CANADIAN TAX Highlights

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NEW PROTOCOL AND HYBRIDS

On Friday, September 21, 2007, after nearly 10 years of on-and-off negotiations, the United States and Canada jointly released a signed fifth protocol to the Canada-US treaty. Among other matters, the protocol introduces new rules regarding hybrid entities.

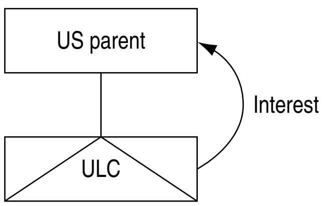
The current treaty contains no specific rules altering benefit entitlement for income derived through a hybrid entity—that is, an entity such as a partnership or a disregarded entity that is fiscally transparent in one country but not in the other. The longstanding US model treaty position (supported by US Code section 894(c)) is essentially embodied in new article IV(6) of the treaty: a resident is entitled to treaty protection for income flowing through a hybrid and on which the resident is taxable, provided that the income's treatment vis-à-vis the resident is the same as if it had been received directly. For example, the rule should allow a US resident who derives Canadian-source income through a flowthrough US LLC or Cayman corporation to access treaty benefits.

As anticipated, treaty benefits are denied to a US resident who derives Canadian-source property income through a Canadian partnership that is a check-the-box corporation for US tax purposes. But that denial is further predicated on the resident's being treated differently under its domestic laws if it had received the income directly (article IV(7)(a)). In the example above, the US tax treatment of interest received directly is presumably not the same as the treatment of income received from a controlled foreign corporation (the hybrid) that receives interest income, whether or not any US anti-deferral regime (such as subpart F) applies. Article IV(7)(a) also catches a Canadian resident who derives US-source interest income that is otherwise subject to US withholding tax and that passes to the resident through a US LLC; this denial of treaty benefits was already in effect as a result of the Code section 894(c) treaty override effective after July 2000.

What was not widely anticipated was article IV(7)(b). This rule denies treaty benefits if (1) a resident receives an amount such as interest, dividends, or royalties from a hybrid entity that is a resident of the other country and is a passthrough entity for the recipient country; and (2) the recipient would have been subject to different tax treatment in its jurisdiction if the hybrid entity were not a passthrough entity in its country. Accordingly, two commonly used structures will suffer denial of treaty benefits on amounts received: the Canadian inbound "disregarded" loan structure (figure 1) and the Canadian outbound "tower" structure (figure 2).

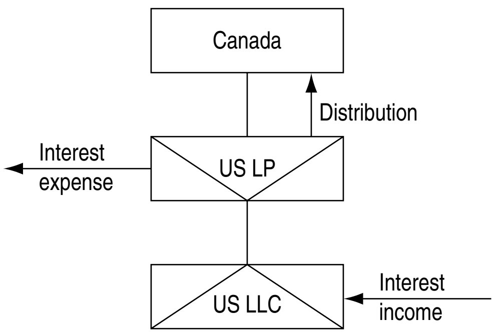
In the structure shown in figure 1, the interest paid by the Canadian unlimited company is tax-deductible in Canada; but because the ULC is disregarded from a US tax perspective, there is no loan, and therefore no interest is included in the US parent's income for US tax purposes.

Figure 1



In the structure shown in figure 2, a Canadian partner of the US limited partnership may receive a partnership distribution that is not taxed in Canada, but the distribution is treated as a dividend if the US LP (treated as a corporation for US tax purposes) were actually a US corporation. Arguably, the structure is offside under the new protocol because Canada treats a partnership distribution and a dividend differently for tax purposes. The structure

Figure 2



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creates tax arbitrage only to the extent that US LLC distributions are paid out of exempt surplus, but this element does not appear to be a prerequisite to the denial of treaty benefits. It is noteworthy that the Canadian deduction for the interest expense paid by the US LP may be denied under the 2007 federal budget proposal dealing with restricted interest expense.

The US domestic rules dealing with treaty benefits for income derived through a hybrid entity deal only with property income such as dividends, interest, and royalties. On a literal reading of article IV(7)(b), it is unclear whether the rule should also apply to active business income. For example, does it apply to a US resident that wholly owns a disregarded Canadian unlimited company—or a Canadian resident that wholly owns a US LP hybrid (shown in figure 2)—that carries on only an active business in its country of formation? In the former case, should Canada be able to impose a 25 percent withholding tax on ULC dividends paid, when from a policy perspective the right result is only 5 percent withholding because the ULC's income is typically fully taxable in the United States? Does it make any difference whether there was also a disregarded loan from the US shareholder into the ULC? One hopes that the competent authorities will shed some light on article IV(7)'s application.

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Interest Withholding Exemption

A Finance comfort letter of September 4, 2007 deals with proposed changes to subparagraph 212(1)(b)(vii) and the withholding tax exemption for interest paid by a corporation on so-called five-year debt. Finance agrees that when cross-border interest payments are eliminated under the newly signed Canada-US treaty protocol, the current wording of the exemption will create different tax treatment for a borrower depending on whether the borrower issued its obligation before or after the protocol's effective date. As a result, it is Finance's intention to recommend appropriate changes to the domestic exemption.

Subparagraph 212(1)(b)(vii) exempts from withholding tax any interest paid by a corporation relating to an obligation under which, inter alia, the corporation and the creditor deal at arm's length and not more than 25 percent of the principal amount is payable by the corporation within five years of the obligation's issue. Under the current Canada-US treaty, cross-border interest payments may be subject to 10 percent withholding. The new protocol eliminates withholding in the source country on arm's-length interest paid as of the second month after the protocol enters into force. Withholding tax on interest payments between related parties is reduced to 7 percent in the first calendar year ending after entry into force, to 4 percent in the second such year, and to 0 percent thereafter. Once the treaty exemptions are implemented, Finance proposes to eliminate Canadian withholding tax on interest paid to all arm's-length non-residents, regardless of their country of residence.

When the treaty protocol comes into effect, subparagraph 212(1)(b)(vii) will no longer operate to dictate a five-year rule to ensure a withholding tax exemption for Canada-US interest payments. Thus, if debt was issued before the protocol amendment's effective date and included a five-year repayment limit in order to qualify for a withholding exemption, the borrower will be at a disadvantage compared with a borrower that issues debt after the treaty comes into effect and needs no such restriction to qualify for an exemption.

The comfort letter request asked Finance to change the law so that debt that otherwise met the requirements of subparagraph 212(1)(b)(vii) at the time of issue—without compromising its exemption status under that rule—might specifically allow for the subsequent amendment of its terms so as to require the repayment of the principal within five years of the date of issue in the event that, by virtue of a tax treaty or legislation, withholding tax no longer applies to the debt. Changes to subparagraph 212(1(b)(vii) are included in clause 48(1) of draft legislation released on October 2, 2007 for the remaining budget 2007 tax measures. Under the draft legislation, a debt that requires repayment of more than 25 percent of its principal within five years may nonetheless qualify for the withholding exemption, provided that the obligation to repay arises only if a change to the Act or a tax treaty has the effect of relieving the non-resident lender from tax on the debt's interest. The amendment applies to all obligations and agreements in respect of obligations entered into on or after March 19, 2007, when the 2007 federal budget first announced the elimination of withholding tax on cross-border interest payments in the Canada-US treaty.

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New Protocol: Transfer Pricing

The main features of the newly signed Canada-US treaty protocol that may affect transfer pricing are highlighted below.

Arbitration. An arbitration procedure is added to the article XXVI mutual agreement procedure (MAP). A MAP helps taxpayers resolve cases of double taxation or taxation not in accordance with a tax treaty by requiring the assistance of the competent authority (in Canada, delegated senior CRA officials). The protocol provides for arbitration for competent authority cases that have gone on for at least two years from their commencement date (the earliest date when both competent authorities had the information necessary to substantively consider the MAP request). Further conditions must be met: (1) tax returns were filed with at least one contracting state; (2) the case involves one or more treaty articles agreed upon by the competent authorities in an exchange of notes as eligible for arbitration; (3) the competent authorities agree that the case is suitable for arbitration; and (4) a non-disclosure agreement has been reached by all concerned persons relating to the arbitration. A taxpayer can refuse to be bound by the arbitration's results, just as it can refuse other MAP results; otherwise, the competent authorities are bound.

Unlike other protocol changes, the new MAP measures, including arbitration, apply immediately when the protocol comes into force and that date is the commencement date for cases then under consideration. The first arbitration cases will thus be heard two years after the protocol comes into force—in January 2010 at the earliest.

Guarantee fees. The protocol specifies that guarantee fees are taxable only in the recipient's state of residence, unless the fees are business profits attributable to a PE in the payer's state of residence (new article XXII(4)).

Interest. New article XI states that interest arising in a contracting state and beneficially owned by a resident of the other contracting state may be taxed only in that other state, thus effectively eliminating withholding tax on interest. The withholding rate drops to 7 percent during the first year the protocol is in force and to 4 percent in the second year, before being eliminated.

Exchange of information. Minor changes are made to article XXVII. (1) The standard of relevance that defines whether information is exchangeable is broadened to "such information as may be relevant" from "such information as is relevant." (2) A contracting state cannot decline to provide information on the ground that the state has no domestic interest in it. (3) A contracting state cannot refuse to supply information merely because it is held by a bank or other similar institution. (4) A requested state must allow the requesting state's representatives entry into the requested state in order to interview individuals and examine books and records with the consent of persons subject to examination.

The change requiring a requested state to permit entry to representatives of the requesting state should simplify the lives of taxpayers who were often asked by the CRA to "invite" CRA auditors to perform an audit in the United States without informing the US competent authority. The former practice arguably contravenes the principle that Canadian authorities cannot apply Canada's laws in another country. If the taxpayer agrees to the audit on US soil, the US competent authority must grant the request and, the rule implicitly requires, must be informed of a proposed audit.

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Seniors and Retirement Income

As Canada's population ages, the tax treatment of seniors and their specialized forms of income assumes more importance. More taxpayers than ever are over the age of 65, and an increasing proportion of income—the tax base—comes from income directly linked to retirement.

Statistics produced annually by the CRA show that 18.1 percent of all income tax returns were filed by those receiving Old Age Security (OAS) pensions in 2005 (the latest year for which data are available), an increase over the comparable 2000 figure of 17.2 percent. The tax statistics separately identify each of OAS pensions, Canada and Quebec pension plan benefits, and other pensions and superannuation income. As shown in the table, these three components of retirement income were equivalent to 12.4 percent of all reported income in 2005, but to only 10.9 percent five years earlier. Total reported income on all returns increased by 18.3 percent from 2000 to 2005, but over the same period OAS income rose 21.4 percent and CPP and QPP benefits rose 24.6 percent. Other retirement income—tax-sheltered during the recipients' working life—was 48.0 percent higher in 2005 than in 2000. Because the number of returns filed by those over 65 also rose, average total income increased at a slower rate: relative to 2000, average CPP and QPP benefits were 12.4 percent higher in 2005, and average retirement income was 24.4 percent higher.

Tax Returns Identified as from Seniors, Taxation Year 2005

	Seniors' returns as a percentage of all returns	Retirement income as a percentage of all reported income
Newfoundland and Labrador	17.9	15.1
Prince Edward Island	18.9	15.5
Nova Scotia	19.5	16.8
New Brunswick	18.7	16.1
Quebec	18.3	13.7
Ontario	18.2	12.5
Manitoba	19.1	14.2
Saskatchewan	21.1	14.0
Alberta	14.8	7.5
British Columbia	19.1	12.7
National average	18.1	12.4

The national figures hide significant provincial variations, as shown in the table. In Saskatchewan, 21.1 percent of all returns filed in 2005 came from those over 65. In Alberta, by contrast, only 14.8 percent of all returns were filed by those over 65. The proportion of total income coming from the three sources identified specifically as retirement income in the CRA statistics varied from a high of 16.8 percent in Nova Scotia to a low of 7.5 percent in Alberta in 2005.

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Purpose, Motive, and Pension Plans

The idea was simple enough: allow departing civil servants to move funds from their pension plan (the PSSA) to another registered group pension plan. The Crown made available to participating employers transfer agreements that granted PSSA members otherwise unavailable portability and set out a formula that, for many members, allowed a transfer of amounts exceeding their PSSA benefits' commuted value. Related litigation and other repercussions set the stage for two recent FCA cases involving transfers from large public sector pension plans to individual pension plans (IPPs).

***Loba* and *Boudreau*.** The transfer of excess funds from the PSSA attracted attention, and various arms of the government, including the CRA, decided to stanch the flow. The RCMP was brought in. Participating employers were investigated, some covertly; the employment relationship with former PSSA members was questioned; motives were impugned; and criminal charges were laid. The charges were later withdrawn, but they left an indelible mark. The CRA served notice of intent to revoke the registration of two plans. Appeals were filed; because the facts were similar, it was agreed that the results for the Loba plan would bind the Cryptic Web plan. The FCA in *Loba* (2004 FCA 342), on the basis of the record prepared by the CRA, upheld the decision to revoke registration because the plan's primary purpose was not to provide periodic payments in respect of employment service. The three-paragraph judgment did not discuss any facts or arguments and held that the determination of the plan's primary purpose was "essentially a question of fact" and, on the basis of the record, the CRA's decision was reasonable.

A Cryptic Web plan member sought judicial review of the intended revocation date, which was the plan's registration date, January 1, 1996 (*Boudreau #1*, 2005 FCA 304). Funds had been transferred on behalf of Ms. Boudreau in 1999, after she became an employee of the plan's sponsor; she would suffer dire consequences if revocation preceded the transfer. The FCA said that she had standing to question the effective date but must await the outcome of *Loba*. The plan's registration was revoked after *Loba*, and Ms. Boudreau returned to the FCA (*Boudreau #2*, 2007 FCA 32). The court said that the CRA need not extend to transferees the right to be heard because the Act did not specify that they be notified. She argued that the plan's registration under the Ontario pension benefits legislation meant that its primary purpose was the provision of pension benefits. The FCA disagreed; it was the plan sponsors' purpose that was relevant for revocation, and that purpose was to facilitate pension transfers as part of a "scheme to induce the government to pay substantial premiums to the pension accounts of departing public servants."

***1346687 Ontario* and *Jordan Financial*.** Transfers were made from public sector pension plans to IPPs. The CRA had outlined in writing to the IPPs' sponsors its interpretation of the primary purpose test. The IPP members were unable to show any employment income from the sponsors, and inconsistent statements were made with respect to members' employment and earnings. Surplus was withdrawn from both IPPs, and one was wound up and its assets transferred to an RRSP. The CRA served notices of intent to revoke the plans' registration ab initio, because they failed the primary purpose test. On appeal, in *1346687 Ontario* (2007 FCA 262) and *Jordan Financial* (2007 FCA 263), the FCA dismissed arguments that the CRA failed to comply with the rules of natural justice, and it repeated (from *Loba*) that a pension plan's primary purpose is a question of fact. On the basis of the absence of remuneration, the failure to provide any services, and the inconsistent statements, the CRA said that there was no bona fide employment relationship with the IPP sponsors. The CRA also said that the removal of surplus and the collapse of one IPP showed that the IPPs were established primarily to receive funds from the exporting plans, not to provide lifetime pensions. Although the FCA concluded that the standard of review was correctness, it found against the taxpayers because they failed to show that the CRA's conclusions were unsound or unsupported by the evidence and that the CRA's conclusion that the IPPs had not met the primary purpose test was unreasonable.

The IPPs' revocation will likely result in the transferred amounts being fully included in income if the relevant taxation year is not statute-barred. The IPPs and the transfers will be considered, respectively, retirement compensation arrangements (RCAs) and RCA contributions subject to withholding tax. Any subsequent transfer to an RRSP will also result in an income inclusion and possibly in RRSP overcontribution taxes. Taxes, interest, and penalties could easily eat up the taxpayers' entire retirement savings.

Even after four FCA decisions, it is not clear whether the standard of review in revocation proceedings is correctness or reasonableness. The primary purpose of a pension plan was determined by the sponsor's motives, not the object and scheme of the plan's terms. Neither the Crown nor the FCA raised the long line of case law that explores whether a true pension plan is established or whether it is a mere "simulate" (*Susan Hosiery Ltd.*, [1969] 2 Ex. CR 408) or "cloak" (*West Hill Redevelopment Co.*, [1969] 2 Ex. CR 441). Because the primary purpose test applies to pension plans, it was not the nature of the plans in issue that was questioned but their potential uses: full consistency with pension standards legislation was not enough.

These decisions are disquieting. Not only must pension plan sponsors meet the requirements of pension standards legislation and the Act, but their motives must be pure. The only potential tax advantage in these cases was the tax-deferred transfer of assets from one defined benefit pension plan to another. Transfers from defined benefit plans to money purchase vehicles are restricted. The other advantages were related to financial or estate planning. In effect, the decisions make the CRA the final arbiter of motive—a question of fact—and its interpretations must be heeded. An appeal to the FCA is based on a record whose facts are decided by the CRA; disproving the CRA's presumptions presents a formidable task.

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De Facto Directors' Liability

Subsection 323(1) of the Excise Tax Act (and subsection 227.1(1) of the Income Tax Act) provides that corporate directors can be jointly and severally liable with the corporation to remit the corporation's tax, interest, and penalties, if assessed within two years of their last ceasing to be directors. The term "director" is not defined. The courts have said that a director may be a de jure director (formally appointed under corporate law) or a de facto director (by virtue of performing the functions of a director). In *Bremner* (2007 TCC 509), the Tax Court upheld a director's liability assessment because Mr. Bremner was a de facto director, even after the company ceased business operations.

Mr. Bremner was assessed under ETA subsection 323(1) on October 1, 2002. The corporation had no de jure director since Mrs. Bremner, the first director, resigned in writing in 1997. The Ontario Business Corporations Act provides that, in the absence of de jure directors, for OBCA purposes any person who "manages or supervises the management of the business and affairs of the corporation" is deemed to be a director (section 115(4)). Mr. Bremner admitted to being a de facto director (and therefore a deemed director under the OBCA), and to not having exercised the degree of care, diligence, and skill required to prevent the corporation's failure to remit GST. However, he argued that he ceased to be a de facto director on September 1, 2000, when the corporation ceased to carry on business (although it was dissolved much later); thus, his assessment was issued more than two years after he ceased to be a director and was invalid.

The TCC agreed that Mr. Bremner was the de facto director; he "did everything a director is authorized and required to do." The TCC summarized the general law with respect to de facto directors: the cessation of commercial activities does not normally relieve de jure directors from their obligations and responsibilities, and the directors do not then cease to be directors. The court extended this principle to de facto directors, saying that they should not be able to avoid liability on more favourable terms than de jure directors.

The court said that there is no fixed rule to determine when a de facto director ceases to be a director. The course of the person's conduct is important: a de facto director ceases to be a director "when the shareholders elect his or her replacement or if he or she resigns" or "by giving notice to the corporation and actually stop [sic] managing or supervising [the company's] management." The TCC reviewed a number of factors, including the fact that Mr. Bremner was the sole shareholder and the only person who ever managed and supervised the corporation; that there was no evidence that Mr. Bremner informed third parties that he was no longer holding himself out as a director; and that he continued to act for the corporation after September 2000. (It appears that the only act he performed in this capacity was to make GST payments to the CRA.) The court concluded that even though the corporation ceased to carry on its business, Mr. Bremner continued to be its director; thus, the assessment was issued on a timely basis.

Bremner appears to place a significantly greater burden on a de facto director to establish the time that status terminates. The steps required to resign as a de jure director are clearly delineated in the corporate law and that date is, arguably, prima facie the date that he or she ceases to be a director. Determining the effective date that a de facto director's status ceases is much more difficult. Practically speaking, most de facto directors—unlike the director in *Bremner*—are not aware of the de facto director concept, nor do they realize that they have acquired that status through their actions. Therefore, the TCC's suggested actions for terminating de facto status are unlikely to occur, such as the date on which the shareholders elect his or her replacement, or the date on which a resignation notice is given to the corporation. Given the court's reasoning in *Bremner*, a person who has unwittingly become a de facto director may successfully terminate that status only by the corporation's dissolution. This may be particularly true of an Ontario corporation, for which a de facto director is the "last person standing" in terms of managing the corporation's affairs, as was the case in *Bremner*.

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Replacement Is an Independent Contractor; RRIF Reporting

Replacement worker. The Tax Court recently decided in *Plant* (2007 TCC 453) that a replacement worker for an employee was an independent contractor of Canada Post in the 2004 taxation year. In contrast to most cases dealing with the employee versus independent contractor issue, the taxpayer (Mrs. R) wished to be treated as an employee, for reasons not clear. The court concluded that the Canada Post employee whom Mrs. R replaced would also have been an independent contractor under common law if she had not been party to an agreement with Canada Post to be treated as an employee.

A Canada Post employee (Mrs. E) occasionally hired and paid Mrs. R to perform Mrs. E's employment duties as a rural and suburban mail carrier on days when Mrs. E was not well enough to work. Mrs. R performed the same duties as Mrs. E, using her own vehicle to travel on the route assigned to Mrs. E. Mrs. R was provided with flashing lights and a sign for her vehicle by Canada Post and was paid "a daily rate payable for covering the route . . . and . . . an amount for the use for her vehicle." Mrs. R was not entitled to hire assistants, to receive benefits, or to become unionized; she was required to carry liability insurance to cover any damages she might cause while performing her duties as a mail carrier. The main issue was whether Mrs. R was an employee of Canada Post—given that she was performing the same duties as a Canada Post employee—or an independent contractor.

The TCC applied the test developed in *Wiebe Door*, looking at such factors as the control the employer had over the worker's performance, the opportunity the worker had for profit or loss, the degree of responsibility for investment and management, and whether the worker supplied her own tools or hired others to help in performing the duties. The TCC concluded that a mail carrier was an independent contractor. Prior to 2004, Canada Post treated its mail carriers as independent contractors. Effective January 1, 2004, Canada Post and its mail carriers agreed that the carriers were employees of Canada Post. The testimony was clear: there was no change to the work involved, and replacement workers were not intended to be affected. However, because Mrs. R was not party to the agreement, she was not considered an employee of Canada Post and thus was an independent contractor.

RRIF reporting for 2007. The CRA recently issued its administrative position on the treatment of payments from a registered retirement income fund (RRIF) to taxpayers who turn 71 in 2007 or 2008 (and their spouses) when applying the changes announced in the 2007 federal budget.

A RRIF is generally created on the maturation of a registered pension plan (RPP) or a registered retirement savings plan (RRSP). RRIF annuitants must withdraw a minimum amount from the plan each year. The 2007 federal budget extended the age at which an RPP or RRSP must mature to the end of the year in which the taxpayer turns 71 (from 69). The RRIF provisions were thus amended to reflect a minimum withdrawal of nil until the year after the taxpayer turns 71. It is likely that some taxpayers over 69 (but under 72) were already paid the required RRIF minimum amount before the 2007 federal budget changes were announced.

The CRA's "2007 Budget—Questions and Answers" addresses the T4RIF slip reporting of payments to an annuitant who turns 70 or 71 in 2007 (71 in 2008): such a RRIF withdrawal is technically an excess payment under the new legislation. Technically, an excess payment should be reported in box 16 (Taxable Amounts) and box 24 (Excess Amounts) of a T4RIF slip; but if the payment would have been considered a minimum amount under the previous legislation, it is acceptable to report the amount only in box 16.

The CRA also addressed the question of payments made from a spousal RRIF. Such payments attribute to the contributing spouse who makes a deductible contribution to a spousal RRSP during the taxation year of the RRIF withdrawal, or in either of the two preceding years. Because the RRSP contribution age limits were extended, a taxpayer who was paid a RRIF minimum amount required under the old rules may be unduly penalized under the current legislation. The CRA said that the coming-into-force rules for the 2007 federal budget ensure that the transitional adjustments recognized in the definition of "minimum amount" for a taxpayer turning 71 no later than 2008 are not recognized for the purposes of the attribution rule. As a result, attribution of RRIF payments should apply only in the situations originally intended.

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Section 116 Certificates

A few years ago, the waiting time for a section 116 clearance certificate was a week or two. Currently, my office has several applications for clearance certificates that are over eight months old; it is not unusual for the delay to be as long as one year. A section 116 certificate is required to claim a treaty capital gains exemption on a non-resident's disposition of taxable Canadian property (other than excluded property). The application process can be a significant drain on a non-resident vendor's finances, time, organizational resources, and patience.

Section 116 sets out a compliance procedure in order to ensure collection of tax from the non-resident, but the delay in granting the certificate is disproportionate given that most transactions are treaty-exempt. For example, it took eight months to obtain certificates for an individual US resident who transferred his private Canadian company shares to a US holding company in exchange for shares.

At the 2006 STEP Conference, the CRA said that the significant delay in processing and issuing section 116 certificates resulted from the increased volume of requests over the last few years and the very sophisticated nature of the transactions. The inventory of requests is handled on a first-in, first-out basis; the wait times may vary regionally. A recent call to a tax compliance officer triggered a taped message to the effect that a section 116 certificate currently takes at least three months to process.

Lengthy delays for even a routine certificate have prompted the CRA to issue comfort letters. Following an oral or written request, the CRA may provide a comfort letter if an application for a certificate has already been made, but the certificate cannot be issued before the transaction closes. If the capital gain is treaty-exempt, the requirement to pay 25 percent of the proceeds or provide security is normally waived, but the purchaser must hold 25 percent of the proceeds in trust pending the certificate's receipt. (The funds may be invested and the income paid to the non-resident.) Apparently, the CRA's International Tax Directorate has been working to develop a risk-based audit strategy to improve the use of resources and reduce delays for most requests. The project involves an analysis of the types of property being disposed of and the type and quantum of adjustments made to the taxpayer's representations in the course of the CRA's review of the application for a certificate.

The information required to complete an application for a section 116 certificate can be voluminous, time-consuming, costly to assemble, and sometimes virtually impossible to gather. The rules themselves are numerous and seemingly sometimes without a unifying policy rationale. In the absence of a certificate, the purchaser must withhold 25 or 50 percent of the proceeds, depending on the type of asset, and is otherwise liable for the tax, interest, and penalties. To obtain a refund, the vendor must file a return to claim treaty exemption or costs and expenses related to the sale.

For a non-resident corporate vendor, taxable Quebec property is subject to a similar certificate procedure; a non-resident individual needs only a certificate for Quebec real estate. The vendor must pay a tax in Quebec equal to 12 percent of the gain; in the absence of a certificate, a purchaser must withhold 12 percent of the proceeds. The gain may be treaty-exempt but all dispositions, including those deemed on death (unlike the federal rules) or otherwise, are caught.

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Owner-Manager: Year-End Tips

Owner-managers should begin to focus on year-end planning and remuneration strategies.

Dividend Distributions

■ Compute the CCPC's general rate income pool (GRIP) at its 2007 year-end to determine its ability to pay eligible dividends.

■ Designate qualifying eligible dividends by providing each recipient with written notice on payment.

■ Consider distributing dividends in the following order: (1) eligible dividends that trigger a refundable dividend tax on hand (RDTOH) refund, (2) ineligible dividends that trigger an RDTOH refund, (3) eligible dividends that do not trigger an RDTOH refund, and (4) ineligible dividends that do not trigger an RDTOH refund.

■ If the CCPC has a positive GRIP and RDTOH, consider pre-year-end distributions of eligible dividends that trigger a dividend refund.

Owner-Manager's Optimal Salary-Dividend Mix

■ The lower tax rate on eligible dividends may enhance a shareholder-manager's preference for receiving dividends from income subject to the general corporate rate, but receipt of dividends in lieu of salary may increase his or her alternative minimum tax exposure.

■ Many factors should be considered, including the owner-manager's marginal tax rate, the corporation's tax rate, provincial health and payroll taxes, and the potential for maximizing RRSP contribution room and CPP contributions.

■ A corporation in Alberta or Manitoba may wish to accelerate into 2007 the payment of discretionary non-eligible dividends that trigger a dividend refund to take advantage of currently lower tax rates on non-eligible dividends.

■ Conversely, a corporation in Alberta or Ontario may wish to defer the payment of discretionary eligible dividends to 2008 or later years to benefit from scheduled decreases to the eligible dividend tax rate in those provinces.

Dividend in Lieu of Salary (December 31, 2007 Year-End and $10,000 ABI)

	Eligible for small business deduction		No small business deduction, no M & P deduction		No small business deduction, M & P deduction	
	Deferral	Savings/(cost)	Deferral	Savings/(cost)	Deferral	Savings/(cost)
			dollars			
Alberta	2,288	174	668	(497)	688	(497)
British Columbia	2,608	6	958	(258)	958	(258)
Manitoba	3,140	58	1,140	(382)	1,140	(382)
New Brunswick	2,883	(15)	1,183	(321)	1,183	(321)
Newfoundland and Labrador	2,995	80	1,195	(761)	2,095	(137)
Nova Scotia	3,013	306	1,013	(741)	1,013	(741)
Ontario	2,881	330	1,131	(443)	1,331	(292)
Prince Edward Island	2,968	202	925	(587)	925	(587)
Quebec	2,921	54	1,831	(188)	1,831	(188)
Saskatchewan	2,638	98	838	(472)	1,188	(193)
Northwest Territories	2,793	336	1,143	(68)	1,143	(68)
Nunavut	2,513	113	813	(652)	813	(652)
Yukon	2,528	1	528	(555)	1,778	479

Note: It is assumed that the individual is taxed at the top marginal income tax rate; only federal and provincial income tax, the employer portion of provincial health tax, and the employee portion of payroll tax for Northwest Territories and Nunavut are considered. The SBD figures for Yukon assume that the rate on non-M & P ABI applies; for M & P ABI, the tax deferral and tax savings are $2,678 and $105, respectively.

■ A corporation in Newfoundland and Labrador may wish to defer the payment of salary and/or discretionary dividends to 2008 to benefit from then lower personal tax rates.

■ Forgoing a bonus payment may call into question whether substantially all a CCPC's assets are used in an active business and jeopardize its shares' status as qualifying small business corporation shares.

■ Tax is deferred if the corporation retains income when its tax rate is less than the individual's rate. The table shows the income tax deferral from the corporation's retaining active business income in lieu of paying salary to the shareholder, and the net tax saving (or cost) of ultimately paying out the after-tax corporate income as a dividend.

Corporate Income

■ A corporation subject to the small business rate may wish to defer income until after 2007 by maximizing 2007 discretionary deductions (such as capital cost allowance) in order to benefit from the decrease in the federal small business rate from 13.12 to 11.5 percent (2008) and then to 11 percent (2009). After 2007, small business rates also decrease in Manitoba and Prince Edward Island, and small business thresholds in Alberta and Saskatchewan increase.

■ A corporation subject to the general rate may wish to defer income by maximizing discretionary deductions in 2007 to benefit from future reductions to the federal general corporate income tax rates: from 22.12 to 20.5 percent (2008), to 20 percent (2009), to 19 percent (2010), and to 18.5 percent (2011). Manitoba and Saskatchewan general income tax rates also decline after 2007.

■ Conversely, corporate taxpayers in Quebec may wish to minimize discretionary deductions in 2007 to maximize income and to take advantage of the currently lower corporate income tax rates. Quebec tax rates on active business income above $400,000 (other than for non-insurance financial institutions and oil-refining companies) increase from 9.9 percent (2007) to 11.4 percent (2008), and then to 11.9 percent (2009).

Tax Incentives

■ Ensure that new federal incentives are claimed for 2007, such as the federal child care space tax credit for eligible expenditures incurred after March 18, 2007 to create licensed child-care spaces for employees' children.

■ Benefit from provincial tax incentives and changes thereto. For example, British Columbia businesses and their apprentices may be eligible for refundable tax credits starting in 2007; Manitoba enhances its M & P investment tax credit after 2007; and Manitoba, New Brunswick, Nova Scotia, Ontario, and Quebec have extended the deadlines for, or enhanced, their media incentives.

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US-Resident Child: Estate Planning

Canadian parents face challenging tax and estate planning issues for children living in the United States. Unlike Canada, the United States taxes its permanent residents and citizens on the full FMV of assets passing at death. The estate tax credit that shields the first US$2 million of assets increases to US$3.5 million in 2009; the estate tax is then repealed for 2010, but is revived in 2011 with an exemption of US$1 million. A US generation-skipping inheritance trust may provide some relief.

Among other disadvantages, the outright disposition of property to a US-resident child may unnecessarily augment the child's own estate for US estate tax purposes. A bequest via a disposition to a testamentary trust may also create significant tax exposure because of the US foreign trust accumulation rules. The hallmarks of a properly drafted US generation-skipping inheritance trust are flexibility and control. The trust assets are not subject to US estate tax on the child's death because the assets pass directly to the grandchildren and not through the child's estate. The child may be given liberal access to the trust assets, so long as the access is defined by an ascertainable standard such as health, support, maintenance, and education. As a result, the trust's value is excluded from the child's US estate on his or her death, even if the trust grows considerably in value. Accordingly, the grandchildren inherit the trust assets undiminished by a liability for US estate tax on the child's death. The child may act as sole trustee of his or her generation-skipping trust without adverse US tax consequences, directing investments and controlling distributions to family members during his or her lifetime. The child may also determine how the trust assets pass to family members at death. The child may invest in almost any type of asset (for example, a vacation home or artwork); because the child is the trust's primary beneficiary, there is little to fetter the child's use and enjoyment of the assets. The trust assets may be used for the child's benefit (and for the benefit of his or her descendants) but are not accessible to the child's (or descendants') creditors. Thus, the child may use the trust assets to purchase, for example, a vacation home; provided that the title to the asset remains in the trust's name, claims against the child or his or her descendants will not result in a lien against the property.

A Canadian-resident and Canadian-citizen parent is not subject to US gift and estate tax and thus may transfer property of unlimited value to an inheritance trust, except for the transfer of US-situs assets, which does attract gift tax to the non-resident. The most effective inheritance trust is one structured as a US domestic trust under US income tax law; this is accomplished by designating a US trustee (typically the child) and a US jurisdiction for the trust's governing law. A US trust is preferred because a Canadian trust is subject to the 21-year deemed disposition rule, effectively limiting the benefits to 21 years. Furthermore, a non-US trust that is not properly administered may generate significant tax exposure for the US beneficiary under the US foreign trust accumulation rules. The inheritance trust is established inter vivos as an irrevocable trust, typically by a parent (or a "friendly" US grantor) and funded only nominally on creation. The trust's primary funding is derived from the Canadian parents' estates, often on the death of the surviving spouse, by means of a "pour over" provision in their wills.

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Foreign Tax News

Netherlands

A bill was introduced to simplify the limited liability corporation (Besloten Vennootschap (BV)) legislation, abolishing minimum capital; removing the requirement for an auditor's statement for a contribution in kind; allowing a BV to provide security (or grant a loan, without strict limitations) to a third party for the acquisition of a BV's shares; allowing shares with more than one vote, non-voting shares, and shares that do not participate in profits; removing the 50 percent repurchase of share capital limit; and imposing financial solvency tests on the distribution of assets and on repurchases and redemption of shares.

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