CANADIAN TAX *Highlights*

Editor: Vivien Morgan, LL.B.

Volume 16, Number 2, February 2008

CRA Scolded for Trying To Block Evidence

The TCC recently released its decision in favour of the taxpayer in a procedural motion in *Sentinel Hill Productions (1999) Corporation* and *Robert Strother* (2007 TCC 742), which were heard together. The CRA's motions for orders to remove several paragraphs from the taxpayers' amended notices of appeal were rejected. The paragraphs contained information about the advance tax rulings obtained by the taxpayers and statements that the taxpayers had relied on those rulings when embarking on the transactions underlying the substantive issue before the TCC.

The CRA filed a motion with the TCC for an order under rule 53 of the Tax Court of Canada Rules (General Procedure) to strike out several paragraphs from the taxpayers' amended notices of appeal. The taxpayers asserted in those paragraphs that they entered into certain transactions involving Canadian-based film and television productions and in doing so relied upon a number of advance tax rulings issued by the CRA regarding investments in the limited partnership tax shelters. The taxpayers alleged that the transactions conformed to the advance tax rulings.

Rule 53 states that the TCC may strike out or remove all or part of a pleading or other document if the pleading or document may prejudice or delay the fair hearing of the action; if it is scandalous, frivolous, or vexatious; or if it is an abuse of the process of the court.

The TCC outlined principles well established in the jurisprudence for application on a motion to strike under rule 53, including the following:

- Rule 53 cannot be used to attack a pleading to challenge assertions of fact.
- To strike out a pleading or part of a pleading under rule 53, it must be plain and obvious that the position has no hope of succeeding. The test is stringent, and the power to strike out a pleading must be exercised with great care.
- A motions judge should avoid usurping the function of the trial judge in making determinations of fact or relevance; those matters should be left to the judge who hears the evidence.

The TCC said that in light of the jurisprudence on rule 53, it could not conclude that the arguments and facts advanced in the amended notices of appeal plainly and obviously fell within the rule. The TCC said that the taxpayers should be entitled to advance their arguments at trial on the basis of all the evidence. The court added:

> Where senior and experienced counsel advances a proposition of fact or law in a pleading that merits serious consideration by a trial judge, it is at least presumptuous and at most insulting and offensive to force counsel to face the argument that the position is so lacking in merit that it does not even deserve to be considered by a trial judge. It is a deplorable tactic for the Crown, as soon as it sees a legal argument that it does not like, to move to strike. . . . [I]t is this sort of skirmishing that is putting tax litigation out of the reach of ordinary people. I do not wish to see this court turned into a forum for procedural manoeuvring.

To support their position that information about the rulings should not be removed from their notices of appeal, the taxpayers referred to the TCC decision in *Goldstein*, which had quoted from the SCC in *Canadian Superior Oil* to the effect that advance rulings form an important and necessary part of the administration of the Income Tax Act. Apparently, the CRA asserted that advance rulings are not binding; Bowman CJ further showed his displeasure with the CRA when he stated,

> If the [CRA] is now seeking to establish that advance tax rulings can be repudiated by the Minister after decades of reliance by taxpayers upon them, this proposition, which would startle most practitioners, should be tested in a full trial and not a preliminary motion. This preliminary motion is certainly not the time or place to discuss the complex issues arising out of the Minister's remarkable position. The rulings process, which was created by Revenue Canada and has been enormously beneficial to taxpayers in creating certainty in predicting the tax consequences of commercial transactions, constitutes a fundamental cornerstone of Canadian tax administration. The idea that a motions judge could, on the basis of a one hour argument without evidence, demolish one of the essential underpinnings of our system is, quite frankly, appalling.
>
> The magnitude of this question transcends the boundaries of a preliminary motion and is indeed of a greater

In This Issue

importance in the field of taxation than any I have seen in many years.

The TCC dismissed the CRA's motion and took the unusual step of awarding costs to the taxpayers.

Paul Hickey
KPMG LLP, Toronto

Exempt Surplus and TIEAs

The 2007 federal budget proposed extending exempt surplus treatment to an FA that is resident in and carrying on an active business in a non-treaty country, if that country enters into an OECD-style tax information exchange agreement (TIEA). From Canada's perspective, a TIEA provides an opportunity to access foreign information to assist in tax compliance. A foreign jurisdiction without a treaty may agree to sign a TIEA to attract inbound investment; if a TIEA is not then signed or is signed and does not enter into force, all income—including active business income—of an FA in that jurisdiction is FAPI to Canadian taxpayer investors. Thus, Canadian multinationals may find TIEA jurisdictions attractive if active business income earned there benefits from low foreign tax and can be repatriated to Canada with minimal or no additional Canadian or foreign tax.

The enabling TIEA legislation was enacted in Bill C-28, but proposed changes to the "designated treaty country" regulations (regulation 5907(11) and new regulation 5907(11.11)), which were released in November 2007, have not been promulgated. In accordance with the budget, the proposed regs provide exempt surplus status for an FA's active business income earned from the beginning of the year in which a comprehensive TIEA with the relevant country enters into force.

Currently, an FA may be a designated treaty country resident if Canada has a comprehensive tax treaty with that country and the various treaty provisions do not exclude it (regulation 5907(11.2)). For example, an FA may operate in the other country under a tax-favoured regime that is excluded by the treaty. Or, if the FA is not subject to income tax or is taxed at low rates and the particular treaty requires that the entity be "liable to tax" to be a treaty resident, the CRA may consider the FA a "resident of convenience" and not extend its administrative position as outlined in *Income Tax Technical News* no. 35 (February 26, 2007). The policy grounds for current regulation 5907(11.2) suggest that Canada may not have wished to broadly extend exempt surplus treatment to FAs operating under tax-favoured regimes. However, it is difficult to rationalize why regulation 5907(11.2) remains a requirement for an FA operating in a tax treaty country that has a comprehensive exchange-of-information article, but not for an FA operating in a tax haven jurisdiction where there may be no taxing regime.

Paul Barnicke and Melanie Huynh
PricewaterhouseCoopers LLP, Toronto

US Treasury Report: Treaty Abuse

On November 28, 2007, the US Treasury sent Congress the mandated *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*. The report describes current issues regarding US earnings-stripping rules, transfer-pricing rules, and the misuse of US income tax treaties, and provides conclusions and recommendations in each area. The treaty abuse commentary is of particular interest.

The study on US tax treaties focuses on combating abuse by third-country residents of treaty-based withholding rate reductions, particularly on dividends, interest, and insurance premiums. A review of US corporate tax returns indicates that widespread abuse of US tax treaties without limitation-on-benefits (LOB) provisions has led to significant reductions in withholding rates for persons who would not have been entitled to benefits if the relevant treaty had contained an LOB provision. For example, the US treaties with Iceland, Hungary, and Poland have no LOB provisions and provide a low or zero rate of tax on certain payments. The report evaluated data gathered from form 5472 ("Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a Trade or Business"). Those data provided some (but not conclusive) evidence of the potential extent of abuse of the treaties with Iceland and Hungary. For example, the data showed that interest paid to related parties in Iceland increased from $300,000 in 1996 to $912.7 million in 2004; interest paid to related parties in Hungary increased from $197.5 million in 2000 to $1.24 billion in 2004. In many cases, if the interest had been paid directly out of the United States to the third-country resident, withholding tax would have applied.

LOB provisions are intended to determine whether a person is sufficiently connected to the treaty-partner resident to warrant receiving treaty benefits; this approach is designed to prevent third-country residents from treaty shopping by routing investments through a treaty country and thus receiving tax benefits not otherwise available to them. LOB provisions are now routinely included in US tax treaties to ensure that a treaty claimant has an adequate nexus with the applicable country of residence. The report notes that the core of the current LOB provisions in US treaties embodies the "publicly traded" test, the "ownership/base erosion" test, and the "active trade or business" test.

Recent refinements have been made to the "publicly traded" test to ensure that the intended nexus exists between a publicly traded company and its country of residence. For example, the US-Barbados 2004 protocol's modified LOB provision requires not only that a corporation's stock be listed on the Barbados stock exchange but also that it be primarily traded on that exchange. Thus, a Barbados corporation largely traded on a US stock exchange no longer qualifies, eliminating treaty benefits for corporations that undertook corporate-inversion transactions. The US-Netherlands treaty's LOB provision has also been changed to provide that a public corporation without sufficient nexus to its country of residence via trading on the stock exchange there must establish nexus through primary management and control. The LOB provision in the 2006 US model treaty also includes these revisions and will form the starting point for US negotiations. However, the recently announced Canada-US 2007 protocol does not contain the revisions.

The report highlights that in an effort to combat the potential for abuse, a new income tax treaty with Iceland (signed on October 23, 2007) incorporates a comprehensive LOB provision. Further treaty negotiations with Hungary are anticipated for 2008, as is the commencement of negotiations with Poland to conclude a new treaty. The US Treasury will continue to review the US tax treaty network to identify deficiencies in existing treaties, paying special attention to LOB provisions.

Other anti-abuse rules relating to dividends, interest, and insurance premiums are discussed in the report. Recent treaties that exempt certain intercompany dividends from source country withholding include safeguards such as meeting one LOB test to ensure that the exemption is not exploited. The report also notes that Treasury places importance on ensuring that the United States has flexibility to deal with the evolving financial products market and to treat the income generated as dividends or as interest, consistent with US domestic law. For example, the interest article of the 2006 US model treaty preserves the United States' right to tax contingent interest at a rate similar to that for dividends. (The Canada-US 2007 protocol includes this change.) The report also discusses special rules developed for dividends paid by RICs and REITs, excess inclusions for residual interests in REMICs, and the methodology for analyzing potential waivers of the federal excise tax on insurance premiums.

Steve Jackson
Ernst and Young LLP, New York

Chris Netram
Ernst and Young LLP, Washington, DC

PHASED RETIREMENT REGS

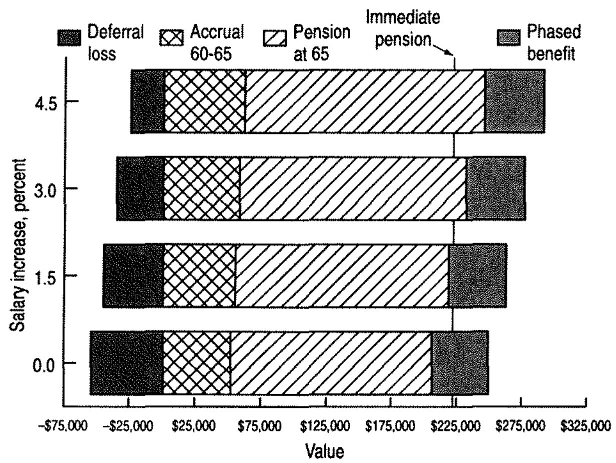
In pursuit of two policy goals, amended income tax regulations permit pension plan sponsors to (1) increase the reward to older workers who work full time and (2) accommodate phased retirement programs. The amendments allow qualifying members of defined benefit (DB) plans to receive up to 60 percent of their earned pensions (an anticipated benefit), including bridge benefits, while they continue to earn further DB benefits. A qualifying member must be age 60 or over, or at least age 55 and entitled to immediate payment of a pension without reduction for age or service. There is no requirement that work or salary be reduced for a worker to receive the anticipated benefits.

Gauging the impact of these simple changes is complex. Assume that a 60-year-old member of a final average, noncontributory DB plan is entitled to an immediate (unreduced) pension of \$15,000 after 15 years of service. The pension's present value is about \$222,000. If the member continues to work, he cannot collect that pension and thus loses the value of the forgone pension (V_{FP}), but he does earn the value of new DB benefits for service after age 60 (V_{DB60+}) and, if his earnings increase from age 60 to 65, he benefits from an increase in the value of his pension earned to age 60 (this increase is referred to as ΔV_{DB60}).

There is a deferral loss if V_{FP} exceeds ΔV_{DB60}. For example, if the member retires at age 65 with 20 years of service and his salary did not increase after age 60, he has a \$4,000 net loss in pension value. Because his salary did not increase, the value of his pension earned to age 60 did not increase ($\Delta V_{DB60} = 0$), and thus the deferral loss equals V_{FP}. On the other hand, if his final average earnings increased by 3 percent annually, the value of his pension (determined at age 60) is about \$245,000, a net gain of \$23,000 from its value if he had actually retired at age 60. The net gain is the total of the deferral loss of \$38,000, V_{FP} reduced by ΔV_{DB60}, and the V_{DB60+} of \$61,000.

Figure 1 shows the deferral loss and the new accrual associated with annual earnings increases of 0, 1.5, 3, and 4.5 percent. The largest rectangle in each row represents the value of the pension from age 65 earned at age 60, valued at age 60. The rectangle at the far right is the value of a 60 percent anticipated benefit. The straight vertical line shows the value of the immediate pension (\$222,000). With the anticipated benefit under the amended regs, a member's total pension value ranges from \$264,000 to \$309,000. The anticipated benefit pension value ensures that, for all annual earnings increases, there is a net gain in pension value for a member who continues working and earning DB benefits.

Figure 1



Note: Assume that a 60-year-old member of a final average non-contributory DB pension plan was entitled to an immediate $15,000 pension after 15 years of service. The plan's value to the member was approximately $222,000 at age 60.

Figure 2

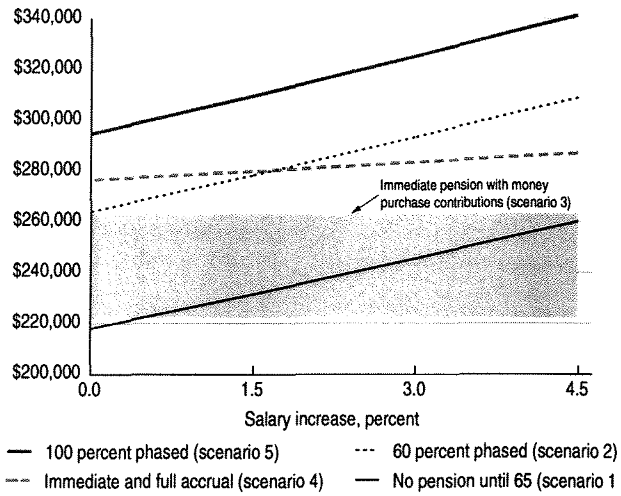


Figure 2 shows the pension values for a worker at age 60 in five different scenarios:

1) a pension payable at age 65, with no anticipated benefits;
2) anticipated benefits of 60 percent payable from age 60, with the full pension payable at age 65, including accruals from age 60;
3) an immediate pension from age 60, with money purchase (MP) contributions anywhere from 0 to 18 percent of remuneration (contributions are assumed to earn 5 percent);
4) an immediate pension from age 60, with full DB accruals from age 60 (not allowed under the regulations); and
5) anticipated benefits of 100 percent payable from age 60, with the full pension payable at age 65 (not allowed under the regulations).

Scenarios 1 and 2 in figure 2 are linear representations of data in figure 1. The shaded area in figure 2 represents the possible pension values with MP contributions from 0 to 18 percent of remuneration. Interestingly, if the largest annual MP contribution allowed by the regs—18 percent—earns 5 percent per annum, a larger pension value is always achieved under the 60 percent anticipated benefit in scenario 2. Scenarios 4 and 5 are not permitted, but they show the full potential range of value under a DB plan. Scenario 4 might apply to an individual who retired from one employer and became employed with another arm's-length employer.

The regulations prescribe the ceiling for benefits; the pension regulators must define the floor. Many employers intend phased retirement programs to be cost-neutral and thus wish to claw back from the ultimate pension all or part of the value of the anticipated benefits paid; the federal regulator of pensions disagrees. Federal Pension Benefits Standards Act (PBSA) proposals treat the anticipated benefit as an additional benefit payable under a DB plan, and thus as an increased cost to the plan or the sponsor or both. Employers with DB plans may think twice about offering phased retirement programs, but if the projected labour shortage materializes, they may use the strategy to retain older employees. The PBSA does appear to allow employers to cherry-pick those employees who will receive anticipated benefits, although this point may be challenged by employee groups. No province has yet released any legislation to accommodate the tax regulation changes.

Marcel Théroux
Mercer Limited, Toronto

Reversing Pre-2007 FIE and NRT Income

A CRA notice of January 3, 2008 concerns taxpayers affected by proposed changes to the taxation of non-resident trusts (NRTs) and foreign investment entities (FIEs). These changes, included in Bill C-10, generally apply to taxation years beginning after 2006, instead of after 2002 as originally proposed. Bill C-10 is still before Parliament, but the CRA notice appears to assume that it will soon be enacted. Taxpayers who, on the basis of the proposed rules, filed returns for tax years that began before 2007 must amend the returns or file an election to have the proposed rules apply to those pre-2007 tax years. All affected taxpayers must work through the rules to determine their impact on 2007 tax filings.

The CRA notice also says that if a taxpayer who filed pre-2007 returns on the basis of the proposed legislation does not intend to make an election to have the proposals apply to those years, he or she should write to the CRA as soon as possible to request an adjustment to those tax returns. The taxpayer should include the reasons for the reassessment and supporting documentation, along with amended information slips where appropriate. A taxpayer who does not have the necessary documentation to request a reassessment within the normal reassessment period should file a waiver request to allow the CRA to reassess beyond the normal reassessment period.

An NRT may elect to apply the proposed legislation to any tax years that begin after 2002 (and before 2007) and to subsequent tax years (that begin before 2007). An NRT created in 2001 or 2002 may elect to have the legislation apply beginning after 2000.

Jim Yager
KPMG LLP, Toronto

Interpretation: Consider Every Word

In *North Shore Health Region* (2008 FCA 2), the FCA provides guidance on the interpretation of the statutory conditions in subsection 191(3) of the Excise Tax Act. The decision is a reminder that all the necessary conditions of a legislative rule must be met and all the words of the rule must be considered.

As a consequence of the definition of "self-supply" in subsection 191(3), a builder of a multiple-unit residential complex is deemed to have sold and repurchased the complex—and triggered a liability for GST—prior to its actual sale. Thus, if work on the complex is substantially completed, if possession of the complex is transferred to a particular person (not a purchaser), or if the complex is occupied by the builder, the builder must account for and remit the GST on the complex's FMV at the time of the self-supply. The FCA said that the self-supply rule did not apply and overturned the TCC's decision: the TCC had failed to expressly consider whether the statutory conditions in subparagraph 191(3)(b)(i) were met and, specifically, failed to give meaning to the word "possession" in the rule.

North Shore was a public health authority operating a number of health-care facilities in British Columbia; it operated the facility in question as a long-term care facility with multiple rooms. The patients admitted to the facility were senior citizens, with different degrees of disability; the facility provided a required level of care and accommodation and meals. The personal and medical care and supervision provided typically did not reach the level of medical care provided by a hospital. Initially, North Shore did not self-assess for a self-supply of the facility, but it later made a voluntary disclosure to the minister of national revenue and reported the GST payable on the facility's FMV. Whether North Shore was obliged to self-assess for a deemed self-supply of the facility was one of the issues on appeal.

The TCC focused analysis on subparagraph 191(3)(b)(i), which triggers a self-supply obligation if a builder "gives, to a particular person, who is not a purchaser under an agreement of purchase and sale of the complex, possession of any residential unit in the complex under a lease, license or similar arrangement entered into for the purpose of the occupancy of the unit by an individual as a place of residence." The TCC considered all legislatively defined terms ("multiple unit residential complex," "residential complex," and "residential unit") and concluded that Parliament intended the words "lease, license or similar arrangement for the occupancy thereof as a place of residence or lodging" to cover any lawful basis under which a person might, with permission, take up residence in the facility. The TCC concluded that the facility was a "multiple-unit residential complex" and was occupied by the patients as a place of residence; thus, the self-supply rules applied.

North Shore appealed. The FCA focused on the requirement at the beginning of subsection 191(3) that the resident have "possession" of the unit as a place of residence. The FCA found that the TCC had failed to consider the word "possession" and the implicit condition it placed on the application of the self-supply rules. In the FCA's view, the patient's right of occupancy did not amount to "possession" of the room. For example, the facility staff might decide that a patient's needs had altered and then change a room assignment without the patient's input or consent. The FCA concluded that the use of the word "possession" in subparagraph 191(3)(b)(i) suggested a right to the exclusive use and enjoyment of a particular apartment for residential purposes that could not be defeated except on a breach by the tenant of the terms of the tenancy. In this light, the court concluded that the patient's habitation of the facility was not "possession" within the meaning of subparagraph 191(3)(b)(i), and thus the conditions for the application of the self-supply rules were not met.

The FCA was critical of the TCC's definition-based approach, which resulted in the TCC's failure to give meaning to the word "possession," an incorrect interpretation of the self-supply rule, and a wrong decision on the rule's application to the facts of the case. The focus on statutory definitions obfuscated the meaning of undefined terms that also had to be interpreted in the context of both the common law and the rule.

The lesson for taxpayers and tax practitioners alike is that every word in the statute has potential relevance; and even where a word is not defined, the legal meaning of the word must be considered. What the FCA may not have considered is the apparent resulting exempt use of commercial property on which no GST is ever imposed. The decision may also raise the issue of whether North Shore's supply of the rooms—in the absence of affording the resident legal "possession"—still qualifies for exempt treatment for GST purposes.

Robert G. Kreklewetz and Jenny Siu
Millar Kreklewetz LLP, Toronto

FLOWTHROUGH SHARE INDEMNITY

The FCA in *JES Investments Ltd.* (2007 FCA 337) confirmed the TCC decision that allowed the taxpayer's capital loss on the disposition of shares acquired through a renunciation agreement with Deena Energy Inc. The facts in this case were favourable to the taxpayer, but only because the flowthrough share agreement was flawed vis-à-vis its intended purpose.

Deena breached the renunciation agreement, did not incur and renounce Canadian resource expenses in the taxpayer's favour, and went into receivership, rendering the shares worthless. Because no resource deductions were renounced, the taxpayer sought an equitable result and claimed a capital loss equal to the subscription price paid for the shares. The minister argued that the shares were flowthrough shares and thus had a deemed cost of nil; no capital loss arose on their disposition. The TCC said that Deena had breached the agreement in numerous ways and therefore the shares issued did not attain their intended status as flowthrough shares. The FCA said that whether a share is a flowthrough share is determined at the time of issue, a time when Deena had not breached the agreement. The narrow issue was whether the shares were carved out from flowthrough shares as prescribed shares.

The flowthrough share rules that allow the renunciation of Canadian resource deductions apply to common shares for which the investor is at risk for the subscription price and is not protected in any way. Any third-party indemnity or undertaking that directly or indirectly limits any loss sustained by the taxpayer from holding, owning, or disposing of the shares triggers prescribed share status. Before 1986, a taxpayer incurred the Canadian resource expenses directly (through the corporate issuer as agent), and thus the flowthrough shareholder was at risk for environmental or other operator liability stemming from exploration activity undertaken on the taxpayer's behalf. The flowthrough mechanism was later inverted; the company, not the taxpayer, incurred the expenses (and was potentially liable for related damages) and simply renounced the Canadian resource deductions in favour of the taxpayer, who was then deemed to have incurred them. These rule changes were designed to insulate the taxpayer from operator risk but still achieve flowthrough of tax benefits. Interestingly, the CRA's administrative practice (outlined in 1984) under the old flowthrough regime indicated that the prescribed share rules did not block flowthrough treatment where an exploration company indemnified a subscriber to insulate against liability related to exploration activity.

The FCA found that under a provision in the agreement Deena indemnified the investor from third-party liability as a result of the expenditure of the subscription amount. The FCA concluded that the provision tainted the shares as prescribed shares, because the modern flowthrough mechanism required no protection from third parties. Indemnity from Deena constituted rights conveyed to the taxpayer that "protected" it from loss, falling within the ambit of the broad language of regulation 6202.1. Thus, the shares were prescribed shares, not flowthrough shares, even though the court realized that the taxpayer would not have supported this interpretation if Deena had fulfilled all of its obligations under the agreement. Because the shares were not flowthrough shares, their cost was not deemed to be nil and the taxpayer was permitted to claim a capital loss on the subscription amount paid. Oil and gas and mining corporations issuing flowthrough shares are well advised to ensure that there are no similar indemnities in their flowthrough share agreements.

John Jakolev and Graham Turner
Jet Capital Services Limited, Toronto

PRIVATE FOUNDATIONS' EXCESS SHAREHOLDINGS

Bill C-28, which received royal assent on December 14, 2007, restricts a private foundation's significant holdings in a corporation and may expose private foundations to increased tax governance. The changes address the government's concerns regarding potential self-dealing opportunities between a private foundation and non-arm's-length persons.

The changes generally apply to taxation years of private foundations commencing after March 18, 2007, but can restrict shareholdings by private foundations in both a public and a private corporation, whether that holding was acquired before, on, or after March 18, 2007, and regardless of whether any donor obtained tax relief related to the shares' gifting. (The new measures, introduced in the 2007 federal budget, were included in draft legislation released on October 2, 2007, a notice of ways and means motion tabled on November 13, 2007, and the Budget and Economic Statement Implementation Act (Bill C-28).)

The excess corporate holdings regime applies to classes of shares, regardless of voting or other rights, held by the private foundation. The ownership threshold is based on the number of shares held relative to the number of shares outstanding in each class. Shares held by a "relevant person" are also counted. A relevant person is generally an individual, trust, or corporation that does not deal at arm's length with the person (or any non-arm's-length group of persons) that controls the foundation. (Control is determined as if the foundation were a corporation.) Provincial legislation may further limit the level of shareholdings that a charity may hold and retain.

The proportion of shares of a class held by a private foundation and related persons determines its reporting and divestiture responsibilities.

Safe harbour. If a private foundation holds 2 percent or less of a class, no action is required by it. Relevant persons may hold any number of shares of the class.

Monitoring and reporting. If a private foundation holds more than 2 percent of a class by itself and up to 20 percent in combination with relevant persons, it may be required to track and report their shareholdings in the class and transactions in respect of the class.

Mandatory divestiture. If a private foundation holds more than 2 percent of a class by itself and more than 20 percent in combination with relevant persons, mandatory divestiture applies in addition to the monitoring and reporting requirements. To avoid penalty tax, combined shareholdings of the class must be reduced before the divestiture deadline to 20 percent or less, or the foundation's holdings of the class must be reduced to 2 percent or less (safe harbour). In certain circumstances, the penalty tax is satisfied by payment to an eligible donee.

Divestiture is required by the private foundation and/or relevant persons if the foundation has an unfulfilled divestiture obligation at the end of a taxation year; the foundation's charitable registration can be revoked for failure to divest. The required timing of divestiture depends on how the excess holdings arose, but it generally ranges from the taxation year in which the excess holdings arose to the 10th subsequent taxation year. (The divestiture period may be extended for excess shareholdings held on March 18, 2007.) Failure to comply with the divestiture requirements also attracts penalties.

Meghan Arthur and Brenda Lee-Kennedy
PricewaterhouseCoopers LLP, Toronto

US Regs on Artists' and Athletes' Compensation

On October 16, 2007, the IRS issued proposed regulations addressing the application of sourcing rules to artists or athletes who receive compensation for performances at specific events. The proposed regs, which are effective when finalized, generally adopt an event-based approach for the purposes of sourcing compensation paid to artists or athletes, but they leave many questions unanswered. The IRS also recently launched an initiative focused on improving US income reporting and compliance by foreign athletes and entertainers who work in the United States; the initial focus is on performers engaged in tennis, golf, and music.

Internal Revenue Code sections 861(a)(3) and 862(a)(3) generally provide that compensation for services performed in the United States is considered US-source, whereas compensation for services performed outside the United States is considered foreign-source. When the services are performed both inside and outside the United States, the current regs indicate that the taxpayer must determine the source of such income in a manner that most correctly reflects the proper source of the income on the basis of each case's facts and circumstances. In most cases, a time basis approach is acceptable; the amount of compensation for services performed within the United States is based on the ratio that the number of days the individual works within the United States bears to his total number of work days.

The proposed regs provide new event-based rules for determining the source of compensation for services performed both inside and outside the United States. The existing regs reserve guidance only for artists and athletes, but the proposed regs, read literally, apply to other persons too. The preamble to the proposed regs supports the contention that the regs apply to employees in addition to artists or athletes: the IRS and Treasury are said to have determined that compensation received by a person (including an individual who is an artist or athlete) who specifically performs services at an event is properly sourced to the event's location. Thus, the new rule in the proposed regs appears to apply to any compensation determined on an event basis.

The amount of compensation determined on an event basis is the amount, based on the facts and circumstances, that is attributable to the work performed at the location of the particular event. The examples in the proposed regs indicate that income determined on an event basis means any amount, whether fixed or determined by a formula, that is contingent on a person's making a specific appearance or performance; it does not encompass a fixed salary earned for a fixed period by an employee.

The proposed regs suggest that the source of event-based compensation for services is the event's location. It is not clear whether this new approach is mandatory or permissive, but the proposed regs' wording suggests that this new sourcing rule is mandatory for individuals treated as employees and elective for non-employee individuals and for all entities. The preamble also states that the IRS has discretion to determine source on a different basis. The proposed regs also state that time spent by the taxpayer to prepare for the performance of services at a specified event is generally not taken into account in determining the source of this type of compensation, because doing so generally does not lead to the best determination of source. However, the proposed regs do not preclude consideration of preparation time.

The proposed regs and the IRS's compliance initiative suggest that the IRS is paying closer attention to foreign athletes and entertainers who work and perform in the United States, including Canadian athletes and entertainers. The proposed regs make several changes to the existing source-of-compensation rules for artists and athletes, but many questions regarding the implications of the event-basis rule remain unanswered.

Marla Waiss and James M. Bandoblu
Hodgson Russ LLP, Buffalo

Income-Splitting Strategies

Income splitting is the diversion of income to family members in lower tax brackets. The practice has many advantages, and there are many strategies designed to effect it.

Income-splitting advantages include (1) multiple graduated tax rates and personal exemptions; (2) receipt, by a family member who has no other income, of $50,000 a year of eligible dividends free of tax; (3) a $750,000 capital gains exemption for each family member who owns part of a family business; (4) multiplication of dissociated companies, each entitled to the full small business deduction; (5) a reduction in capital gains tax on the death of the parents by virtue of shifting asset ownership to children; (6) reduced or no probate fees on assets previously transferred to a trust or other family members; and (7) asset protection for assets transferred to family members who do not have creditors. Notwithstanding the enactment of numerous avoidance provisions, income splitting continues to be possible.

- Assume that a husband paid $10 for a publicly traded share that is now trading at $1, and that he has no previously realized or presently contemplated capital gains. His wife is selling shares with an accrued gain. If the husband sells the share to his wife for $1, he is denied the capital loss, and the wife's tax cost is $10. If the wife sells the shares after 30 days, she will realize a $9 capital loss to offset her capital gain.
- A parent may incur a capital loss upon transferring shares to children or a trust for children.
- A non-resident may gift or lend to a Canadian resident without attribution.
- Reasonable salaries may be paid to a spouse or a child.
- An individual may contribute annually to a spousal RRSP without attribution if the spousal RRSP is not collapsed for three years.
- CPP and QPP, and now amounts under a RRIF or RRSP annuity, can be transferred to a spouse.
- Income earned on property transferred to a spouse or minor child or income earned on property acquired with a low-interest or interest-free loan is attributed back to the transferor/lender, but there is no attribution of income earned on previously attributed income. Thus, if $500,000 is loaned to a spouse or minor child without interest and earns $25,000 in the year before the loan's repayment, there is no attribution of the income generated by the investment of the $25,000.
- A parent or grandparent who makes an interest-free loan or a gift to a trust for a minor child to be invested in publicly traded securities suffers no attribution of the capital gains.
- Share ownership of a small business corporation may be structured to allow the payment of dividends to a spouse or adult children using an estate-freezing technique (either a section 85 rollover or a share-for-share exchange).
- In *Overs* (2006 DTC 2192 (TCC)), the taxpayer avoided a shareholder loan income inclusion by repaying the loan with proceeds from the tax-deferred sale to his wife of his common shares in a private company. The wife had borrowed the funds, and the husband personally deducted the wife's interest expense.
- There is no attribution on an FMV transfer of property. In *Evans* (2005 DTC 1762 (TCC)), a dentist sold $487,000 of shares of a professional corporation to a limited partnership owned by his spouse and children. Deemed and actual dividend receipts by the partnership were allocated to the spouse and children and were used to pay the promissory note. A GAAR attack was not successful.
- Income earned on a loan at the prescribed rate to a spouse or to a trust for minor children is not attributed back if interest is paid within 30 days of year-end.
- Funds may be loaned and property may be transferred to a small business corporation owned by a spouse or minor children.
- Interest-free loans may be made to a corporation owned by adult children.
- Income earned on cash gifts made to adult children is not attributed back.
- An RESP may be acquired for a child.
- A terminal loss may be triggered on a sale to a spouse, a child, a trust, or a family holding company.
- Interest-free loans may be made to a spouse or to a minor child to finance a sole proprietorship or an investment in a general partnership.

The editor of *Canadian Tax Highlights* welcomes submissions of ideas or of written material that has not been published or submitted elsewhere.
Please write to Vivien Morgan in care of the Canadian Tax Foundation.

Published monthly
Canadian Tax Foundation
595 Bay Street, Suite 1200
Toronto, Canada M5G 2N5
Telephone: 416-599-0283
Facsimile: 416-599-9283
Internet: http://www.ctf.ca
E-mail: vmorgan@interlog.com
ISSN 1496-4422 (Online)

■ A transfer of property on a tax-deferred basis to a spouse trust resident in a low-tax province, coupled with an election under subsection 104(13.1) or (13.2), enables the trust income or capital gain to be taxed at a lower rate without attribution.

■ A trust for minor children may provide personal services to a company whose specified shareholders are not related persons. The kiddie tax does not apply, and income is not attributed back.

■ A management limited partnership owned by a spouse and adult children may provide administrative and management services to a professional partnership for a fee without triggering the attribution rules.

■ A professional may, subject to the restrictions of his or her governing body, form a professional corporation in which a spouse and children own shares.

■ Some doctors or dentists may be able to have a technical service company that is owned by family members to benefit from the small business deduction with no attribution of the dividend income. The kiddie tax applies to dividends paid to minors.

■ A will may create multiple testamentary trusts, each of which is entitled to its own graduated tax rates.

Jack Bernstein
Aird & Berlis LLP, Toronto

FOREIGN TAX NEWS

Argentina

A preferential regime for the bioethanol industry (sugar cane producers) entered into force for a minimum of 15 years.

Germany

Justice released for comments a draft bill on the appropriate corporate law to govern legal entities with cross-border relationships.

OECD

The United Kingdom deposited its instrument of ratification of the OECD-Council of Europe Convention on Mutual Administrative Assistance in Tax Matters on January 24, 2008. There are now 13 parties to the agreement.

A public discussion draft on transactional profit methods, issued January 25, 2008, incorporates comments following a 2006 invitation. Interested parties should send comments by April 30, 2008 to jeffrey.owens@oecd.org.

China

The state council issued a notice effective after 2007 on transitioning for tax incentives under the old foreign income tax regime.

Chile

Chile expects to sign a free trade agreement (FTA) with Australia in the first half of 2008, adding to its list of FTA partners, which includes Canada, China, the European Union, Japan, Mexico, and the United States.

European Union

The report *Activities of the European Union (EU) in the Tax Field in 2007* was published January 30, 2008.

Details are now available of working documents, prepared for the Common Consolidated Corporate Tax Base Working Group, that discuss alternative sharing mechanisms and administrative frameworks.

Malaysia

The Labuan International Business and Financial Centre (IBFC) is one of several initiatives intended to update Malaysia's status as an offshore financial centre. The IBFC will offer full-spectrum financial services and products, and niche products such as holding companies, Islamic trusts, and captive insurers.

Jersey

GST comes into effect on May 1, 2008. Phased-in registration begins January 14 to March 18, 2008, depending on the 12-month turnover; all businesses with 12-month taxable turnover exceeding £300,000 must register by May 1, 2008.

Guernsey

The "zero-ten" corporate tax regime came into force after 2007: the standard rate is 0 percent, and a special 10 percent rate applies to banking and some activities regulated by the Financial Services Commission.

Portugal

New forms allow claims for total or partial withholding tax exemptions for one year, beginning when the competent authority certifies the residence of the income's beneficial owner.

Vivien Morgan
Canadian Tax Foundation, Toronto