CANADIAN TAX Highlights

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CRA REINTERPRETS KRUCO ON SAFE INCOME

On February 15, 2008, *Income Tax Technical News* (ITTN) no. 37 announced an abrupt change to the CRA's administrative policy on the determination of a corporation's safe income on hand. All safe income dividends paid after that date, other than "a dividend paid in a transaction, or as part of a series of transactions, the arrangements for which, evidenced in writing, were substantially advanced at the date of release," are subject to this new interpretation.

ITTN no. 37 revises the CRA's interpretation of the FCA decision in *Kruco Inc.* (2003 FCA 284) and its impact on the determination of a corporation's safe income on hand. Previous CRA interpretations of *Kruco* (in ITTN nos. 33 and 34) concluded that an amount was generally included in safe income if it was included in income for tax purposes or specifically adjusted for per paragraph 55(5)(b) or (c); a tax-deductible amount reduced safe income. Otherwise, safe income was reduced only by cash outflows occurring after the determination of net income, such as taxes and dividends. However, the CRA became concerned that this calculation could yield a safe income amount that exceeded the FMV of the corporation's shares and undermine tax policy if an amount paid out as safe income represented unrealized gains on corporate assets.

The CRA relies on *Kruco* and the TCC decision in *Gestion Jean-Paul Champagne* (97 DTC 155, cited in *Kruco*) as support for its revised interpretation that "cash outflows (such as non-deductible expenses) which are not deducted in the computation of the corporation's net income for tax purposes but still have the effect of reducing the amount of disposable after-tax income by an equivalent amount" must be deducted in computing the safe income on hand attributable to the shares on which the dividend is being paid.

ITTN no. 37 specifically refers to paragraph 38 of the *Kruco* decision, in which the court states that the calculation of safe income on hand "calls for an inquiry as to whether 'the income earned or realized' was kept on hand or remained disposable to fund the payment of the dividend. It follows, for instance, that taxes or dividends paid out of this income must be extracted from safe income." In the CRA's view, the use of the words "for instance" and "inquiry" is evidence that items other than simply taxes and dividends should reduce a corporation's safe income on hand. The CRA also believes that this new position is consistent with the tax-policy intent of subsection 55(2) to permit payment of a tax-free intercorporate dividend to reduce a potential capital gain that is attributable to the retention of "post-'71" income.

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US TIMELY FILED RETURN REQUIREMENT UPHELD

The Third Circuit of the US Court of Appeals in *Swallows Holding, Ltd.* (no. 06-3388, February 15, 2008) recently affirmed the denial of deductions to a foreign corporation for years for which the corporation failed to timely file US income tax returns. This newly added support by a Court of Appeals decision will reinforce the IRS's practice of denying US tax deductions and credits otherwise allowable to a Canadian corporation that fails to file its US return on time.

To secure compliance with US tax laws, the Internal Revenue Code denies deductions and credits otherwise permitted to a foreign corporation that fails to file a true and accurate income tax return. Treasury regulation 1.882-4 augments this rule. The return must not only be true and accurate, as required by the Code, but it must also be timely filed; otherwise, most of the forco's deductions and credits for the year of an untimely return are denied, with a few exceptions.

Whether a return is timely filed depends on the foreign corporation's filing history vis-à-vis its US income tax returns. If the forco filed a return for the immediately preceding year or if the current year is the first year for which it must file, the current return is timely filed if it is filed within 18 months of its due date. On the other

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hand, if the forco did not file a return last year and this is not the first year for filing, then the return is timely if it is filed on the earlier of (1) 18 months from its due date and (2) the date on which the IRS notifies the forco of the failure to file. The IRS may waive the timely filing requirement if a forco was genuinely unaware of its obligation to file a US income tax return and can establish that it acted reasonably and in good faith when it failed to file the return.

Many commentators have questioned the validity of the "timely filed" requirement since its creation, saying that the Treasury, which is responsible for promulgating regulations, overstepped its authority when it added a condition not contemplated by the Code. The Tax Court in *Swallows Holding* delivered a blow to the requirement in 2006 by declaring it invalid because the Treasury had exceeded its rule-making authority. The victory was short-lived: the Tax Court was reversed and the requirement upheld in February 2008 on the IRS's appeal to the Third Circuit of the Court of Appeals.

The Third Circuit's decision will generally be followed by any lower court whose decision could be appealed to the Third Circuit, but the future of the timely filing requirement in the other circuits is uncertain. However, it seems clear that the decision will embolden the IRS to continue denying deductions and credits to forcos for timely filing failures. Litigating the validity of the timely filing requirement in other circuit courts can be avoided altogether if a forco—including a Canco—timely files its US tax return. If a Canco concludes that it need not file a US return for a given year but is concerned that its determination may be challenged, it should consider timely filing a protective return. If it is later determined that the Canco should have filed a US income tax return, the timely filing of the protective return will allow the Canco to claim its deductions and credits attributable to that year.

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Alabama Addback Update

The advent of US state addback statutes may affect Canadian multinationals that use common tax-favoured financing and royalty structures. Because the statutes are so new, jurisprudence is virtually non-existent. In an appellate decision in the Alabama Court of Civil Appeals, a taxpayer was required to add back royalties paid to related parties and did not meet the "unreasonable" exception (*Alabama Department of Revenue v. VFJ Ventures, Inc.*, no. 2060478 (February 8, 2008); see also "Alabama Addback Statute," *Canadian Tax Highlights*, March 2007). The court also addressed the "subject to tax" exception and the taxpayer's constitutional challenges, even though neither issue was addressed at trial.

VFJ Ventures, Inc. (Opco), which manufactured and sold jeanswear, had two distribution facilities and a cutting facility in Alabama. Opco licensed trademarks from two related Delaware corporations engaged in the business of owning, managing, and licensing trademarks (TMcos). On the audit of Opco's 2001 Alabama income tax return, Alabama said that in computing its taxable income Opco must add back the royalties paid to the TMcos.

At trial, Opco argued that the "unreasonable" exception applied, because it would be unreasonable to require the addback in the circumstances. The term "unreasonable" was not defined; thus, the court looked to the legislative intent and concluded that the addback statute's purpose was to prevent abusive deductions and to ensure that income fairly attributable to Alabama was taxed by Alabama. The trial court concluded that the addback was unreasonable because Opco's royalty payments were not abusive, had economic substance and business purpose, and represented real and necessary costs of doing business; furthermore, an addback would distort Opco's income fairly attributable to Alabama.

The appeals court reversed the trial court decision and supported the state's argument that the unreasonable exception applied when an addback resulted in Alabama tax disproportionate to a taxpayer's Alabama activities, but it did not apply merely because business purpose or economic substance supported the otherwise disallowed payment. Alabama had consistently interpreted the addback in this way, and the regulations were consistent with this interpretation. The appeals court concluded that Alabama's interpretation was entitled to deference and was consistent with the commonly accepted definition of "unreasonable." Furthermore, the court agreed that finding an addback to be unreasonable for payments with business purpose or economic substance would leave the addback statute with little purpose other than to disallow sham transactions, which were assailable on other grounds. Alabama also argued that the trial court's interpretation rendered useless another addback exception for payments that did not have a tax-avoidance purpose (provided that the related-party recipient was not primarily engaged in managing intangible assets). The appeals court concluded that Alabama's interpretation of the "unreasonable" exception was appropriate. Opco presented no evidence that its income was distorted by the addback or that taxes paid were disproportionate to its Alabama activities.

The appeals court next addressed the subject-to-tax exception. A taxpayer need not add back either interest and intangible expenses, or costs directly or indirectly paid, that are accrued to or incurred with respect to a related member who was subject to a tax on the related income that was based on or measured its net income in Alabama or another state. According to the statute, this means that "the receipt of the payment by the recipient related member is reported and included in income for the purposes of a tax on net income, and not offset or eliminated in a combined or consolidated return which includes the payor."

The TMcos filed North Carolina tax returns on which they reported all their federal taxable income, but only part thereof was apportioned to and taxed by North Carolina. The appeals court agreed with Alabama that the subject-to-tax exception applied only to income apportioned to North Carolina; otherwise, the addback statute would be rendered meaningless by the simple expedient of having a minimal amount of income taxed by another state. The appeals court was also persuaded by Alabama's consistent application of the subject-to-tax exception on a post-apportionment basis, back to a point before the addback regulations' adoption. Moreover, the court noted that the legislative definition of "subject to tax" required income to be both reported and included in income for the purposes of a tax on net income: each statutory word must be presumed to have effect and each condition must be fulfilled.

In its constitutional challenges, Opco argued unsuccessfully that disallowing the royalties' deduction was an attempt to impose income tax on entities that lacked substantial nexus with Alabama. Nor, the court found, did the addback statute disproportionately tax Opco's activities in Alabama. The court also said that the addback statute did not discriminate against interstate commerce: in-state corporations did not benefit to the detriment of, or disproportionately to, out-of-state corporations.

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Provincial Tax Comparisons

Statistics Canada's annual release of details of provincial economic accounts for 2005 provides an opportunity to compare tax burdens across the nation. Once again, having extensive oil exploration and production activities in a province reduces tax collections as a percentage of GDPP.

It should not be surprising that Alberta residents enjoyed the lowest tax burden in 2005, measured by expressing tax collections as a percentage of GDPP, thanks to the lowest combined provincial and local tax collections. The table shows that the total tax burden in Alberta was 23.7 percent of GDPP; federal taxes represented 13.3 percent, but provincial and local tax collections were only 8.4 percent of GDPP, just over one-half of the national average. At the other extreme, total tax collections in Quebec represented 39.0 percent of GDPP, split almost equally between the federal and the provincial and local levels.

Tax Collections as a Percentage of GDPP, Calendar Year 2005

	Federal	Provincial and local	CPP/ QPP	All levels
Newfoundland and Labrador	10.8	12.4	2.4	25.6
Prince Edward Island	17.3	16.7	3.7	37.8
Nova Scotia	14.9	16.3	3.0	34.2
New Brunswick	14.4	15.5	3.4	33.3
Quebec	15.2	20.6	3.3	39.0
Ontario	16.4	16.4	2.9	35.7
Manitoba	13.9	16.3	3.1	33.3
Saskatchewan	11.7	15.1	2.3	29.1
Alberta	13.3	8.4	2.0	23.7
British Columbia	15.4	13.4	3.0	31.8
Canada (including the territories)	15.1	15.4	2.8	33.3

The differences between the federal and provincial tax systems can be inferred from the wide variation between the federal and the provincial and local ratios across the country. Not surprisingly, federal taxes as a percentage of GDPP ranged from a high of 16.4 percent in Ontario, where average incomes and economic activity were buoyant, to a low of 10.8 percent in Newfoundland and Labrador, where the economy had not yet responded fully to oil industry developments. The federal variations can be accounted for by the type and wealth of taxpayers; the uniform system produces different results according to the specific circumstances in each province. Provincial and local variations in the ratios reflect the same differences in the tax base and in the rates applicable in each area.

These ratios provide a useful measure of the extent to which each region calls upon its taxpayers to fund the cost of public services. However, because the ratios are influenced by the composition of the tax base and by the rates and structure of the taxes themselves, any extension or extrapolation from the very general conclusions based on these ratios to the relative tax position of specific taxpayers or even types of taxpayers is not warranted.

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FIE and NRT Rules in Process

The 1999 federal budget announced proposals to prevent tax deferral and avoidance through the use of non-resident trusts (NRTs) and foreign investment entities (FIEs). Each successive draft of the legislation has been roundly criticized as far broader than necessary to address the concerns

Finance raised in 1999 about inefficiencies in the existing legislation. It appears that we have yet to see the final version of the rules.

On October 29, 2007, the minister of finance reintroduced, for the seventh time, detailed NRT and FIE legislation (Bill C-10), effective for taxation years beginning after 2006. This latest bill received third reading in the House of Commons in 2007, but is still awaiting final Senate approval. From the transcript of the January 30, 2008 hearing of the Standing Senate Committee on Banking, Trade and Commerce, it appears that the proposed legislation may be amended. The committee chair indicated that solutions were being worked on to address certain consequences of the bill that were raised in the December 12 and 13, 2007 hearings, where significant discussion surrounded the breadth of the NRT deemed residence rule's application and its potential impact on institutional investors and others with regard to non-tax-motivated interests in NRTs.

The FIE rules aim to prevent the deferral of offshore investment income held by Canadian residents, both individual investors and multinationals with investments in non-resident entities. Several aspects of the latest proposals create difficulty. One legislative area particularly targeted by critics deals with certain investments in trusts that are exempt from the NRT rules but may still be subject to the FIE rules. The NRT rules aim to tax the income earned by an NRT that has either a "resident contributor" or a "resident beneficiary" (defined terms in the new legislation): the non-resident trust is deemed to be a resident of Canada and is taxed on its worldwide income. An interest in a trust subject to the NRT rules is outside the FIE rules' ambit, but many trusts subject to the NRT rules may be FIEs.

■ **FIE exception tainted?** A Canadian-resident beneficiary is subject to the new FIE rules if, at the end of the NRT's taxation year, he or she has a specified interest in a foreign trust. The definition of "specified interest" is extremely broad, and includes any beneficiary's interest in a foreign trust unless "every amount of income and capital of the trust that the entity or individual may receive at or after that time depends at and after that time on the exercise . . . of a discretionary power [of any other entity or individual]." Thus, the exception from the application of the FIE rules is very limited: the beneficiary's trust interest must be entirely discretionary with respect to income and capital distributions. It is common for a trust deed to contain a termination clause that provides for the mandatory distribution (whether "in equal shares" or otherwise) by the trustees at the end of the trust's life. Although the termination clause does not affect the discretionary nature of the trust's distributions during its existence, there is a concern that the mere inclusion of a termination clause in a trust may be sufficient to bring the Canadian-resident discretionary beneficiary within the ambit of the FIE rules.

Because the new legislation is effective for taxation years beginning after 2006, and because the FIE rules apply to taxpayers only if they have a specified interest at the end of the trust's taxation year, taxpayers should review their existing trust arrangements to assess exposure to the FIE rules. Any investment in a foreign entity may be caught unless it falls within a specific exemption. Affected taxpayers should consider whether it is appropriate (or possible) to vary or amend the trust terms without triggering an indirect contribution. For example, trustees should consider amending the termination clause or using the "successor beneficiary" exception to prevent the FIE rules' future application.

■ **Designated cost of NRT interest.** The FIE rules present many challenges, especially with respect to determining an interest's "designated cost." The base case results in an income inclusion equal to a prescribed rate (currently 6 percent) times the "designated cost" of the participating interest; for a December 31 year-end trust, the designated cost is the FMV on January 1, 2007. Arguably, the FMV is negligible because the interest is purely discretionary until the date of final distribution, a position that the CRA formerly seemed to agree was reasonable. More recently, however, the CRA has indicated (although not in the FIE rule context) that if the value is not readily determinable, the value of the trust's underlying assets should be divided by the number of Canadian beneficiaries; under this approach, a Canadian beneficiary may be taxed on significant income that he or she never receives.

■ **Granny trusts.** In a personal tax setting, many so-called granny trusts are offshore trusts settled by a non-resident relative for the benefit of the next generation. They may not be caught by the NRT rules even if there are Canadian beneficiaries, because there is no Canadian contributor to the trust. If the settlor was never resident in Canada and settled the trust with offshore assets, it is unlikely that a granny trust will be caught by the NRT rules; but if a granny trust is not purely discretionary with respect to all income and capital distributions, the beneficiaries' trust interests may nonetheless be caught by the FIE rules.

■ **Accounting impact.** Because the legislation passed third reading in the House of Commons in October 29, 2007, it appears that under Canadian GAAP the legislation is considered substantively enacted at that date. Thus, the impact of the legislation (based on the text existing on that date) must be reflected in December 2007 financial statements. Any subsequent changes will presumably be sent back to the House for its approval, and the consequent accounting impact of changes then ratified by the House will be made in the period in which the changes are approved. From a US GAAP perspective, tax effects are only recorded in the period when the legislation is formally enacted (royal assent); thus, the legislation's impact has not yet been recognized for US GAAP.

■ **Filing 2007 income tax returns.** The rules are not yet law but are retroactive to January 1, 2007; taxpayers must decide whether to file their 2007 returns on the basis of the draft legislation. Normally, taxpayers file on the basis of draft legislation that has passed third reading in the House, but some judgment may be required to avoid interest and penalties because it appears that at least some further modification of the legislation may be forthcoming.

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Verifying Registration Numbers for GST ITCs

It remains uncertain whether a registrant can lose the right to claim an input tax credit (ITC) for GST paid to a supplier whose GST registration number was retroactively cancelled by the CRA.

Entitlement to claim ITCs arises when the would-be claimant acquires property or services for use in commercial activities; however, the claimant must create an audit trail to substantiate this entitlement. If the consideration for a taxable supply exceeds $30, subsection 169(4) of the Excise Tax Act and the Input Tax Credit Information (GST/HST) Regulations require that the claimant obtain documentary evidence supporting the supplier's GST registration number before it files the return containing the ITC claim. The CRA can cross-check the supplier's remittance of the relevant taxes.

Case law has gradually brought into focus the strictness of the supplier's obligation to have a valid registration number: it is not enough for the supplier to obtain a number. The point was confirmed in *Systematix Technology Consultants Inc.* (2006 TCC 277), in which the registrant claimed ITCs based on suppliers' registration numbers that (1) had been cancelled before the supply was made, (2) were issued after the supply was made, or (3) were never issued. The TCC recognized the difficulty in policing the validity of supplier registration numbers, but nonetheless concluded that the Excise Tax Act requirements were mandatory and that a valid registration number must have been assigned by the CRA at the time of the supply or, at the latest, when the return was filed. The FCA upheld the TCC decision (2007 FCA 226).

The CRA's Web registry goes a long way toward eliminating uncertainty. A registrant can now check and confirm online the validity of a supplier's GST number. What the search cannot predict, however, is whether the CRA will subsequently cancel a registration number effective prior to the date of the search. The minister can cancel a registration number "after giving a person . . . reasonable written notice" if the minister "is satisfied that the registration is not required for the purposes of this Part" (subsection 242(1)). If the minister cancels the registration, he "shall notify the person in writing of the cancellation . . . and the effective date thereof" (subsection 242(3)). The minister has interpreted the reference to the "effective date" of the cancellation as allowing retroactive cancellation of registrations. Retroactive cancellation may often be inconsequential, but it may have serious implications for a third party who relied on the existence of a valid GST registration number for, among other things, paying GST and claiming related ITCs. Basic fairness suggests that a registrant who pays GST and obtains supporting documentation bearing the supplier's registration number should not bear the risk of a retroactive cancellation.

Retroactive cancellation of a supplier's registration number was the central issue in *Westborough Place Inc.* (2007 TCC 155). The ITC claimant was billed for GST in 2002 by a supplier that provided a GST registration number. The ITC claim was filed before February 28, 2003. On December 23, 2005, the CRA closed the supplier's GST account and deregistered its GST number retroactive to June 30, 2001. Westborough's ITC claim was denied for failure to comply with subsection 169(4), because the supplier's registration number was invalid. Westborough appealed successfully to the TCC, which said that the CRA may cancel if it is reasonable to conclude that the supplier's registration was not required after June 30, 2001, the retroactive cancellation date. The evidence showed that the supplier had continued to carry on business and collect GST until at least 2003, and therefore was required to be registered until at least that time. Thus, the court held that when the ITC claimant obtained the GST number from the supplier in 2002, it had obtained a number that was valid for the purpose of claiming ITCs.

The court rejected the CRA's retroactive deregistration, but only because the provision's requirements were not met. The court referred in passing to the "purported" retroactive deregistration of the supplier, but it did not discuss the power of the CRA to deregister the supplier retroactively. Implicitly, the decision concludes that the deregistration cannot predate a time when the supplier's registration was required (a prerequisite of the empowering provision). The judgment raises the question of whether section 242 allows the CRA to cancel a registration number retroactively. There may be circumstances in which a registration could be viewed as a nullity from the start—for example, if it was never required—but otherwise the words of subsection 242(1) arguably do not authorize retroactive deregistration ab initio. Authority for deregistration ab initio cannot be read into subsection 242(3), which merely requires the CRA to give notice of the date of cancellation in writing: the substantive authority to deregister appears to be confined to subsection 242(1).

The conclusion in *Westborough* seems correct and fair, but it was decided under the TCC's informal procedure and thus has no precedential value. The CRA in any event continues to deny ITC claims because of "invalid" GST numbers that were cancelled after the supply was made. Surely a registrant must be eligible to claim ITCs under an invoice showing a GST registration number that is valid at the time the supply is made; to conclude otherwise places an undue onus on the ITC claimant, particularly if it confirmed the registration number online. Moreover, a contrary conclusion renders the allowance of ITCs effectively a discretionary function within the authority of GST administrators. The GST system presumably should not inhibit the flow of commerce for participants acting prudently and in good faith, especially when the legislative authority is ambiguous at best.

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Owner-Manager Remuneration

Reduced tax rates for eligible dividends paid by a Canadian corporation may change the optimal owner-manager compensation.

Previously, a company commonly accrued a bonus on all corporate income exceeding the small business deduction and paid it within 179 days of year-end; the tax withheld was remitted on the 15th of the next month. If the company's fiscal year-end was between July and December, the individual's tax liability was shifted to the following calendar year. An Ontario resident in the top tax bracket paid tax of 46.4 percent.

If the corporation retains income that exceeds the small business limit, it benefits from more after-tax funds to invest and the deferral of tax. However, in the past income taxed at the corporate level and then paid as a dividend suffered some double taxation. Assuming, for example, a 36.12 percent corporate rate and a 31.2 percent rate on dividends, the combined rate was 56.07 percent. In 2007, the combined rate is only 50.42 percent (assuming a 36.12 percent corporate rate in 2007 and 22.38 percent on dividends). In 2012, the combined rate drops to 44.69 percent (assuming a corporate rate of 32.5 percent and 22.38 percent on dividends).

In Ontario, the current corporate rate is 40.79 percent (falling to 33.6 percent in 2012) on non-manufacturing and processing active business income over $400,000 but under $1,128,519 (due to the Ontario small business deduction clawback), and 36.12 percent on the excess. Compared with the bonus alternative, retaining the funds in the corporation yields about 10.3 percent more funds to invest, and avoids EI, CPP, and employer health tax contributions, and challenges to the quantum of salaries paid to less active family members. Provincial capital tax may increase as retained earnings rise. However, an owner-manager may wish to take sufficient salary (about $115,000) to maximize his RRSP contribution.

Excess funds accumulating in an opco may be exposed to trade creditors. If excess cash exceeds 10 percent of the share value, the company ceases to be a qualified small business corporation. Corporate attribution may be triggered if there is a designated shareholder and the $750,000 capital gains exemption is jeopardized unless it is crystallized before then by the owner-manager's rolling his shares for another class in the opco or for holdco shares. A holdco facilitates the payment of tax-free intercorporate dividends out of retained earnings and protects the investments from opco's trade creditors. The holdco can lend funds back to the opco to cover its cash needs and take back security subordinate to opco's bank.

An owner-manager who owns a related company (a holdco) that has refundable dividend tax on hand (RDTOH) but insufficient funds to pay the dividend required to generate a full refund may roll his opco shares to the holdco and crystallize his capital gains exemption. Income taxed in the opco at the top corporate rate may be paid as an eligible dividend to the holdco, which then pays an eligible dividend to the owner-manager, generating the RDTOH refund.

Investment tax credits (ITCs) are also eroded if the company earns income exceeding its small business limit. For SR & ED, a company qualifies for the full refundable ITC if the income in its associated group is no more than $400,000 and the taxable capital is no more than $10 million; the ITC is eliminated if the company has income of $600,000 or more or the group's taxable capital exceeds $15 million.

Alternative minimum tax may be accelerated by the receipt of non-eligible dividends because the gross-up is greater. An adult child with no other income may receive approximately $50,000 a year of eligible dividends free of tax, although AMT may apply. Dividends paid to a shareholder reduce the cumulative net investment loss, if any, and free up any unutilized capital gains exemption.

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Value for Customs Duty

In *The Pampered Chef* (AP-2006-048, February 13, 2008), the Canadian International Trade Tribunal (CITT) concluded that the value for duty was the transaction value of goods imported in an intercompany transfer between Pampered Chef USA and Pampered Chef Canada, and was not based on Pampered Chef Canada's subsequent sales of the goods to Canadian customers.

Section 48(1) of the Customs Act generally provides that the value for duty of goods is the transaction value of the goods, if the goods are (1) sold for export to Canada (2) to a purchaser in Canada, either a Canadian resident or a person with a Canadian permanent establishment (PE) through which it carries on business. In transfers between related corporations, it can be particularly difficult to determine whether those conditions are fulfilled.

In *The Pampered Chef*, sales consultants took orders for Canadian customers and sent them to Pampered Chef Canada's support centre for processing. Then a request was sent to Pampered Chef USA's warehouse, and the goods were delivered by UPS to its Canadian hub, which then shipped the goods to the customer. The parent invoiced Pampered Chef Canada monthly for all shipments; all payments by the end customer were made to Pampered Chef Canada's bank account (or an account that it had access to). Pampered Chef Canada paid the consultants' commissions, bonuses, and overrides; paid all customs charges and freight costs incurred; and bore the risk of loss, damage, non-delivery, returns, warranties, and product liability once the goods left the parent's warehouse.

The CBSA said that the value for duty should be based on the sale from Pampered Chef USA to its consultants in Canada—that is, at full consumer price—because the consultants processed all the order forms, forwarded the orders to Pampered Chef USA, and were responsible for the collection of bad debts. CITT disagreed: the sale for export was the sale from Pampered Chef USA to Pampered Chef Canada. CITT said that the consultants were only facilitators who earned a commission and did not buy the imported goods on their own account for resale at a profit. CITT also found that title of the goods passed from Pampered Chef USA to Pampered Chef Canada at Pampered Chef's USA's warehouse, because Pampered Chef Canada was responsible for customs charges and bore all financial risk once the goods left the warehouse.

CITT further said that Pampered Chef Canada was a purchaser in Canada: it had a Canadian PE because it managed its business through its office, employees, and warehouse, all located in Ontario. CITT cited the FCA's test for "carrying on business" in *FosterGrant* ([2004] 3021 ETC)—namely, whether the company buys and sells goods on its own account for a profit in Canada. Pampered Chef Canada was carrying on business in Canada because payments by the end customer were sent to it directly or deposited in an account to which it had access, and it resold the goods in Canada for a profit. Thus, the goods were sold for export to Canada to a purchaser in Canada, and the value for duty was the goods' transaction value based on the intercompany transfer price.

The Pampered Chef is yet another blow to the CBSA, which has not had much success in its position on the transaction value method. (See also the FCA decision in *FosterGrant* and the CITT decision in *Ferragamo USA*, AP-2005-053.) We understand that the CBSA's administrative policy on the issue (*Memorandum* D13-1-3, "Customs Valuation: Purchaser in Canada Regulations (Customs Act, Section 48)," dated April 9, 2001) is currently under revision and that the underlying legislation will not be amended.

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Interest Receivable: Income for Departure Tax

The TCC recently decided in *Holzhey* (2007 TCC 247) that an emigrant's proceeds from the deemed disposition of the right to receive accrued interest were included in his or her income as an amount received "in lieu of interest" under paragraph 12(1)(c).

Under paragraph 128.1(4)(b), a taxpayer who ceases to be a Canadian resident is generally deemed to have disposed of each property he or she owns for proceeds equal to its then FMV. Under paragraph 12(1)(c), a taxpayer must include in his or her income "any amount received or receivable . . . on account of, in lieu of payment of or in satisfaction of, interest to the extent that the interest was not included in computing the taxpayer's income for a preceding taxation year."

Mr. H gave up Canadian residence on November 30, 2000 and took up German residence on December 1, 2000. Mr. H was a minority shareholder of Germanco, to which he made several interest-bearing loans over the years. Under the loans' terms, interest accruing during a particular calendar year was payable in December of that year. For all years prior to his emigration, the interest that Mr. H received on the loans was correctly reported in his Canadian income tax return as income in the year of receipt. Mr. H still held the loans when he ceased to be a Canadian resident.

From January 1, 2000 to November 30, 2000, just prior to emigration, about $126,000 of interest accrued on the loans. Mr. H did not report the accrued interest as income in his Canadian 2000 taxation year return, but reported it as a capital gain arising from a deemed disposition of the interest accrued up to November 30, 2000. He also reported the accrued interest in his German tax return.

The CRA reassessed Mr. H's 2000 taxation year in December 2002 and included the accrued interest of $126,000 as interest income under paragraph 12(1)(c): the deemed proceeds from the deemed disposition of the right to receive the accrued interest "in lieu of interest." The CRA cited the FCA decision in *Transocean* (2005 FCA 104) as support for interpreting the phrase "in lieu of" broadly. (In that decision, a $40 million settlement paid by a Canadian resident to a non-resident for damages for terminating an offshore drilling rig contract was held to be a payment in lieu of rent and thus subject to withholding tax under paragraph 212(1)(d).)

The CRA said that Parliament used the phrase "in lieu of" because it intended to expand the scope of paragraph 12(1)(c) to include payments other than those with the legal character of interest. Since Mr. H's proceeds on the deemed disposition resulted from his lending money to Germanco and from earning interest thereon, the gain was a deemed payment in lieu of interest.

The TCC in *Holzhey* said that the FCA decision in *Transocean* determines whether the deemed proceeds from the deemed disposition of the right to the accrued interest were received "in lieu of" interest; the question then to be answered was whether the deemed proceeds in *Holzhey* were a "reasonable substitute for the interest earned on the loan" but not yet payable. The TCC concluded that the link between the deemed proceeds and the accrued interest was even stronger than the link in *Transocean* between the damages settlement for terminating the contract and the rent payable under the contract: the loans to Germanco already existed and the interest had already accrued before the deemed disposition occurred. The interest accrued during the period up to November 30, 2000 could be precisely calculated under the loan agreement; according to the agreed statement of facts, the amount of the accrued interest was equal to the FMV of the right to receive the accrued interest. The TCC said that the proceeds received from the emigrating taxpayer's disposition of the "expectancy to receive interest" were a reasonable substitute for interest, and thus the proceeds were received in lieu of interest within the meaning of paragraph 12(1)(c).

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CRA's SR & ED Small Business Action Plan

The CRA's SR & ED small business action plan addresses the needs of SR & ED small business claimants. (See also "CRA To Help Small Businesses Reduce the Compliance Burden," *Canadian Tax Highlights*, July 2007.) The action plan identifies four key objectives and several specific actions to achieve these objectives that the CRA will implement before 2009, some of which are noted below.

Objective 1: Ensure public awareness of SR & ED program and services

- Develop and distribute a one-page outline of the SR & ED program to businesses, government agencies and departments, professional and business associations, and embassies.
- Partner CRA outreach activities with other federal and provincial R & D programs and develop an SR & ED national information package available on CD-ROM for use at outreach activities and public information sessions.
- Place articles about the SR & ED program in trade and professional publications.

Objective 2: Make SR & ED publications easier to understand

- Develop one publication to comprehensively provide an overview of the SR & ED program.
- Simplify Guide T4088, "Claiming Scientific Research and Experimental Development."
- Publish a clear explanation of the documents needed to support an SR & ED claim.

Objective 3: Improve accessibility to the SR & ED pages on the CRA Web site

- Redesign the SR & ED home page (http://www.cra-arc.gc.ca/taxcredit/sred/menu-e.html) and create Web pages that highlight the requirements for filing an SR & ED claim.
- Create an online self-assessment tool to help businesses determine eligibility of their R & D projects.
- Develop an online guide, and a Web-based claim form that links to readily accessible information to help complete SR & ED claims.
- Consider adding samples of completed claim forms and project descriptions to the Web site.

Objective 4: Simplify the process for filing an SR & ED claim

- Simplify claim forms and enhance the "Complete Claim Checklist" on claim forms.
- Develop a clear format for submitting project details to help determine eligibility for the program.

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FOREIGN TAX NEWS

Liechtenstein

Liechtenstein's banking secrecy laws make the jurisdiction attractive to investors who wish to cloak their investments and thus, critics say, facilitate tax evasion, money laundering, terrorist financing, and corporate fraud. A convicted fraudster and former employee of LGT, a bank owned by the Liechtenstein royal family, approached foreign tax authorities with four CDs of information that he had taken from the bank concerning some 1,400 foreign persons. Germany's foreign intelligence agency paid several million euros for the information and has made it available to other governments free of charge. Countries around the globe are involved in investigations, including Australia, Canada, France, Iceland, the United Kingdom, and the United States.

Germany had been investigating the use for tax evasion of Liechtenstein foundations, which make the determination of the ultimate beneficiaries of foundation income all but impossible. A report seven years in the making that proposed reform of the law on foundations has been submitted for debate in the Liechtenstein Parliament. Proposals include general supervision, mandatory registration for all non-profit foundations (excluding private foundations, such as family foundations), and making it more difficult to change a foundation's purpose.

New Zealand

On February 25, 2008, the government announced that it will retroactively amend its income tax law to deny a deduction for interest paid on a debt stapled to a share instrument. The decision was triggered by a recommendation on February 24, 2008 from the board of Auckland International Airport Ltd. to its shareholders to accept a Canadian pension fund's share purchase offer that included a stapled stock issue to the fund. The perceived urgency of the matter precluded consultation with the interested parties.

United Kingdom

It is proposed that a non-domiciliary resident in the United Kingdom for 7 of the previous 10 years pay an additional £30,000 tax annually to maintain a remittance basis for tax purposes. The government has abandoned proposals that would have required such taxpayers to make extensive disclosure of income and gains abroad, including the source of the remittance income.

Portugal

To combat tax fraud and evasion, a new law establishes disclosure requirements for promoters and users of "aggressive" tax plans, although commentators say that the breadth of the legislative wording may enable the government to cast its net much further.

European Union

A conference held in Vienna in February 2008 focused on a possible EU common consolidated corporate tax base, including its technical outline, administrative framework, sharing mechanism, and relationship with tax treaties.

An EC communication suggests far-reaching measures to combat VAT fraud, including taxation of intra-EC supplies in the member state of origin at 15 percent and application of the general reverse charge mechanism to domestic transactions.

Germany

The minister of finance asked for comments on a draft letter regarding the application of new thin cap rules limiting interest deductibility.

Australia

A Taxation Office non-binding interpretation concludes that a CFC can exist by way of de facto control, but attribution requires ownership of direct or indirect interests in the CFC.

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