CANADIAN TAX Highlights

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HOLDCO BENEFICIAL OWNER

The landmark TCC decision in *Prevost Car* (2008 TCC 231) held that a Dutch holdco was the beneficial owner of dividends paid by a Canadian opco and thus was entitled to the benefits of the Canada-Netherlands treaty. The ultimate corporate shareholders were UK and Swedish residents.

Prevost Car, a Canadian-resident corporation, paid dividends to its sole shareholder, a Dutch-resident holdco. Prevost manufactured and serviced buses and related products in North America. In 1995, the Swedish-resident Volvo Bus Corporation and the UK-resident Henleys Group PLC acquired Prevost via a Dutch holdco in the proportions of 51 percent and 49 percent, respectively. They wanted a non-UK, non-Swedish holdco resident in a less expensive European jurisdiction where business could be conducted in English; the Netherlands was chosen on the basis of an accounting firm's advice. Other projects for the holdco never materialized.

A shareholders' agreement between Volvo and Henleys (not the holdco) provided that not less than 80 percent of the holdco profits were to be distributed as dividends as soon as practicable up to the year-end. The holdco's board of directors must take reasonable steps to ensure that Prevost took all necessary action to enable the holdco to make the payments. Some documentation was inconsistent with the holdco's owning the Prevost shares, such as minutes of an early shareholders' meeting that referred to Volvo and Henleys as shareholders.

The Canada-Netherlands treaty allows 5 percent withholding on dividends paid by a Canco to a Dutch-resident corporation that is the beneficial owner and meets shareholding thresholds. The minister said that the holdco was not the beneficial owner and was not entitled to the reduced rate. The TCC noted that the term "beneficial owner" is not defined in the treaty or the OECD model treaty. Commentary to the 1977 model treaty said that the reduced rate was not available to an intermediary (such as an agent or nominee); any term not defined in the treaty, unless the context otherwise requires, has its meaning under domestic tax law. The Income Tax Conventions Interpretation Act provides that a treaty term that is undefined, is not fully defined, or is defined by reference to the laws of Canada has its meaning for the purposes of the Act as amended from time to time.

Expert evidence at trial showed that under Dutch law the holdco was the beneficial owner (but not a holdco legally obliged to pass on dividends to its shareholders). Dutch corporate law required profits to be distributed to shareholders in full, subject to the requirements of solvency and reserves and the corporate articles. The dividend policy set out in the shareholders' agreement did not limit the discretion of the holdco's board to determine the adequacy of working capital reserves before dividends were paid.

Another expert witness with extensive experience as a treaty negotiator and as a member of various OECD fiscal committees testified that the term "beneficial owner" in the 1977 model treaty was intended to exclude agents and nominees from treaty benefits, but not a holdco unless there is strong evidence of tax avoidance or treaty abuse. Summarizing an OECD report on conduits, he said that a conduit's main function of holding assets or rights is not sufficient to categorize it as a mere agent or nominee. But if it has "very narrow powers, performs more fiduciary or administrative functions and acts on account of the beneficiary (most likely the shareholder)," it is normally not the beneficial owner because it has only title and "no other economic, legal or practical attributes of ownership." The expert said that under model treaty article 4, a conduit is not a mere agent or nominee for income if it is liable to tax in its residence country on the basis of domicile, place of management, etc. and holds the income's underlying assets and rights.

The TCC referred to dictionary definitions of "beneficial" and "owner" and the treaty's Dutch term. The court cited the SCC decision in *Jodrey Estate* ([1980] CTC 437), which held that a "beneficial owner" is "the real or true owner of the property," who can ultimately exercise rights of ownership. The TCC also cited the UK case of *Indofood* ([2006] EWCA Civ 158), which concluded that a Dutch special-purpose vehicle would not be the beneficial owner of interest received on back-to-back loans because it would not have "full privilege to directly benefit from the income."

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The TCC said that *Indofood* conflicted "somewhat" with the expert evidence before it that a beneficial owner may be contractually obliged to pay out most of its income. The TCC noted that the court in *Indofood* had regard to an Indonesian substance-over-form principle and did not rely on the contractual obligation to forward the interest.

The Crown in *Prevost* did not argue that the holdco was an agent, trustee, or nominee; it argued that the holdco acted as a conduit or funnel to Volvo and Henleys. The TCC disagreed: "[T]he person who receives the dividends for [its] own use and enjoyment and assumes the risk and control of the dividend received . . . is the beneficial owner . . . [and] is not accountable to anyone for how it deals with [the] dividend." Per *Jodrey*, the corporate veil should not be pierced "unless the corporation is a conduit . . . and has absolutely no discretion as to the use or application of [the] funds . . . or . . . act[s] on someone's behalf pursuant to . . . instructions without any right to do [otherwise]."

The fact that the holdco had no physical office or employees was not evidence of a conduit. The holdco's financials and income tax return indicated that it owned assets and had liabilities. The holdco directors must declare interim dividends for subsequent shareholder approval; there was no predetermined or automatic flow of funds to Volvo and Henleys. If the shareholders' agreement's mandated dividends were not paid, Volvo and Henleys may have been able to sue each other, but the holdco was not party to the agreement. Moreover, the holdco's deed of incorporation did not oblige it to pay dividends. The holdco was the registered owner of the Prevost shares and had paid for them.

This is a welcome decision for taxpayers in Canada, and indicates a divergence from *Indofood*. A number of questions remain unanswered. The decision does not directly reject a possible international fiscal meaning, as suggested in *Indofood*. The CRA's current attack on royalties and interest payments received by non-resident holdcos will test *Prevost*'s breadth of application; the fact that a dividend must be declared by the board before it is legally payable may be a distinguishing factor. Unfortunately, the TCC said that the holdco was not a "conduit," a term not used in the OECD model treaty commentary in the years in issue; the FCA emphatically denied reliance on later commentary in *MIL (Investments)* (2007 FCA 236), and the TCC may have muddied the waters of its decision.

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OECD Commentary Update

On April 21, 2008, the OECD released a draft 2008 update to its model tax treaty; the final update is expected to be released in June. Comments from the public should be submitted by May 31, 2008.

The draft is divided into two parts; part 2 includes changes to the articles and commentary that flow primarily from previously released reports, including improving the resolution of tax treaty disputes; revised commentary on article 7; the application and interpretation of article 24 (non-discrimination); tax treaty issues related to REITs; and proposed commentary changes on the tax treatment of services. The impact of these reports is reflected in proposed changes to article 25 (mutual agreement procedures), and commentary to articles 4, 5, 7, 9, 10, 12, 13, 15, 17, 21, 23A, 23B, 24, and 25.

Part 1 of the draft includes technical changes released for the first time to the public for comment, including the "place of effective management" concept; dual-resident persons who are treaty non-residents under the tiebreaker rule; the royalty definition; software distribution; the computation of the 183-day rule for the purposes of determining residence under article 15(2)(a); minor drafting changes and an update to paragraph 32.6 of the commentary on articles 23A and 23B; and a minor update to paragraph 12 of the commentary to article 21. The first two changes involve residence. Model treaty article 4(3) provides that where a non-individual person is a resident of both contracting states under article 4(1), the question of residence is resolved in favour of the state where the person's place of effective management is situated.

Current paragraph 24 of the commentary on article 4 states:

> The place of effective management will ordinarily be the place where the most senior person or group of persons (for example a board of directors) makes its decisions, the place where the actions to be taken by the entity as a whole are determined.

The draft proposes to eliminate this statement and to include in new paragraph 24.1 of the commentary a statement that as an alternative to the concept of the place of effective management, some countries may wish to resolve cases of dual residence case by case through competent authority. Competent authorities are expected in such circumstances to take into account various factors in determining residence, including which country's laws govern the legal status of the entity, where its board of directors' meetings are usually held, where its CEO and other senior executives normally carry on their activities, where its senior daily management is carried on, and where its headquarters and accounting records are located.

Although the location of the board of directors' meetings is still relevant in determining residence, its hierarchy or importance as a determining factor may now be different—a change apparently motivated by advances in communications technology that allow directors and other senior executives to meet and make important business decisions without being present in the same physical location. The proposals stem from a technical advisory group established by the OECD in 2001 to study certain treaty aspects of electronic commerce, including its impact on the place of effective management as an effective tiebreaker rule.

But difficulty in determining the place of an entity's effective management is not confined to situations in which a board of directors does not physically meet. It may also be an issue if an entity has multiple divisions operating in different countries, or if the CEO or a senior executive commutes and spends comparable amounts of time in different countries. In these cases the location of the board's meetings may be relevant, but other factors may be equally, if not more, important in determining the place of effective management. The proposals may respond to the realities of modern business practices, but the removal of a hierarchical test may lead to increased uncertainty that can be resolved only through a lengthy and time-consuming competent authority process.

Another proposed change to the commentary on article 4 addresses the consequences to a person who is considered to be a dual resident by each state's domestic law and who is deemed to be resident for treaty purposes in one state under the tiebreaker rule. Article 4(1) provides that a person is not a resident of a contracting state for model treaty purposes if it is only subject to tax on income sourced in that state or on capital situated in that state. Application of the tiebreaker rule results in the taxpayer's not being considered subject to the most comprehensive liability to tax in the state that loses the tiebreaker. Proposed changes to articles 4(8) and 4(8.4) mean that the person may not be considered to be a resident of the losing state in the context of treaties it concluded with third states. The draft commentary proposes an addition to paragraph 8.2 of the commentary on article 4:

> [The term "resident of a contracting state"] also excludes companies and other persons who are not subject to comprehensive liability to tax in a Contracting State because these persons, whilst being residents of that State under that State's tax law, are considered to be residents of another State pursuant to a treaty between these two States.

Consider a corporate taxpayer that under the domestic law of states A and B is resident in each state. The tiebreaker rule in the A-B treaty resolves residence in favour of state A. The taxpayer earns interest income sourced in state C; the reduced interest withholding tax rate is 15 percent under the A-C treaty and 10 percent under the B-C treaty. The proposed changes prevent the taxpayer from benefiting from the reduced B-C treaty rate because it is not resident in state B by virtue of the A-B treaty tiebreaker.

Another proposal that relates to residence also addresses triangular situations. A proposed addition to paragraph 1 of the commentary on article 21 (other income) provides as follows:

> Where, for instance, a person who would be a resident of two Contracting States under the provisions of paragraph 1 of Article 4 is deemed to be a resident of only one of these States pursuant to the provisions of paragraph 2 or 3 of that Article, this Article will prevent the other State from taxing the person on income arising in third states even if the person is resident of this other State for domestic law purposes.

If this proposal applies and the losing state gives up its right to tax the income, the proposed denial of treaty benefits may be more palatable.

If the proposed changes to the commentary are adopted, it will be interesting to see what impact they have on the interpretation of treaties drafted in the context of earlier commentary versions, which presumably best reflected the parties' intentions. Not all tax authorities consistently adopt the historic interpretive position. The ambulatory approach was clearly rejected in *MIL (Investments)* (2006 TCC 460, affirmed 2007 FCA 236), but a more ambiguous approach was taken most recently in *Prevost Car* (2008 TCC 231). Under the static or historic approach, it must be determined whether the amendments simply clarify previous commentary or fundamentally change it, a view that may limit the changes' interpretive impact.

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DEMAND LOAN STATUTE-BARRED

Section 80 applies if a commercial debt obligation between unrelated parties becomes statute-barred and thus unenforceable. The 2006 Ontario Court of Appeal decision in *Hare v. Hare* (2006 CanLII 41650) concluded that the two-year limitation period on a demand promissory note starts to run when the loan is delivered.

Mrs. Hare loaned her son $150,000 evidenced by a promissory note dated February 17, 1997 and payable on demand with annual interest at prime plus 1 percent. The son paid interest until October 26, 1998. On November 10, 2004, Mrs. Hare sent her son a letter demanding payment. On February 17, 2005, she commenced legal action for all sums due on the loan. The Ontario lower court held that the action was statute-barred because the limitation period for commencing an action was October 26,

2004, six years from the date when interest was last paid. Mrs. Hare appealed, saying that the new Ontario Limitations Act, 2002 had not been properly considered.

The Limitations Act, 2002 reduces the limitation period from six years to two years if two conditions are met: (1) the six-year limitation period under the old act must not have expired before January 1, 2004, and (2) no action was commenced on the claim before that date. The Ontario Court of appeal considered whether the new act applied and, if it did, whether it fundamentally changed the law so that refusal to repay a demand promissory note now triggers the running of the limitation period.

The majority of the court found that the new act applied: the creditor did not discover her claim until the default following the November 10, 2004 demand for repayment, which was launched within the two-year window. However, the court denied the appeal because the claim was based on an act or omission that occurred before January 1, 2004 (in October 1998, when the last payment was made). The majority relied on extensive jurisprudence to the effect that the limitation period for a demand promissory note begins to run when the demand promissory note is delivered, not when actual demand for payment is made. Technically, the limitation period starts on initial delivery, but the start date is refreshed each time a payment is made.

The decision is perplexing both from a fairness and a commercial viewpoint. Most tax and legal practitioners would assume that the clock starts ticking when the creditor demands payment, not when the note was issued, because the earliest date that a creditor can "discover" a claim based on a demand is when a default in repayment occurs (if all other loan conditions are met). The dissenting minority expressed similar views. *Hare* has not been appealed to the Supreme Court, and accordingly it is considered good law. We understand that the Ontario Bar Association has requested that the law be amended to clarify that the start date for the limitation period of a demand note is the date when default in making repayment occurs (provided that all other loan conditions are met), not the date when the demand loan is made. To date, there has been no indication that such an amendment will be enacted.

Demand promissory notes are frequently used for tax purposes. Tax practitioners should be aware of Ontario's two-year limitation period for demand notes, which starts the clock when the demand promissory note is delivered. The expiry or deferral of the limitation period can be either mitigated or refreshed if an action is taken on the note (such as an acknowledgment of the debt or a partial payment of principal or interest). Deemed interest income for tax purposes—for example, under section 80.4—would not be considered relevant in determining whether a payment has been made under the common law.

Many family loans involve related parties and thus do not suffer the negative tax consequences of the debt forgiveness rules, notwithstanding the commercial consequences of the lender's not being able to enforce payment. However, section 80 applies to commercial debts that have become statute-barred if the debtor and creditor are either arm's-length or non-arm's-length but unrelated. Tax practitioners may wish to review various client situations involving demand promissory notes subject to Ontario law.

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INTEREST AND PENALTY DE-WAIVER

The CRA sometimes exercises its discretion to waive interest and penalties payable if an assessment is paid in full (ITA subsection 220(3.1) and ETA section 281.1). In *Liddar* (2007 FCA 323), the CRA first agreed and then refused to waive the amounts. The FCA ordered that the respondent's request for a waiver of interest and penalties be sent back to the CRA for reconsideration.

In *Liddar*, the respondent, who had an interest in a corporation that was assessed for GST, interest, and penalties, claimed that the CRA had promised to waive the interest and penalties if the respondent personally paid the entire corporate liability as assessed. The respondent agreed and paid the amount, but the CRA then refused the respondent's request for a waiver—in this case, a refund—of the interest and penalty components of the corporate tax liability.

The respondent applied under section 18.1(1) of the Federal Courts Act for judicial review of the CRA's decision and for an order to refund the interest and penalties. The FCTD ordered the CRA to repay the interest and penalties, based on the respondent's evidence that the CRA had promised to waive the interest and penalties if he paid the corporate liability. The Crown appealed, saying that section 18.1(3) of the Federal Courts Act did not give the Federal Court the authority to order the CRA to refund ETA interest and penalties. The FCA said that the FCTD was entitled to quash the CRA's decision to deny a waiver, but also said that the judge should have referred the matter back to the CRA for reconsideration and that he had erred in law by ordering a refund.

A review of the Federal Court's authority under section 18.1(3) showed that a refund of tax and interest that the corporation was legally obliged to pay was refundable only to the corporation, not to the payer respondent. The FCA set aside the order of a refund, but said that there was no doubt that the CRA's decision should be quashed. Furthermore, the request for waiver was referred back to the CRA for reconsideration because the respondent paid

the corporate liability on the strength of the CRA's promise that the included interest and penalties would be waived. The CRA was not allowed to determine whether the waiver assurance had in fact been made, because it had not adduced any evidence in the lower court contradicting the respondent's evidence, and the FCTD had determined the matter in the respondent's favour. The CRA thus appears bound to reconsider the request as if the assurance had been made and to grant the waiver request.

Liddar is very favourable to taxpayers because it limits the circumstances in which the CRA can successfully refuse to act on a promise to or an agreement with a taxpayer. If the CRA makes a deal with respect to collections and promises or agrees to waive interest or penalties (or to refund them once paid), it appears that the courts are prepared to effectively enforce those promises and agreements. *Liddar* also highlights the importance of documenting such arrangements. However, the decision starkly contrasts with the general rule that there is "no estoppel against the Crown," which must enforce the law and no more. It will be interesting to see how the decision is interpreted in other contexts.

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WITHHOLDING GROSS-UP TRAP

In *Sentinel Hill No. 29 Limited Partnership* (2008 ONCA 132), the Ontario Court of Appeal upheld the Ontario Superior Court of Justice's decision that the partners were not entitled to recover an overpayment of part XIII withholding tax. The excess tax was withheld and paid in error on the non-resident creditor's behalf pursuant to a gross-up clause in the loan agreement and following an income tax ruling that the CRA subsequently said did not apply. Because the non-resident was the legal taxpayer under the Act, the court concluded that the Canadian-resident payers of the tax had no legal right to a refund of the overpayment.

A person who pays amounts such as management fees or interest payments to a non-resident must deduct a 25 percent withholding tax (or a treaty-reduced amount) and remit it to the CRA on the non-resident's behalf. A partnership is a person for the purposes of part XIII withholding tax if, inter alia, it may deduct the payment to the non-resident. If it is later determined that too much tax was withheld, the non-resident can request a refund.

In *Sentinel Hill*, several Ontario limited partnerships (LPs) were formed to invest in tax-sheltered film and television productions financed through loans received from a US-resident film studio. The loan agreements required that the LPs pay the US studio a fee and interest; if the fee and/or the interest was subject to Canadian withholding, it was to be grossed up so that the US studio received a net amount not less than the amount that would have been received if no withholding applied. Under the gross-up clause, the LPs effectively bore the cost of the US studio's withholding tax liability.

The LPs obtained a tax ruling to the effect that the fee and interest were tax-deductible and subject to withholding, so they grossed up the payments and withheld and remitted the withholding required on the US studio's behalf. The LPs deducted the payments on their December 31, 2000 and December 31, 2001 partnership information returns. Contrary to its ruling, on reassessment the CRA partially denied a deduction for the payments; thus, no withholding was legally owed on the non-deductible portion.

The LPs said that the overpaid tax unjustly enriched the CRA and the minister, and sought damages on appeal to the Ontario Superior Court of Justice. That court said that a successful unjust enrichment claim must show that (1) the CRA was enriched, (2) the LPs suffered corresponding deprivation, and (3) there was no juristic reason for the enrichment. The court allowed the CRA's motion to dismiss "as a matter of law and for lack of jurisdiction": the gross-up clause did not alter the fact that the US studio was entitled to a refund of the overpayment, and thus the LPs could not sustain an action for unjust enrichment because they suffered no deprivation from the overpayment. Moreover, the court said that it had no jurisdiction regarding the part XIII tax's recovery: the Act provides a "complete statutory code for the recovery of funds remitted in error or where no tax liability exists."

On appeal, the Ontario Court of Appeal considered whether the CRA owed any money to the LPs and whether part XIII constitutes a complete procedural code that provides adequate refunds for overpaid taxes. Although on the facts the LPs actually bore the Canadian tax cost and the CRA received more money than was ultimately payable as tax, the Act provides that the CRA need only refund any overpayment of tax to the US studio. As a result, the LPs could not bring an action against the CRA. Moreover, if a non-resident decides to dispute a remedy provided under the Act, the proper forum for an appeal is the Tax Court of Canada, not a provincial superior court. (See subsections 227(7), 165(1), and 169(1).) "It would appear that if the person resident in Canada who is obliged to withhold and remit to [the] CRA wants the ability to claim a refund from [the] CRA in case of an incorrect or over payment, it must have an assignment or other legal arrangement with the non-resident that allows the resident to assert the non-resident's rights." Absent such an arrangement, only the non-resident has a remedy against the CRA, and part XIII provides a complete procedural code.

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SCHOLARSHIP TO EMPLOYEE'S CHILD

The TCC in *DiMaria* (2008 TCC 114) held that a $3,000 scholarship paid by an employer under its higher education award program to an employee's child was not a paragraph 6(1)(a) taxable benefit to the employee. The amounts involved were small, and *DiMaria* appears to be a test case to challenge an unfavourable response in December 2004 to the employer's advance ruling request regarding its award program. As the TCC noted, the case appears to be the first to come before the court in which the employee and the student were different taxpayers. The Crown has appealed to the FCA.

The taxpayer was employed by Dow Chemical Canada Inc., and his son was enrolled at the University of Waterloo. As part of its compensation plan, Dow's award program annually reimbursed up to $3,000 of tuition fees for eligible employees' children enrolled in postsecondary studies. The taxpayer's son received a $3,000 award in 2004. Dow had initially treated the awards as income to the students, but following a 2004 CRA audit, payments were treated thereafter as taxable income to the employees.

Paragraph 56(1)(n) includes in a taxpayer's income amounts received as a scholarship, fellowship, or bursary in excess of the scholarship exemption amount under subsection 56(3). For 2004, the maximum exemption was $3,000; for 2007 and later years, certain scholarships, fellowships, and bursaries are fully excluded from income.

Interpretation Bulletin IT-75R4, "Scholarships, Fellowships, Bursaries, Prizes, Research Grants, and Financial Assistance," states that payments by employers for tuition fees, grants, or awards to school-age or university-age children of employees are considered to be a scholarship or bursary and income of the child under subparagraph 56(1)(n)(i) if the payment is part of a plan to help a certain number of children on the basis of their scholastic records or other achievements or qualities. The IT also states that if a payment is not taxable to the student as a scholarship or bursary, it will normally be considered employment income of the parent-employee under subsection 56(2) and paragraph 6(1)(a).

The TCC referred to the CRA's December 2004 response to Dow's advance-ruling request, which concluded that a payment may be taxable as a scholarship or bursary to the student if the CRA is satisfied that objective selection criteria focused on the student's scholastic achievement. The CRA said that the selection criteria must exceed the minimum entrance requirements for most postsecondary institutions; otherwise, any dependant could qualify. The CRA also said that an employer must limit the number of scholarships. The CRA said that the presence of these factors ensures that the student's merit, not the employee's relationship with the employer, is the overriding criterion for the scholarship award. The ruling concluded that paragraph 6(1)(a) employee benefits were broad enough to include employer-provided scholarships to employees' dependants. On the facts, the CRA concluded that Dow's awards were taxable to the employees because the award program required only a 70 percent average in the graduating year of high school, the minimum postsecondary entry requirement; once granted, the award was renewable for three years if the student met the school's passing requirements; and although the awards were limited to 100 per year, that number had never been exceeded and was thus not really a limit.

The TCC concluded that the award was a scholarship and should have been included in the son's income. The court distinguished on the facts cases cited by the CRA because there is no obligation to send children to postsecondary school; the son's award was not a benefit received and enjoyed by the taxpayer. As to the 70 percent average threshold qualification for an award, the court said that the purpose of any scholarship was to enable the student to pursue his or her studies. The criteria for granting a scholarship should be determined by its donor, and the CRA should not impose its view of eligibility. Furthermore, the Act does not require that any academic threshold be met.

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US SUPREME COURT: FILE TIMELY REFUND CLAIMS

On April 15, 2008, the US Supreme Court reversed the Court of Appeals for the Federal Circuit (473 F. 3d 1373 (2007)) and held that under the Internal Revenue Code a taxpayer must timely file a refund claim with the IRS before suing for a refund of a tax assessed—even a tax assessed in violation of the US constitution (*Clintwood Elkhorn Mining Co.*, 101 AFTR 2d 2008-1612, April 15, 2008).

For decades, three coal companies paid taxes on coal exports under Code section 4121 before it was held unconstitutional in relation to coal exports. The taxpayers filed administrative refund claims for the most recent prior periods (the statute of limitations had not expired), and the IRS refunded the taxes paid with interest. For taxes paid in earlier periods that were statute-barred under the Code, the companies sued for a refund in the Court of Federal Claims and did not file refund claims with the IRS. The US Supreme Court unanimously concluded that a taxpayer suing for a refund of taxes could not proceed

under an alternative statute if the Code's time limits for refund actions were not met. The Code requires that a taxpayer file a refund claim with the IRS before commencing suit, generally within three years from the date when the return was filed or, if no return was filed, within two years from the date when the tax was paid.

The specific issue in the case may be somewhat obscure, but the decision has a much broader application. For example, the decision is a reminder to Canadians in the process of selling US real estate. Under the Code, a non-US person is taxable on the gain from the sale of a US real property interest, which generally includes an interest in US real property held not solely as a creditor, whether held directly or through certain entities (such as ownership in fee simple, co-ownership, leasehold interests, time-sharing interests, life estates, remainders, and reversionary interests). To ensure that the IRS can collect the tax, the purchaser generally must deduct and withhold 10 percent of the gross sales proceeds, not just of the gain. Thus, even a sale yielding a tax loss may trigger withholding unless an exception applies and a FIRPTA withholding certificate is granted. The purchaser must report the sale to the IRS and remit the amount withheld within 20 days of the sale.

Given the currently depressed state of the Florida real estate market, and depending upon when a Canadian investor purchased the property, a sale may generate an insignificant gain or even a loss. A Canadian investor-seller who is not properly advised and does not obtain a withholding certificate may need to file a US income tax return to obtain a refund of overwithholding. The *Clintwood* decision is a reminder that the return's filing must be timely or the refund is lost. The preferable route is to obtain a withholding certificate before the sale. A certificate may be issued on various grounds, but the primary one is the appropriateness of reduced withholding when the normal withholding would exceed the tax liability on the transaction. For example, if a Canadian individual sells his Florida home for US$500,000, US$50,000 withholding is normally mandated unless a certificate is issued. If the property's basis is US$480,000, the US$20,000 gain at the preferential long-term capital gain rate of 15 percent yields a tax liability of only US$3,000. To obtain a refund of the US$47,000 overpaid tax, the seller must timely file a US income tax return. Prior planning to obtain a withholding certificate prevents cash flow and filing inconveniences.

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SAFE INCOME: PUBLIC COMPANY TAKEOVERS

A taxable Canco may reduce its capital gain on the sale of its shares in a target Canco by causing the target to first pay a tax-free intercorporate dividend of its share of the target's safe income. Proposed changes regarding eligible dividends and ACB additions may affect this common planning technique.

The target's safe income is generally the income that the target and its affiliates earned for tax purposes less taxes paid and non-deductible outlays. A dividend in excess of safe income is taxed as a capital gain. On a takeover bid for a public company, some large and influential shareholders may want to engage in safe-income planning; but securities law, commercial, and practical considerations, and the interests of minority shareholders militate against the target's paying a safe income dividend directly to the existing shareholders. One alternative involved a rollover by an interested vendor-shareholder of its target shares to a new holdco. The new holdco paid the safe-income dividend on to the vendor; its shares, whose ACB included the dividend, were then sold to the purchaser.

Corporations will generally prefer that the holdco's dividend be designated an eligible dividend. A CCPC vendor benefits from a GRIP addition that allows it to pay eligible dividends; a non-CCPC vendor avoids an LRIP addition that would force it to pay ineligible dividends before eligible dividends. A CCPC holdco may designate dividends paid as "eligible" without penalty up to its GRIP at the end of the year of payment; but as a newco with no prior activity (the purchaser will likely insist on this) and a taxation year-end imminent on the acquisition of its control, it should have no GRIP at year-end. In contrast, a non-CCPC holdco has unlimited ability to designate an eligible dividend if it has no LRIP at the time of payment, which is the case for a newco with no prior activity. The holdco can achieve non-CCPC status (retroactive to its incorporation) and an unlimited ability to designate dividends as eligible dividends simply by filing a subsection 89(11) election (form T2002) by its filing due date for its first taxation year (the year ending when the purchaser acquires the holdco). The election may be revoked by the filing due date for a particular taxation year and effective at the end of that year (subsection 89(12)). A holdco acquired by a CCPC can file both a subsection 89(11) election and a subsection 89(12) revocation to become a non-CCPC for its brief taxation year ending on the acquisition and return to CCPC status after the year-end. The minister's consent to any further such elections and revocations may be subject to conditions.

The CRA ruled that a subsection 89(11) election was acceptable planning if the safe income designated as an eligible dividend and paid by the holdco was linked to the target's underlying and fully taxed income. Otherwise, the anti-avoidance rule in paragraph (c) of the definition of "excessive eligible dividend designation" may apply, rendering the payer subject to part III.1 penalty taxes on the entire eligible dividend paid if one of the transaction's main purposes was to artificially maintain or increase the holdco's GRIP or to artificially maintain or decrease its LRIP. Because the holdco is a newco with no balances and is thus not manipulating its GRIP or LRIP, it is difficult to see how this rule is applicable. However, a dividend paid by the vendor as part of the same series of transactions may attract the rule.

In the past, the holdco safe-income dividend may have been a stock dividend from the holdco and triggered an addition to the vendor's holdco shares' ACB (paragraph 52(3)(a)). Alternatively, a deemed dividend to the vendor equal to its safe-income share may have arisen through the holdco's capitalization of contributed surplus from the transfer of the target shares into the holdco; the vendor's holdco shares' ACB increased accordingly (paragraph 53(1)(b)). A promissory note with a cost equal to its value may have been issued in payment for a declared dividend and used to subscribe for additional holdco treasury shares: the cost was added to the holdco shares' cost on the subscription (subsection 52(1) or (2)). Proposed amendments to paragraphs 52(3)(a) and 53(1)(b) make the first two scenarios ineffective for dividends received after November 8, 2006. One amendment proposes that the cost of the stock dividend shares not include any amount of the dividend deductible under subsection 112(1); similarly, subsection 112(1) deductibility eliminates an addition to the shares' ACB for any portion of a deemed dividend that arises on the direct or indirect capitalization of contributed surplus.

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FEDERAL ELIGIBLE DIVIDEND RATE

Bill C-50, the Budget Implementation Act, 2008, adjusts the eligible dividend gross-up factor and tax credit rate after 2009 to reflect recently enacted federal corporate income tax rate reductions. (See table 1; the bill received second reading in the House of Commons on April 10, 2008.) The increase in effective federal tax rates on eligible dividends is intended to ensure that the combined corporate and personal tax on business income earned through a corporation roughly equals the tax payable by an individual earning such income directly, but to achieve this objective further dividend gross-up and tax credit changes at the federal and provincial/territorial levels may be required.

Table 1 Eligible Dividends

	2008	2009	2010	2011	After 2011
			percent		
Dividend gross-up	45.00	45.00	44.00	41.00	38.00
Federal dividend tax credit (on grossed-up dividend)	18.97	18.97	17.97	16.44	15.02
Top federal rate*	14.55	14.55	15.88	17.72	19.29

* Assumes that the top federal marginal income tax rate remains 29 percent.

Table 2 Eligible Dividend Tax Credit Rates on Grossed-Up Dividends

	2008	2009	2010	2011	After 2011
			percent		
Alberta	9.00	10.00	9.84	9.36	8.87
British Columbia	12.00	11.00	10.83	10.31	9.76
Manitoba	11.00	11.00	11.00	11.00	11.00
New Brunswick	12.00	12.00	11.81	11.24	10.65
Newfoundland and Labrador	6.65	6.65	6.55	6.23	5.90
Northwest Territories	11.50	11.50	11.32	10.78	10.20
Nova Scotia	8.85	8.85	8.71	8.29	7.85
Nunavut	6.20	6.20	6.11	5.82	5.51
Ontario	7.00	7.40	7.70	7.70	7.70
Prince Edward Island	10.50	10.50	10.34	9.84	9.32
Quebec	11.90	11.90	11.90	11.90	11.90
Saskatchewan	11.00	11.00	10.83	10.31	9.76
Yukon	11.00	11.00	10.83	10.31	9.76

The federal decreases to the eligible dividend gross-up factor apply automatically to all provinces and territories, except Quebec, which announced that it will harmonize with the federal changes. Except in Manitoba and Quebec, the federal changes also affect the provincial/territorial eligible dividend tax credit rates, which are linked to the federal eligible dividend gross-up. Without revisions to the relevant provincial/territorial legislation, the decreases to the federal eligible dividend gross-up reduce provincial/territorial eligible dividend tax credit rates after 2009 in all provinces and territories except Manitoba and Quebec. (See table 2.) To date, only Ontario has confirmed that its eligible dividend tax credit rate increases for 2010 and subsequent years.

As a result of these changes, tax rates on eligible dividends increase after 2009; table 3 shows the top combined

Table 3 Top Combined Federal and Provincial/Territorial Marginal Tax Rates on Eligible Dividends*

	2008	2009	2010	2011	After 2011
			percent		
Alberta	16.00	14.55	16.11	18.62	20.85
British Columbia	18.47	19.92	21.45	23.91	26.11
Manitoba	23.83	23.83	25.09	26.74	28.12
New Brunswick	23.18	23.18	24.72	27.18	29.37
Newfoundland and Labrador	28.11	27.38	28.77	30.79	32.54
Northwest Territories	18.25	18.25	19.81	22.33	24.61
Nova Scotia	28.35	28.35	29.80	32.00	33.94
Nunavut	22.24	22.24	23.64	25.72	27.56
Ontario	23.96	23.06	23.65	25.33	26.74
Prince Edward Island	24.44	24.44	25.95	28.36	30.50
Quebec	29.69	29.69	30.68	31.85	32.81
Saskatchewan	20.35	20.35	21.88	24.33	26.52
Yukon	17.23	17.23	18.80	21.34	23.64

* Assumes that the top combined federal and provincial/territorial marginal income tax rates remain at 2008 levels (2009 levels for Newfoundland and Labrador).

Table 4 Integration: $10,000 Active Business Income Subject to Tax at the General Corporate Income Tax Rate, Saving/(Cost)*

	2008	2009	2010	2011	After 2011
			dollars		
Alberta	(178)	(33)	(60)	(118)	(164)
British Columbia	(4)	(24)	(53)	(37)	(88)
Manitoba	(144)	(30)	(4)	(9)	(0)
New Brunswick	(119)	(81)	(111)	(171)	(219)
Newfoundland and Labrador	(611)	(576)	(597)	(631)	(652)
Northwest Territories	146	187	158	97	46
Nova Scotia	(553)	(518)	(542)	(585)	(617)
Nunavut	(423)	(384)	(405)	(439)	(462)
Ontario	(200)	(101)	(65)	(67)	(56)
Prince Edward Island	(389)	(352)	(376)	(427)	(467)
Quebec	(109)	(109)	(108)	(88)	(55)
Saskatchewan	(184)	(104)	(132)	(190)	(236)
Yukon	(339)	(297)	(320)	(372)	(415)

* Assumes that the individual is taxed at the top marginal income tax rate. Only federal and provincial/territorial income tax, the employer portion of provincial health tax, and the employee portion of Northwest Territories and Nunavut payroll taxes are considered—not, for example, Canada Pension Plan contributions. Different results may occur for specific industries, such as credit unions and Quebec financial institutions and oil-refining companies.

federal and provincial/territorial marginal tax rates on eligible dividends). Integration of personal and corporate taxes is affected; table 4 shows the tax saving or cost of paying out the corporate income as a dividend rather than salary.

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INVESTMENT MANAGEMENT: GST-EXEMPT

Industry has always argued that discretionary investment management is not merely the provision of advice that is taxable for GST purposes, but rather is a GST-exempt financial service. In *The Canadian Medical Protective Association* (2008 TCC 33), the TCC agreed.

The CMPA is a non-profit association that self-insures against doctors' professional liability. Amounts paid by doctors to the CMPA are set aside against the risk of future claims by doctors charged with malpractice; the CMPA pays both doctors' legal bills and claimants' awards. The CMPA engaged several investment managers to invest the funds on a fully discretionary basis—about 75 percent in segregated funds and the balance in pooled funds. The investment managers collected GST on their charges; the CMPA filed a rebate claim to recover the GST it said was paid in error. The minister denied the claim and the CMPA appealed.

The CMPA argued that the investment managers' services were GST-exempt financial services as defined under paragraph 123(1)(a), (b), (c), (d), (f), or (l) of the Excise Tax Act. The Crown contended that the "dominant element" of the services supplied was the skill and abilities of the managers, not the "mechanical aspects" of moving securities around. The CRA also argued that the services were specifically excluded by paragraphs (p), (q), and (t) of the definition.

A review of the agreements between the CMPA and the investment managers showed consistently that the latter had full discretion to buy and sell securities on the CMPA's behalf, subject to limits established by its investment committee. Evidence from the CMPA's director of finance and CFO was critical in establishing that the investment managers were not paid to give advice: "I didn't receive advice. We don't use Phillips, Hager & North to provide advice, we use them to provide us with portfolio management." The managers themselves also characterized their service as investment management, not advice. Even if the service's dominant element involved skill and expertise, it was the service that the CMPA needed, not simply skill and expertise.

The TCC cited the *Royal Bank* decision (2005 TCC 802) and confirmed the industry's position when it found that the services were "the arranging for . . . the transfer of ownership . . . of a financial instrument" and fell within paragraphs (d) and (l) of the financial services definition, and that the securities lending services fell within paragraphs (c) and (l).

The exclusion in paragraph 123(1)(q), amended repeatedly, has created much confusion: it excludes a "management and administrative service" from the financial services definition. The TCC in *CMPA* concluded that "the juxtaposition in paragraph (q) of the words 'management' and 'administrative' implies the type of managerial function associated with running a business. . . . I should not have thought that 'managing' a portfolio of investments carried that type of connotation." The court also concluded that the prescribed exclusion for "any administrative service" in the financial services (GST/HST) regulations could not be relied upon once a narrower interpretation of "administrative" had been established in paragraph (q): the regulation must not extend the statutory limitations. The court cited with approval the *Royal Bank* decision, which concluded that the regulation's intention was to exclude from the definition of "financial services" ancillary services only, not services specifically enumerated in paragraphs (a) to (l).

The TCC's decision was deferred pending the decision in *General Motors* (2008 TCC 117), which ultimately allowed GM to claim input tax credits for GST charged on investment management services related to its pension plan; the services were not exempt financial services. The TCC in *CMPA* distinguished *General Motors* on the facts, saying that GM relied on the advice provided and exercised control over its investment managers' decisions.

Given the CRA's heavy reliance on paragraph (q) and its frequent amendment, the TCC's speedy and unequivocal dispatch of the Crown's argument may portend an appeal. The CRA will doubtlessly seek further amendments to paragraph (q) and perhaps to the regulation: GST revenue raised from the investment sector is in the hundreds of millions of dollars. Investment managers may suffer only relatively minor GST costs in providing GST-exempt financial services—salaries and wages represent the bulk of the value added—but the prospect of their clients' saving 5 percent of their fees by enhancing managers' discretion may motivate all parties to undertake further planning.

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FOREIGN TAX NEWS

Australia

The Australian Taxation Office publishes Taxpayer Alerts that warn taxpayers of significant and emerging tax-planning issues under the ATO's review. A recent alert warns of arrangements in which Australian taxpayers provide funds to tax promoters in Vanuatu to be loaned back to the taxpayers, who then deduct the interest paid.

Treaties

A **Japan-EU** Agreement on Cooperation and Mutual Administrative Assistance in Customs Matters was signed, effective February 1, 2008. The agreement establishes a framework to relieve regular traders, to combat fraud, and to enhance cooperation in protecting intellectual property rights. Japan has similar agreements with 13 other countries, including Australia, China, and the United States. A first **Poland-Canada** social security treaty was signed on April 2, 2008. The US Tax Court held that the 90 percent FTC limitation on AMT (since repealed) took precedence over the **Canada-US** treaty under the "later-in-time" rule. (*Jamieson*, US Tax Court docket no. 16421-05, April 29, 2008.) The IRS issued interim guidance on a case's commencement date under the new mandatory arbitration procedure in the 2006 **US-Germany** protocol; mandatory arbitration generally begins two years after a case's commencement date.

South Africa

Under the Expropriation Bill 2008, the Ministry of Public Works can expropriate property to achieve equitable access to mineral and water resources. An explanatory summary has been gazetted.

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