613259 Saskatchewan Ltd.* (2007 TCC 421) that the taxpayer general contractor did not supply materials (goods) in the course of its home renovation business.

The taxpayer's business supplied "labour only"; the actual work was subcontracted to various third parties. Homeowners were responsible for providing the materials for use in renovations. Occasionally, a homeowner did not have the materials required for the renovation; in that case, the subcontractor purchased the necessary materials and was reimbursed by the company. The amount reimbursed for the materials was charged back to the homeowner in the company's final invoice, with no markup or other charges, and was shown separately from labour costs. The company collected and remitted the GST correctly for the labour charges. The CRA audited and assessed the company on the basis that the company made a taxable supply of the materials purchased by the subcontractors and should have collected GST. (The CRA also apparently assessed the subcontractors.)

The court said that the starting point for the analysis of whether a supply has been made is to determine the "reality" of what the company was in the business of supplying. A review of the company's operation showed that it was not in the business of supplying building materials; it only supplied labour for home renovations. The company specifically marketed its labour services on the basis that the purchase of materials was the homeowners' responsibility, and it did not maintain any inventory of building supplies. This arrangement allowed the homeowner to acquire materials without a builder's markup or to use materials that the homeowner had on hand. The company's forms used for estimates and invoices contained a notation that the homeowner was responsible for buying materials. When a homeowner lacked the required materials, the practice of "purchas[ing] on behalf of the homeowner by the [company] through its subcontractors" and billing back to the homeowner in the final invoice, in the court's view, resulted in the company's reimbursement by which the "homeowner effectively purchased the materials, just as if he had personally gone to the home renovation store himself." The court said that the CRA's assessment ignored the reality of the company's business: there was no "taxable supply" of materials by the company to the homeowner. The appeal was allowed, and the matter was referred back to the minister for reassessment.

The decision highlights the importance of properly characterizing the flow of goods and services to determine whether there is a supply for GST purposes. Although "at first blush, it may seem self-evident that the [company] would be obliged to" charge GST, proper characterization of the transaction indicated that there was no supply.

Although the point was not explicitly part of the court's analysis, applying an agency rationale yields the same conclusion. Under the law of agency, the agent's actions are considered to be those of the principal. Thus, if an agent acquires property on behalf of the principal, that property is legally considered to have been acquired by the principal. There is no supply of the property between agent and principal. Accordingly, GST does not apply to the agent's reimbursement if there is no markup or other charges. Successfully establishing an agency relationship may allow flexibility in tax planning. If the relationships in *613259* had been properly structured and documented so that the subcontractors acquired the building materials as the homeowners' agent, then for GST purposes there would have been no supply between the company and the homeowner and none between the company and the contractor.

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Shareholder Benefit from Access

In *Dyck* (2007 TCC 458), the TCC upheld the CRA's assessment that a shareholder benefit resulted from a transfer of corporate funds into the shareholder couple's joint investment account, even though they never withdrew any money from the account and they subsequently reversed the transfer.

The taxpayers (Mr. and Mrs. D) were husband and wife; each owned 50 percent of the outstanding shares of Ed Dyck Ltd. (Canco). In February 1997, six years after Canco sold its assets in 1991, Mr. D followed his accountant's advice and transferred corporate funds (about $96,000) into the investment account that he and Mrs. D held jointly to "produce better returns on the combined funds." Three year later, in March 2000, at the accountant's suggestion, they reversed the account consolidation and transferred about $98,000 from their joint investment account back into a corporate account "to restore the *status quo ante*." At no point did Mr. and Mrs. D withdraw any funds from the joint account.

The CRA determined that the transfer of the funds into the joint account fell within the shareholder benefit provision in subsection 15(1), and assessed both Mr. D and Mrs. D as having received a taxable benefit equal to one-half of the amount transferred for the 1997 taxation year.

Mr. and Mrs. D argued that no benefit was received as a result of the transfer because neither of them used any of the transferred funds during the period that these funds were held in the joint account. The taxpayers also claimed (but no evidence was presented) that they entered into an agreement with Canco (1) for the consolidation of $96,000 of Canco's funds with the funds in their joint investment account and (2) for Mr. and Mrs. D to act as bare trustees of the corporate funds. Several cases were cited in support of this position, including *Chopp* ([1998] 1 CTC 407 (FCA)), which deals with revising incorrect bookkeeping entries, and *Franklin* ([2002] 2 CTC 88 (FCA)), which deals with the recognition of transactions that were mistakenly not recorded at all.

The TCC found that the case at hand differed from the cases cited: the transfer of funds to the joint account was a "real transaction," and the reversal three years later was also a real transaction, not an effort to "properly reflect an earlier transaction that had been wrongly recorded." The taxpayers "cannot undo history . . . when it turns out that they have made a mistake, except in a very limited class of cases where the applicable legislation specifically sanctions it." In response to the argument that the taxpayers did not withdraw any funds, the TCC said that "they could have withdrawn any or all of the funds in the account and put them to any purpose they wished"; on the transfer to the joint account the funds became their property, a fact that was not changed just because they made no withdrawals. Thus, subsection 15(1) was sufficiently broad to support the shareholder benefit assessment, regardless of the economic reality that Mr. and Mrs. D did not actually benefit from the transfer.

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Foreign Tax News

OECD

On August 22, 2007 the Committee on Fiscal Affairs released a revised discussion draft on part IV of the report on the attribution of profits to PEs related to insurance activities. Comments are due by October 31, 2007 to the Director of the Centre for Tax Policy and Administration (jeffrey.owens@oecd.org).

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Canada-US Protocol

As noted in last month's issue, the minister of finance had indicated that the Canada-US treaty protocol would be signed on September 10, 2007 in British Columbia. As of the date of publication, the protocol has not been signed; however, Finance officials informally express optimism that it will soon be finalized.

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