CANADIAN TAX Highlights

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Interest on Line of Credit

Recently released technical interpretation TI 2007-0221071E5 indicates a change in the CRA's flexible approach to tracing and linking funds. The CRA now says that a taxpayer cannot specifically allocate repayments on the principal portion of an investment or personal line of credit to money that was borrowed for personal or ineligible uses: any repayment of the line of credit's principal portion reduces the borrowings used for eligible and ineligible purposes.

The example given in the 2007 TI was first presented to the CRA in a 2006 TI. Assume that the taxpayer has a personal line of credit for $60,000 on January 1 in year X. In January, the taxpayer increases the line of credit to $100,000, investing the extra $40,000 in securities. For January, the taxpayer says that she can deduct 40 percent of the interest on the line of credit of $100,000 for income tax purposes. The taxpayer then pays down the line of credit by $20,000 as of February 1 and argues that 50 percent of the interest owed on the line of credit was deductible: $40,000 of the $80,000 owing on the line of credit had been invested in securities. By extension, if the taxpayer then pays down the line of credit by another $40,000 as of March 1 (a new balance of $40,000), she will argue that 100 percent of the interest owed for the line of credit is deductible as long as the $40,000 from January was still invested in securities.

In the 2006 TI, the CRA agreed with the taxpayer. The 2007 TI concludes that this approach is not in line with its views or the courts' on the flexible approach to tracing and linking funds. The CRA says this approach allows taxpayers to allocate repayments to specific advances from a line of credit, contrary to the finding in *Colin C. Mills* (85 DTC 632 (TCC)) and the intent of paragraph 20 of IT-533. The CRA says that paragraph relates to tracing to eligible uses borrowed money that was commingled with cash in an account with cash and does not relate to tracing or allocating repayments of money borrowed for various uses under a single line of credit to specific eligible or ineligible uses. Any repayment of the principal owing under a line of credit reduces the portions used for both eligible and ineligible purposes. Accordingly, the CRA says that the taxpayer in the 2007 TI cannot allocate payments on the personal line of credit to borrowings for personal or ineligible uses. When the line of credit rises to $100,000, its use is 60 percent ineligible and 40 percent eligible. Any payments on the line of credit are made in that same 60:40 ratio, and any interest paid is deductible in that ratio. Thus, in the above example, as of March 1 when the loan balance is $40,000, the taxpayer may deduct the interest expense on only $16,000 of the loan: 40% × $40,000.

In the 2007 TI, the CRA says that the taxpayer may dispose of the investment and pay off the $40,000 March 1 balance in the line of credit and then reacquire the investment with a $40,000 line of credit (or other borrowing), for which the interest is 100 percent deductible. The CRA notes that the disposition must be reported for tax purposes; if a loss arises within 30 days of the same investment's being reacquired, the superficial loss rules apply. In another technical interpretation dated September 2007 (TI 2006-0218381E5), the CRA gave virtually the same response to a situation involving a mortgage account that was increased to purchase securities.

The CRA's revised position seems to result in inequitable treatment for taxpayers who are in substantially similar circumstances—the taxpayer in the TI and a taxpayer who restructures his or her borrowings as the CRA suggests.

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In This Issue

Joint Tenancies: US Tax Pitfalls

Canadian spouses frequently hold property as joint tenants to avoid provincial probate fees. However, if one spouse is a US citizen, joint tenancy may give rise to an increased US tax liability that often outweighs the savings on probate. Several US tax issues should be considered before a joint tenancy is created between a US citizen and a Canadian spouse.

Stepped-up basis on death. A US taxpayer who sells property realizes a taxable gain equal to the difference between the US tax basis and the sale price. The basis depends on whether the taxpayer purchased the property or obtained it as an inter vivos gift or on the previous owner's death. Property received on the owner's death generally enjoys a step-up in basis to its FMV on the date of death. If a co-tenant dies and leaves his half of the property to the other tenant, the survivor takes a stepped-up basis in the decedent's half; the new overall basis is the average of the original basis and the FMV at the death. But if the property is held in joint tenancy (or as tenancy by the entirety), the decedent was not a US resident or citizen, and the property is not located in the United States, then the surviving joint tenant may not receive a step-up in basis; the Code allows a step-up only if the value of the decedent's gross estate for US estate tax purposes included his share of the subject property.

A non-US-citizen or domiciliary decedent is not subject to US estate tax on property not located in the United States; thus, the property is not included in the decedent's gross estate and there should be no step-up. It is unclear whether the surviving joint tenant carries over the decedent's basis or must take a zero basis in the decedent's half. However, it is arguable that although the estate tax is imposed only on the gross estate of US citizens and residents, all individuals have a gross estate; under this view, the surviving joint tenant should receive a stepped-up basis.

The lack of a step-up in basis on a joint tenant's death can be a considerable detriment. Assume that a Canadian-citizen and Canadian-resident husband and his US-citizen wife own vacation property in Europe. Each has a $250,000 basis in the property, for a total of $500,000. The husband dies when the property is worth $1 million and his share passes to his wife. If the two spouses hold the property as tenants in common, the wife's new basis is $750,000 ($500,000 date-of-death value for the husband's share plus the wife's original $250,000). A sale of the property at $1 million triggers a reportable gain of $250,000 on the wife's US income tax return. However, if the property is held in joint tenancy and the wife is not allowed a stepped-up basis—but assuming that she can carry over her husband's basis—the wife's new basis is $500,000 (her husband's original $250,000 basis plus her $250,000 basis). A subsequent sale at $1 million yields a reportable gain of $500,000 on the wife's US income tax return.

Tracing requirement on death of joint tenant. If assets are held jointly and one spouse is not a US citizen, the entire value of the jointly owned asset is prima facie included in the US-citizen decedent's gross estate unless the estate can prove that some of the purchase price was contributed by the surviving joint tenant. If the surviving joint tenant is also a US citizen, only one-half of the property is included in the decedent spouse's estate.

Assume that a US-citizen wife predeceases her Canadian husband. Her only substantial asset is a Canadian brokerage account held jointly with her husband, the primary wage earner, who contributed all the account's assets. The value of the entire account is included in the wife's US estate unless the estate can provide adequate records of his contributions to the account, in which case none of it is included.

If the couple knows that their records are inadequate, they should consider severing the joint tenancy while both spouses are alive. When joint property is severed during life, there is less scrutiny, and it is likely that the couple need not provide documentation of their individual contributions. Nevertheless, to avoid making a potentially taxable gift, the value of property allocated to each spouse on the severance should be roughly proportionate to the value of his or her contributions to the account.

Possible gift on creation of joint tenancy. For US gift tax purposes, if an individual purchases real property and conveys title to himself and another as joint owners who can unilaterally sever the joint tenancy, there is an effective gift of one-half of the property to the donee. The governing regulation refers to another regulation, which provides that no gift occurs if the joint tenants are husband and wife. However, the cited regulation has been revoked, and thus it is unclear whether a US taxable gift occurs on the creation of a joint tenancy between a husband and wife. The uncertainty is inconsequential if both spouses are US citizens, because they are entitled to an unlimited gift tax deduction for gifts to spouses: even if a gift occurs, they can claim the deduction and avoid any tax. However, if the donor spouse is a US citizen and the donee spouse is not, the gift tax marital deduction is limited to $125,000 per year ($128,000 in 2008). If a US-citizen wife purchases real property and takes title as joint tenant with her Canadian husband, a gift may occur on the joint tenancy's creation, and the wife may be liable for US gift tax (or use her lifetime gift tax credit) if the gift's amount exceeds $125,000.

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OBCA Changes

Recent amendments to the Ontario Business Corporations Act (OBCA) allow the issuance of separate classes of shares without differentiating attributes. Other provisions expand and clarify when high-low shares may be issued in respect of property transfers and stock dividends, respectively.

■ New OBCA section 22(7) permits two or more classes (or series within a class) of shares to be issued even though the shares may be identical or virtually identical to shares in another class or series in terms of their rights, privileges, and restrictions. In other words, two classes of shares can now be identical in all respects except their name. This provision will facilitate the payment of discretionary dividends via the use of multiple classes of shares in estate freezes and similar transactions. Prior to this amendment, corporate lawyers generally were forced to be creative in characterizing slight variations in the share classes' terms in order to legally establish separate classes of shares. If the share attribute variations were so minor (such as a $1 preference on liquidation) as to call into question whether the shares could be recognized as distinct classes of shares, a significant concern arose because of the tax and economic factors attached to each class of shares.

■ New OBCA section 24(3)(a)(iii) allows the directors of an OBCA corporation to set the stated capital (and hence the paid-up capital) at any amount up to the FMV of property exchanged on the issue of shares, whether the parties are at arm's length or not. The extension of this flexibility from non-arm's-length transactions is a welcome change. Previously, an arm's-length section 85 rollover could result in a different corporate stated capital (equal to the transferred property's FMV) from the tax paid-up capital. (ITA subsection 85(2.1) reduces the paid-up capital of shares issued on a section 85 rollover to the elected amount.) This difference set the stage for future problems by creating a trap for the unwary. Moreover, this problem could never be corrected because a subsequent reduction of stated capital (allowed under OBCA section 34) also reduced tax paid-up capital.

■ New OBCA section 38(2) allows the amount of the stated capital (and hence the paid-up capital) of a stock dividend to be set at any amount up to the issued shares' FMV. Previously, OBCA section 38(2) required that a corporation add the "declared amount" of a stock dividend to the shares' stated capital account. Under section 23(3), a corporation cannot issue shares until the consideration therefor is fully paid in money, property, or past service, and then it must add that full amount to the appropriate stated capital account. There was a question whether shares issued as a stock dividend were issued for consideration (and thus whether the stated capital account must equal FMV). If the stock dividend shares could be said not to be issued for consideration, then the amount added to stated capital need not bear any relation to that FMV, although this view was not free from doubt.

As a matter of corporate law, the usual procedure is to declare a dividend of a particular amount and provide that it be paid by the issuance of shares. Because the paid-up capital is generally the amount of the dividend for income tax purposes (but see the more complex definition of "amount" in subsection 248(1)), new section 38(2) facilitates the issuance of high-value stock dividends by private corporations to shareholders by limiting immediate tax consequences to a minimum. (High-low stock dividends in public corporations are also permissible, but note that part II.1 of the ITA can create a tax trap on any subsequent corporate buyback of issued shares.) Although good arguments (as noted above) could be made that high-low stock dividends were permitted under the prior OBCA, there was no specific provision authorizing the setting of low stated capital for shares issued via stock dividends. The path is now clear to allow for giving a "clean" corporate opinion on the issue and to allow for the implementation of transactions calling for high-low stock dividends by an OBCA corporation.

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Intangible Supply Exports

After the federal budget date of March 19, 2007, amended export rules extend GST zero rating to a broader range of intangible property supplied to a non-resident; zero rating also applies to earlier supplies if the supplier did not charge or collect GST/HST (section 10.1 of part V of schedule VI of the Excise Tax Act).

Before the budget announcement, section 10 of the rules zero-rated intellectual property supplied to a non-resident only if the non-resident was not GST-registered. Intellectual property means an invention, patent, trade secret, trademark, trade name, copyright, industrial design, or other intellectual property, and any right, licence, or privilege to use any such property. In 1998, the minister's response to an advisory committee report on electronic commerce raised the possibility of extending zero rating to a broader range of intangible property to deal more effectively with e-commerce issues.

Section 10.1 is useful in zero-rating subscriptions to Web sites that offer access rights to and the use of digitized content, including the right to download. However, section 10.1 excludes, inter alia, a supply of intangible property "that may only be used in Canada"; it is too early in the provision's interpretive evolution to tell how restrictive an interpretation the CRA will apply to this exclusion. Section 10 has always been lacking in its ability to zero-rate the supply of goodwill to a non-resident, a scenario more frequently encountered as businesses try to park their intangible property outside Canada. A Canadian business may decide to sell its goodwill as part of a bundle of intangible property, with the exact split between goodwill and intellectual property rights not always readily determinable. In the past, GST was exigible on the consideration attributable to goodwill; the non-resident's GST registration (if available) was its only hope of recovering the GST. Under section 10.1, the options with respect to goodwill appear just as bleak. If goodwill is generated solely on activities undertaken in Canada, and its value in generating revenue is only of relevance to the Canadian marketplace, can one successfully avoid the exclusion by arguing that the goodwill may also be used outside Canada? If the purchase agreement does not contain a restrictive covenant limiting the use of the goodwill to Canada, can the contracting parties argue that the goodwill is not technically restricted to use in Canada and thus obviate the exclusion's application?

Distribution rights may be supplied to non-residents to enable them to sell product in Canada without owning or having the right to use the underlying product—a not uncommon practice, for example, for distributors in the IT industry. A GST-registered non-resident software licensor may provide distribution rights to a non-registered non-resident to resupply the software exclusively in Canada. The distribution rights, severed from any rights to the underlying software, are presumably not zero-rated under either section 10 or section 10.1 of the export rules. Taxing such a supply of distribution rights arguably achieves a desired policy result because the non-resident distributor that registers to recover the GST charged to it must charge GST on the supply of the software in Canada. However, unexpected tax exposure and unequal treatment may also result, depending on how the Canadian rights are ultimately packaged. For example, if Canadian and US rights are supplied separately (not bundled as North American rights), GST may apply to the Canadian element, to the surprise of the unsuspecting vendor—particularly a non-resident vendor selling to a non-resident distributor.

Section 10.1 is clearly successful in addressing many of section 10's more egregious shortcomings. However, introducing exclusions that limit zero rating increases interpretive complexity and leaves pitfalls for unwary IP suppliers of intangible property.

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Rented Shipping Pallets RST-Exempt

Non-returnable containers and other packaging materials used to deliver products for sale are not subject to Ontario retail sales tax (RST) under administrative policy and section 7(1)(41) of the Retail Sales Tax Act (RSTA). Returnable containers generally attract RST. Contemporary packaging and shipping practices have made the application of these rules less certain. In *Proctor & Gamble* (2007 ONCA 784), the Ontario Court of Appeal clarified the RST status of returnable wooden shipping pallets in a decision likely to benefit manufacturers, distributors, and other users of such pallets.

The taxpayer manufactured, distributed, and marketed various commercial goods that it sold to high-volume retailers. In order to ship product to its customers, the taxpayer stacked boxes of the goods on wooden pallets and secured the loaded pallet with industrial-strength stretch wrap: the "palletized product" was the unit sold to the customer. Some customers sold the goods directly from the pallet off their sales floors. The particular pallets used were preferred or even required by many customers because their four-sided access facilitated handling by forklifts and handjacks. The taxpayer rented the pallets from a pallet company; the invoiced amount included RST. The taxpayer did not charge a customer directly for its cost for a pallet, but factored the amount into the price that it charged the customer for the goods. The pallet company picked up the unloaded pallets from the taxpayer's customers' premises and cleaned, repaired, and stockpiled them for reuse.

Refund claims for RST paid on the pallets were disallowed; the minister said that the pallets were never "sold" to the taxpayer's customers because the pallet company retained title to the pallets. The taxpayer sought a declaration (by application to the Ontario Superior Court of Justice under rule 14.05(3)(d)) that it acquired the pallets for the purpose of resale and was therefore not a "purchaser" liable to pay RST, or, alternatively, that the taxpayer purchased the pallets for the purpose of attaching or incorporating them into tangible personal property for the purpose of sale, and therefore the purchase was exempt under section 7(1)(41). That exemption excepts "a returnable container for use or sale in Ontario."

The Superior Court of Justice said that the taxpayer was a purchaser as defined in the RSTA: it used the pallets for its own benefit (to move raw materials and to ship and store finished goods) and was thus not entitled to the first declaration. The court also concluded (although the finding was not necessary, given its first conclusion) that the taxpayer "sold" the pallets to its customers when it transferred the pallets to them according to the RSTA definition of "sale": "any transfer of title or possession . . . whereby at a price or other consideration a person delivers to another [TPP]." In the court's view, consideration passed from the customers to the taxpayer because the rental charges for the pallet were factored into the overall price for the goods. However, the court said that the pallets were an essential part of the overall package sold: a palletized and plastic-wrapped package of consumer goods. The pallets could be viewed as "attached to" the taxpayer's goods by the stretch wrap, or "incorporated into" a final palletized product, and were attached to or incorporated into the goods "for the purpose of sale," given the conclusion that the transfer of pallets to the customers was a "sale." Moreover, the pallets were not "returnable containers" as defined—containers "intended to be returned to be refilled by a manufacturer." On the facts, the pallets were never intended to be returned to the taxpayer and could not be "refilled"; they were reused by a large cross-section of users, not all of which were manufacturers. The pallets met the section 7(1)(41) exemption and were not excepted therefrom.

The Crown appealed to the Ontario Court of Appeal, saying that the lower court erred in concluding (1) that the pallets were "attached to" the taxpayer's goods or were "incorporated into" a final product, and (2) that the pallets formed part of the taxpayer's goods "for the purpose of sale." (The finding that the pallets were not "returnable containers" was not appealed.) As to whether the pallets formed part of the taxpayer's goods "for the purpose of sale," the court said that it was open to the lower court to find that the customers paid some consideration for the pallets received from the taxpayer and thus that the transfer of pallets to the customers was a "sale" under the RSTA. The definition of "sale" under the RSTA was more expansive than just a passage of title.

As to whether the pallets were "attached to" the taxpayer's goods or were "incorporated into" a final product, the court was satisfied that it was open to the lower court to find that the taxpayer sold a palletized package consisting of a stretch-wrapped pallet stacked with consumer goods. This conclusion was supported by the evidence and reflected the marketing techniques employed to meet the needs of big-box stores, which "prefer, even require, a palletized product." The Ontario Court of Appeal, in substantial agreement with the lower court's reasons, dismissed the Crown's appeal.

Both courts in *Proctor & Gamble* confirmed that a transfer of title is not required to constitute a "sale" for the purposes of the RSTA section 7(1)(41) exemption: a transfer of possession and consideration (even simply a recovered cost) is sufficient. Both courts narrowly interpreted the phrase "returnable container," limiting the scope of the exception to the exemption. Thus pallets and other returnable packaging may meet section 7(1)(41) without being excepted. However, whether a particular container or package is "attached to" or "incorporated into" tangible personal property is highly fact-dependent. As the Ontario Court of Appeal noted, the RSTA may easily be amended to tax pallets that are recycled and re-leased by their owner.

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Ontario CMT: Unrealized Gains and Losses

Ontario regulation 509/07 to the Corporations Tax Act, filed August 27, 2007, eliminates the adverse Ontario corporate minimum tax (CMT) effects of accounting changes created by Accounting Guideline AcG-18, "Investment Companies."

For fiscal years beginning after June 30, 2004, AcG-18 requires "investment companies" (including many investment holding corporations) to measure their investments at FMV and to include the resulting gains and losses in accounting income. An investment company for these purposes is generally either an investment fund (as defined by the Canadian securities regulatory authorities) or a separate legal entity whose primary business activity for the period is investing. Taxpayers should refer to AcG-18 to determine whether a company is an investment company.

Because CMT is computed using GAAP net income, CMT may be triggered on the unrealized gains mandated by AcG-18. Even if the corporation prepares notice-to-reader non-GAAP financial statements that record the investments at cost, for CMT purposes GAAP net income must be calculated and used. Although any CMT paid can be carried forward 20 years (10 years for taxation years ending before March 23, 2007) to reduce a corporation's regular Ontario income tax liability, CMT is an absolute cost to the company if the carryforward expires (because, for example, the corporation has a long-term-hold strategy for investments).

Ontario regulation 509/07 excludes from income for CMT purposes any unrealized gains and losses that are not required to be included in computing income for income tax purposes. The rule applies both to mark-to-market changes in asset values and to unrealized foreign currency gains and losses related to assets. The regulation is effective for taxation years ending after March 22, 2007 (as proposed by Ontario's 2007 budget), and for earlier taxation years beginning after June 30, 2004 if the corporation files an election "in the form approved by the Minister" within 180 days of the regulation's filing date (presumably before February 23, 2008). It is not expected that a form will be prescribed; the election can be made in a letter. To eliminate any potential CMT exposure for prior years, an investment company should consider filing the election before February 23, 2008. Information Notice 6023, "Corporations Tax Act Regulation for Corporate Minimum Tax" (August 2007), provides additional information.

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Ontario Harmonization and CMT Update

The CRA may begin partial administration of the harmonized Ontario-federal corporate tax system as early as December 2007. Current CRA plans envision that the majority of Ontario corporate tax administrative functions will be integrated with the federal system as of April 2008.

Ontario's harmonized tax system takes effect for an Ontario-resident corporation's taxation years ending after December 31, 2008. Under the harmonized system, the CRA will administer Ontario's corporate income tax, capital tax, corporate minimum tax, and special additional tax paid by life insurers. The CRA provided an update on the transition of responsibilities to it from the Ontario Ministry of Finance at a recent meeting of the Tax Practitioners Consultation Group in London, Ontario. Currently, Ontario Finance is the contact for inquiries concerning the Ontario Corporations Tax Act, and it will continue to publish interpretation bulletins and related documents addressing corporate taxation for years ending before 2009. However, the CRA advises that as of December 2007, it will respond to inquiries relating to taxation years beginning after 2008 (the harmonized taxation years). The CRA will also receive combined tax instalments beginning in February 2008.

According to the CRA's update, it will hire experienced Ontario Finance employees effective April 3, 2008, when it becomes the contact for certain processes related to pre-harmonization taxation years: (1) The CRA handles new (integrated) audits of all large corporations and assumes Ontario audits in progress. New audits of small businesses shift in phases to the CRA, with full transition by April 2009. (2) The CRA assumes the majority of ongoing Ontario objections and the majority of new objections. (3) The CRA administers any appeals related to objections that it processes. (4) The CRA deals with all inquiries for the Income Tax Act and Ontario's Corporations Tax Act and Taxation Act, 2007. The CRA plans to create a new division within its income tax rulings directorate to address requests for rulings and interpretations relating to Ontario corporate taxation. (5) The CRA processes all Ontario credits, including pre-assessment reviews for R & D refundable tax credits.

Ontario CMT fix for rising Canadian dollar. A 2007 Ontario budget measure removed unrealized foreign exchange gains and losses from the corporate minimum tax (CMT) base to prevent a CMT liability otherwise arising because of the strengthening Canadian dollar. A taxpayer who broke even or realized a net loss in the year because of poor export sales arising from a relatively stronger Canadian dollar might otherwise be faced with a surprise CMT liability. Assume that an Ontario-based Opco issued US$20 million of debt in December 2006, when the Canada-US exchange rate was $1.17, and used the funds to acquire capital property for use in its business. At Opco's July 31, 2007 year-end, the exchange rate had fallen to $1.07, and Opco must report an unrealized foreign exchange gain of almost $2 million for financial statement purposes. In the absence of the new regulation, a CMT liability would result because unrealized foreign exchange gains were recognized for Ontario CMT purposes, which follows financial statement treatment, but not for income tax purposes.

Ontario Finance has indicated that the CMT changes in regulation 509/07 are intended to exclude from CMT unrealized gains or losses that are not required to be included in computing income for income tax purposes. In August 2007, Ontario Revenue issued a Corporations Tax Information Notice to provide details on the amendments. The budget says that CMT measures are effective for taxation years ending after March 22, 2007; the bulletin adds that the regulation also applies to taxation years beginning after June 30, 2004 and ending before March 23, 2007 if the corporation makes a written election within 180 days of the regulation's filing date. Because the regulation was filed on August 27, 2007, the election presumably must be made before February 23, 2008. A corporation cannot elect to apply the rules only to specific taxation years during this period (taxation years beginning after June 30, 2004 and ending before March 23, 2007).

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Foreign Exchange Gains and Losses

A recent technical interpretation revisits the thorny issue of when a corporation realizes a foreign exchange gain (or sustains a foreign exchange loss) under subsection 39(2) on a redemption of its own shares (document no. 2007-0228601I7, available only in French).

In 1999, the FCA held in *MacMillan Bloedel* (99 DTC 5454) that a corporation can sustain a foreign exchange loss on a redemption of its US-dollar-denominated preferred shares if the value of the Canadian dollar relative to the US dollar is lower on the redemption date than on the issue date. The CRA accepted *MacMillan Bloedel*, but struggled to define parameters for its application. The recent TI clearly attempts to limit *MacMillan Bloedel* on a principled basis (at least as it applies to the redemption of shares), but the approach is novel, differs from previous positions, and may have significantly (and perhaps unintentionally) broader application.

On the TI's facts, a Canadian corporation (Parentco) owned a Canadian sub (Canco) and a controlled foreign affiliate (CFA). Parentco transferred CFA to Canco in exchange for shares with a US-dollar redemption amount. In a subsequent year, after the Canadian dollar appreciated in value against the US dollar, Parentco incorporated another Canadian sub (Sisterco), to which Canco rolled the CFA shares for US-dollar preferred shares; at the time, Canco had an accrued foreign exchange gain on the CFA shares. Sisterco redeemed for a note its US-dollar preferred shares held by Canco, thereby converting Canco's accrued gain into a tax-free intercorporate dividend (but with no corresponding loss to Sisterco). In the course of a reorganization of Canco's capital under section 86, Parentco exchanged its US-dollar preferred shares for Canadian-dollar preferred shares. Because the Canadian dollar had appreciated in value against the US dollar, the amount that was added to the legal stated capital of the Canadian-dollar preferred shares exceeded the original Canadian-dollar equivalent of the subscription price for the US-dollar preferred shares. The share-for-share exchange did not result in a deemed dividend to Parentco. The TI concluded that Canco did not sustain a foreign exchange loss under subsection 39(2) on the exchange.

The TI's conclusion makes sense in the circumstances, but the CRA's approach is interesting and somewhat inconsistent with its previously published administrative positions. In essence, the CRA concluded that Canco did not sustain a loss on the share-for-share exchange because the transaction did not affect its "patrimony," a civil-law concept that loosely refers to all of a person's assets and liabilities (a person's financial "soul"). The TI suggests that a taxpayer can realize a gain or sustain a loss under subsection 39(2) only by transferring money or other property from its patrimony to another person. The equity-for-equity exchange did not involve a transfer of property.

Requiring a taxpayer to actually transfer or dispose of property before subsection 39(2) applies departs from previously published administrative positions. For example, an earlier TI indicated that a debtor's foreign exchange gain or loss on a conversion of debt into shares would depend on the amount paid by the debtor to settle the debt, a determination largely dependent on the amount added to its legal stated capital on the conversion (document no. 2004-0085081E5). In contrast, the recent TI said that the "amount paid" by the corporation on its share conversion was irrelevant in determining its subsection 39(2) gain or loss because that amount did not relate to property transferred from the corporation's patrimony.

Although the TI's conclusion as it applies to equity-for-equity exchanges is probably correct, questions arise as to the application of subsection 39(2) to other debt or equity exchanges (debt-for-equity, equity-for-debt, and debt-for-debt exchanges): many taxpayers have long maintained that the provision requires an economic analysis of gain or loss, and thus no gain or loss results on any such exchanges. For example, if a taxpayer amends a foreign-currency-denominated debt obligation to extend its maturity date, should it realize a foreign exchange gain or loss if the debt's fundamental terms are significantly altered? (See *General Electric*, 2002 DTC 6734 (FCA).) Previously, the CRA applied subsection 39(2) whenever amendments created a new debt—for example, in document no. 9721495. The recent TI suggests a new acceptance of an economic analysis for subsection 39(2), which may not only preclude the recognition of foreign exchange losses in circumstances such as the TI's equity-for-equity exchange, but may also avoid recognition of foreign exchange gains in other circumstances where no economic gain is realized.

The recent TI does not appear to alter the CRA's acceptance of *MacMillan Bloedel*'s general proposition that a foreign exchange gain (from the holder's perspective) can be converted into a tax-free intercorporate dividend without affecting the foreign exchange loss sustained by the payer. This is implicit in the TI. However, it appears that the TI's taxpayer did not redeem the Canco Canadian-dollar preferred shares because their PUC may have been less than their ACB and a redemption would trigger a capital gain for the holder, not a tax-free deemed dividend. This followed because the PUC of the US-dollar preferred shares was maintained in US dollars; the US dollar depreciated, and when the shares were converted to Canadian-dollar preferred shares under section 86, the PUC may have been limited under subsection 86(2.1) to the Canadian-dollar equivalent of the original US-dollar subscription price on the original subscription. The CRA's longstanding but much debated position is that the PUC of US-dollar shares must be converted into Canadian dollars on the subscription date. (See *Interpretation Bulletin* IT-463R2, paragraph 6.) Unfortunately, the CRA did not specifically address the issue, and its resolution must wait for another day.

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Iceland-US Treaty Signed

On October 23, 2007, a new Iceland-US treaty and protocol was signed to replace the existing treaty. The treaty is generally consistent with the 2006 US model treaty; for example, it does not provide for a nil rate of withholding on parent-subsidiary dividends. Unlike the pending protocol with Canada, it does not contain a mandatory arbitration clause. Inter alia, the treaty (1) introduces a comprehensive limitation-on-benefits (LOB) article, including a triangular provision; (2) modernizes the dividend, interest, and capital gain articles; and (3) allows withholding tax on certain royalty payments.

The treaty enters into force following ratification by each country. The US process involves a hearing by the Senate Foreign Relations Committee (unlikely to be scheduled before 2008), approval by the full Senate, and ratification by the administration. For withholding taxes, the treaty is effective on income derived after the year in which the treaty enters into force; for all other taxes, the treaty takes effect for taxes chargeable for any tax year beginning after that year. Certain taxpayers may elect to have the old treaty apply for one additional year. Most affected taxpayers will thus have a two-year window in which to consider alternative structures.

The new LOB article 21 generally provides that a treaty-resident company eligible for treaty benefits must satisfy one of several tests. The derivative benefits test (paragraph 3) is of most interest to a Canadian multinational with an Icelandic sub: generally, the Icelandic sub must initially satisfy both an ownership and a base erosion test. The ownership test is met if no more than seven persons own directly or indirectly at least 95 percent of the votes and value of the Icelandic sub; those persons must be resident in member states of the European Union or the European Economic Area, or in parties to NAFTA or the European free trade agreement (EFTA). The base erosion requirement is met if less than 50 percent of a company's gross income for the tax year is paid or accrued, directly or indirectly, in the form of deductible payments to persons who are not residents of EU, EEA, NAFTA, or EFTA member states. Moreover, for dividends, interest, and royalties, the Canadian parent must be entitled to the Canada-US treaty rate on the item that is at least as low as the rate provided to the sub under the Iceland-US treaty.

In short, the treaty essentially provides that a Canadian parent must first qualify under the Canada-US treaty LOB rules. With respect to dividends, interest, and royalties, the Canadian must also be entitled under that treaty to an equally low tax rate on the item of income. For example, if the Iceland treaty has full effect after 2008 and Canada's rate on interest does not reach nil under the new Canada-US protocol until 2010, then the sub may be subject to 30 percent US withholding on interest it receives in 2009 because it does not satisfy the complete derivative benefits test until 2010.

The Iceland LOB article goes another step further. It contains a triangular provision that applies with limited exceptions to all income categories, similar to the recent Germany-US protocol. If an Icelandic-resident enterprise derives US income attributable to a PE of the enterprise in a third state, the treaty benefits otherwise applicable are generally denied if the tax actually paid with respect to such income in the residence state and the third state is less than 60 percent of the Icelandic tax applicable if the income was earned solely there. The benefits on dividends, interest, and royalties are not completely denied, but are subject to 15 percent withholding.

A 5 percent withholding tax continues on certain intercorporate dividends (15 percent otherwise). A 5 percent branch profits tax may be imposed. The new treaty generally continues the zero rate of withholding tax on interest, but for certain types of contingent interest (determined with reference to receipts, sales, income, profits, or other indices), the source state may impose up to a 15 percent withholding tax. The general exemption on royalties continues, but a 5 percent withholding tax applies to royalty consideration for the use of, or the right to use, (1) a trademark; (2) any information concerning industrial, commercial, or scientific experience provided in connection with a rental or franchise agreement that includes rights to use a trademark; and (3) a motion picture film or work on film or videotape for use in connection with television. An unusual rule generally deems a royalty to arise in a contracting state in which the payer is a resident; the previous rule deemed a royalty to arise in a state if it related to the use of or a right to use intangible property in that state. The capital gains article has been modernized and repeals the prior exemption from bilateral taxation for investment in real property holding company shares.

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Foreign Affiliate Computations Morph

Draft legislation of October 2, 2007 substantially revised the rules for computing foreign affiliate (FA) income and capital gains and losses, including the relevant currency. The ensuing November 13, 2007 notice of ways and means motion restored the rules—principally paragraphs 95(2)(f), (f.1), and (f.2)—to their February 27, 2004 version. The October 2007 rules were in large part relieving or clarifying and were generally retroactive to taxation years beginning after December 20, 2002. It is assumed that Finance received a number of questions and comments about some aspects of the October 2007 rules (including their retroactive impact), and that Finance then withdrew the rules so as not to impede the enactment of the balance of the draft legislation (Bill C-28). Thus, one may anticipate a later reintroduction, with modifications, of a major portion of the October 2007 rules.

■ The October 2007 rules provided that the Canadian dollar must be used to compute (1) capital gains and losses (other than from excluded property), and (2) income or loss from property (other than paragraph 95(2)(a) amounts recharacterized as active business income) and from a non-active or a non-qualifying business (generally, an active business carried on in a jurisdiction that has declined to sign a tax information exchange agreement). All other amounts were generally computed using the FA's calculating currency. The October 2007 rules changed the 2004 proposal so that FAPI-included capital gains and losses on

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excluded property (such as gains under paragraph 95(2)(c)) were not computed in Canadian dollars. If a receipt, expenditure, or other amount must be converted into Canadian dollars or a calculating currency from the currency in which the amount arose, the October 2007 rules required the use of the noon-quoted Bank of Canada rates for the day on which the item was accounted for. The use of daily exchange rates instead of a monthly or an annual average may be a compliance burden for many taxpayers.

■ A basic component of the February 2004 version of paragraphs 95(2)(f) and (f.1) is that income, gains, and losses that were accrued before a non-resident corporation was an FA of a taxpayer (and some other non-arm's-length persons) are excluded from the FA's amounts. For example, under paragraph 95(2)(f), a non-resident corporation can only be an FA of a Canadian resident; pre-acquisition gains and losses of an FA acquired from a non-arm's-length foreign parent are carved out. The October 2007 proposal removed the requirement that the non-arm's-length person hold the shares as an FA: thus, retroactive to December 20, 2002, such gains and losses were no longer eliminated. This change went beyond taxing accrued gains and losses earned on behalf of a non-arm's-length Canadian resident, a result that was questionable on policy grounds and may have contributed to the withdrawal of the October 2007 rules.

■ Currently proposed paragraph 95(2)(f) contains wording designed to prevent the elimination of pre-acquisition gains and losses to a taxpayer on a non-arm's-length transfer under an amalgamation or windup. The October 2007 rules included welcome relief for amalgamations (in addition to the current law's relief for windups) that are part of an arm's-length acquisition of a Canco that owns FAs; the non-arm's-length restrictions (subsection 95(2.6), noted below), however, appeared to frustrate the intended carve-out of pre-acquisition gains and losses on certain arm's-length transactions.

The determination of whether a gain or loss accrued in respect of a non-arm's-length person is based on two or more entities having a non-arm's-length relationship throughout a particular period. For this purpose, the current rule assumes that a discontinued entity continues to exist and thus could have a non-arm's-length relationship with an FA's subsequent owner throughout the period. The rule is deficient for some newly formed FAs' subsequent owners and has been replaced with a "deemed prior existence" rule for subsequent owners (subsection 95(2.6)). Unfortunately, subsection 95(2.6) may sometimes be read as creating a non-arm's-length relationship in years preceding an FA's arm's-length acquisition. For example, if a newly incorporated Canco 1 acquired Canco 2 (with an FA) from an arm's-length person, the FA could not exclude gains and losses accrued prior to Canco 1's acquisition. It is expected that subsection 95(2.6) will be modified before it is reintroduced.

■ Clauses 95(2)(f.2)(iv)(B) and (C) provide that an FA must compute its share capital in its calculating currency. Finance has yet to release draft legislation dealing with its new "foreign paid-up capital" (FPUC) concept, but these clauses may portend Finance's saying that capital and FPUC should be computed in the FA's calculating currency and not in Canadian dollars (as previously discussed in various comfort letters).

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Foreign Tax News

New Zealand

The Climate Change (Emissions Trading and Renewable Preference) Bill was introduced, covering all sectors and all greenhouse gas emissions. A 10-year restriction is placed on new fossil-fuelled thermal electricity generation (unless required to secure the country's electricity supply).

A recently released consultative paper proposing changes to the petroleum mining expenditure tax rules is designed to remove uncertainty and disincentives in the current rules. Comments should be submitted by January 17, 2008 to the Inland Revenue petroleum mining project group.

United States

Treasury released reports on studies into the US earnings-stripping rules, the US transfer-pricing rules, and US tax treaties. The last study focuses on the need to prevent third-country residents from inappropriately benefiting from US treaties, particularly via US withholding tax reductions.

Confédération Fiscale Européenne (CFE)

A CFE conference held in Brussels in November 2007 focused on the topic of "Tax Advisers—Undermining or Enhancing the Tax System?"

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