CANADIAN TAX Highlights

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Volume 16, Number 1, January 2008

Canada-US Zero Interest Withholding

On December 14, 2007, Canada ratified the fifth protocol to the Canada-US treaty. The protocol comes into force after it is ratified by the United States, likely sometime in 2008, and notices of ratification are exchanged. Key protocol measures include (1) elimination of withholding taxes on cross-border interest payments (phased in over three years for interest paid or credited to related-party lenders); (2) extension of treaty benefits to limited liability companies (LLCs); (3) denial of treaty benefits for payments to and from certain hybrid entities such as unlimited liability corporations (ULCs); (4) comprehensive limitation-on-benefits (LOB) provisions applicable to both Canada and the United States; (5) changes to the permanent establishment (PE) definition for service providers; (6) changes to the dual residence rules; and (7) the introduction of new arbitration measures.

On the same day that Canada ratified the protocol, it enacted important changes eliminating Canadian domestic withholding tax on most interest paid to arm's-length non-resident lenders (other than interest paid on participating debt). The change to Canada's domestic law is important: US ratification of the protocol is no longer a prerequisite for Canadians and their arm's-length foreign lenders to benefit from the elimination of withholding tax on interest paid or credited. The withholding tax elimination applies to interest payments arising after January 1, 2008, regardless of the protocol's effective date. However, the protocol's effective date remains relevant for interest paid to non-arm's-length lenders (referred to in the protocol as "related lenders" in the United States). Withholding tax on interest paid or credited to related US lenders is reduced to 7 percent for the first year, 4 percent for the second year, and 0 percent for subsequent years following the protocol's entry into force.

Finance commented on the protocol at the 2007 annual conference of the Canadian Tax Foundation on November 27, 2007. Finance representatives shed light on several issues, including the following.

■ **Timing of reduced withholding on related-party interest.** Although the matter was unclear under the protocol, Finance confirmed that both Canada and the United States take the position that if the protocol is ratified in 2008, January 1, 2008 will be the effective date for the withholding tax reduction (to 7 percent) on interest paid on non-arm's-length debt. (Earlier in November 2007, similar comments were made at a meeting of the Senate Committee on Banking, Trade and Commerce.)

■ **Guarantee fees.** In the past, guarantee fees were treated as interest payments in Canada and as other income in the United States. Finance clarified the intent to achieve symmetrical treatment and thus will not assimilate guarantee fees to interest for protocol purposes. Thus, after being in force for (up to) two months, the protocol will eliminate withholding tax on guarantee fees.

■ **Fiscally transparent entities and S corporations.** Finance acknowledged that the concept of the fiscally transparent entity (FTE) is not well developed in Canada and is more meaningful in the United States. Finance confirmed that it will likely follow the US definition of an FTE: an entity not subject to tax at the entity level because its income is taxed in its members' hands. Finance said that S corporations were not contemplated when the FTE provisions were written. Generally, an S corporation elects to be treated as a passthrough entity for US tax purposes and may be considered transparent. In the past, the CRA said that an S corporation was a US resident for the purposes of the Canada-US treaty and thus received full treaty protection (currently, a 5 percent withholding tax on dividends: see CRA documents 9822230 and 9713120). Because an S corporation is owned by individuals, if the CRA looked through to the shareholders a 15 percent withholding tax would apply to its dividends. Finance recognizes that this is an important issue and will address it with the United States when Canada has the opportunity to review and comment on the US-drafted technical explanation to the protocol.

■ **Benefits extended to LLCs carrying on business in Canada through a PE.** Under Canadian domestic law, Canada may tax income attributable to a foreign corporation carrying on business in Canada. The treaty provides that business profits of a foreign corporation carrying on

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business in Canada are taxable only on business carried on through a PE. The protocol is intended to extend treaty benefits to LLCs. Arguably, however, the protocol attributes the LLC's income and related treaty benefits to the LLC's members, while from a Canadian domestic perspective the LLC itself is subject to Canadian tax. Finance indicated that the PE's profits are not attributable to the LLC members; the LLC is the taxpayer from a compliance perspective. However, the treaty benefits of the LLC members are effectively attributed to the LLC. For example, Finance indicated that the section 116 filing requirement is the LLC's and not the members', but the LLC must document eligibility for treaty benefits based on its members' eligibility.

■ **Multiple tiers of LLCs.** Finance was asked how it would view tiers of LLCs with both treaty-protected and non-treaty-protected members. For example, assume that USco 1 and USco 2 are members of LLC 1, which owns 75 percent of LLC 2 (25 percent owned by a non-treaty company). LLC 2 invests in Canco. Are USco 1 and USco 2 entitled to treaty benefits? Finance indicated that the chain's composition is looked through to calculate notional treaty-protected income. Tax liability and the filing requirements remain at the LLC level. The protocol's administrative challenges in achieving these results are easily foreseen.

■ **Impact on ULCs of the protocol's hybrid entity treaty benefit denial rules.** Under the protocol, treaty benefits may be denied to entities disregarded in one country but not the other (hybrid entities). When asked whether the new hybrid entities rule was intended to preclude ULCs from accessing treaty benefits, Finance said that the rule was intended to apply to deductible payments such as interest and royalties. Non-deductible payments such as dividends do not seem to have been considered, although the protocol does not differentiate between the two. In a very straightforward structure in which a US company owns the shares of a Canadian opco through a ULC, the protocol may deny benefits to cross-border dividends as well as to interest and royalty payments, making ULC structures tax-inefficient. The denial of benefits on dividends paid in such a structure is very hard to understand. Although Finance may consider the issue further, representatives indicated that they were concerned with providing exceptions and pointed out that taxpayers have three years in which to restructure.

■ **Meaning of "same treatment" for article IV.** The protocol denies treaty benefits if an FTE's earned income is not subject to the same treatment in both countries. "Same treatment" is not defined. Finance listed several factors to be considered in determining the meaning of the term: the amount of the income, how the income is characterized, the timing of the income inclusion, and the income's geographic source. Without committing to a conclusion, Finance seemed to agree that if a ULC receives a dividend from a Canadian Opco (not a ULC) and then pays it to the US shareholder, the income enjoys the same treatment in both countries. However, Finance also indicated that certain other (unspecified) treaty provisions might deny the benefits.

■ **FTE intermediary in a non-treaty country.** If a Canco pays a dividend to a non-treaty-country FTE that is wholly owned by a US-resident corporation, are treaty benefits available? Finance indicated that if the United States taxes the income of the non-treaty country FTE, the 5 percent rate applies.

■ **FTE intermediary in a treaty country.** Assume that under the Canada-Country X treaty the withholding tax rate is 5 percent, and that a Canadian corporation pays a dividend to a Country X FTE that is owned by US-resident individuals. Which treaty rate applies—5 percent under the Canada-Country X treaty or 15 percent under the Canada-US treaty? Finance confirmed that the taxpayer could choose the better of the two rates.

■ **Limitation on benefits.** Canadian residents are now subject to the LOB clause in the treaty. Finance is continuing to develop its position regarding the application of the LOB clause and therefore did not address the topic.

The introduction of the broader domestic exemption from withholding tax on interest paid to arm's-length parties is very welcome and long overdue. Finance's discussion was informative and illustrates that while the new protocol is generally welcome, it necessitates Canadian companies' re-examining their cross-border structures. In addition, the definitions of "fiscally transparent entity" and "same treatment" and the application of the LOB provisions require interpretation, which will lead to increased complexity and additional administrative requirements. The denial of treaty benefits for ULCs is unexpected and unwelcome, and it mandates the otherwise unnecessary reorganization of a number of structures that were not Canadian-tax-motivated.

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Cross-Border Shopping

The Canadian dollar soared against the US dollar in recent months, and many Canadians headed across the US border to shop. Most Canadian shoppers do not know the real consequences of failing to declare goods purchased in the United States, or falsely declaring their value, on their return to Canada.

An individual returning to Canada with goods purchased abroad is importing those goods, and must declare the goods and their proper value. Failure to declare goods, or falsely declaring the value of the goods, may result in the goods' being seized by the Canada Border Services Agency (CBSA). Retrieving the seized goods may be difficult and expensive, if not impossible; at best, stiff penalties can apply, ranging from 25 to 80 percent of the value of the goods. In some circumstances, the goods may be seized permanently and forfeited to the Crown. Even more seriously, the CBSA can seize the vehicle that was used to import the goods; penalties must be paid to obtain the vehicle's release, unless the vehicle is seized permanently. A record of infractions is generally kept in the CBSA's computer system, and a traveller with an infraction record may undergo more detailed examination on all future trips. Canadian shoppers should ensure that they make a full and proper declaration of all goods acquired on cross-border shopping trips to the United States, and they must pay any duties and taxes owing if personal exemption limits are exceeded. (A child has his or her own exemption for goods for his or her exclusive use or benefit.)

A Canadian resident returning with non-commercial goods purchased abroad is entitled to personal exemptions from duties and taxes (in Canadian dollars) of $750 for trips of at least 7 days, $400 for trips of at least 48 hours, and $50 for trips of at least 24 hours. No exemption applies for trips under 24 hours. (A significant portion of cross-border shopping takes place on day trips.)

If no exemption is available, duties and taxes may apply to the value of the goods. The application of duty depends on the type of goods purchased and where they were made. Goods made in the United States or Mexico are duty-free under NAFTA. (In practice, goods qualify for NAFTA treatment if they are marked or labelled as made in Canada, the United States, or Mexico.) Goods made elsewhere usually qualify for the most-favoured-nation (MFN) tariff (including goods made in China). The MFN rates range from 0 percent to over 10 percent, depending on the type of good. Some sample MFN rates are as follows: fur jackets, 8 percent; artificial furs, 15.5 percent; most leather clothing, 13 percent; babies' clothing, 18 percent; most other clothing, 16-18 percent; portable electronic organizers, 0 percent; golf clubs, 7.5 percent; and imitation jewellery, 0-8.5 percent. A person who travels to the United States for at least 48 hours is entitled to a special 7 percent MFN rate on the first $300 in excess of personal exemptions for non-commercial goods that come with the traveller. Special rules apply to alcohol and tobacco products. If personal exemptions are exceeded and the trip was at least 48 hours, the traveller pays duties and taxes on the value of the goods in excess of the personal exemption limit. For a trip less than 48 hours (but over 24 hours), duty and taxes apply to the goods' entire value without any $50 exemption.

If no exemption is available, GST/HST and provincial sales tax almost always apply and are collected by the CBSA. The GST is now 5 percent, and the PST varies by province of importation. GST or HST exemptions are rare, but some provinces exempt some goods.

As a practical matter, the technical rules are often not applied; travellers are subject to a variety of administrative practices at the various border points. For example, sometimes no duties or taxes are collected even though a shopper has exceeded his or her personal exemption limits, or NAFTA status is applied for duty purposes to all goods that are being imported regardless of the actual country of origin. Nevertheless, a cross-border shopper's best rule of thumb is to always fully and properly declare the goods he or she is importing, and their true value. Otherwise, serious consequences may follow if non-compliance is discovered.

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PLANNING FOR HARMONIZATION

Harmonization of the provincial retail sales taxes (PST) with the GST in the remaining provinces of British Columbia, Manitoba, Saskatchewan, Ontario, and Prince Edward Island may be emerging as a real possibility. Some commentators have suggested that the likelihood of some form of harmonization in those provinces in the next two to three years has been crystallized by a combination of political and economic factors—the rise in the Canadian dollar, the challenges faced by Canadian manufacturers and exporters, and GST rate reductions. Harmonization raises a number of issues, including whether all the remaining PST provinces will harmonize, and whether tax rates and tax bases will be the same in every province.

Economists may be best equipped to assess the benefits of harmonization in general, as well as the disadvantages of a patchwork of systems if not all provinces opt in. However, even at this early date taxpayers may be wise to consider planning their affairs to cover all eventualities. Contracts and agreements whose terms may conceivably straddle the eventual implementation date for harmonization should clearly address the potential impact. To cover the possibility that goods and services not previously subject to PST become taxable under a harmonized system, the vendor should ensure that it has recourse to charge the purchaser for the harmonized tax (HST) as appropriate. Conversely, in the case of goods currently subject to PST, a purchaser may wish to ensure that it can reap harmonization's benefits. Consider a three-year real property construction contract under which the construction materials are currently subject to PST. In the second year of the project, the PST is harmonized with the GST, replacing the PST cost with a recoverable HST. If any direct or indirect PST costs were included in the original contracted amount, the purchaser may not benefit from the potentially significant savings unless the vendor is contractually obliged to pass them along. Other types of contracts that involve embedded PST costs subject to potential elimination under an HST include IT outsourcing, real property supply-and-install contracts, software contracts, and telecommunications.

If a supplier currently charges GST on a tax-included basis, some form of contractual escalation clause may be necessary to ensure that the vendor will not absorb a significant increased amount under an HST. With respect to existing funding arrangements, if non-recoverable PST is replaced with recoverable HST, the funder should ensure that any reduction in costs translates into a reduction in the funding formula or amount. Conversely, certain sectors that currently enjoy fairly broad PST exemption (such as Ontario hospitals) but only partial GST recovery may need to evaluate the sufficiency of funding on transition to an HST.

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Employee Stock Option Surrender Payments Deductible

In *Shoppers Drug Mart Limited* (2007 TCC 636), the taxpayer reimbursed its parent $55 million for payments the parent made to the taxpayer's employees when they surrendered their options to acquire the parent's shares. The TCC said that the reimbursement was a deductible business expense in 1999, not a capital outlay.

Shoppers Drug Mart (Opco) was a wholly owned subsidiary of Parentco. Opco's officers and key employees were granted options to purchase Parentco's shares under an employee stock option plan (ESOP). In March 1999, the ESOP was amended so that the option holders had the right to surrender the options for cash equal to the excess of the shares' March 1999 FMV over the option price. In August 1999, Parentco entered into an agreement with a third party (Bidco); the agreement contemplated significant changes to Parentco's holdings and share structure through Bidco's acquisition of Parentco's publicly held common shares.

In January 2000, Parentco paid the employee option holders to surrender their options, at an amount grossed up so that the options' surrender was economically equivalent to the capital gains treatment of subsection 7(1) stock option benefits (paragraph 110(1)(d)). Parentco paid $54.4 million for the options' surrender and $500,000 for the gross-up, a total of $55 million. Opco reimbursed Parentco.

The TCC's analysis started from the premise that an employer's payment to an employee for the surrender of options under a stock option plan to acquire the company's shares is ordinarily deductible. "This conclusion is not based on any specific provision of the [Act. Such a payment] is simply part of employee compensation and is therefore a cost of doing business under section 9." Because the CRA did not rely on paragraph 18(1)(a) when it issued Opco's assessment, or when it argued its case before the TCC, the court said that the payments were made or incurred for the purpose of gaining or producing income from Opco's business. Therefore, a payment to employees who are option holders is not a capital expense just because it is made in the course of a corporate reorganization of the parent company. The TCC noted that Opco's business continued throughout the reorganization of Parentco's corporate structure and that Opco, a separate corporate entity, was not reorganized.

The CRA relied on the decision in *Kaiser Petroleum Ltd.* (90 DTC 6603). The FCA said that an employer's payment to extinguish a stock option plan for certain officers and key employees was an outlay on account of capital under paragraph 18(1)(b) and was not deductible. The FCA based its decision on the factual finding that the payment was a "once and for all" payment directly affecting the corporation's capital structure.

The TCC said that the CRA's reliance on *Kaiser* was interesting, because the CRA had said in a technical interpretation that the case should be confined to its own facts. TI 2000-0048355 states:

> In our view, the result in *Kaiser* follows from the facts in that particular case and is not inconsistent with our position that the payment by an employer of cash rather than shares pursuant to the terms of a stock option plan, in the absence of evidence to the contrary (e.g. the fact situation in *Kaiser*), will be a deductible expense to the employer.

The TCC distinguished *Kaiser* because Opco's corporate structure was not changed. Opco's reimbursement of Parentco for payments to Opco's employees did not create or achieve anything of lasting benefit to Opco; the business of Opco proceeded as usual. The "practical effect" of the $55 million reimbursement of Parentco for payments it made to Opco's employees "was identical to that which would have prevailed if [Opco] had made the payments directly to its employees." A subsidiary's reimbursing its parent for compensation paid to the subsidiary's employees does not turn the payment into a capital expenditure just because the parent is in the midst of a corporate reorganization.

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PRIVATE FOUNDATION DONATIONS

Tax incentives for donations of publicly listed securities to private foundations have been recently enhanced. (Bill C-28, the Budget and Economic Statement Implementation Act, 2007, received royal assent on December 14, 2007.) For donations made after March 18, 2007, the inclusion rate is reduced from 50 percent to nil both for capital gains on gifts of qualifying publicly listed securities from any donor and for donations of qualifying publicly listed securities acquired through employee stock options. Tables 1 and 2 illustrate the changes. The new rules (tabled in the House of Commons on November 13, 2007) refine draft rules of October 2, 2007, based on 2007 federal budget measures.

The new incentives parallel rules for donations made after May 1, 2006 to public charities and apply to qualifying publicly listed securities, including shares, debt obligations, and rights listed on a designated stock exchange (a prescribed stock exchange in the former rules); shares in a mutual fund corporation, units in a mutual fund trust, and segregated fund units; and prescribed debt obligations. A "designated stock exchange" includes the Toronto and Montreal exchanges, tiers 1 and 2 of the TSX Venture Exchange, the NYSE, NASDAQ (but not the over-the-counter bulletin board), and most other major foreign exchanges.

The securities (not cash proceeds) must be transferred to the charity. Donations of securities acquired through employee stock options are eligible for the reduced inclusion rate if an employee who deals at arm's length with the employer exercises options granted by the employer to purchase qualifying publicly listed securities and then donates the securities to a qualified donee within 30 days of their acquisition. Table 2 shows that the resulting employment deduction offsets the related employment income inclusion. An employee may be eligible for the reduced inclusion rate by completing a cashless exercise: exercising the stock option, directing the broker or dealer to sell the securities immediately, and then donating all or part of the proceeds to charity.

Quebec and Ontario have said that they will harmonize with the federal rules. No other province or territory has made similar promises, but the federal changes automatically apply in all other jurisdictions for individuals and (except in Alberta) for corporations. Thus, it is uncertain whether the Alberta rules will parallel the federal rules for corporate tax purposes.

Table 1 illustrates the results of a donation of qualifying publicly listed securities with an FMV of $11,000 and a cost of $1,000. It is assumed that the donor is an individual with a combined federal and provincial/territorial marginal tax rate of 45 percent.

Table 1 Donation of Qualifying Securities

	Sell shares and donate cash	Donate shares: Before March 19, 2007	Donate shares: After March 18, 2007
		dollars	
Proceeds of sale/ donation	11,000	11,000	11,000
Less: cost	(1,000)	(1,000)	(1,000)
Capital gain	10,000	10,000	10,000
Tax on capital gain	2,250	2,250	0
Less: donation tax credit ($11,000 x 45%)	(4,950)	(4,950)	(4,950)
Net tax benefit from donation	2,700	2,700	4,950

Table 2 Donation of Qualifying Securities Acquired Through Employee Stock Options

	Sell shares and donate cash	Donate shares: Before March 19, 2007	Donate shares: After March 18, 2007
		dollars	
Income inclusion ($11,000 – $1,000)	10,000	10,000	10,000
Less: employee stock option deduction	(5,000)	(5,000)	(5,000)
Less: charitable donation deduction	0	0	(5,000)
Net income inclusion	5,000	5,000	0
Tax on income	2,250	2,250	0
Less: donation tax credit ($11,000 x 45%)	(4,950)	(4,950)	(4,950)
Net tax benefit from donation	2,700	2,700	4,950

Table 2 illustrates the results of a donation of qualifying publicly listed securities with an $11,000 FMV that are acquired through the exercise of employee stock options at an exercise price of $1,000. It is assumed that the donor is an individual with a combined federal and provincial/territorial marginal tax rate of 45 percent.

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DELIBERATELY OVERSTATED TAX LOST

Students of taxation are often taught tax cases with fact patterns on the fringes of commerce—for example, the case of the madam who was not allowed to deduct bribes to police officers as business expenses only because in the final analysis she had no receipts. In a more recent case, a drug dealer whose cash was confiscated by the police was nonetheless liable for tax on the gross amount (but escaped penalties on the underreported income). In another very recent decision of the Federal Court in *Abakhan, Trustee in Bankruptcy for Taylor Ventures Ltd.* (2007 FC 1327), the taxpayer, TVL, which eventually went bankrupt, in an apparent effort to deceive its creditors had allegedly deliberately grossly overstated its income for 1990-1995 and had thus overstated its tax liability for years that were now statute-barred.

A trustee in bankruptcy has basically all the rights that the bankrupt would have. The trustee in this case asked the minister to exercise his special power to reassess under subparagraph 152(4(a)(i) for a statute-barred year if there has been misrepresentation attributable to neglect, carelessness, or wilful default. The trustee wished to obtain a significant refund of overpaid taxes for the benefit of TVL's creditors. Although the minister's special reassessment power is normally confined to opening up prior years because the taxpayer's conduct was designed to understate tax, there does not appear to be a legal reason why the taxpayer (or its creditors) cannot request a reassessment based on a deliberate overstatement of tax.

The minister declined to reassess TVL, saying that there was insufficient reliable information available to make a determination of the taxable income, or even to conclude that there had been a misrepresentation. Although the trustee asserted that previous filings were false and that a reliable financial statement had been pieced together, he did not supply any reliable evidence to CRA officials or to the minister. Furthermore, TVL's principals were no longer available to be questioned. The minister was of the view that no reassessment was possible and that the circumstances did not warrant a deployment of limited audit resources to deal with the matter.

The trustee applied for judicial review by the FC on the question of whether the minister erred in declining to reassess. The Crown launched a number of arguments designed to show that judicial review in effect amounts to an improper remedy in addition to the right to appeal an income tax matter, and that "collateral attacks" such as this are prohibited by section 18.5 of the Federal Court Act. The FC disagreed and said that it had the power to review the minister's decision not to reassess: because there was no reassessment, the case was not within the TCC's jurisdiction. Instead, the case was about the exercise of ministerial power—an attempt to make the minister exercise his power by reassessing TVL. The TCC would take over if and when a reassessment was issued. The issue before the FC was whether the decision not to reassess was a "reasonable" exercise of ministerial power. Although the trustee won his initial point that the minister's decision not to reassess was reviewable, the FC found that the decision not to reassess was, in fact, reasonable. As a result, there was no refund for TVL's creditors to share.

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IRS Rules: Debt Modified

A debt restructuring between two subs in an affiliated group was proposed to reallocate liabilities between them to better reflect the subs' respective assets and income. The IRS ruled that the proposed debt exchange results in a significant modification and is therefore a taxable event (PLR 200742016, June 21, 2007; 2007 TNT 404-35). Moreover, the inducement payment should be treated as a repurchase premium, deductible as interest (Reg. 1.163-7(c)) in the year paid.

In the PLR, Parentco, Sub 1, and Sub 2 are an affiliated group of US corporations that files a consolidated federal income tax return. Parentco files a single set of consolidated financial statements in order to satisfy SEC disclosure rules and to obtain a credit rating for debt issued by any member. Parentco guarantees any debt issued by Sub 1 or Sub 2. Both Sub 1 and Sub 2 have multiple issues of publicly traded debt outstanding. For good business reasons, Parentco wishes to reallocate the liabilities between the subs.

It is proposed that Sub 2 extend a tender offer for certain debt of Sub 1. Sub 1 then fully reimburses Sub 2 to acquire and retire the debt. Sub 2 offers its own new debt (guaranteed by Parentco) and a cash inducement payment. The yield and maturity of the new debt (ignoring the inducement paid) is identical to the retired debt's. Essentially, the legal obligor has changed, but economically (ignoring the inducement) the holder is arguably likely in the same position as before.

The rules for debt exchanges are spelled out comprehensively in Reg. 1.1001-3, which governs actual and deemed exchanges. Any modification of a debt instrument, however effected, is tested. A "significant modification" results in a fully taxable deemed exchange of the old debt for a new debt that reflects the modified terms. The substitution of a new obligor on a recourse debt instrument is generally a significant modification (Reg. 1.1001-3(e)(4)(i)(A)), unless the substitution arises when an acquiring corporation merely steps into the shoes of its target corporation in an asset-based income-tax-free transaction. The release of a guarantor is a significant modification if, and only if, there is a change in payment expectations (Reg. 1.1001-3(e)(4)(iv)).

On the ruling's facts, Sub 1 is the primary obligor of the retired debt, which was guaranteed by both Parentco and Sub 2; Sub 2 is the primary obligor of the new debt, which is guaranteed solely by Parentco. No other meaningful changes occur. Solely on the basis of the replacement of legal obligors, and without any meaningful analysis, the IRS ruled that a significant modification had occurred. Following the logic of this ruling, an affiliated group of US corporations seems to be given wide latitude to restructure its third-party debts for business reasons and to a large extent control whether a taxable or tax-free transaction occurs. As the ruling shows, on the right facts a taxable exchange may be beneficial.

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Non-Resident Employee Stock Options

Some recent buyouts of Canadian-resident corporations have raised a number of issues for non-resident employees who exercised stock options granted by a Canco and performed employment duties in Canada. The new Canada-US protocol changes the Canadian tax consequences.

An employee who exercises a stock option to acquire shares of the corporate employer (or a corporation not at arm's length with it) is deemed to have received a benefit from employment in the year of exercise. The benefit, which is included in the employee's income for the year unless deferred, is equal to the shares' value when exercised net of the strike price and any amount paid for the options. In some cases the employee may deduct 50 percent of the benefit; 100 percent is added to the shares' cost base. A subsequent change in the shares' value is a capital gain or capital loss to the employee.

A non-resident employee must include the deemed employment benefit in income for Canadian tax purposes if he or she performed employment duties in Canada in the year in which the options were granted. The deemed benefit is fully taxable in Canada to the non-resident, subject to treaty relief, because the benefit relates to the period when the options were granted, not exercised; the benefit is considered received for past services, and it is sourced in the country where the services were performed. For Canadian tax purposes, there is no allocation of the income between Canada and the employee's country of residence.

Treaty article XV(2) exempts the employment benefit from taxation if (1) the total remuneration does not exceed Cdn$10,000 in the calendar year, or (2) the US-resident employee was not present in Canada for more than 183 days in the calendar year in which the option was granted, and the remuneration was not borne by a Canadian-resident employer or an employer's PE or fixed base in Canada. The benefit from an employee stock option is not remuneration borne by the employer because the employer cannot deduct the amount from its income for tax purposes. Under article XV(2)(b), a US resident's Canadian employment income is not taxable in Canada unless it is deductible by the Canadian employer and the employee was present in Canada for more than 183 days in the calendar year in which the option was granted.

The protocol changes the 183-day calendar-year sojourn period in article XV(2)(b) to read "183 days in any twelve-month period commencing or ending in the fiscal year concerned," being the calendar year when the options are granted. Thus, an employee present in Canada for more than 183 days in a 12-month period straddling a calendar year-end is no longer entitled to the treaty exemption if the total remuneration, including the deemed employment benefit, exceeds Cdn$10,000. It is no longer clear whether the Cdn$10,000 exemption in article XV(2)(a) applies on a calendar-year basis.

The protocol also changes the test for remuneration in article XV(2)(b): the new exemption applies only if "the remuneration is not paid by, or on behalf of, a person who is a resident of that other State and is not borne by" a PE there. The CRA says that the employer is considered to be the "payer" of a stock option benefit for the purposes of Canadian withholding tax—a questionable position because the Act does not deem the employer to pay an amount equal to the benefit deemed received by the employee. The CRA is also likely to take this position for the purposes of new article XV(2)(b), eliminating a US-resident employee's exemption under current article XV(2)(b), which is based on the lack of a deduction by the Canadian employer. The US-resident employee who performs employment duties in Canada is thus taxable on the stock option benefit even if he or she is not present in Canada for more than 183 days in a 12-month period starting or ending in the grant year (unless his or her total remuneration is Cdn$10,000 or less).

The protocol rules also apportion the employment benefit between Canada and the United States based on the amount of time that the holder of the employee stock option resided in each country. The diplomatic notes say that the employee stock option benefit is generally sourced on the basis of the number of days spent in each of the employee's principal places of employment between the option's grant and its exercise or disposition. The Canadian and US competent authorities retain an overriding right to attribute income in a different manner if it is more appropriate to treat the option's grant as a transfer of ownership of the underlying securities—for example, if the options granted were in the money or not subject to a substantial vesting period.

Thus, a US-resident employee taxable on 100 percent of the deemed employment benefit in Canada under the treaty may allocate the benefit between Canada and the United States, depending on the time spent in each principal place of employment between the option's grant and exercise dates. However, a US-resident employee who was not present in Canada for more than 183 days in the calendar year in which the options were granted is taxable in Canada on the deemed employment benefit if he or she (1) performed employment duties in Canada and (2) was present in Canada for at least 183 days in any 12 months commencing or ending in the calendar year of the grant (subject to the Cdn$10,000 exception).

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Stock Incentive Plan Conversions: CRA Review

The CRA is currently reviewing its policy on the tax treatment of the conversion of a restricted stock unit into a deferred stock unit and is expected to clarify its position in the near future. Currently, in certain circumstances, the CRA allows stock-based incentive plan participants to exchange units granted under one type of plan for units of another without triggering taxable income (advance tax ruling 2006-0210171R3).

Stock-based incentive plans (stock plans) can be structured in many ways, but generally either issue shares or benefits whose calculation is based on the value of shares. Generally, an employee's benefit under a stock plan (stock benefit) is taxable under section 6 or 7. A stock plan that provides only a cash payment of the stock benefit is not taxed under section 7 because there is no agreement to issue shares.

Various factors determine when a stock benefit is taxable to the employee, particularly on exchanges between stock plans. Section 7 stock benefits are generally taxable on the purchase date of the share granted under the plan; tax may be deferred under subsections 7(1.1) and 7(8) until the shares are sold. Stock benefits taxed under section 6 may be taxable when awarded or received, depending on the stock plan. Under the CRA's current position, stock benefits not taxed until receipt include (1) a bonus based on the value of a company's shares paid in accordance with a restricted stock unit (RSU) plan within three years of being earned; and (2) shares and/or cash received under a deferred share unit (DSU) plan governed by an employee stock option plan, as defined in regulation 6801(d), within a specified time after the employee's retirement or death.

CRA ruling 2006-020171R3 addresses two questions: (1) whether an existing RSU plan (that is not a "salary deferral arrangement" per subsection 248(1)) can be amended to allow participants to convert awarded RSUs into DSUs, and (2) whether such a conversion results in a taxable income inclusion to the participant. The transactions proposed in the ruling are intended to amend the attributes of outstanding RSUs awarded to employees under the former (closed) plan so that they are comparable to RSUs awarded under the new plan, which allows employees to exchange RSUs on their vesting date for an equivalent amount of DSUs. The CRA ruled that the employee has no taxable income inclusion on the exchange, because (1) neither the RSU plan nor the DSU plan was a "salary deferral arrangement" or an "employee benefit plan" (defined in subsection 248(1)); (2) the DSU plan was not a "retirement compensation arrangement" (defined in subsection 248(1)); and (3) the employee did not receive an amount at the time of the exchange. The CRA is currently reviewing its position in this advance tax ruling.

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EC Dividend Taxation and Third Countries

The European Court of Justice's decision in *Denkavit Internationaal* (C-170/05, December 14, 2006) casts doubt on the legality of withholding taxes imposed by EC member states on outbound dividends. The recent ECJ decision in *Amurta* (C-379/05, November 8, 2007) confirms that withholding taxes on dividends are incompatible with the free movement of capital if a taxpayer resident in the same member state as the dividend-distributing company is effectively exempt from tax on the dividends.

In *Denkavit*, French withholding tax levied on dividends paid by French subs to a Netherlands parent was held to be incompatible with the freedom of establishment guaranteed by the Treaty Establishing the European Community (TEC). A French parent company is effectively exempt from tax on such dividends; thus, France's imposition of a second layer of tax on dividends to a non-French-resident recipient parent favoured parent companies from France over those from other member states.

In principle, the TEC guarantee of free movement of capital applies on the same basis to third countries (non-EC members) as it does between EC members. Thus, although *Amurta* concerned dividends paid by a Netherlands company to a 14 percent shareholder in Portugal, the case opens the door to a challenge by a non-EC-resident shareholder to withholding tax imposed by an EC member state if a shareholder resident in that state is not subject to an equivalent tax on the dividend by the member state.

Amurta recognized that a tax treaty between the EC member state of the distributing company and the country of residence of the dividend recipient may "neutralize" the discriminatory treatment, and that tax treaties form part of the relevant legal framework for assessing compatibility with the TEC. However, since the Netherlands-Portugal

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
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ISSN 1496-4422 (Online)

tax treaty was not raised in the proceedings, the ECJ did not indicate the type of tax treaty provision that would have this effect. The ECJ clearly states that the unilateral grant by the dividend recipient's home country of a tax advantage offsetting the withholding tax does not neutralize the restrictive effect on free movement of capital. It is also clear from *Denkavit* that the exemption from tax by the recipient's country does not neutralize the restrictive effect of the second layer of tax (the withholding tax imposed by the member state of the distributing company).

In *Skatteverket v. A* (C-101/05, December 18, 2007), the ECJ again looked at the free movement of capital, this time with respect to stock dividends received by a resident of Sweden from a company resident in a third country, Switzerland. Sweden provided a tax exemption on the distribution by a Swedish or foreign parent company of all the shares of its subsidiary pro rata to the shareholders of the parent, provided that certain conditions were met. The exemption did not apply to such dividends from a third country whose tax treaty with Sweden did not contain an exchange-of-information provision.

The ECJ ruled unequivocally that limiting the availability of the exemption in the case of third-country distributing companies effectively discouraged Swedish taxpayers from investing capital in those companies, and was thus a restriction on the free movement of capital. On the question of whether the restriction could be justified, the court recognized that movements of capital between EC member states and third countries takes place "in a different legal context"; specifically, third countries are not bound by the obligations to exchange tax information (provided by EC Directive 77/799, which establishes a framework for cooperation between member states' tax authorities) or by the EC rules on the harmonization of company accounts. The denial of the exemption might thus be justified if the Sweden-Switzerland tax treaty did not provide for adequate mandatory exchange of information, preventing the Swedish authorities from obtaining information from the Swiss tax authorities necessary to verify fulfilment of the exemption's conditions. The latter issues were referred back to the Swedish courts.

Amurta and *Skatteverket v. A*, taken together, constitute strong affirmation that in principle third-country investors in EC member-state companies (and EC investors in third-country companies) have TEC-guaranteed rights to equal tax treatment of dividends, even in the absence of any reciprocal obligations on the part of the third countries. However, the need to ensure effective fiscal supervision may justify refusal of a tax advantage where adequate exchange-of-information provisions do not apply between the member state and the third country. Moreover, the restrictive or discriminatory effect of dividend withholding tax is at least potentially offset by tax treaty provisions that neutralize the unequal tax burden domestically imposed on a dividend recipient resident in the third country vis-à-vis a recipient resident in the EC member state of the distributing country.

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Foreign Tax News

United States

The Internal Revenue Service (IRS) updated procedures for private letter rulings and other guidance from the IRS National Office.

On December 20, 2007, Treasury and the IRS issued regs on the reduction to two baskets for the foreign tax credit limitation. The regs were issued in final, temporary, and proposed form to allow for public comments.

The US Deputy International Counsel summarized US treaty activities and priorities. In treaty negotiation, the United States views three items as non-negotiable: the inclusion of LOB articles, the inclusion of effective exchange-of-information articles, and the exclusion of tax-sparing provisions.

United Kingdom

HMRC announced a new approach to transfer pricing, including more staff specialization, a focus on higher-risk issues, agreed action plans with companies, and active monitoring of progress. Current plans aim to resolve transfer-pricing issues in 18 to 36 months, depending on their complexity. Statistics will be published in April 2008 showing average resolution times from January to March 2008.

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