CANADIAN TAX Highlights

Editor: Vivien Morgan, LL.B.

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LIABILITY NOT CONTINGENT

A majority of the SCC in *McLarty* (2008 SCC 26) concluded that a principle of taxation law adopted from the 1963 English House of Lords decision in *Winter* ([1963] AC 235) continues to be the basis for establishing whether a liability is contingent for Canadian income tax purposes.

In 1992, Mr. McLarty purchased an interest in seismic data from Compton Resource Corporation for $100,000: $15,000 in cash and an $85,000 promissory note payable in 2002 with interest. The whole $100,000 was claimed as a Canadian exploration expense, which the minister challenged on a number of grounds.

The note's terms limited the note holder's recourse, and no action lay against Mr. McLarty for repayment. Mr. McLarty assigned to the vendor 60 percent of the cash proceeds received from any future sales or licensing of technical assets (seismic proceeds) and 20 percent of production cash flow generated in exploiting petroleum rights through drilling programs. These assigned shares of seismic proceeds and production cash flow were to be applied toward payment of interest and principal under the note; however, there was no certainty of any future sales or licensing of technical assets, any drilling programs, or any production cash flow.

The Crown argued that no liability ever existed because the note's repayment depended upon uncertain future events. However, the note also provided that if any interest or principal remained outstanding at the note's maturity, a trustee would be appointed to sell the seismic data, and 60 percent of the proceeds would be allocated to pay the amount owing.

The SCC's decision in Mr. McLarty's favour rests upon and reinforces the principle that a liability is absolute unless its existence depends upon the happening of an event that may never occur. Under the McLarty note, the liability to pay did not only come into existence if and when seismic proceeds or production cash flow was generated. This fact thus distinguishes the case from earlier cases such as *Mandel* ([1980] 1 SCR 318), where the liability to pay the note came into existence only on the generation of partnership profits.

McLarty is also notable for its statement that the role of the court is not one of "protector of government revenue." The court characterized the root of the minister's objection to the note as involving a belief that the price of the seismic data was inflated, and thus even though the seismic data were given as collateral security, they were the only security and their value was insufficient to cover the note's repayment. The court stated several times that the fact of a debt's being non-recourse or limited-recourse does not make the liability contingent. The court added that the minister has numerous means of challenging taxpayer deductions, such as sham and GAAR; the court's role is solely to adjudicate disputes upon the bases raised by the minister, not to rule on the validity of deductions generally.

On a successful cross-appeal by Mr. McLarty, the SCC reinstated the trial judge's finding that the transaction took place at arm's length. The relevant transaction point for determining the issue was when McLarty acquired an interest in the seismic data: at the time, was he dealing at arm's length with the vendor? The SCC found that the trial judge had regard to the relevant indicia for determining the arm's-length question, and had applied those indicia to the evidence. No palpable and overriding error could be discerned in the findings of fact.

Robert McMechan
www.TaxAssistance.ca

In This Issue

IFRS AND CANCO TAX REPORTING

The Canadian Accounting Standards Board recently confirmed that Canadian publicly accountable companies must adopt international financial reporting standards (IFRS) for fiscal years beginning on or after January 1, 2011. The move to IFRS marks a fundamental shift in financial reporting that will affect all areas of a company, including its tax department. IFRS will affect a company's reported pretax profits and thus its tax provision and tax return. A company adopting IFRS will have to include the tax return and financial reporting impact in its conversion plan.

IFRS is similar to Canadian GAAP, but there are numerous measurement and recognition differences, including a requirement or an option to measure more items at fair value and an enhanced likelihood and acceleration of impairment charges, which generally must be reversed in later periods if facts and circumstances change. A company adopting IFRS must make certain changes to its accounting policies retroactively and report the cumulative effect of these changes as an adjustment to opening retained earnings. Because the determination of retroactive adjustments can be onerous, IFRS 1, "First-Time Adoption of International Financial Reporting Standards," provides some relief to a company preparing its first IFRS-compliant annual financial statements.

The standards for income taxes are similar to those under Canadian GAAP. Deferred tax is recognized for the estimated future tax effects of temporary differences, and tax loss carryforwards and temporary differences are similarly defined. Like Canadian GAAP, IFRS uses substantively enacted tax rates in computing deferred taxes. Certain differences between the two standards are expected to be eliminated when the much-anticipated exposure draft of IFRS amendments is issued later in 2008; however, certain key differences will remain.

A tax return preparer must understand the differences between the company's Canadian GAAP-reported balances and its IFRS-reported balances in order to determine the proper treatment for the company's tax returns and to compute its tax provision. Many of these differences will create new or additional temporary differences that must be recognized.

Consider items that are currently treated the same for accounting and tax purposes. Changing the accounting treatment as a result of implementing a new IFRS method may raise several questions: (1) Is there a tax rule requiring conformity with financial accounting rules? (2) Can the method that developed historically to arrive at the correct amount for tax purposes continue to be followed, or does the new IFRS accounting method omit information required for the historical method to produce the correct tax result? (3) Does the company have the information available to compute and schedule the new temporary differences? Depending on the answers to these questions, companies may need to change some of their historical income tax valuation methodologies. For assets such as inventories, companies may even need to obtain CRA approval for the change.

On adopting IFRS, a company may encounter differences from GAAP standards such as the following:

- Under IFRS, each item of property, plant, and equipment must be broken down into its components, including physical components, major inspections, and overhaul costs. Each component is depreciated separately over its useful life and is accounted for separately, but the financials continue to disclose a single asset. For tax-reporting purposes, a company must determine the tax treatment of the components and schedule the reversal of their related temporary differences.
- Under IFRS, a company may elect to revalue property, plant, and equipment to fair value as an accounting policy choice and on first adopting IFRS; the resulting surplus is generally recognized directly in a revaluation reserve within equity. For Canadian tax purposes, these revaluation adjustments are generally not allowed, and a company must determine their impact on the tax return and tax provision, including the nature and quantum of any offsetting adjustment required to reconcile net income for tax and accounting.
- Under IFRS, a provision is recognized for a legal or constructive obligation that arises from a past event, if the amount can be reliably estimated and the outflow of resources is probable. Because "probable" in this context means "more likely than not"—lower than Canadian GAAP's "likely" threshold—more items may be recognized under IFRS. If these additional provisions are contingent, an adjustment may be required on the tax return and may trigger temporary differences and concomitant additional deferred taxes to be recorded in the financials.
- Many other IFRS provisions that affect tax reporting, including those for revenue recognition, debt versus equity classification, related parties, financial instruments, and joint ventures, are also expected to create different financial reporting results relative to GAAP standards.

Pamela Zabarylo and Laura Woodhouse
KPMG LLP, Toronto

CRA Powers To Obtain Third-Party Information

The SCC recently denied leave to appeal the FCA's decision in *Greater Montréal Real Estate Board* (2007 FCA 346), which concerned a CRA request for information from the board as part of an audit project of real estate agents in the Montreal area. The SCC denied leave to appeal, and thus the FCA decision stands, giving the CRA access to the information it sought.

In 2004, the CRA wanted to commence an audit project concerning the income of real estate agents and licensed brokers living or carrying on business in the Montreal area to determine whether they were complying with the Act, and in particular whether they had completed their income tax returns properly and reported the commissions they earned. To carry out the investigation, the CRA required a judge's authorization.

For any purpose related to the administration or enforcement of the Act, the CRA may require that any person provide within a reasonable time any information or document relating to a named taxpayer. However, the CRA must obtain prior judicial authorization if it wants to issue a requirement to provide information or documents to a person (such as the board) and the requirement relates to "unnamed persons" (such as individuals falling into a category of real estate agents and licensed brokers).

The CRA applied to the Federal Court for an order requiring the board to provide the names of members located within certain postal codes, together with their home addresses, telephone numbers, birthdates, social insurance numbers, and business addresses, as well as information on the transactions in which they had taken part over the preceding three taxation years, the addresses of all properties sold, the dates and prices of all sales, and the remuneration received in each sale.

A judge may authorize the CRA to require a third party to produce information or any document relating to unnamed persons, subject to such conditions as the judge considers appropriate. The judge must be satisfied that the person or group is ascertainable and that the requirement to provide information is issued so as to verify compliance by the person with any obligation under the Act. The FC judge originally granted the order ex parte but on review set the order aside, saying that although the group referred to in the order was ascertainable, the evidence did not disclose the existence of a genuine and serious inquiry.

On appeal to the FCA, the CRA argued that the FC was incorrect when it found that there was no "genuine and serious inquiry" concerning the agents and brokers; the board argued that the FC was incorrect when it found that the group was ascertainable. The board argued that a group is ascertainable when the particular persons who make up the group do something specific together in the pursuit of a common objective; on the facts, the unnamed persons had not acted together. The FCA found that there was an ascertainable group as required under the Act; the existence of about 2,000 members did not negate this finding. The FCA noted that the CRA audit involved a group composed of real estate agents and brokers living or carrying on business in the area served by the local CRA office; this was an ascertainable group for the purposes of the audit project.

The FCA said that an order will be granted if the person or group referred to is ascertainable and if the information or documents are required to verify compliance with any duty or obligation under the Act. The FC had incorrectly concluded that a prerequisite to a judicial authorization under the Act was the existence of a "genuine and serious inquiry," a "genuine audit" in regard to each group member. The FCA noted that such a condition was not mentioned in the current legislation and was thus not the appropriate test. Instead, a judge must be satisfied that the information or documents relating to one or more unnamed persons who form the ascertainable group are required to verify compliance with the Act.

The FCA said that under 1996 legislative amendments, "Parliament permitted a type of fishing expedition, with the authorization of the Court and on conditions prescribed by the Act, all for the purpose of facilitating the [CRA's] access to information." The FCA said that a tax system based on the principle of self-reporting and self-assessment must give the CRA broad powers to audit taxpayers' returns and inspect all records that may be relevant to the preparation of the returns. As a result, the FCA set aside the FC's reversal of the original ex parte order and found that the relevant legislation allowed the CRA access to the information it had requested from the board.

Paul Hickey
KPMG LLP, Toronto

Personal Income Tax Across the Provinces

As a general rule of thumb, federal personal income taxes represent about two-thirds of the combined federal and provincial personal income tax burden. The latest data from Statistics Canada's Provincial Economic Accounts confirm this rule as a national average, but the data are a reminder that the situation in each province may be very different.

In 2005, the latest year for which complete information is available, federal taxes ranged from a high of 72.4 percent of combined collections in Alberta to a low of 57.0 percent in Newfoundland and Labrador. In Quebec, federal collections amounted to only 48.3 percent of all income taxes; the higher provincial and lower federal taxes reflected the special abatement of federal tax as compensation for the province's opting out of certain shared-cost programs.

The table shows both federal and provincial income taxes collected during the calendar year 2005 as a percentage of personal income determined for national accounts purposes (defined more broadly than income for tax purposes). Federal taxes were below the national average in the Atlantic provinces, Manitoba, and Saskatchewan because lower average incomes there meant that fewer taxpayers were subject to the federal highest marginal rate. The provincial rates in those provinces were apparently designed to be more effective so that the provincial collections were closer to the national average.

Personal Income Taxes as a Percentage of Personal Income, 2005

	Federal	Provincial
Newfoundland and Labrador	8.09	6.09
Prince Edward Island	7.98	5.26
Nova Scotia	8.70	5.81
New Brunswick	8.10	5.25
Quebec	7.93	8.48
Ontario	10.75	5.92
Manitoba	8.65	5.92
Saskatchewan	8.96	5.05
Alberta	11.89	4.53
British Columbia	10.15	4.37
Canada, including the territories	9.92	6.06

In Ontario, Alberta, and British Columbia, federal collections were well above the national average, ranging from 10.2 percent in British Columbia to a high of 11.9 percent in Alberta. Provincial collections were close to the national average in Ontario, but Alberta and British Columbia provincial collections were well below the average, expressed as a percentage of personal income. Quebec, as noted above, is a special case.

Although the numbers do not reflect the changes under way in some provinces, they are useful to show how a uniform federal tax system can have such a different impact in each province because of the different attributes of the taxpaying populations.

David Perry
Canadian Tax Foundation, Toronto

Premium for Voting Control on Estate Freeze

In the Vancouver TSO, the CRA is apparently assessing a premium on the value of a private company's voting non-participating preference shares acquired on an estate freeze and held by a taxpayer at death. In the absence of a spousal rollover, such shares are deemed disposed of at FMV the instant before death, triggering a gain. Assessing a premium in such circumstances is an unannounced change in policy.

Retention of control is a common objective for a parent executing an estate freeze. Thus, the parent may receive redeemable retractable preference shares (voting or non-voting) on a share-for-share exchange in the opco or in a holdco. Alternatively, the parent may receive a separate class of voting non-participating preference shares that are redeemable for a nominal amount (skinny shares). In both cases, the preference shares enable the parent to retain control after the frozen shares' redemption. Arguably, the value of the skinny voting shares should not exceed the redemption amount, particularly in a non-arm's-length context.

To avoid any possible premium, the share attributes may be drafted so that the voting rights terminate immediately prior to death. On the basis of the decision in *Bowater Canadian Ltd. v. R.L. Crane Inc.* ((1987), 46 DLR (4th) 161 (Ont. CA)), it may not be possible to restrict the voting rights on shares to the original holder: according to *Bowater v. Crane*, share attributes must attach to the shares as a class and not be personal to the holder. A shareholders' agreement may provide some protection if it states that the shares must be redeemed for nominal consideration on death. Arguably a shareholders' agreement is a factor that should be considered in the shares' valuation. The case law supports this position, as does the CRA's administrative position: IC 89-3 provides that options, buy-sell agreements, and other contractual rights and obligations must be considered. The same information circular also confirms the view that control is relevant in the valuation process.

One suggestion is to have the voting non-participating shares held in an inter vivos trust controlled by the parent; if the trust is not an alter ego trust, there is no deemed disposition of the trust assets at the parent's death and the valuation issue does not arise then. The trust is subject to a deemed realization in 21 years unless the shares are distributed before then to a Canadian-resident beneficiary on a tax-deferred basis.

However, a further complication arises if the voting shares are placed in an inter vivos trust. For the estate to be able to reorganize a holdco after a shareholder's death and bump the opco shares' ACB, there must be an acquisition of control on death. To access the bump, the estate typically forms a newco and rolls the holdco shares to the newco in exchange for shares. The holdco is either wound up into or amalgamated with the newco, and a designation is made in order to bump the opco shares' ACB up to the FMV of the shares owned by the deceased. The bump limitations are contingent on the ACB to the parent company (the newco) of the shares and on an acquisition of the control from a person with whom the newco dealt at arm's length. Paragraph 88(1)(d.3) deems the acquisition of control that follows from the individual death to be an arm's-length acquisition of control; if all or a significant portion of the voting shares is held by an inter vivos trust, the requisite acquisition of control for the bump under paragraph 88(1)(c) does not occur. Although it is conceivable that a change in the trustees on the death of a freezor may result in a change of control, the inter vivos trust does not have the required cost base to obtain the bump, because its cost emanates from the individual parent's historical cost in the freeze shares and not from their FMV on his or her death.

Jack Bernstein and Elisabeth Atsaidis
Aird & Berlis LLP, Toronto

CRA Pension Positions Change

Two recently released CRA interpretations related to pensions upset positions widely relied on by taxpayers. One follows new case law; the other springs from an administrative reinterpretation of the Act.

Surplus. The CRA has long considered that surplus paid to an employer under a pension plan or for its rights thereunder is a superannuation or pension benefit. Most recently, however, the CRA said that an amount received by a business's vendor for its rights to surplus under a pension plan should be included in income as an amount "in lieu of payment of" a superannuation or pension benefit (document no. 2007-0256401I7, February 14, 2008). The CRA relies on the FCA decision in *Transocean Offshore Limited* (2005 DTC 5201), which held that a payment made to terminate a rental agreement with a corporation not resident in Canada was subject to withholding as an amount paid "as, on account or in lieu of payment of . . . rent." The decision was not based on the surrogatum principle, nor did it distinguish income from capital receipts; rather, it gave the phrase "in lieu of" a sufficiently broad meaning to include the concept of a reasonable substitute. The CRA also relies on the TCC decision in *Holzhey* (2008 DTC 2607), which dealt with the resulting deemed disposition, on a change of residence, of a loan on which interest had accrued but was not payable: the proceeds related to accrued interest were held to be received "in lieu of" interest.

The traditional view that amounts received for rights under a pension plan were treated as proceeds of an eligible capital property enjoyed symmetry with the treatment afforded the purchaser: amounts paid to acquire the rights were eligible capital expenditures. Technically, the price paid by the purchaser of surplus in a pension plan does not appear to qualify as an eligible capital expenditure, and it does not appear to be deductible against business income. This new asymmetry of tax treatment makes the acquisition of surplus unpalatable to both vendor and purchaser; however, the problem flows not from CRA fiat but from the terms of the Act and the governing case law.

RCAs and letters of credit. In contrast, the recent change in CRA policy regarding RCAs and letters of credit (LOCs) is merely a change in administrative practice.

Since the early 1990s, the CRA's approval of a well-defined structure facilitated the use of LOCs under RCA arrangements. An employer contributes twice the LOC fee under an RCA arrangement. The RCA trustee pays the fee to an issuing bank to obtain a previously arranged LOC. The RCA trust is the LOC holder and beneficiary. The employer agrees to reimburse the bank if a call is made on the LOC; the agreement to reimburse is not considered an RCA contribution.

In the past, the CRA said that a payment by a bank under such a LOC was an RCA contribution subject to the RCA tax, because the payment was made on behalf of, and was repayable by, the employer. It was understood that the bank was obliged to withhold refundable tax on any draw made under the LOC. Three advance income tax rulings issued in 1997 and 1998 said that the bank's payments under a LOC were deductible by the employer as an RCA contribution (document nos. 970667 (1997), 971807 (1997), and 973392 (1998)). Many RCA-LOC arrangements were based on these interpretations and rulings, and taxpayers and their advisers reasonably relied on the CRA's guidance. The CRA has now repudiated an important element of this well-established mechanism (at the APFF conference, October 5, 2007) and says that the bank's payment is not deductible by the sponsoring employer because it did not make the payment.

The principle of autonomy distinguishes a LOC from a guarantee or an indemnity. The agreement by the issuer of the LOC to pay under the LOC is not a subsidiary obligation of the bank but an independent undertaking of the issuer. When an issuer pays under a LOC, it is not entitled to claim subrogation or reimbursement from the employer unless it has contractually provided for such with the employer. The LOC does not depend upon the underlying contractual promise secured by the RCA. On the basis of these general principles, the payment by the LOC's issuer cannot be considered a payment by the employer. Although the CRA's previous position was thus incorrect, taxpayers relied on that position and structured long-lived arrangements accordingly.

Is the reimbursement by the employer to the bank deductible? It is not deductible as an RCA contribution because the employer has made no contribution under the RCA. The reimbursement is made under a contract between the employer and the issuer that is separate from the contract between the issuer and the LOC holder. To claim a deduction for the reimbursement, the employer must establish that the reimbursement was a current business expense and not capital, a position apparently not supported by existing case law. Current RCA-LOC arrangements need to be reviewed; it may prove difficult to perform the necessary restructuring to reduce or eliminate draws on LOCs.

Marcel Théroux
Mercer LLC, Toronto

SERVICES OR SALE OF GOODS?

The TCC in *Triple G Corporation* (2008 TCC 181) characterized a supply as one of a taxable service, not of a non-taxable good. The court focused on the nature of the contract to characterize the supply, an approach not taken in many other cases. Although the result in *Triple G* appears to be correct, it is unfortunate that the court left for another occasion the opportunity to provide a definitive usable test for taxpayers on what is perhaps the most fundamental issue in the GST's application—characterization of a supply.

The appellant in *Triple G* operated a meat-processing shop, which, inter alia, custom-cut and custom-processed meat. Customers left an animal's carcass at the appellant's premises; as agreed with the customer, the appellant broke down, cut, wrapped, and made the carcass into a form that could be used by the customer at home. For example, in making sausage, hamburger, steaks, roasts, or jerky, the appellant added extra ingredients, such as pork, spices, and sausage casings, and wrapped and delivered the product to the customer. The appellant charged by the pound for the custom cutting. Was the agreement for the supply of a service subject to the GST or for a zero-rated supply of a basic food item?

The TCC rejected the appellant's main argument that the ownership of the carcass passed to it and it supplied food to the customer. There was nothing in the agreement to support a transfer of the carcass's ownership. The TCC was satisfied that food was delivered to the appellant for processing, and the appellant returned food—in a different form—to the customer. The court cited the TCC decision in *Robertson* (2002 GTC 143), which found that a single main supply of taxidermy services was provided for a single consideration; materials used in providing those services were incidental thereto.

Robert G. Kreklewetz and Vern Vipul
Millar Kreklewetz LLP, Toronto

NON-ELIGIBLE DIVIDEND RATES

Non-eligible dividend tax rates after 2007 are increased in Alberta, British Columbia, Manitoba, and Prince Edward Island, by reducing their tax credit rates to correspond to provincial small business rate changes (see table 1). The rate changes are intended to ensure that the combined corporate and personal tax on business income eligible for the small business deduction and earned through a CCPC is roughly equal to the tax payable by an individual earning such income directly. (For changes to eligible dividend rates, see "Federal Eligible Dividend Rate," *Canadian Tax Highlights*, May 2008.)

Table 1 Non-Eligible Dividend Tax Credit Rates (on Grossed-Up Dividends)

	2008	2009	2010	After 2010
		percent		
Alberta	4.50	3.50	3.50	3.50
British Columbia	5.10	4.20	4.20	4.20
Manitoba	3.15	2.50	2.50	2.50
New Brunswick	5.30	5.30	5.30	5.30
Newfoundland and Labrador	5.00	5.00	5.00	5.00
Northwest Territories	6.00	6.00	6.00	6.00
Nova Scotia	7.70	7.70	7.70	7.70
Nunavut	4.00	4.00	4.00	4.00
Ontario	5.13	5.13	5.13	5.13
Prince Edward Island	4.30	3.20	2.10	1.00
Quebec	8.00	8.00	8.00	8.00
Saskatchewan	6.00	6.00	6.00	6.00
Yukon	4.45	4.45	4.45	4.45
Federal	13.33	13.33	13.33	13.33

Table 2 Top Combined Federal and Provincial/Territorial Marginal Tax Rates on Non-Eligible Dividends[a]

	2008	2009	2010	After 2010
		percent		
Alberta	26.46	27.71	27.71	27.71
British Columbia	31.58	32.71	32.71	32.71
Manitoba	37.40	38.21	38.21	38.21
New Brunswick	35.40	35.40	35.40	35.40
Newfoundland and Labrador	33.33	32.71[b]	32.71[b]	32.71[b]
Northwest Territories	29.65	29.65	29.65	29.65
Nova Scotia	33.06	33.06	33.06	33.06
Nunavut	28.96	28.96	28.96	28.96
Ontario	31.34	31.34	31.34	31.34
Prince Edward Island	36.63	38.15	39.66	41.17
Quebec	36.35	36.35	36.35	36.35
Saskatchewan	30.83	30.83	30.83	30.83
Yukon	30.49	30.49	30.49	30.49
Federal	19.58	19.58	19.58	19.58

[a] Assumes that the top combined federal and provincial/territorial marginal income tax rates remain at 2008 levels (2009 levels for Newfoundland and Labrador).
[b] The top combined federal/Newfoundland and Labrador rate declines after 2008 because of a decrease in the provincial top rate.

In Alberta, the reduction in the non-eligible dividend tax credit rate (a gradual decrease from 2006 to 2009) corrects an inadvertent benefit provided when the small

Table 3 Integration: $10,000 Active Business Income Subject to Tax at the Small Business Tax Rate (Saving/Cost)[a]

	2008	2009	2010	After 2010
	dollars			
Alberta	225	117	117	117
British Columbia	186	123	123	191[b]
Manitoba	199	190	190	190
New Brunswick	122	122	122	122
Newfoundland and Labrador	208	211	211	211
Northwest Territories	485	485	485	485
Nova Scotia	448	448	448	448
Nunavut	289	289	289	289
Ontario	476	476	476	476
Prince Edward Island	157	95	31	(86)
Quebec	189	189	189	189
Saskatchewan	245	245	245	245
Yukon[c]	148	148	148	148

[a] 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.

[b] Assumes that British Columbia's small business rate decreases to 2.5% on January 1, 2011.

[c] The figures assume that Yukon's rate on active business income that is not M & P income applies; if it is M & P income, the tax saving is $252.

business tax rate was reduced from 6 percent to 3 percent between April 1, 2001 and April 1, 2004. British Columbia will decrease its non-eligible dividend tax credit rate in 2009 because of the reduction in its small business rate from 4.5 percent to 3.5 percent on July 1, 2008; the tax credit rate is likely to further decline with the reduction of the province's small business rate to 2.5 percent (expected by 2011). Manitoba's non-eligible dividend tax credit rate decreases in 2008 and 2009 to reflect the reduction in the provincial small business rate from 3 percent to 2 percent on January 1, 2008, and to 1 percent on January 1, 2009. Prince Edward Island decreases its non-eligible dividend tax credit rate from 2008 to 2011 to correspond to decreases in its small business rate of 1.1 percent on April 1 annually, until the rate reaches 1 percent on April 1, 2010.

These changes increase tax rates on non-eligible dividends in Alberta, British Columbia, Manitoba, and Prince Edward Island. (See table 2 for the top combined federal/provincial and territorial marginal tax rates on non-eligible dividends.) The changes also affect the integration of personal and corporate taxes. Table 3 shows the tax saving or cost of paying out corporate income that is subject to the small business rate as a dividend in lieu of its payment as salary.

Louis J. Provenzano and Donald E. Carson
PricewaterhouseCoopers LLP, Toronto

Interest on Nil Section 216 Return

The TCC held in *Pechet* (2008 TCC 208) that a non-resident's filing of a section 216 income tax return, which resulted in her owing nil part I income tax, did not relieve the resident payer of rents from its obligation to withhold part XIII tax. Thus, the non-resident was liable to pay interest that accrued on the unremitted part XIII withholding tax between the time when the amounts should have been withheld and the time when the non-resident filed the return showing a nil tax liability.

The non-resident taxpayer, Ms. Pechet, had a 50 percent interest in the Pechet family partnership, which owned commercial rental property in Canada; the other 50 percent was owned by trusts whose beneficiaries were Ms. Pechet's children. Ms. Pechet's share of the gross rents for the 1997-2001 taxation years was $225,000; the Canadian-resident tenant did not withhold part XIII tax on the rents it paid.

In October 2001, the partners (Ms. Pechet and the trust) made a voluntary disclosure on a no-name basis, advising the CRA of the property's revenues and expenses for the years in issue (which resulted in a nil operating profit after capital cost allowance). In May 2002, the partners filed a section 216 Canadian income tax return under part I, showing no part I income tax owing for each relevant taxation year.

On April 3, 2003, the CRA assessed Ms. Pechet for part XIII withholding tax for each year and for the related arrears interest on the withholding that would have been payable by the partners if the returns had not been filed. Notices of reassessment issued on the same date reversed the part XIII withholding tax ($56,000) but not the assessed arrears interest ($4,500). In June 2003, Ms. Pechet filed objections, and the CRA confirmed the reassessments in June 2005.

The issue was whether Ms. Pechet was liable to pay interest on part XIII tax even though the ultimate part I tax liability was nil. Did the filing of the elective, nil part I income tax returns eliminate retroactively the part XIII withholding tax liability and thus the related arrears interest? Or did the obligation to withhold remain intact? It is not clear whether the CRA also assessed interest against the resident payer.

The TCC noted that subsection 216(1) makes a non-resident liable for part I tax "in lieu of" paying part XIII tax. In contrast, subsection 216.1(1) (dealing with actors' services) states that "no tax is payable" under part XIII if the person files a part I return and elects to have section 216.1 apply. The TCC said that in section 216.1, "[t]he phrase 'no tax is payable under this Part' completely dispenses with Part XIII tax whereas the words 'in lieu of' [in section 216] connote the continued existence of, but substitution for, Part XIII tax. Although this distinction is subtle, it underscores the importance of the meaning of the words 'in lieu of.'"

The court noted that the phrase "in lieu of" in section 216 was given an "expansive scope" by the FCA in *Transocean.* Ms. Pechet argued that the phrase as used in section 216 should be read to mean "instead of" or "in substitution for," and that the section 216 election set up an alternative tax regime that substituted a part I tax liability for a part XIII liability; because the obligation to withhold or remit tax under part XIII was then obviated, the failure to remit could not attract an interest charge. However, the TCC noted that the FCA in *Transocean* did not focus on the fate of the original obligation once the substitution occurred.

The TCC's textual and contextual analysis showed that there was nothing in the Act to suggest that a non-resident's ultimate tax position affects the resident payer's obligation to withhold and remit part XIII amounts. The TCC said that it was doubtful that a subsection 216(1) income tax return extinguished the part XIII tax liability, because subsection 216(1) states that the non-resident person can file a return of income under part I and "thereupon be liable, in lieu of paying [part XIII] tax . . . to pay [part I] tax." The word "thereupon," the court said, "suggests that prior events would be unaffected by the subsequent filing of the section 216 return," and thus "interest would accrue at the very least up to the filing date."

The TCC said that part XIII's basic scheme is straightforward. The intent of subsection 215(1) is to require a resident payer to withhold and remit amounts without consideration for the non-resident recipient's tax position. Failure to do so renders the non-resident jointly and severally liable for interest on those amounts. Despite the filing of income tax returns, the TCC said that the amount on which part XIII is payable still exists for the purposes of a resident payer's obligation to withhold tax. That obligation continues to apply to the resident payer even though a subsequent event (the section 216 return's filing) results in the non-resident recipient's having no part XIII tax liability. Therefore, Ms. Pechet was still obliged to pay interest on the amount that the resident payer should have withheld.

Jim Yager
KPMG LLP, Toronto

MARKET DEFINES PRODUCT

The FCA in *ATCO Electric Ltd.* (2008 FCA 188) concluded that characterization of a product defined by its marketability must take into account the peculiar fact situation. In the light of *ATCO*, an affected taxpayer may determine that the part of its integrated Canadian mining operations that could be defined as mining extends further than formerly thought, giving rise to an enhanced preferred CCA classification.

A taxpayer with integrated mining operations that include M & P (processing beyond the prime metal stage or equivalent [PMSE]) must segregate M & P profits from resource profits, which are used to calculate special deductions such as resource and depletion allowances and which also affect the ordering of deductions. The regulations defining "income from a mine" also use PMSE as a separation point to distinguish ordinary assets from mining assets eligible for class 41, which qualifies for accelerated CCA.

The interpretation of PMSE was at issue in *ATCO*. The phrase is not specifically defined in the Act, but the jurisprudence generally considers it to be the point at which a marketable, saleable commodity is produced—that is, where mining stops and manufacturing begins. The parties disagreed on how to determine when the commodity (in this case, thermal coal) became marketable as a saleable commodity. On the facts, the distinction affected whether assets were classified for tax purposes as class 41 mining assets (a 25 percent CCA rate) or class 1 assets (a 4 percent CCA rate).

ATCO was in the business of generating, transmitting, distributing, and retailing electricity. As part of its operations, it ran some coal-fired generating stations that were fuelled by coal from adjacent mines. The particular coal (sub-bituminous) had a low energy content, which was acceptable for fuelling the neighbouring generating station, but it was uneconomical for, and thus not marketable to, third parties if it had to be transported any significant distance. Thus, the only market for the coal produced from the mine was the adjacent generating station.

The taxpayer was successful in the TCC; the Crown appealed. The parties agreed that the PMSE ends at the point where the production process has produced a marketable, saleable commodity that meets consumer specifications, but they disagreed on when the commodity was marketable. The coal mining, extraction, and processing can be broken down into six stages: (1) strip mining, (2) blending coal of varying qualities in a pit and transferring it to a conveyer system, (3) primary crushing to a size not exceeding six inches and then stockpiling it in a reclaim pile, (4) secondary pulverizing to not more than one inch and removing metals with electromagnets, (5) pulverizing to remove impurities, and (6) blowing the coal into a combustion chamber to start the process of electricity generation.

The CRA said that the PMSE for coal was reached after stage 3, primary crushing. The taxpayer computed its resource profits and classified equipment as class 41 up to and including the stage 5 pulverizing. The taxpayer said that marketability of a particular commodity for PMSE purposes must be determined with regard to the unique facts; the CRA said that a uniform determination should apply to each particular commodity regardless of the taxpayer's idiosyncratic situation. Oddly, the CRA's approach was not consistent with its published interpretation on PMSE (document no. 9826855, February 10, 1999), which stated that the PMSE separation point can be determined only after a review of all the relevant facts relating to the specific mining operation. In *ATCO*, the Crown's witness conceded that the coal had no marketable value until fully processed. The FCA rejected the CRA's approach because there was no alternative viable market for the coal in its reclaim pile condition at the end of stage 3.

The FCA distinguished the limited jurisprudence (*Canadian Pacific* (1994), 171 NR 64 (FCA) and *Gulf Canada Resources Ltd.* (1996), 192 NR 283 (FCA)) on the facts. The court further noted that the relevant regulations and provisions of the Act do not generally define or specify a PMSE cutoff point, and the term has no industry-accepted general meaning. Although the matter was not raised by the court, the regulations contain some clear cutoff points between mining and M & P. For example, in the case of iron ore, the regulations clearly specify that processing after the pellet stage is considered M & P and not mining; for tar sands operations, the mining stage occurs right up to the point of processing bitumen to the crude oil stage or its equivalent.

John Jakolev and Graham Turner
Jet Capital Services Limited, Toronto

CRA on Canada-US Protocol

At the Canadian IFA Branch Seminar held on May 12, 2008, the CRA responded, inter alia, to questions related to the Canada-US treaty as amended by the fifth protocol.

■ A Canadian making payments to a US resident bears the increased responsibility of determining whether the recipient is a qualifying person under the limitation-on-benefits (LOB) article (XXIX A). The CRA acknowledged that the present standard of "know your customer" due diligence is not sufficient; it plans to introduce a new form (currently in draft) to supplement existing procedures. (The United States requires non-resident recipients to file form W-8BEN, "Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding").

■ A US resident that does not meet the "qualifying person" test can apply to the competent authority for entitlement to treaty benefits (article XXIX A(6)). In the next few months, the CRA plans to develop policies and procedures to govern this discretionary authority "consistent with addressing the problem of treaty shopping."

■ The CRA said that it views an entity as "fiscally transparent" (an undefined term) if its income is taxed at the beneficiary, member, or participant level, but not if its tax is relieved at the owner level under an integrated tax system. In the Canadian context, the CRA said that partnerships are fiscally transparent but trusts generally are not.

■ Some ambiguity exists regarding the taxation of a US-resident individual owner of a US S corp who receives dividend income from a Canadian sub, due to the fiscal transparency of the S corp under article IV(6). The CRA said that although under article IV(6) the US individual is seen to derive the income, it views the S corp as owner for the purposes of article X(2), not the US individual. Thus, the 5 percent withholding rate applies if the S corp owns at least 10 percent of the Canadian sub's voting shares and is a "qualifying person."

■ If a recipient US-resident company or trust is not the ultimate owner and there are intermediary fiscally transparent US entities in front of what would be the ultimate US qualifying person, the CRA will ignore the fiscally transparent entities in determining qualifying-person status. For example, if a US-resident individual owns a US LLC, which in turn owns a US C corp, the CRA views the US individual as the C corp's owner for this purpose. Thus, there is no non-qualifying person in the chain of ownership so as to render the US-resident individual not a qualifying person.

■ Paragraph 3 of the LOB article provides treaty benefits for "income derived from [the other contracting state] in connection with or incidental to" an entity's active business. Asked to comment on the meaning of the phrases "in connection with" and "incidental to," the CRA somewhat surprisingly cited Canadian jurisprudence. Each country is able to give its own meaning to these undefined terms, but it has been expected that the forthcoming joint technical explanation will provide guidance similar to the US domestic law interpretation of this paragraph. A literal reading of the paragraph from a Canadian perspective might yield a different and more restrictive meaning from that attributed to the LOBs in other US treaties and that expected to be given by the United States to the Canada-US treaty LOB.

■ In response to a question about the procedural aspects of claiming treaty benefits on Canadian-source income flowing through a transparent US LLC, the CRA said that the US LLC recipient claims treaty relief on behalf of its members. The CRA expects to provide further guidance

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Facsimile: 416-599-9283
Internet: http://www.ctf.ca
E-mail: vmorgan@interlog.com
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after it completes a review (currently under way) of its relevant procedures.

Paul L. Barnicke
PricewaterhouseCoopers LLP, Toronto

Canadian Plans US Withholding Exempt

In private letter ruling 200810013 (December 6, 2007), the IRS addresses the question whether dividends and interest paid to certain Canadian investors are exempt from US withholding tax under article XXI (Exempt Organizations) of the Canada-US treaty.

A series of Canadian funds were formed, each a unit trust. It was represented that the Canadian funds would not carry on a trade or business in the United States. The funds' investors were limited to trusts governed by Canadian tax-exempt plans—namely, a registered pension plan (RPP), a registered retirement savings plan (RRSP), a registered retirement income fund (RRIF), a deferred profit-sharing plan (DPSP), an employees' profit-sharing plan (EPSP), and a registered supplementary unemployment benefit plan—as well as a tax-exempt vacation pay trust; a master trust whose beneficiaries are DPSPs, RPPs, or both; a tax-exempt pension investment corporation (TEPI); and certain Canadian master trusts whose only beneficiaries were RPPs.

Treaty article XXI(2) provides that, in general, dividends and interest derived by a trust, company, organization, or other arrangement resident in a contracting state, and operated exclusively to administer or provide pension, retirement, or employee benefits, are income-tax-exempt in that taxable year in the other contracting state. Article IV(1) generally requires that a resident under the treaty be liable to tax; article XXI(2) also requires that the trust income be liable to tax either in the hands of the trust or its beneficiaries.

The PLR concludes that on the basis of the information provided and the representations made by the taxpayers, if the investors as described are Canadian residents within the meaning of treaty article IV and were qualifying persons within the meaning of article XXIX A (LOB), interest and dividends derived by such unitholders are US withholding-tax-exempt under article XXI(2). In analyzing whether the named organizations qualify for article XXI(2) exemption, the ruling points out that the trusts must meet the requirements of article XXIX A. Accordingly, not only must the organization be a resident of Canada, it qualifies only if more than 50 percent of the trust beneficiaries are (or were within the preceding five years) individuals who were Canadian residents or US residents or citizens. Thus, plan beneficiaries must be continually monitored to ensure that the article XXIX A requirements are met.

Carlos Probus
Ernst & Young LLP, Washington

Steve Jackson
Ernst & Young LLP, New York

Foreign Tax News

Canada's International Agreements

To date in 2008, free trade agreements have been concluded with Colombia and signed with Peru and with EFTA (the European Free Trade Association: Iceland, Liechtenstein, Norway, and Switzerland). Canada is one of Peru's most important sources of foreign direct investment in its mining sector and among its largest investors overall. The EFTA free trade agreement is Canada's first in Europe and will "provide a strategic platform that Canadian companies can use to tap into value chains all across Europe." (See Foreign Affairs and International Trade Canada, *News Release* no. 21, January 26, 2008.)

Canada's tax treaties are now tabled by the minister of foreign affairs in the House of Commons for a 21-sitting-day review period. The full text of a treaty and an explanatory memorandum is distributed to each member of Parliament. The government maintains the legal authority to decide whether to ratify the treaty, giving consideration to the views of the House. In some circumstances, the government may bind Canada to the treaty before it is tabled, and it will inform the House at the earliest opportunity. Similar procedures are longstanding in the United Kingdom and Australia.

Vivien Morgan
Canadian Tax Foundation, Toronto