CANADIAN TAX *Highlights*

Editor: Vivien Morgan, LL.B.

Volume 15, Number 11, November 2007

Double Double Dip and Trouble

On October 2, 2007, Finance released draft legislation largely relating to several measures announced in the March 2007 budget. As expected, the draft legislation includes Finance's so-called anti-tax haven initiative, which seeks to restrict the deductibility of interest on outbound double-dip structures that rely on intermediary financing companies, including tower structures, for periods beginning after 2011. The draft legislation is generally consistent with amended proposals from May 2007. A Canco's deduction for "specified financing expenses" in respect of an interaffiliate loan will be reduced by the amount of its "aggregate double dip income" in respect of the loan.

A "specified financing expense" in respect of an interaffiliate loan is defined as interest (and other paragraph 20(1)(e) costs) paid or payable in a taxation year in respect of borrowed money or an amount payable for property (or substituted property). The borrowed money or amount payable must be used directly or indirectly for the purpose of funding (wholly or partly) the interaffiliate loan. If the borrowed money or amount payable is on-loaned, amounts included in the corporation's income in respect of that on-lending are deducted. The definition is quite expansive. If an amount payable relates to property or substituted property that is corporate shares, the definition is extended to include an amount payable for any property of the underlying corporation or of a related person, or property substituted for such property.

The definition's broad scope can capture a particular expense that, at first blush, appears to escape. In example 3 in the explanatory notes, Canco purchases all Cansub's shares from a third party for an interest-bearing note. Canco immediately sells all Cansub's assets for cash and uses the proceeds to fund an interaffiliate loan. The interest-bearing note is an "amount payable for property," and the original property is Cansub's shares. Because the property is corporate shares, all Cansub's assets, or property substituted therefor, are also property for the purposes of the specified financing expense definition. Thus, Cansub's proceeds from the sale of its assets are property substituted for Cansub's assets and are caught under the definition. Because the proceeds are used to fund an interaffiliate loan, the interest on the note payable by Canco qualifies as a specified financing expense and is subject to the interest deductibility restrictions.

An interaffiliate loan is a debt owing to a foreign affiliate (FA) of the particular Canco (or of a corporation not dealing at arm's length with the Canco) or to a partnership of which the FA is a member. The income derived from the debt is "recharacterized income" of the FA—essentially, income deemed to be active business income under subparagraph 95(2)(a)(ii)—or would be if it were income from property.

"Aggregate double dip income" is the Canco's participating percentage of the recharacterized income earned by the FA, less foreign tax paid on such income, grossed up by the relevant tax factor. The definition of "participating percentage" in subsection 95(1) is adapted for these purposes.

Previous iterations of the proposals created a number of policy and technical problems, many of which unfortunately continue under the current proposals. From a policy perspective, it remains unclear why Canada should deny a tax deduction to a Canadian taxpayer solely because a foreign country's tax rules allow a deduction. Finance has said, inter alia, that the rule is intended to prevent the exploitation of Canada's FA rules, which allow exempt surplus dividends to be returned without incremental Canadian tax. However, the current proposals restrict interest deduction even if the Finco's interest income is taxable surplus, which is taxable in Canada when returned as a dividend; thus, the Canadian interest deduction is restricted even if the income earned by Finco is ultimately subject to Canadian tax.

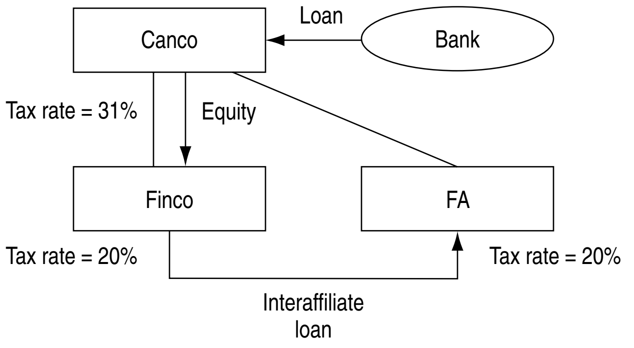
Another area of concern is the proposals' reliance on tracing to determine whether a particular expense is a specified financing expense. The expenses must be traced, directly or indirectly, to the funding of an interaffiliate loan. If tracing must proceed through a number of entities or types of investments, it may be difficult if not impossible

In This Issue

for many companies to apply the tracing rule to existing borrowings for which there is insufficient evidence to establish which funds were used to finance local operations versus foreign operations. For prospective borrowings so-called cash damming may be useful, but practically speaking may require significant time and resources.

The proposals are intended to restrict the deductibility of interest where there are two interest deductions (one in Canada and one in a foreign jurisdiction) for the same borrowing, but the current draft restricts deductibility in the absence of an effective double deduction, as illustrated in figures 1 and 2.

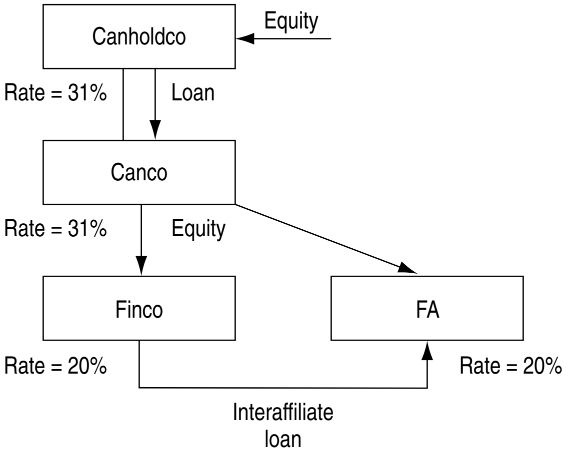
Figure 1



In figure 1, Finco and FA are resident in the same country and have the same tax rate but do not file a consolidated tax return. FA and Finco have an interest deduction and interest income, respectively, on a single-entity basis, but on a consolidated basis there is no net foreign tax deduction for tax purposes. Nonetheless, the proposals restrict Canco's interest expense with respect to the bank loan. Similarly, the proposals may yield an unfair result where there is no net Canadian interest deduction. In figure 2, there is no net Canadian interest deduction within the corporate group because Canco borrows from Canholdco, which is equity-funded, and Canholdco is taxed on the interest income. However, the proposals deny or restrict Canco's interest expense.

The foregoing examples illustrate that the proposals, if implemented, will have significant implications for a number of Canadian businesses. Proposals of such importance warrant an appropriate consultation period to allow taxpayers and tax advisers to comment on any technical and policy-based deficiencies. The period for consultation was limited to only three weeks, although the rules do not take effect until 2012. Furthermore, it remains unclear why the amendment is a priority for the Canadian government. The "second deduction" is grounded in the tax policy of another jurisdiction, which bears the cost thereof: the resulting reduced financing costs for Canadian multinationals maintain their competitiveness

Figure 2



against multinationals based in other jurisdictions that continue to allow double dips.

Albert Baker and Tanvi Vithlani
Deloitte & Touche LLP, Vancouver

US Estate Tax Charitable Deduction

Whether the goal is to provide for philanthropic organizations, to reduce estate taxes, or both, charitable bequests can play an important role in an estate plan. Special considerations apply in the cross-border context to ensure that a charitable bequest accomplishes its goals. The long-awaited fifth protocol to the Canada-US tax treaty, signed on September 21, 2007, contains several significant changes for US and Canadian individuals and businesses; one less publicized change replaces the estate tax charitable deduction in article XXIX B(1) with a completely new provision.

The United States imposes an estate tax on the transfer of the taxable estate of every deceased US citizen or resident; a deduction is available for the full amount of a bequest to or for the use of any charitable organization. The Code allows the deduction regardless of whether the charitable organization is located in the United States: the Code thus entitles a US-citizen Canadian resident to a full estate tax charitable deduction for US estate tax purposes, whether the property is left to a US or a non-US charitable organization. Neither the current treaty nor the 2007 proposed protocol affects this entitlement.

A decedent who is neither a US citizen nor a US resident (an NRA) is subject to US estate tax on the transfer of assets with US situs at the time of death. (US-situs assets for these purposes include real property and tangible personal property located in the United States, US stocks, and debts of US persons or companies.) Under the Code, if an NRA leaves US-situs property to a US charitable organization, the estate receives an estate tax charitable deduction for the full amount of the bequest, an outcome not affected by the treaty or by the 2007 protocol. However, if an NRA's estate leaves the property to a non-US charity, there is no estate tax deduction under the Code or regulations, although there is currently a deduction under the treaty. The 1995 treaty protocol added article XXIX B(1), which provides that when property is bequeathed by a resident of one state to an exempt organization, it is treated for tax purposes in a state as a resident thereof. Thus, if a Canadian citizen and resident leaves property to a Canadian charity, the treaty (not the Code) allows a US estate tax charitable deduction if the donor directs that the bequest be satisfied from property subject to estate tax. If the donor does not so specify, the estate tax deduction for the US assets that pass to the charitable organization is limited to the proportion that the estate's US assets bear to total assets.

The 2007 protocol proposes to eliminate that benefit. Article 26(1.1) replaces the 1995 protocol's article XXIX B(1). The new rule merely provides that if a Canadian-resident individual bequeaths property to a US-resident organization, the Canadian tax consequences apply as if the individual received proceeds equal to an elected amount between cost and FMV. On its face, the new rule eliminates the charitable deduction provided by its predecessor and precludes the estate of a Canadian citizen and resident from obtaining a US estate tax charitable deduction when US-situs property is given to a Canadian charity. (If a US resident leaves property to a Canadian-resident organization, it is deemed to be a US resident for US tax purposes.) Thus, the benefit granted by the 1995 protocol is eliminated. A literal reading of the new rule also appears to limit the benefit for a US citizen or resident who leaves Canadian real property to a US charity: the individual does not receive any reduction in Canadian tax at death, a change that would negatively affect many US taxpayers who own vacation property in Canada.

Kevin K. Gluc
Hodgson Russ LLP, Buffalo

Planning for Existing ULCs

Americans have used Canadian ULCs extensively in their tax planning, but proposed changes to the fifth protocol of the Canada-US treaty dictate the consideration of restructuring alternatives.

- The best alternative is to transfer the ULC's shares to a Luxembourg SARL or another treaty-country holding company; this is also likely the preferred structure for new US-owned Canadian ULCs. There is a capital gains exemption under the Canada-US treaty (except for real estate), and a section 116 certificate is required. Query whether GAAR applies.
- Convert the ULC into an ordinary corporation for US purposes. This may trigger US tax on intangibles.
- Liquidate the ULC and convert it into a Canadian branch. There is a deemed disposition in Canada of the assets at FMV and Canadian dividend withholding tax is triggered on the distribution.
- Restructure non-arm's-length interest through another treaty country. A minimum 10 percent Canadian withholding tax applies. (Only the Canada-US treaty has a proposed non-arm's-length exception. Temporarily, there is no US tax if Code section 954(c)(6) applies.)
- If the ULC is paying royalties to the parent, interpose an Irish, Swiss, or Netherlands company. There is no limitations-on-benefits clause in those countries' treaties with Canada, but the application of the beneficial ownership concept in *Indofoods* ([2002] EWCA Civ. 158) should be considered. Transfer pricing may also be an issue.
- Pay a dividend equal to the ULC's retained earnings in December 2009 and benefit from a 5 percent withholding tax rate.
- Wind down the ULC and start a Canadian branch or subsidiary. The disposition of goodwill may result.

Jack Bernstein
Aird & Berlis LLP, Toronto

The Power of Progressive Taxation

Details from Statistics Canada's analysis of government finance show how personal and corporate income taxes have maintained their relative importance in the overall tax structure despite the fact that rates have dropped. Social security levies have roughly kept pace with the growth in income taxes despite a doubling of pension plan rates over the past 16 years.

All social security levies rose from a low equivalent to 25.6 percent of total personal and corporate income taxes in 1990 to a high of 33.4 percent in 2003, and subsided to 29.6 percent by 2006. During the period 1997 to 2003, Canada and Quebec pension plan rates increased by 77 percent, raising collections from the equivalent of 9.0 percent of income taxes in 1990 to a high of 19.5 percent in 2003. Reductions in personal and corporate income tax rates since then were offset by increases in the tax bases, so that collections of pension plan levies as a percentage of income taxes fell in stages to the equivalent of 17.7 percent in 2006.

Federal social security levies—primarily employee and employer contributions to employment insurance—dropped steadily between 1990 and 2006, as shown in the table, from the equivalent of 11.5 percent of all income taxes in 1990 to only 7.4 percent in 2006. The decline in collections

Social Security Levies as a Percentage of Income Taxes, 1990 to 2006

	Federal	Provincial	CPP/QPP	All social levies
1990	11.5	5.1	9.0	25.6
1991	13.4	4.6	9.7	27.7
1992	16.0	4.9	10.4	31.3
1993	16.5	5.1	10.8	32.4
1994	16.7	5.1	10.8	32.5
1995	15.2	5.1	11.3	31.6
1996	13.5	4.6	10.6	28.6
1997	13.2	4.1	10.2	27.5
1998	11.9	3.9	11.4	27.2
1999	10.7	3.5	12.1	26.3
2000	9.8	3.2	13.0	25.9
2001	10.1	3.4	15.7	29.2
2002	10.4	3.8	18.7	32.9
2003	9.9	4.1	19.5	33.4
2004	8.7	4.1	18.6	31.5
2005	8.3	4.0	18.1	30.5
2006	7.4	4.4	17.7	29.6

resulted partly from the decline in rates. Provincial social security levies (mainly employer contributions to workers' compensation programs) also declined over the period from a high in 1994 of 5.1 percent to a low in 2000 of 3.2 percent and have since settled around the 4.4 percent shown for 2006.

Most of the social security programs are designed to be self-financing, and are structured to provide coverage and levy taxes on limited amounts of income. It is thus not surprising that they would not grow as quickly as personal income tax collections based on progressive rates or corporate tax collections based on a flat tax system. What is strikingly illustrated in the table is the continued strength of income taxes despite major reductions in rates: only the major increase in the compulsory pension plan rates has allowed social security levies to maintain their position relative to income taxes.

David B. Perry
Canadian Tax Foundation, Toronto

New Protocol: Permanent Establishment

The fifth protocol contains significant amendments to the Canada-US treaty, including the article V definition of permanent establishment that will affect US and Canadian businesses performing cross-border services. It is particularly significant that the amendments may override existing FCA decisions on the issue of what constitutes a PE in the treaty context.

Assume that a US entity performs services in Canada. Article VII provides that a US person's business profits are taxable in Canada only to the extent that they are attributable to a Canadian PE where the business is carried on. Article V(1) defines a PE generally as "a fixed place of business through which the business of a resident of a Contracting State is wholly or partially carried on." Using the specific rules that determine whether a PE exists, a US business could thus structure its activities to avoid having a PE whose profits were taxable in Canada, regardless of how long a particular service provider remained in Canada (except for a building site or a construction or installation project).

The FCA in *Dudney* (2000 DTC 6169) provided guidance on the PE concept for service providers. An individual contractor for a US entity, which provided services to a Canco client at its Canadian premises, was in Canada for approximately 300 days in one taxation year. The FCA said that the "fixed base" test (article XIV, repealed by the fifth protocol) was substantially equivalent to the test for a PE. In determining whether a fixed base existed, the court said that the key question was "whether the person carried on his business at that location during the relevant period. The factors to be taken into account . . . include the actual use made of the premises . . . , whether and by what legal right the person exercised or could exercise control over the premises, and the degree to which the premises were objectively identified with the person's business." The Canco's premises were not the contractor's place of business: the contractor had access to the client's offices, but only during its office hours and only for the purpose of performing the services required by his contract. He could not and did not use the premises for his own business operations. US-resident independent contractors followed the prescription in *Dudney* when performing services in Canada on medium-term or even long-term projects. The CRA said that it would apply *Dudney* to fact patterns in which the taxpayer did not have sufficient physical control of space to carry on his business there.

The fifth protocol adds new article V(9), which amends the PE definition. First, the definition is expanded to include a US enterprise providing services in Canada by an individual present in Canada in any 12-month period for at least 183 days during which more than 50 percent of the US enterprise's gross active business revenues is income derived from the individual's Canadian services. Thus, if the 183-day threshold is met, the US enterprise of an individual providing services in Canada is deemed to have a Canadian PE unless the related income is less than 50 percent of the enterprise's total revenue. The rule applies whether the individual is self-employed, an independent contractor, or the US enterprise's employee or shareholder. Second, a US entity is deemed to have a PE if services are provided in Canada for at least 183 days in any 12 months with respect to the same or a "connected" project for the entity's Canadian-resident customers or for its non-Canadian resident customers that have a Canadian PE for which the services were provided. New annex B provides that projects that are a coherent whole, commercially and geographically, are connected. The amendments effectively override *Dudney* if the service provider has an extended presence in Canada.

However, new paragraph 9 may be overridden by paragraph 6 of the PE definition, which deems a location not to be a PE if it is used solely for "the display of merchandise" of or "advertising or the supply of information" about the US entity. Moreover, new paragraph 9 does not apply to contractors providing services at a building site or a construction or installation project.

The fifth protocol generally comes into force on ratification by both the Canadian and US governments (or on January 1, 2008 if it is ratified in 2007), but the article V amendments come into force the later of January 1, 2010 and the third year that ends after the protocol enters into force. Affected service providers will thus have time to consider the ramifications.

Kristina Soutar and Steven McLeod
Thorsteinssons LLP, Toronto

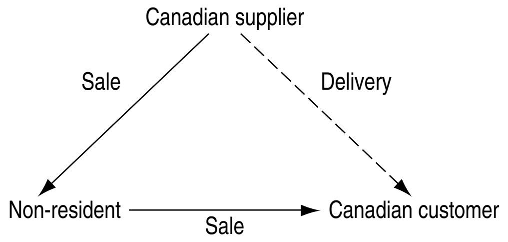
Drop Shipment Rules

The CRA recently released draft revised *GST/HST Memorandum 3.3.1 on Drop Shipments*, requesting comments by January 31, 2008.

The GST drop shipment rules generally (1) provide an anti-avoidance rule requiring GST to be charged and collected on the FMV of goods sold to a non-resident and delivered to a third party in Canada, and (2) provide relief if the goods are ultimately exported or used by a GST registrant exclusively in commercial activities. Consider the simple scenario (illustrated in figure 1) of a non-resident who purchases goods from a GST-registered Canadian supplier and arranges for the goods to be delivered directly to its Canadian customer. Subject to GST relief under the drop shipment rules, GST applies on the goods' FMV on their supply to the non-resident because the goods remain in Canada at all times; the tax is potentially unrecoverable.

In more complex scenarios, a number of Canadian suppliers provide the non-resident with goods and related commercial services before the goods are delivered to the non-resident's customer (the consignee). Subject to certain conditions, the drop shipment rules can prevent the application of GST to both the supply of goods by the Canadian

Figure 1



vendor and the related services provided by other suppliers in the chain.

For the rules to apply, the non-resident cannot be registered for GST purposes; generally, this means that the non-resident cannot be carrying on business in Canada. Depending on the specific rule applicable, the consignee may need to provide a drop shipment certificate (DSC) stating its name and business number, and acknowledging that it assumes a potential tax obligation with respect to the goods by taking physical possession of them. As the CRA states in the memorandum, the DSC does not "impose a tax obligation" where there was no such "potential obligation."

The memorandum is extensive, incorporating 46 example scenarios; although it may not reveal much new material, it is a comprehensive source of information and guidance. The rules' potential retroactive effect is confirmed: if the drop shipment conditions are met, a DSC can be issued for prior shipments and any tax previously collected by the GST-registered Canadian supplier from the unregistered non-resident can be refunded, subject to the issuing of a debit memo by the purchaser or a credit note by the vendor, within two years of its collection.

One troublesome example involves a Canadian manufacturer's sale of goods to a non-registered non-resident, which resells them to Canadian customer A, which in turn resells them to Canadian customer B for its use exclusively in its commercial activities. To simplify matters, the Canadian manufacturer agrees to deliver the goods directly to Canadian customer B. Although this scenario arguably falls squarely within the wording of the drop shipment rules, the CRA says that the supply by the Canadian manufacturer is not relieved of tax by virtue of a DSC's issuance.

The CRA gave another troublesome interpretation at the March 8, 2007 CBA/CRA GST round table Q & A. A questioner asked about the GST status of a non-registered non-resident that sourced goods in Canada from a local supplier and resupplied them to a Canadian customer by way of drop shipment. The CRA said that if the non-resident also solicited orders for the supply of its goods in Canada, it was carrying on business in Canada, must register, and thus could not rely on the drop shipment rules. The rationale behind the drop shipment rules suggests that a non-resident that purchases goods in Canada for delivery directly to a

Canadian customer is not necessarily carrying on business in Canada and required to register. To suggest that soliciting orders in Canada to obtain those Canadian sales is sufficient to trigger a registration requirement and thus eliminate the drop shipment rules' application is a regrettable interpretive evolution.

Audrey Diamant
PricewaterhouseCoopers LLP, Toronto

Interest Withholding Exemption

The draft legislation of October 2, 2007 proposes to implement the 2007 federal budget proposal to amend the withholding tax on interest payments by Canadian residents to non-residents. The effective date of the proposal is tied to recent changes to the Canada-US tax treaty so that, once the new treaty protocol comes into force and precludes Canada from taxing arm's-length interest payments to US residents (and vice versa), Canada will no longer tax payments of arm's-length interest to residents of other countries.

Canada currently imposes a 25 percent withholding tax on interest payments made by Canadian residents to non-residents, except for certain types of interest. The new draft legislation proposes that withholding tax will not apply to interest payments made by a Canadian resident to a non-resident with whom the Canadian resident deals at arm's length. Interest (other than "fully exempt interest") that is non-arm's-length and "participating debt interest" remain subject to withholding tax.

The draft legislation also includes the transitional rule for five-year debt. (See "Interest Withholding Exemption," *Canadian Tax Highlights*, October 2007.)

Paul Hickey
KPMG LLP, Toronto

Stricter Michigan Nexus

Michigan recently passed legislation to replace its single business tax (SBT) with the new Michigan business tax (MBT) effective January 1, 2008. This comprehensive business tax reform package has significant implications for foreign persons, including Canadian businesses.

A Canadian company with nexus in Michigan may be adversely affected by the MBT sourcing rules: sales receipts that now appear to be included were previously excluded from Michigan income apportionment. This is a significant change that will substantially affect the Michigan tax base of a foreign taxpayer who has Michigan-destination sales for which title passes outside the United States.

The MBT replaces the SBT with four tax regimes: a business income tax (BIT); a modified gross receipts tax (GRT); a premiums tax on insurance companies; and a capital-based franchise tax on financial institutions. The BIT is a traditional income-based tax imposed at 4.95 percent on income apportioned to Michigan using a single-factor apportionment based on sales. The GRT is imposed at 0.80 percent on gross receipts, apportioned to Michigan using the BIT apportionment methodology. The premiums tax on insurance companies is largely a flat tax for both in-state and out-of-state insurance companies. The franchise tax rate on financial institutions is based on net capital.

An out-of-state company satisfies the GRT nexus standard if it 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. Thus, the GRT nexus threshold is even lower than the SBT bright-line tests. Income derived within Michigan from interstate commerce is not subject to the BIT if the only business activity within the state is the solicitation of orders for tangible personal property.

A foreign person that satisfies the GRT or BIT nexus thresholds must source its receipts to Michigan on a destination basis, resulting in an MBT liability for some taxpayers that previously had no SBT liability. The SBT sourcing rules were quite favourable to foreign persons (including Canadian companies) with a Michigan nexus: tangible personal property sales in which title passed from a foreign seller to a Canadian buyer in Canada were not treated as Michigan sales for apportionment or tax base purposes even if the purchaser brought the goods back to Michigan. The Michigan Treasury Web site now advises that the previous treatment of foreign persons will not apply to the MBT: under the MBT, all Michigan sales will be sourced on the basis of destination rather than the place where title passes.

Jeffrey Brown and Barry Nussbaum
KPMG LLP, Toronto

Functional Currency Tax Reporting

Finance issued draft legislation on October 2, 2007 detailing the functional currency reporting rules proposed in the 2006 federal budget. Under these rules, an eligible corporation may soon elect to report its income for Canadian tax purposes in a functional currency other than the Canadian dollar. This measure could greatly simplify the financial statement reporting of a multinational organization doing business in Canada.

Generally, a taxpayer may initially elect functional currency tax reporting if (1) it is a Canadian-resident corporation throughout the taxation year (other than an investment corporation, a mortgage investment corporation, or a mutual fund corporation); (2) it has filed in prescribed form to have the functional currency rules apply (filing appears to be required by the due date of the prior year's corporate income tax return); and (3) it has a functional currency for the taxation year that it applies consistently from year to year.

A "functional currency" is a "qualifying currency" (currently, US, UK, or EU currency) that is the prevalent currency for the taxpayer's "principal business activities" and is used for GAAP financial statement reporting purposes. The minister may prescribe additional qualifying currencies. In some cases, a corporation may use more than one functional currency to compute its financial results in its consolidated financial statements or even in its legal-entity financial statements if it has multiple divisions with different functional currencies. The "functional currency" definition is not clear on how the rules apply to such companies. Although the election is a one-time election that must be applied consistently from year to year, if the taxpayer no longer meets the necessary criteria (possibly owing to a change in its business activities or ownership structure), it must revert to reporting in Canadian currency for income tax purposes according to the methodology in the draft legislation. The new rules apply to taxation years that begin on or after the date that the legislation receives royal assent. Thus, if the draft is enacted in 2007, a Canadian corporate taxpayer with a calendar year can elect to adopt functional currency reporting on its 2008 taxation year income tax returns at the earliest.

The functional currency tax reporting rules are a federal initiative. It is not yet known whether the provincial governments that administer their own tax systems (Ontario, Quebec, and Alberta) will adopt similar legislation; if they do not, a taxpayer may need to prepare two sets of legal-entity financial statements for tax-reporting purposes.

Note that even if a corporation adopts functional currency tax reporting, tax payments must be made in Canadian dollars.

Paul Hickey
KPMG LLP, Toronto

RESPs Enhanced

Registered education savings plans (RESPs) offer parents a tax-efficient way to save for their children's post-secondary education. Recent federal and Quebec changes make these plans even more attractive.

Table 1 shows enhancements commencing in 2007 to RESP contribution limits and to maximum annual Canada education savings grant (CESG) payments. The elimination of the annual contribution limit is particularly important and creates planning opportunities for contributors to optimize the lifetime CESG paid to an RESP. Annual CESG limits, which depend on net family income, should be considered. If the maximum CESG was not received in previous years, the CESG may be higher, as shown in table 2.

Table 1 Federal RESP Limits

	Per-beneficiary amount	
	Before 2007	After 2006
	dollars	
Annual RESP contribution limit	4,000	Eliminated
Lifetime RESP contribution limit	42,000	50,000
Maximum annual CESG		
Low-income	500	600
Middle-income[a]	450	550
Other	400	500
Maximum annual RESP contribution qualifying for the CESG	2,000	2,500
Lifetime CESG limit	7,200	7,200

[a] For 2007, the thresholds are ≤$37,178 (low-income) and then up to $74,357 (middle-income), indexed annually.

Table 2 CESGs: RESP Catch-Up Contributions

	Per-beneficiary amount	
Maximum annual CESG[a]	Before 2007	After 2006
	dollars	
Low-income	900	1,100
Middle-income	850	1,050
Other	800	1,000

[a] If maximum not received in prior years.

Certain payments to fund part-time studies now qualify as educational assistance payments (EAPs), which are distributions from an RESP (accumulated income on contributions and CESGs) to finance a beneficiary's post-secondary education. Commencing in 2007, an EAP includes a payment for a student who is at least 16 and is enrolled in a specified educational program, which is a post-secondary program that lasts at least three consecutive weeks and requires a student to spend at least 12 hours per month on course work. The EAP is limited to $2,500 for the first 13 consecutive weeks in a specified educational program. For an individual enrolled in a qualifying post-secondary educational program for at least 10 hours per week, payments to the student continue to qualify as EAPs and are limited to $5,000 for the first 13 consecutive weeks in the program.

Quebec's 2007 budget introduced a refundable tax credit for an RESP trust for contributions paid after February 20, 2007; the credit is intended to supplement the federal CESG program. To qualify, the RESP beneficiary must be under 18 and both the beneficiary and the trust must reside (or be deemed to reside) in Quebec at the

Table 3 Quebec RESP Credits

Net family income[a]	Quebec RESP tax credit on annual RESP contributions: First $500	Next $2,000	Maximum annual Quebec RESP credit	Maximum lifetime Quebec RESP credit
Low-income	20%	10%	$300	$3,600
Middle-income	15%	10%	$275	$3,600
Other	10%	10%	$250	$3,600

[a] Will match federal CESG thresholds in the note to table 1.

end of the year. Table 3 shows the basic credit and enhanced credits. In most cases, if the beneficiary does not pursue post-secondary education, the trust governed by an RESP pays a special tax to recover the tax credits.

Louis Provenzano and Ruby Lim
PricewaterhouseCoopers LLP, Toronto

GST: Frequent Flyer Points

Determining whether a supply involves an exempt "financial service" continues to be an issue for GST purposes. The term is defined in the ETA to include "the making of any advance, the granting of any credit or the lending of money," and "the agreeing to provide, or the arranging for, a service" that is a financial service. In *Royal Bank of Canada* (2007 TCC 281), the TCC said that consideration paid to an airline in exchange for frequent flyer points was not a payment for an exempt financial service for GST purposes.

The bank (RBC) made payments to Canadian Airlines International Ltd. (CAIL) under an affinity credit card agreement according to the number of frequent flyer points that CAIL issued to holders of the RBC Visa Canadian Plus credit card (the affinity card): affinity card holders received one point for every affinity card dollar spent, redeemable for CAIL's travel services. CAIL also participated in the program's establishment and operation, including advertising, marketing, and promotion. RBC was assessed for non-payment of GST; CAIL had already been assessed for non-collection on the same transactions.

RBC argued that it paid CAIL not for the points but for services in the nature of "arranging for" the "granting of any credit," an exempt financial service. The TCC reviewed the case law and determined that the dominant element of the supply was the issuing of points, not other services CAIL provided with respect to the program. CAIL's role in arranging the credit facility was incidental to the selling of points; CAIL had no business risk in the credit-granting process, and the payments could not be considered commissions for credit card usage. Moreover, the agreement itself said that the consideration was for the points, and thus case law that interpreted "arranging for" broadly was distinguished.

The TCC rejected RBC's alternative argument that the points were gift certificates and deemed not to be a supply under ETA section 181.2, but it said that the CRA's administrative policy that a gift certificate must have a stated or face value and be acquired for that amount was unsupported by the ETA and case law. The court said that it was not inconsistent with the ETA to treat the sale of points as a sale of coupons, a taxable supply. Furthermore, there was no double taxation: the ETA allows two parties to be assessed on the same transaction—the recipient for payment and the supplier for non-collection—and the RBC had only one payment obligation.

Royal Bank of Canada provides important guidance to financial service providers on the meaning of the term "arranging for" and to taxpayers involved in affinity (points) programs. The court appears to affirm that the supply of points is prima facie taxable. (The supply is likely in the nature of a supply of intangible property, given its genesis in a contractual right.) In practice, the incidental supply rule in ETA section 138 will often result in points acquired with the purchase of other goods, services, and intangible property being taxed in accordance with the tax status of the main supply. However, the court placed particular emphasis on the facts and the agreement in characterizing the supply, and said that frequent flyer programs are not necessarily subject to tax: "It is always a question of fact as to how GST will be applied in the context of a particular affinity or loyalty program." *Royal Bank of Canada* also provides excellent commentary on the meaning of a gift certificate for GST purposes, and effectively disposes of the CRA's long-standing administrative position that a gift certificate must have a stated or face value. The decision also confirms the validity of dual ETA assessments.

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

New Goods Not Assembly

A recent tariff classification decision by the Canadian International Trade Tribunal (CITT) illustrates that the structure of goods' importation can reduce customs duties and avoid anti-dumping duties.

On July 25, 2007, the CITT rendered its decision in *Tai Lung (Canada) Ltd.* (AP-2006-034) on the Canada Border Service Agency's customs classification of footwear components imported together: a boot upper made of leather, incorporating a metal toe cap and a plastic outer sole. After importation, Tai Lung subjected the components to a number of manufacturing operations in Canada to produce finished safety footwear sold at Canadian Tire stores. A CBSA audit concluded that the imported footwear components constituted complete footwear, classified under tariff heading 6403.40 of the Customs Tariff (dutiable at 18.5 percent). Tai Lung argued that the footwear components were parts of footwear, classified under tariff heading 6406.10.90 (dutiable at 8 percent).

Section 10 of the Customs Tariff states that classification of imports is determined under the general rules for the interpretation of the harmonized system and the Canadian rules set out in the schedule. According to the explanatory notes, the six general rules are set out in order of precedence. Tai Lung argued that the footwear components could be classified according to rule 1, "according to the terms of the headings and any relative Section or Chapter Notes, and provided such headings or Notes do not otherwise require, according to the following provisions," and that the imported goods fell squarely within heading 64.06 as "parts of footwear" and additional rules should not be considered. The CBSA argued that rule 2(a) applied: "Any reference in a heading to an article shall be taken to include a reference to that article incomplete or unfinished . . . that, as presented . . . has the essential character of the complete or finished article." The CBSA argued that the imported components had the essential character of the finished product and that the processes Tai Lung performed did not alter the principal features of the footwear, which was to cover the foot, ankle, and part of the leg. Furthermore, the outer soles were imported with the corresponding number and sizes of uppers, which had attached to them hanging tags describing the product, along with the price, labels, and laces.

Tai Lung said that it did not merely assemble; it subjected the goods to a variety of processing methods, including priming, gluing, heating, trimming, polishing, grinding, quality control, and testing—processes that resulted in the goods' taking on a new form and possessing different qualities and properties from the original components. Moreover, the footwear could not be sold until the footwear conformed to CSA safety standards; thus, the goods did not satisfy the rule 2(a) requirements for articles presented unassembled or disassembled. The CITT agreed: tariff heading 64.06 clearly encapsulated the imported goods as "parts of footwear," including uppers whether or not they were attached to soles other than outer soles. Rule 1 resolved the classification; resorting to rule 2(a) was unnecessary and improper. Even if there was ambiguity, rule 2(a) did not result in the classification of the goods as unassembled complete footwear under heading 64.03: the "further working" by Tai Lung went beyond mere assembly and changed the essential character of the goods so that the goods could be worn for their intended purposes.

Tai Lung is a good example of the distinction between goods that are "parts" and goods that are "unassembled or disassembled" for tariff classification and illustrates the benefits of carefully structuring an import transaction. Because "parts of footwear" rather than the fully assembled footwear were imported, the tariff rate dropped from 18.5 to 8 percent; the importer also saved a 39.4 percent anti-dumping duty on imports of completed footwear from China before December 27, 2006.

Greg Kanargelidis and Elysia Van Zeyl
Blake Cassels & Graydon LLP, Toronto

Sole Proprietor's Cash Damming

A recently released technical interpretation (TI 2006-0218241E5) confirms that interest on a line of credit is deductible when a sole proprietor commingles sales revenues with personal funds and uses the commingled funds to pay down a personal mortgage but only pays the proprietorship's business expenses by using the line of credit.

Paragraph 16 of *Interpretation Bulletin* IT-533, "Interest Deductibility and Related Issues," sanctions cash damming:

> Taxpayers may segregate (typically in separate accounts) funds received from borrowed money and funds received from other sources (e.g., funds received from operations or other sources and that are otherwise not linked to money previously borrowed). This technique, commonly referred to as cash damming, readily allows taxpayers to trace borrowed money to specific uses.

The CRA is of the view that the cash-damming techniques discussed in the IT include the scenario described in the TI. The TI says, "The CRA accepts that cash damming is consistent with the wording of paragraph 20(1)(c) as well as court decisions and serves to facilitate the tracing/linking process."

The TI confirms that the CRA's views on interest deductibility in IT-533 are still current, including its acceptance of cash damming. The recent FCA decision in *Lipson* (2007 FCA 113) created doubt that the CRA still considers cash damming acceptable. In *Lipson*, the FCA upheld the CRA's argument that GAAR applied to a series of transactions designed to convert non-deductible home mortgage interest payments into deductible interest payments on money borrowed to purchase shares. The SCC granted leave to appeal. In the application for leave, the taxpayer argued that the TCC and FCA decisions are inconsistent with earlier SCC decisions and thus carry major implications for Canadian taxpayers. In particular, both the TCC and the FCA relied on the concept of economic reality or overall purpose to find that GAAR applied. The taxpayer argued that introducing an "overall purpose" test for a borrower makes the law unclear.

Jim Yager
KPMG LLP, Toronto

Foreign Tax News

OECD

The OECD Web site published a public discussion draft of REITs' tax treaty issues. Interested parties should submit comments before January 15, 2008 to jeffrey.owens@oecd.org.

Australia

If elected, the Labour party will enact a plan that includes a water tax credit for approved desalination, water recycling, and storm water capture projects.

The Treasury issued a discussion paper proposing to eliminate most of the more than 100 unlimited assessment periods in income tax legislation—for example, for transfer-pricing adjustments. The unlimited period for reassessing frauds or evasion will remain.

Isle of Man

On October 30, 2007, first-time exchange-of-information agreements were signed with Denmark, Faroe Islands, Finland, Greenland, Iceland, Norway, and Sweden.

Effective November 1, 2007, three new fund categories will encourage the incorporation, domiciliation, and establishment of fund management operations.

Norway

Finance issued a letter of interpretation saying that its participation exemption holding requirement is determined at the level of a partnership and not at the level of the partners.

Jersey

In 2008, certain unregulated funds need not be approved by the financial regulator, have an audit, or have a Jersey-domiciled administrator, director, or custodian.

Argentina

A preferential tax regime has been established for R & D based on the application of modern biotechnology, which is defined as being derived from certain scientific disciplines and using live organisms (or parts thereof) for the production of goods and services or the substantial improvement of productive processes or products.

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)

New Zealand

An emissions-trading proposal, released September 2007, outlines the main tax issues. The plan is effective for forestry after 2007, liquid fuels after 2008, and all sectors by 2013. Submissions from interested parties were invited by October 28 (for forestry) and November 30, 2007 (for other sectors).

Netherlands

Finance's 2008 tax plan includes greening measures to better reflect the environmental costs of products in their consumer prices: new taxes on flight tickets and packaging materials, and an increase in tax on polluting and uneconomical cars and an excise duty on environmentally unfriendly fuels.

Sweden

Several 2008 budget measures aim to limit CO_2 emissions, increasing the tax on diesel and petrol; the tax on small trucks increases 45 percent.

China

The withholding tax exemption on dividends paid to a foreign investor is likely abolished after 2007 and a 20 percent tax imposed, except for designated encouraged sectors such as high technology.

Vivien Morgan
Canadian Tax Foundation, Toronto