CANADIAN TAX Highlights

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No Agent's Rebate for GST Overpaid

A 5 percent GST applies on nearly all goods imported to Canada, under division III of the ETA in combination with various provisions in the Customs Act. The tax is payable by every person liable to pay customs duty, but it is usually paid by the importer's customs broker, acting as agent, who is ultimately reimbursed by the importer. The FCA in *United Parcel Service Canada Ltd.* (2008 FCA 48) recently overruled the TCC and denied the GST rebate claim of a customs broker who overpaid GST while acting on the importer's behalf.

UPS carried on business as a courier, bringing shipments into Canada for delivery to consignees at addresses in Canada. These shipments attracted Canadian customs duties (sometimes) and GST (almost always), both payable at the border. As the licensed customs broker, UPS paid the customs duties and GST and sought reimbursement from its customers. Sometimes UPS overpaid GST, and instead of seeking reimbursement for the overpayment from its customer—leaving the customer to claim any allowable GST ITCs or rebates—UPS had the customer sign a credit note authorizing UPS to take an input tax credit (and effectively a GST rebate) for the overpayment. If a customer had an active brokerage account with UPS, the two parties entered into a general agency agreement under which the customer constituted UPS its agent for the purposes of dealing with the CBSA and for paying GST. UPS claimed a rebate of GST for an overpayment pursuant to subsection 296(2.1); the minister disallowed the rebate claim and assessed interest and penalties.

In This Issue

The TCC found in favour of UPS, largely on the basis that it overpaid GST as its customers' agent and was jointly and severally liable for the GST payable. The FCA reversed the decision and said that case law established that UPS's remitting of the tax did not entitle it to a rebate of an overpayment of tax that was not its liability. Unfortunately, the ETA provides no specific relief for a person who pays GST on behalf of another and whose claim for reimbursement remains unsatisfied. Moreover, nothing in the ETA contemplates an authorization such as the credit note, which was a contractual arrangement and ineffective to transfer the customer's rights and obligations under the ETA.

The FCA's decision is very unfavourable for taxpayers because it severely limits the circumstances supporting recovery of tax overpaid. An agent who overpays tax is not entitled to a rebate that is not claimed by the principal. For customs brokers and other similar agents, the FCA decision in *UPS* increases the administrative burden for recovering GST overpayments on imports, because the principal must submit the necessary documentation. Given the windfall to the federal government and the unfairness of the economic loss to the agent in these situations, which occur with some regularity, a legislative amendment may be necessary.

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Harmonization Crunch for Miners

The recent Ontario budget provided a reminder that harmonization is fast approaching and that the CRA will commence to administer Ontario's corporate income tax and capital tax, corporate minimum tax, and certain other taxes for taxation years ending after 2008. Harmonization may bring an unexpected burden for Ontario mining companies.

Under the Ontario-federal 2006 harmonization agreement, a corporation must determine its federal and Ontario tax attributes at the end of 2008 to establish whether a transitional debit or credit to Ontario taxes, payable over the reference period, arises when the Ontario pools are reset to the federal balances for the first taxation year ending after 2008. For a calendar-year-end company, the reference period starts on January 1, 2009 and ends five years later on December 31, 2013. For most mining companies, the tax attributes generally consist of UCC balances for fixed assets, eligible capital expenditures, paragraph

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20(1)(e) deductions, resource pools for CCEE and CCDE, and losses (the tax balances).

A transitional credit, deductible from Ontario taxes, arises if the Ontario tax balances exceed the federal tax balances immediately before the transition time. The Ontario tax balances are reduced to the federal tax balance amounts, and there is compensation in the form of reduced Ontario taxes payable (the reduction amount times 14 percent times the Ontario allocation factor). The credit is available over five years. The Ontario allocation factor is tested annually over the next five years; transitional credits never exceed the Ontario tax payable in any year but are available for carryforward.

The flip side, a transitional debt, is bad news for junior mining companies: additional Ontario taxes payable equal the excess of federal tax balances over the Ontario tax balances, multiplied by 14 percent and the Ontario allocation. Assume that a mining company (Mineco) with a calendar year-end owns mining properties and carries on operations exclusively in Ontario; its federal tax balances are $1,000,000 more than its Ontario tax pools at December 31, 2008. Harmonization requires that Mineco pay additional Ontario taxes of $140,000 for the extra $1,000,000 of tax attributes it will receive through the harmonization process. The Ontario allocation is redetermined every year over the five-year reference period; if Mineco continues to operate exclusively in Ontario in each of the next five years, the additional $140,000 of Ontario tax is payable pro rata over five years. Junior and mid-sized mining companies are generally never taxable until production, and even then they are not taxable for many years because of accelerated tax writeoffs provided on mining facilities constructed for a new mine or a major expansion of an existing mine. A junior resource company in an exploration and development phase has little use for additional tax deductions: its key concern is raising cash to finance such activities. In fact, a junior resource company typically raises financing by issuing flowthrough shares, and renouncing tax deductions in favour of funds from flowthrough share investors.

Junior mining companies might consider emulating the lobbying efforts of other sectors for special relief to further defer transitional tax; SR & ED claimants have been partially successful in this quest. A preferable approach for junior mining companies would be a rule requiring the payment of additional Ontario taxes only if the additional deductions are actually used; actual deductions could be tracked easily in a separate tax pool and the additional taxes payable made equal to 14 percent of deductions claimed in a year. A main reason for the disparity between Ontario and federal tax pools that creates a transitional debit is the "negative resource allowance," which results in income to a taxpayer that has a resource loss. The federal resource allowance was completely phased out by 2006 in favour of lower tax rates. Ontario retained the 25 percent resource allowance (or loss) rules.

The recent Ontario budget also has good news for a corporation engaged primarily in mining or manufacturing: Ontario capital tax is eliminated (retroactively) as of January 1, 2007, one year earlier than previously scheduled. Ontario retains its 2 percent corporate tax rate reduction, which reduces tax from 14 to 12 percent on M & P profits earned in Ontario, including Ontario mining profits.

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Protocol Process and Basis Bump

Protocol ratification. The US process to ratify the Canada-US treaty protocol finally commenced on March 13, 2008, when President George W. Bush sent it to the Senate for advice and consent to ratification. The Senate promptly referred the protocol to the Senate Foreign Relations Committee, where it will be fully considered and subject to a public hearing. During this stage, the Treasury generally presents a technical explanation and the Joint Committee on Taxation generally prepares an explanation—developments highly anticipated by practitioners on both sides of the border. These reports and the Senate Foreign Relations Committee report are often released shortly before the public hearing, following which the committee sends its report to the full Senate for advice and consent to ratification by a vote of two-thirds of the members present. If the Senate approves the protocol without a reservation or amendment that requires further negotiations with Canada, the instruments of ratification are prepared for the president's signature. Canada completed its ratification in December 2007, and the protocol is effective on the exchange of the instruments of ratification.

Basis bump for emigrating Canadians. Although the protocol provides for various effective dates depending on the particular provision, one change is effective immediately and retroactively to September 18, 2000: the election to step up the basis of property deemed disposed of by an individual ceasing to be a resident of one country and becoming a resident of the other country (protocol article 8(3)). The provision primarily benefits an individual who abandons Canadian residence in favour of US residence.

In 2000, both the United States and Canada agreed to provide double taxation relief to a Canadian resident (a non-US citizen, non-green-card holder) who abandons that residence and establishes US tax residence. Under Canadian tax law, a taxpayer who abandons Canadian residence is deemed to have disposed of certain property at its FMV;

but for US tax purposes, the Canadian deemed disposition is not recognized and the property retains its historic tax basis. Assume that Mr. X—a Canadian resident, non-US citizen, and non-US resident—owns Canco shares with a cost basis of $100 and an FMV of $1,000 when he ceases to be a Canadian resident. Canada treats Mr. X as having sold the shares for $1,000, realizing a $900 gain. Mr. X then becomes a US tax resident and sells the shares two years later when they are worth $1,500. For US tax purposes, Mr. X's shares have a $100 tax basis and the $1,400 gain realized has a US source because he is a US resident and a non-Canadian resident at the time of the actual disposition; thus, the US tax cannot be offset by foreign tax credits for the Canadian tax paid. Mr. X is subject to tax in both countries on the same $900 gain, and without further planning he will likely incur double taxation.

The various strategies used over the years to trigger a pre-emigration taxable event for US tax purposes can be expensive and complicated, may not completely avoid double taxation, and can accelerate the individual's tax liability. The protocol remedies the double taxation and avoids complicated tax planning by allowing a taxpayer to simply elect to be treated for US tax purposes as having sold and reacquired the shares at their FMV when he changes residence. If Mr. X makes such an election, his shares' cost basis is $1,000 on the date his US residence begins, and on the actual disposition US tax is imposed only on any intervening appreciation. Although one must still consider whether an individual should make this election, the protocol's simplified coordination of the two tax regimes for Canadian tax emigrants to the United States is generally welcomed by both Canadian and US practitioners.

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The Bottom Line: Federal Deficits

Statistics Canada's Provincial Economic Accounts provide details on the financial operations of the federal government in each of the provinces and territories on a national accounts basis. The table shows that in 2005, the latest year available, the federal government enjoyed a surplus of $2.0 billion, down from the average over the past decade.

The total surplus measures the fiscal and economic impact of the national government; the provincial breakdown shows the differing impacts on the provinces. In seven provinces, federal spending exceeded income, but in three provinces the surpluses were large enough to offset those deficits. As shown, the federal surpluses in those three provinces represented 3.8 percent of gross domestic provincial product in Ontario, 5.8 percent in Alberta, and 1.4 percent in British Columbia. The federal deficits ranged from a high of 21.3 percent of GDPP in Newfoundland to a low of 1.3 percent in Quebec.

Federal Surplus or Deficit, 2005, National Accounts

	Millions of dollars		As a percentage of GDPP	
	Including transfers	Excluding transfers	Including transfers	Excluding transfers
NL	−4,584	−824	−21.3	−3.8
PE	−830	−295	−20.2	−7.2
NS	−5,907	−2,144	−18.7	−6.8
NB	−3,713	−1,127	−15.3	−4.7
QC	−3,569	7,691	−1.3	2.8
ON	20,147	35,113	3.8	6.5
MB	−4,434	−700	−10.6	−1.7
SK	−2,530	−423	−10.6	−1.7
AB	12,967	16,937	5.8	7.6
BC	2,374	8,858	1.4	5.2
Canada, including the territories	2,019	57,768	0.1	4.2

Part of the variation in federal balances can be explained by the implicit and explicit equalizing in federal transfers to the provinces, territories, and local governments, which transfers, net of small transfers in the other direction, amounted to $55.7 billion. Excluding transfers, Ottawa would have yielded a surplus of $57.8 billion or 4.2 percent of GDPP, but the redistributive function of federal spending is not limited to transfers. Direct federal spending on goods and services, transfers to persons and businesses, and interest on the public debt exceeded federal revenue in six provinces; but in the three provinces in which the federal government realized overall surpluses (and in Quebec), the federal government also showed a surplus on direct spending net of revenue.

The federal surplus or deficit is often used as a proxy measure of the financial gains or losses that result from belonging to the confederation. It is useful and illuminating to realize how much of the federal bottom line is attributable to explicit policy and how much can be explained by indirect policy.

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Partnership Losses GAARed

The FCA overruled the TCC's decision in *MacKay et al.* (2008 FCA 105) and found that GAAR denied the taxpayers' deductions for a partnership's $6 million loss because the underlying transactions were avoidance transactions and abusive within the meaning of subsection 245(4). In *MacKay*, the transactions were part of a real estate acquisition in which a partnership was created and used to transfer unrealized losses to its partners, the taxpayers.

In 1993, the taxpayers had an opportunity to purchase a shopping centre located in Kamloops. At the time, a bank-held mortgage receivable of $16 million over the shopping centre was in default. The bank commenced foreclosure. The taxpayers struck a deal with the bank based on a business plan to acquire the property, improve it, stabilize the tenancies, and sell it for a profit. Evidence showed that tax considerations were never a factor in the decision to acquire the shopping centre; the taxpayers became aware of the tax benefits only after deciding to invest.

The taxpayers' tax adviser suggested that the shopping centre acquisition could be structured using a partnership. In a series of transactions, the bank became a partner of the partnership and transferred the mortgage receivable and its interest in the foreclosure proceedings to the partnership before any of the taxpayers became partners. The taxpayers then became partners and redeemed all the bank's partnership units for $10 million. At the partnership's December 31, 1993 year-end, it wrote down the shopping centre's value from $16 million to its FMV of $10 million. The partnership allocated the $6 million non-capital loss among the taxpayers, each of whom claimed the losses against other income in subsequent taxation years. The transfer and the subsequent writedown of the shopping centre were in accordance with subsections 18(13) and 10(1).

The TCC agreed with the taxpayers' position that the primary purpose of each transaction was to enable the taxpayers to complete the acquisition of a shopping centre from the bank and not to obtain tax losses. Thus, the transactions were not avoidance transactions within subsection 245(3), and GAAR did not apply. In reaching this conclusion, the TCC said that the avoidance transaction analysis is not a results-based one that focuses on the tax benefit, but rather a primary-purposes analysis of each individual transaction. In determining the primary purpose of the individual transactions, the overall purpose of the series of transactions is relevant but not determinative. The TCC said that it is necessary to objectively assess the relative importance of the driving forces of the transaction and determine whether it is reasonable to conclude that the transaction was undertaken or arranged primarily for a non-tax purpose.

The FCA found that the TCC erred in law when it failed to identify, within the entire series of transactions, the specific transactions that gave rise to the tax benefit, and then to determine whether those transactions were undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit. The FCA said that the TCC's interpretation was inconsistent with the language and the purpose of subsection 245(3), and in particular paragraph 245(3)(b), which requires a determination of the primary purpose of any transaction (or transactions) within a series. The existence of a bona fide non-tax purpose for a series of transactions does not preclude the possibility that the primary purpose of one or more transactions within the series is to obtain a tax benefit. As a result, the FCA found that the primary purpose of the subset of the series of transactions was to obtain a tax benefit, being the transfer of tax losses to the partners: the bank became a partner of the partnership at the outset, transferred the mortgage receivable to the partnership before any of the taxpayers became partners, and remained a partner for more than 30 days after the transfer.

The FCA then considered whether the tax avoidance was abusive within the meaning of subsection 245(4). Because the TCC's analysis stopped at whether an avoidance transaction existed, the parties had not presented related arguments or evidence. Rather than refer the matter back to the TCC, the FCA proceeded to consider whether there had been an abuse. The FCA said that in any event the taxpayers would have been unsuccessful had they argued at the TCC that the avoidance transaction was not abusive, because of the SCC's decision in *Mathew* (2005 SCC 55), which involved a transfer of losses in a similar series of transactions. The FCA quoted from *Mathew*:

> Parliament could not have intended that the combined effect of the partnership rules and s. 18(13) would preserve and transfer a loss to be realized by a taxpayer who deals at arm's length with the transferor. To use these provisions to preserve and sell an unrealized loss to an arm's length party results in abusive tax avoidance under s. 245(4). Such transactions do not fall within the spirit and purpose of s. 18(13) and s. 96, properly construed.

The FCA did not appear to address the four primary factual differences that the TCC said distinguished *Mathew* and *MacKay* on the facts. As a result, the FCA allowed the 12 CRA appeals in *MacKay* and denied the 12 taxpayers the deduction for the $6 million loss.

In reaching its conclusion, the FCA seems to have adopted a results-oriented approach and to have engaged in a more textual analysis of GAAR, in contrast to the textual, contextual, and purposive approach that the SCC has established for the interpretation of subsection 245(3). The FCA's conclusion that GAAR applied in *MacKay* creates uncertainty for taxpayers regarding the extent to which they can structure their affairs to be tax-effective. The decision seems to suggest that whenever a taxpayer carries out tax planning in a bona fide commercial transaction (which the SCC in *Canada Trustco* (2005 SCC 54) said a taxpayer is entitled to do), the only defence against GAAR may be to show that "no abuse" took place. GAAR may now be reduced solely to an abuse test, except in limited cases.

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US MUTUAL FUND DISTRIBUTIONS: CAPITAL GAINS

Two recent private letter rulings are the first published guidance that appears to address US investor issues vis-à-vis Canadian income trusts and other mutual fund entities and opens the door to treat certain mutual fund distributions as eligible for US capital gains treatment.

In PLR 200752029 (2007 TNT 250-15), a US-resident taxpayer held mutual fund units, equal and undivided beneficial interests in the fund. The fund was an unincorporated, open-ended, limited-purpose trust created for investment purposes and qualified as a mutual fund trust under the law of country A (probably a Canadian province); it was treated as a country A resident for tax purposes and was subject to tax. The fund units were traded on a country A stock exchange. The fund also owned 100 percent of a trust, which in turn owned, directly or indirectly, other wholly owned country A entities; together these entities conducted a business. The fund had elected to be classified as an association taxable as a corporation for all US tax purposes (IRS form 8832). The IRS agreed that the fund was not a passive foreign investment company (PFIC).

A US individual taxpayer is eligible for the reduced capital gains tax rate on qualified dividend income: a dividend received in a taxable year from either a domestic corporation or a qualified foreign corporation (QFC). A QFC is generally defined to include a non-PFIC corporation eligible for treaty benefits under a US income tax treaty that, like the Canada-US treaty, includes an exchange-of-information program.

On the facts, the IRS said that the fund was an entity separate from its owners: through its investments it carried on a business for profit that the unitholders divided; the fund's property was held and its affairs were conducted and transacted in the fund's name; and the unitholders were not subject to any liability in connection with the fund.

The IRS also determined that the fund was a business entity; the trustees operated it as a business for profit in the manner of a business trust. Under a so-called business trust, a property's legal title is conveyed to trustees for the benefit of beneficiaries. However, a business trust is not classified as a trust under the Code because it is not simply an arrangement to protect or conserve the property for the beneficiaries: it is a device to carry on a profit-making business normally carried on through business organizations classified as corporations or partnerships. The IRS further found that the fund was a foreign eligible entity. On the basis of these findings and the fund's form 8832 election to be classified as a corporation for US tax purposes, the IRS concluded that the fund was a foreign corporation.

Thus, the IRS was able to opine that the fund may be a QFC, eligible for capital gains taxation on qualified dividend income distributed to taxpayers. But it did not explore whether the QFC tests were met: the fund must be a resident of country A according to the residence article of the country A-US income tax treaty and a qualifying person according to its limitation-on-benefits (LOB) article. The ruling said that "[t]he residence and limitation on benefits articles of the Treaty are applied to the Fund, a Country A entity, without regard to the Fund's entity classification for U.S. tax purposes" as a corporation. The US-resident owner is thus left with one final hurdle to overcome.

The subsequent PLR 200810010 (2008 TNT 47-28) implies that its requesting party is a US broker or other nominee holding the trust units on behalf of a US-resident investor (a person required by Code section 6042 to file income slips). The nominee is entitled to apply certain safe harbour tests in Notice 2003-79 in determining whether such a trust's distributions are eligible for capital gains. One safe harbour requires that the non-PFIC trust be organized in a qualifying treaty country (such as Canada) and have its "common or ordinary stock" listed on an exchange there that is covered by the public trading tests in the relevant treaty's LOB article. The IRS noted that the trust was organized in a qualifying country, that the units traded on a recognized exchange, and that the relevant treaty (probably Canada's) applies the public trading test to shares and units. The ruling states: "[T]he Trust Units will be treated in the same manner as common or ordinary stock for purposes of applying the treaty test safe harbor." The nominee is thus assured that this particular trust's distributions can be reported to US-resident investors as being eligible for capital gains.

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TERMINATION FEES ECP

In *RCI Environnement Inc.* (2007 CCI 647), the TCC recently held that compensation for the termination of a non-compete agreement was taxable under section 14.

In 1997, the taxpayers acquired waste containment assets and obtained the vendors' commitment not to compete in the greater Montreal area for five years; no proceeds were allocated to the restrictive covenant. When the vendors later merged with a US group operating a waste management business in Montreal, the taxpayers formally demanded that the US group cease those activities, saying that the merged group was bound by the non-compete. The US group paid $12 million to the taxpayers for the non-compete's termination. Arguing that it was a windfall because the non-compete was never expected to bind the US group when the taxpayers acquired the assets from the vendors, the taxpayers did not include the amount in their income. The minister reassessed the amount as business income—compensation for losses caused by the US group's Montreal activities. At the TCC, the minister argued section 14 or section 38 alternatively.

The TCC rejected business income characterization: there was no evidence that the covenant's breach resulted in revenue losses for the taxpayers. (In fact, their revenue increased 60 percent during the breach.) The amount was not damages. It was paid to the taxpayers not for the termination of a contract entered into in the normal course of business, but for relinquishing the protection of goodwill, a capital asset, and it was capital in nature. The TCC concluded that the taxpayers' rights under the non-compete agreement were property, although it said that section 14 only required a disposition, not property.

The court distinguished on the facts the FCA decision in *Manrell* (2003 FCA 128), which involved an obligation not to do something. The TCC said that such an obligation was not property at law (that is, at civil law, because Quebec law governed the RCI agreement). But in *RCI* the taxpayers were not themselves precluded from action: their property resulted from their being creditors of the vendors' obligation to refrain from action. The application of *Manrell* in a civil law context may explain the TCC's conclusion, but arguably *Manrell* was based on a conclusion that a non-exclusive, commonly held right to carry on a business was not property for tax purposes and did not explore the need for a positive obligation. If the TCC had followed *Manrell*'s explicit reasoning, it might have concluded that the amount was paid to "reacquire" a "non-exclusive, commonly held right to carry on a business," which was not an acquisition or disposition of property. The TCC also relied on the FCTD *Pe-Ben Industries* decision (88 DTC 6347), which said that the Act's definition of "property" was broad enough to include rights under a contract, and it further quoted from the SCC in *Golden* ([1986] 1 SCR 209): "This extremely broad definition of property leaves very little in the 'non-property' classification. It would appear to include a contract right and might in certain circumstances include a right to assert a covenant by a vendor to deliver 'know-how.'" Alternatively, the TCC said, the amount fell within section 38.

The TCC correctly concluded in obiter dicta that section 56.4 was not applicable at the time and, in any case, was not relevant. Section 56.4 defines a restrictive covenant broadly, but when read in its context, and in light of the mischief to be remedied, its application should be circumscribed to cases where the payee's rights are limited. On its face, section 56.4 could apply to any provision of a contract (a contract always affects "in any way whatever" the acquisition or provision of property or services), a clearly inappropriate result because most contractual payments would bear income treatment regardless of their source. Section 56.4 was directed at the overallocation of proceeds on the sale of a business to a covenant that restricts a payee's or vendor's right to subsequently carry on a business. The *RCI* covenant restricted the acquisition or provision of property or services by the vendors, not the taxpayers, and section 56.4 should not apply to its cancellation.

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Medical Expenses and PHSPs

The CRA regulates private health services plans (PHSPs), primarily because of the dearth of rules in the Act. A PHSP allows an employer to claim deductions for the reimbursement of its employees' medical expenses, without tax consequence to them (except in Quebec). The CRA maintains that PHSPs can only reimburse medical expenses as defined for the medical expense tax credit (METC), although the policy has not been applied completely consistently.

Many PHSPs cover non-qualifying expenses. For example, the federal public service health-care plan covers life-sustaining drugs that do not require a prescription, replacement therapeutic nutrients, allergy serums, and prescribed vitamins and minerals. According to the CRA's stated policy, none of these substances can be reimbursed under a PHSP. In the past, PHSPs covering non-qualifying expenses have relied on the fact that the Act's PHSP definition only requires that the covered expenses be "medical expenses," without reference to the METC definition, and they will continue to make this argument. Some plan sponsors also argue that the CRA has made exceptions to its policy and permitted some plans to cover non-qualifying expenses, apparently including the federal public service health-care plan.

A number of court decisions that sought to relax the strictures of the medical expense definition have all been rebuffed by higher courts, except for the latest in *Breger* (2007 TCC 254). (See "Compassionate Construction," *Canadian Tax Highlights*, June 2007.) Perhaps wishing to foreclose further litigation, the 2008 federal budget proposed to clarify that the METC definition of "medical expense" specifically excludes the cost of any drug or similar substance that can lawfully be purchased without a prescription from a medical practitioner. (This change does not affect existing rules with respect to insulin and certain other named substances.)

The budget change prompted a number of queries to both Finance and the CRA. Finance could have clarified matters by indicating that it would amend the PHSP medical expense definition to refer to the METC definition; instead, it replied, although not in writing, that it never intended to affect the operation of PHSPs. However, the CRA regulates PHSP operation, and it has now replied that the budgetary change does not affect its policy (2008-0270031E5, March 27, 2008). In the CRA's view, the budget change "is intended to confirm our previously existing practice," which is that PHSP-covered medical expenses are tied to the METC definition. From the CRA's perspective, maintaining the status quo does not require it to fashion its own definition of medical expense.

An analogous situation existed for RPP registration requirements before there were written rules in the income tax regulations. The CRA adopted written policies, but the departmental practice of granting numerous exceptions ultimately made the rules unenforceable. If the government of Canada allows its employees' PHSP to cover non-METC-eligible expenses, either the government has concluded that the CRA's policy is not mandatory but merely directory, or the government has been granted an exception by the CRA. In either case, imposing the CRA policy without exception only on private sector employers is unfair and impossible to defend.

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Non-Resident Services FAPI?

The February 27, 2004 technical amendments proposed major changes that were enacted (with modifications) effective for foreign affiliate (FA) taxation years beginning after that date (Bill C-28). Paragraph 95(2)(b), also somewhat modified in its final form, generally sets out the circumstances under which income from services provided to or by an affiliate are deemed to be income from a separate business that gives rise to FAPI.

Previous paragraph 95(2)(b) provided that income of a controlled foreign affiliate (CFA) was FAPI (1) where the amount that arose from the CFA's services income was deductible, or could reasonably be considered to relate to amounts that were deductible, in computing the income from a business carried on in Canada by any person to whom the affiliate was a CFA or by a person related thereto; or (2) where the income was in respect of services performed by a Canadian-resident individual in relation to whom the affiliate was a CFA or by a person related thereto.

The 2004 amendments broadened the scope of the two original income classifications and added a third type of income classified as FAPI: income derived from amounts paid by another FA and deductible in computing its FAPI. The 2004 amendments also extended the rule's application to all FAs from only CFAs and from related persons to certain non-arm's-length persons, including non-individuals. Now, newly enacted subparagraph 95(2)(b)(ii) is further broadened to include services provided by (A) any taxpayer of whom the affiliate is an FA, and (B) another taxpayer not at arm's length with either the affiliate or any taxpayer of whom the affiliate is an FA. (The word "not" was inadvertently omitted in a recent edition of the Act.) (Two additional clauses deal with partnerships.)

The change of substance is Bill C-28's replacement in clause B of "a person resident in Canada" in the 2004 amendments with the word "taxpayer," which is broadly defined in subsection 248(1) to include any person whether or not liable to pay tax. On the basis of *Oceanspan Carriers* (87 DTC 5102 (FCA)), a taxpayer arguably should not include a non-resident person with no connection to Canada. Otherwise FAPI would include services provided by any person—including a non-resident— not dealing at arm's length with the affiliate or with any Canadian resident that holds the affiliate interest as an FA. We understand that there was no intentional policy change to extend the reach of subparagraph 95(2)(b)(ii) to include services provided by a non-resident person, at least to the extent that the services are provided from outside Canada. A retroactive amendment from Finance may be forthcoming.

By the same token, services performed by a Canadian-resident corporation through a PE outside Canada should not be within the reach of subparagraph 95(2)(b)(ii). The technical notes to the 2004 amendments do not provide any policy objective supporting an inclusion of services from carrying on a business outside Canada; perhaps consideration should be given to excluding such services.

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Ontario Eligible Dividend Rate To Fall

Ontario's 2008 budget confirmed its commitment to lower its tax rate on eligible dividends, despite federal tax increases on eligible dividends beginning in 2010. The 2008 federal budget increases tax on eligible dividends by reducing the gross-up factor and tax credit rate for eligible dividends received by individuals, beginning in 2010. Ontario proposes to maintain its plan (announced in August 2006) to increase the dividend tax credit rate on grossed-up eligible dividends to 7.4 percent in 2009 (from 7.0 percent in 2008) and to 7.7 percent in 2010 and subsequent years. The table shows an Ontario individual's top marginal tax rate on eligible dividends, which by 2012 drops to 7.4 percent (from 9.4 percent). The overall

Top Marginal Tax Rates for Eligible Dividends

	2008	2009	2010	2011	2012
			percent		
Federal	14.6	14.6	15.9	17.7	19.3
Ontario	9.4	8.5	7.8	7.6	7.4
Total	24.0	23.1	23.7	25.3	26.7

combined federal and Ontario top marginal tax rate on eligible dividends increases in 2012 to 26.7 percent (from 24.0 percent).

CRA lists top items for T1 audits. A recent CRA news release provides insight into the types of receipts and information slips most commonly examined by the CRA on assessing personal income tax (T1) returns. The release advises taxpayers who file their tax returns electronically, or who do not submit information slips and receipts with their paper-filed return, to retain these tax records in case the CRA contacts them for a review.

The CRA advises that it may contact taxpayers to request more information on income sources or dependants, and copies of receipts or information slips to support claims, including medical expenses, charitable donations, child-care expenses, spousal or child support payments, and moving expenses.

The CRA says that it reviewed the tax returns of approximately 2.7 million individuals last year and that it assessed an additional $700 million in taxes, an average of $260 per taxpayer. The majority of reviews occur as the CRA works to verify an individual's tax return information and compares it with that provided by other parties, such as an employer or a spouse or common-law partner.

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Asset Protection Planning

Economic uncertainty increases the risk of defaults and litigation and highlights the need for asset protection or creditor proofing.

Corporate directors should be concerned about statutory and non-statutory liabilities; a trustee or executor of a trust (private, public, or testamentary) should be concerned about breach of trust. A US company's shareholders may face product liability. Professionals are always concerned about professional malpractice. Other parties exposed to liability include guarantors of debt and other obligations; individuals who provide representations and warranties in agreements; general partners of partnerships; and shareholders of Nova Scotia, Alberta, and British Columbia ULCs. An estranged spouse may become a creditor.

Apart from the Income Tax Act, planning to avoid or reduce exposure to creditors is not effective if it violates the Bankruptcy and Insolvency Act, the Fraudulent Conveyances Act, the Assignment and Preferences Act, or the Criminal Code. Gifts or conveyances for inadequate consideration may be challenged if the individual becomes bankrupt within five years, as may a shareholders' agreement that provides a buyout at a discount in bankruptcy and an assignment or payment made to delay, prejudice, or prefer creditors. A fraudulent conveyance—a transfer of real or personal property, with the intention to defeat, hinder, delay, or defraud a creditor—may be set aside without time limitation even if the transferor is not insolvent. The Criminal Code may apply to a fraudulent disposition or concealment.

The directors of an insolvent company that pays a dividend are liable, and the CRA may recover the dividend from the shareholders to offset the corporate tax liability. Similarly, on a non-arm's-length transfer of property by a transferor who owes tax, the transferee may be jointly and severally liable for the tax up to the value of the transferred property. Income attribution may apply on transfers to family members. The non-resident trust rules may apply to international asset protection trusts.

A variety of strategies may be effective in particular circumstances. RRSPs with insurance companies and insurance policies are protected under the Insurance Act and should have named beneficiaries. An owner-manager may consider the use of an individual pension plan, which is protected. A private company should not have redundant assets in an operating company; retained earnings should be paid as a tax-free dividend to a holding company and, if required, may be loaned back to the operating company on a secured basis. Any loan to a private company should be secured. Where permitted, professional partnerships should be converted to limited liability partnerships; capital accounts should be converted into secured loans. The assets of a professional partnership should be held by a management limited partnership. A lease should be held in a separate company with no guarantee or with a limited guarantee from the shareholders. Personal guarantees on bank loans should be limited. Liability insurance—for example, for directors or product liability—should be maintained. An individual should not directly be a general partner. Assets such as a principal residence should be owned by the spouse who does not have creditors. Funds for a child's purchase of a home should be extended as a loan in order to provide protection against an estranged spouse. Assets should be transferred to a family member only when the transferor can meet his present and contingent debts and before potential liabilities are assumed (for example, becoming a director or signing a guarantee). In a family business, the spouses should not both be directors. A Canadian discretionary trust should contain restrictions on distributions to an insolvent beneficiary. International asset protection trusts in Bahamas, Belize, Cook Islands, and other jurisdictions may be considered; a host of tax considerations include deemed dispositions, non-resident trust rules, revocable trusts, FAPI, and FIEs.

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FEDERAL SR & ED ITCs

Enhancements to the federal SR & ED tax incentive program (1) increase the parameters to determine a CCPC's enhanced SR & ED ITCs; (2) extend the SR & ED ITC to certain salary or wages incurred in respect of SR & ED carried on outside Canada; (3) retroactively extend the carryforward period for unused SR & ED ITCs earned in taxation years 1998-2005 to 20 years from 10; and (4) improve the program's administration. (Changes 1 and 2 are included in Bill C-50, which received first reading in the House of Commons on March 14, 2008.)

1) Table 1 illustrates the parameters for determining a CCPC's enhanced SR & ED ITCs increase for taxation years ending after February 25, 2008. Under the amended rules, qualified SR & ED in Canada enjoys the credit and refund rates illustrated in table 2. Table 3 illustrates the maximum refundable ITCs that a CCPC can earn with a $3 million expenditure limit for taxation years ending after February 25, 2008.

2) The SR & ED ITC is extended to permissible salary or wages incurred by a taxpayer in respect of SR & ED carried on outside Canada after February 25, 2008. The permissible salary or wages must be incurred in respect of Canadian-resident employees carrying on SR & ED activities outside Canada undertaken directly, and performed solely, in support of SR & ED carried on by the taxpayer in Canada. An upper limit is imposed equal to 10 percent of the total salary and wages directly attributable to SR & ED carried on in Canada by the taxpayer; for a straddle taxation year, the 10 percent limit is prorated for the number of days in the taxation year after February 25, 2008. "Permissible salary or wages" does not include a specified employee's remuneration based on profits or bonus, or salary or wages subject to an income or profits tax imposed by a foreign country.

3) A corporation's or individual's carryforward period for unused ITCs earned in taxation years 1998-2005 is retroactively extended to 20 years from 10. SR & ED ITCs incurred or earned in taxation years ending after 2005 were previously so extended.

Table 1

	Taxation years ending	
	Before February 26, 2008	After February 25, 2008
	dollars	
Annual expenditure limit . . .	2 million	3 million
Phaseout range		
Taxable income	400,000 to 600,000	400,000 to 700,000
Taxable capital	10 million to 15 million	10 million to 50 million

Note: For straddle taxation years, separate calculations are required using the old and new phaseout ranges to determine the expenditure limits.

Table 2

	ITC rate	Refund rate
Qualifying CCPCs	35% of annual expenditures up to the limit of $3 million or less	100% of ITCs on current expenditures computed at the 35% rate
	+ 20% of qualified expenditures not eligible for the 35% rate	+ 40% of ITCs on capital expenditures computed at the 35% rate and of ITCs computed at the 20% rate
Other corporations	20%	na
Individuals	20%	40% of ITCs

Note: Generally, the $3 million expenditure limit for a CCPC's associated group is reduced by $10 for every $1 by which its previous year's taxable income exceeded $400,000 (up to $700,000); and $0.075 for every $1 of its previous year's taxable capital employed in Canada above $10 million (up to $50 million.)

Table 3

	Taxable income ($)			
Taxable capital ($)	400,000	500,000	600,000	700,000
10 million	1,050,000	700,000	350,000	nil
20 million	787,500	525,000	262,500	nil
30 million	525,000	350,000	175,000	nil
40 million	262,500	175,000	87,500	nil
50 million	nil	nil	nil	nil

Note: Taxable capital and taxable income are assumed to equal those in the previous year, calculated on an associated basis.

4) To improve the SR & ED program's administration, the CRA will implement a plan that, inter alia, (1) introduces a new SR & ED claim form and guide and an eligibility self-assessment tool; (2) reviews the program's policies and procedures to ensure alignment with current business practices and consistent application nationwide; (3) increases the CRA's scientific capacity and improves its services to claimants by hiring and training SR & ED technical reviewers; (4) enhances the quality assurance methodology at the national and local levels, including real-time review

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of claim decisions; and (5) reviews dispute resolution procedures to ensure effectiveness.

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FOREIGN TAX NEWS

European Union

At the Brussels Tax Forum 2008, titled "Taxation Policy: Enhancing Competitiveness and Growth in a European Way," several speakers discussed the benefits of a shift from direct or indirect taxation, a flat tax rate, and the common consolidated corporate tax base.

Netherlands

The government opposes a bill proposed by Parliament that enhances taxpayer protection against the tax administrations' audit measures, arguing that, inter alia, there will be an increase in lawsuits and fraud. The bill includes an appeal against a request for information and ruling requests regarding the obligation to provide information.

United Arab Emirates

The minister of economy declared that the government expects to introduce a new company law within six months, allowing 10 percent foreign ownership of companies in some sectors outside free trade zones—for example, services, health care, and education. The revisions have been in the making for over two years and are intended to support new free trade agreements and new foreign investment.

Australia

The Australian Taxation Office says that domestic classification as debt or equity does not affect the transfer-pricing rules' application. For example, classification as equity domestically does not preclude the imputation of interest income to an Australian parent from its foreign sub under the transfer-pricing rules.

Switzerland

A Federal Tax Authority circular discusses documentation for the reimbursement of withholding tax and introduces a voucher system to ensure that no reimbursement is made if the tax was not paid to the FTA.

India

The Supreme Court rejected a petition by the tax authorities to review its *Morgan Stanley* decision dealing with the taxability of the foreign corporation's captive business process outsourcing activities.

South Africa

The Financial Intelligence Centre issued Guidance Note 4 on suspicious transaction reporting, aimed at facilitating the detection and investigation of money laundering.

United States

To encourage voluntary compliance, the IRS released a fact sheet that addresses, inter alia, how the IRS obtains information on foreign-source income and foreign transactions and how the IRS measures the international tax gap.

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NORTH SHORE REVERSED

Finance moved quickly in the federal 2008 budget to reverse the impact of the FCA's decision in *North Shore* (2008 FCA 2), which raised serious issues about the GST's application to long-term residential care facilities, effective February 27, 2008. (See "Interpretation: Consider Every Word," *Canadian Tax Highlights*, February 2008). Builders of those facilities must self-assess GST at the end of the construction phase at the facility's FMV and may provide the residential facilities GST-exempt to the users. The budget papers indicate that the change allows owners of long-term care facilities to qualify for GST exempt treatment in a subsequent sale of the facilities and to benefit from the GST new residential rental property rebate.

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