CANADIAN TAX *Highlights*

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Volume 16, Number 7, July 2008

ELIGIBLE DIVIDEND DESIGNATION

The CRA's recent technical interpretation (2007-0249941E5, May 2, 2008) states that a shareholder notification of an eligible dividend by a CCPC must specify the amount of the dividend to be paid. Thus, a simple statement that the total dividend does not exceed the company's general rate income pool (GRIP) is not sufficient to satisfy the subsection 89(14) requirement to designate eligible dividends.

A designation is made by notifying shareholders in writing that the dividend is eligible when paid. In the TI, the CCPC taxpayer (Company) asks whether the designation requirement is met by a notice to a sole shareholder of a particular class of Company's shares that includes the following:

> [T]he directors of Company have determined that an eligible dividend will be paid to you today by Company by credit to your shareholder's loan account. . . . The dividend will be paid on your Class X shares . . . equal [to] the lesser of the amount required to reduce your shareholder loan account to nil as at [Company's] Year-end . . . and the amount in [Company's] general rate income pool (. . . defined in subsection 89(11) . . .) . . . on that date.

The taxpayer also asked whether the following notification meets the designation requirement when there is more than one shareholder of a particular class of shares of a CCPC:

> [T]he directors of Company have determined that an eligible dividend will be paid to you today on your Class X shares . . . equal [to] the amount in [Company's] general rate income pool (. . . defined in subsection 89(11) . . .) . . . at [Company's] Year-end. . . . The dividend will be paid to you by . . . credit to your shareholder's loan account.

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The TI uses the principles of statutory interpretation—textual, contextual, and purposive reviews—to determine the scope of the Act's designation requirement for eligible dividends. The TI says that a textual review of subsection 89(11) indicates that a taxpayer's entitlement to a written and contemporaneous notification each time a dividend is paid underlies Parliament's intent to provide dividend recipients with certainty regarding their tax consequences.

Regarding the context of subsection 89(14), the TI explains that the designation requirement entitles an individual taxpayer to claim an enhanced dividend tax credit for the eligible dividends received in a taxation year. However, a CCPC may be subject to additional tax if the "eligible dividends" exceed its GRIP. In both cases, the amount of eligible dividends must be determined with certainty to properly assess the tax consequences of their payment. The TI also notes that a corporation cannot make a late designation, suggesting Parliament's intention to disallow any method of written notification that does not at the time of distribution provide dividend recipients with sufficient certainty of the distribution's tax consequences. The TI says that the apparent purpose of the designation requirement is to provide certainty about the related tax implications to investors at the time of the dividends' receipt, and thus the need to provide certainty about the related tax consequences to the investor must outweigh any administrative inconvenience.

Its analysis of subsection 89(14) led the CRA to conclude that the taxpayer's proposed notifications did not meet the requirements because they failed to provide each shareholder with the amount of the "eligible dividends" when paid.

The TI's position that a CCPC's eligible dividend designation must specify an amount contrasts with CRA administrative policy for a public corporation. The CRA has said that a public company's eligible dividend designation before or when dividends are paid satisfies the legislative requirement if it states that all dividends are eligible unless indicated otherwise: no quantification is necessary.

Rent averaging not allowed. A recent internal CRA TI (TI 2008-0272771I7, May 26, 2008) confirms that the smoothing of rent expenses generally required by GAAP for accounting purposes is not permitted in computing income for tax purposes.

The CRA was asked to comment on whether a tenant that entered into a lease arrangement with escalating rent may deduct rent expenses using an average over the term of the lease. The TI acknowledges that GAAP provides for the deduction of lease payments on an average basis; however, any expense deductible for income tax purposes

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must satisfy the general limitation of paragraph 18(1)(a), which states, among other things, that an expense must be incurred during a relevant period. According to the TI, an amount that is a calculated average and that exceeds the rent actually payable in a taxation year has not been "incurred" because the lessor has no enforceable claim to such amount at the taxation year-end. Moreover, even if such amounts could be considered to have been incurred, the excess is not deductible because it can reasonably be regarded as incurred for a period after the year-end.

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Compete To Win

Both the continuously decreasing federal debt and Canada's status as the only G7 country with a budget surplus indicate Canada's economic health. To ensure that this trend continues, in July 2007 the ministers of finance and industry created an independent advisory panel to analyze Canada's competitiveness, on the assumption that increased competition leads to a stronger economy. The Competition Policy Review Panel was mandated to review Canada's competition and foreign investment policies, and to recommend ways to improve productivity and competitiveness. The panel's final report, *Compete To Win*, was released on June 26, 2008 (www.competitionreview.ca).

The report contains several policy recommendations aimed at increasing Canada's competitiveness for talent, investment, and innovation, and it identifies a number of broad tax policy priorities. The panel concluded that to encourage more investment and jobs in Canada, priority should be given not to the reduction of consumption taxes, but to the reduction of corporate and personal income taxes. The panel also recognized that provincial capital taxes and the lack of harmonization of indirect taxes affect investment decisions negatively. The panel made the following recommendations:

1) The federal and provincial and territorial governments should continue to reduce corporate tax rates to create a competitive advantage for Canada, particularly relative to the United States.
2) Provinces should phase out provincial capital taxes expeditiously, and Ontario, Manitoba, Saskatchewan, British Columbia, and Prince Edward Island should quickly harmonize their provincial sales taxes with the GST.
3) The federal and provincial and territorial governments should give priority to reductions in personal income taxes, particularly for lower- and middle-income Canadians, and should encourage investment and job creation by making value-added consumption taxes a higher proportion of governments' revenue base.

Some submissions to the competition panel expressed concerns that Canadian tax rules undermine the competitiveness of Canadian companies vis-à-vis foreign-owned companies when they attempt to acquire Canadian assets (presumably a reference to so-called debt dumping). Concerns were also expressed that recently changed interest deductibility rules disadvantage Canadian companies relative to foreign companies when they make acquisitions in Canada or abroad (a reference to the new double-dip rules in section 18.2). The panel agreed, concluding that these disadvantages prevent Canadian companies from becoming global players. However, the competition panel left the making of recommendations on these issues to the Advisory Panel on Canada's System of International Taxation, established in November 2007 with a mandate to recommend improvements to the Canadian international tax policy framework related to Canadian businesses' investment abroad and foreign businesses' inbound investment.

Both the competition panel and the advisory panel are based on the same premise: outbound investment by Canadians and inbound investment by foreign residents are critical to Canada's long-term growth and development. This view is clearly expressed in *Enhancing Canada's International Tax Advantage*, the advisory panel's consultation paper issued on April 25, 2008 (www.apcsit-gcrcfi.ca). The advisory panel indicated openness to guidance from the competition panel on matters related to competition; in response, the competition panel recommended as follows:

1) The advisory panel should give particular attention to an assessment of tax provisions disadvantaging Canadian companies relative to non-Canadian companies in Canadian acquisitions, and craft recommendations that allow Canadian companies to compete on an equal footing.
2) The advisory panel should assess Canadian tax rules limiting interest deductibility by Canadian companies that make foreign acquisitions to ensure that they enjoy every advantage relative to their foreign competitors and can compete globally.

The second recommendation is interesting because the minister of finance had indicated that the new double-dip rules were not part of the advisory panel's mandate. The competition panel's recommendation adds significant weight to similar representations made to Finance by many Canadian companies and their tax advisers. If the advisory panel makes a similar recommendation to

Finance, it is hoped that the department will return to its position on double dips expressed in 1992 by David Dodge, then the deputy minister of finance, before the Public Accounts Committee:

> Provided that the basic structure of the transaction is indeed a structure that fits within our law, even though it minimizes the taxes paid abroad—not the taxes paid here but the taxes paid abroad—then it would not make sense to impose on our companies the necessity to pay more taxes abroad than their competitors.

The advisory panel visited several cities to gather input from companies and the tax community and accepted submissions until July 15, 2008. It will be interesting to see the panel's conclusions on double dips and many other international tax matters in its report, which is due on December 1, 2008.

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CONTINGENT TAX LIABILITY ON DIVORCE

The recent non-tax SCC decision in *Stein* (2008 SCC 35) will likely affect the division of family assets and liabilities on marital breakdown. In *Stein*, the SCC ruled 6:1 that dividing a tax-shelter-related contingent liability equally between ex-spouses was fair.

Mr. and Mrs. S separated in 2003 after a 12-year marriage, during which Mrs. S cared for their two children and the home and Mr. S was the sole income earner. The divorce settlement equally divided family assets of $1.7 million; Mrs. S was awarded support based on Mr. S's annual $200,000 income. Mrs. S was granted ownership of the family home, and Mr. S kept his interest in the family business, worth $650,000. Both received significant interests in the family's bank accounts, investments, and RRSPs. After the separation, Mrs. S completed training to allow her to seek full-time employment.

The SCC stated that it seemed self-evident that both assets and debts must be considered to ensure fairness on the marriage breakdown. The SCC noted that the term "family debt" evolved in jurisprudence in recognition that spouses jointly contribute to the accumulation of assets and debt.

The SCC said that even if an asset or debt cannot be valued precisely at the time of separation, the principle remains that both spouses' complete financial situations must be considered to ensure a just result. The courts have concluded that spouses have a right to claim an interest in an asset even when it is "inchoate, contingent, immature, or not vested," an approach that the SCC said should also apply to debts, even if they cannot be precisely valued. Although Mr. S generated more income than Mrs. S, both were financially stable when the assets were divided and thus fairness required that they both assume responsibility for the contingent liability related to the tax shelter investments from which they had both benefited. Any future profit from the ownership or sale of the tax shelters was also to be split equally. The SCC said that in the event of significant changes in the circumstances of one party, or if the impact of the future liability on one party results in an unfairness, he or she can apply to the court for adjustments.

The one dissenting SCC judge said that Mrs. S's limited earning power and financial experience, together with her uncertain future employment prospects, created a genuine risk that the equal application of a substantial tax burden would materially reduce her own and her children's standard of living, a reduction from which she may not be able to recover financially. Consequently it was more likely that Mrs. S's and the children's standard of living would be substantially lower than that of Mr. S, and thus the equal apportionment of the contingent liability was unfair to Mrs. S.

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THE CHANGING TAX MIX

It seems surprising that despite rate reductions over the past decade, the main income taxes increased in importance as sources of government revenue. Recent Statistics Canada figures on consolidated finance of all levels of government in Canada indicate that both personal and corporate income taxes, as percentages of all government revenues, increased over the period 1999 to 2008.

The table shows that in 1999 (the fiscal year 1998-99), personal income taxes represented 42.7 percent of all public sector revenue, but by 2003 their share had dropped to 39.8 percent. The percentage increased steadily to 45.3 percent in 2008, despite rate reductions over the period. Corporate income tax collections increased from 8.7 percent of all revenue in 1999 to 11.2 percent in 2008, again in contrast to the downward trend in rates over the period.

The table also illustrates the stability of the general sales taxes (the GST and provincial sales taxes) as a percentage of government revenues, although the GST rate reductions in the last two years are reflected. The net effect of natural growth in the economy, however, has been to offset the rate reductions so that the percentage of revenue accounted for by sales taxes was virtually the same in 1999 and 2008.

Other taxes showed little change over the same period. General property taxes dropped slightly from 8.5 percent of all revenues in 1999 to 7.7 percent in 2008. Taxes on

Percentage Share of All Government Revenues

	Personal income taxes	Corporate income taxes	General sales taxes
1999	42.7	8.7	12.3
2000	43.1	8.7	12.4
2001	42.8	9.7	12.4
2002	43.0	8.9	12.8
2003	39.8	7.5	13.4
2004	40.3	8.3	13.3
2005	41.5	9.4	13.3
2006	42.4	9.6	13.1
2007	43.9	10.4	12.0
2008	45.3	11.2	12.2

motor vehicle fuels also dropped from 3.0 percent of all revenues to 2.3 percent, although the value of related sales rose considerably.

The continued strong performance of income taxes shows how difficult it is to hold the tax mix constant without major changes in the tax structure itself. The hope that consumption taxes will assume greater importance in the tax mix is frustrated by the built-in growth of a progressive income tax.

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New US Exit Tax

On June 17, 2008, the US government enacted the Heroes Earnings Assistance and Relief Tax Act (HEART) of 2008. The act provides relief to certain US military personnel and their families, but it creates a revenue offset of two new tax regimes aimed at certain US citizens and long-term residents contemplating expatriation or termination of their long-term residence: (1) a mark-to-market or exit tax, and (2) a new transfer tax imposed on the US-citizen or US-resident recipient of a gift or bequest of property from certain expatriates.

Mark-to-market (exit) tax. A new mark-to-market rule (Code section 877A) deems the FMV sale on the day before expatriation of property held by certain US citizens who relinquish their US citizenship and certain long-term US residents who terminate residence after June 16, 2008. The net gain in excess of $600,000 (inflation-adjusted after 2008) is recognized. Subsequent gains or losses realized are adjusted for deemed gains and losses without regard to the $600,000 exemption.

The exit tax applies to most worldwide property interests held by the individual on the date of expatriation or residence termination. Special rules apply to some deferred compensation items (including stock option and pension rights), interests in non-grantor trusts, and some tax-deferred accounts (such as IRAs and qualified tuition plans). An individual may irrevocably elect to defer the tax's payment, for any or all assets deemed disposed of, by furnishing a bond or other adequate security to the IRS and paying interest for the deferral period at the individual IRS underpayment rate. The deferred tax on a particular asset is due on the due date for the return for the taxable year when the property is disposed of.

The exit tax applies to a US citizen who relinquishes citizenship and a US long-term resident who terminates US residence (covered expatriates) after June 16, 2008 and who (1) has an average annual US net income tax liability for the 5 preceding years of $139,000 (adjusted for inflation); (2) has net worth of $2 million or more on the expatriation date; or (3) fails to certify under penalty of perjury that he or she has complied with all US federal tax obligations for the preceding 5 years. A long-term resident (generally, as defined under current law) is an individual who was a lawful permanent resident of the United States in at least 8 of the 15 taxable years before expatriation; long-term US residence terminates when he or she ceases to be a lawful US permanent resident. The new exit tax regime generally preserves the prior rules' exemptions for individuals born dual citizens of the United States and another country or who expatriate before reaching the age of 18½. An individual who expatriated before the new rules' effective date is subject to the prior law, including the 30 days of physical presence test.

New transfer tax provisions. New Code section 2801 imposes a new transfer tax on a US citizen or resident who receives a gift or bequest of property after June 17, 2008 from a covered expatriate under the mark-to-market deemed sale rules. A US citizen or resident who receives property, directly or indirectly, by gift or inheritance from a covered expatriate after the expatriation date must pay tax on the gift or bequest value at the greater of the highest US estate tax rate in effect (45 percent for 2008-9) and the highest rate on the date of receipt. The tax also applies to a US domestic trust recipient; the tax is imposed on a foreign trust when it distributes income or capital to a US citizen or resident.

The transfer tax applies only to the gift or bequest value in excess of the annual US gift tax exclusion ($12,000 for 2008) and is reduced by any gift or estate tax paid to a foreign country. The new transfer tax does not apply to (1) a property shown as a taxable gift on a timely filed US gift tax return for the covered expatriate; (2) a property included in the covered expatriate's gross estate shown on a timely filed estate tax return; and (3) a property for which a US estate or gift tax charitable deduction or marital deduction would be allowed if the transferor was a US person.

Because expatriating can now result in immediate and significant US federal income taxes to an individual with substantial assets, an individual who is potentially a covered expatriate should consult his or her US tax adviser before renouncing citizenship or relinquishing a green card. The new transfer tax rules, a significant departure from prior law, must also be considered in any estate planning for covered expatriates with US connections.

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GlaxoSmithKline

In 2006, in a 47-day trial in *GlaxoSmithKline*, 1,045 documents totalling more than 23,000 pages were filed in evidence as exhibits, and 10 expert witnesses and 25 other witnesses testified. Nearly two years later, the TCC has given judgment (2008 TCC 324), largely upholding transfer-pricing adjustments exceeding $50 million under now repealed subsection 69(2). The taxpayer has appealed to the FCA.

Glaxo Canada used the active ingredient ranitidine in manufacturing the brand name pharmaceutical product Zantac during the period 1990 to 1993. The Canadian company purchased ranitidine manufactured by an affiliate in Singapore, through a clearing-house affiliate located in Switzerland, at a price set by the UK parent with reference to the Canadian sales price of Zantac. The taxpayer contended that the OECD's resale price method was the most reliable way to determine the arm's-length price for ranitidine, using gross margins of Glaxo's European licensees as comparables. The Crown contended that arm's-length prices paid by Canadian generic drug companies for ranitidine used to manufacture drugs marketed in competition with Zantac were appropriate comparables that permitted the application of the comparable uncontrolled price (CUP) method, the OECD's preferred arm's-length pricing method.

Concerning whether arm's-length ranitidine purchases were comparable, the evidence at trial established that all ranitidine used for the manufacture of drugs in Canada had to be approved under identical safety, efficacy, and quality standards, and that the issue of notices of compliance by the Health Protection Branch signified that the ranitidine purchased by generic companies was pharmaceutically equivalent to and bioequivalent to the taxpayer's ranitidine. The evidence also established that drugs made with ranitidine purchased at arm's length were judged under provincial drug formularies to be therapeutically equivalent to and approved substitutes for Zantac.

The taxpayer's counterarguments consisted of two key points. First, transactions by generic drug companies were not comparable to those of the taxpayer because through its membership in a multinational enterprise it enjoyed various benefits and intangible rights. Second, the language "reasonable in the circumstances" in subsection 69(2) necessitated a consideration of all of the differences between the situations of the generic drug companies and those of the taxpayer, and on the facts it was required to purchase ranitidine from an affiliate.

The TCC rejected the argument that the attendant features of membership in a multinational enterprise were relevant in determining the arm's-length price for ranitidine, largely because the taxpayer's supply agreement for ranitidine only covered the acquisition of the active ingredient. A separate licence agreement covered the taxpayer's obligation to pay royalties for intangibles and services. The TCC applied the principle from the SCC's decision in *Singleton* ([2001] 2 SCR 1046) that a taxpayer's established legal relationships must be respected for taxation purposes, and said that the price to be determined under subsection 69(2) was thus the arm's-length price for ranitidine, which was the sole subject of the supply agreement.

The TCC said that differences between the enterprises of the generics and the taxpayer, which the taxpayer relied on in its "reasonable in the circumstances" argument, were related to the sales of finished pharmaceutical products, not the arm's-length price for ranitidine. Furthermore, the fact that the taxpayer was required to purchase ranitidine from its affiliate did not alter the need to determine an arm's-length price.

The court said that gross margins from European licensees did not provide an appropriate comparator in support of the taxpayer-favoured resale price method, because the taxpayer performed many more functions and assumed more obligations than the licensees. Furthermore, the Glaxo worldwide organization's targeting of a 60 percent gross margin in order to provide a sufficient return for the licensees suggested the marketing function's worth in isolation; in contrast, the taxpayer was earning only a 57 percent gross margin, despite its R & D expenditures and its secondary manufacturing responsibilities.

The Crown's expert evidence on the results of applying the CUP method was supported by reference to the cost-plus method. Under the cost-plus method, the Singapore manufacturer was allowed a 25 percent markup—not the markup in the range of 766 to 1,059 percent that it actually earned—and a 4 percent markup was allowed to the clearing-house affiliate in Switzerland as agreed upon by Glaxo and the Swiss government. Using these assumptions, the resulting transfer price was calculated as virtually identical to the one arrived at under the CUP method after adjustments for research and development, granulation costs, and other factors. The court observed that the taxpayer did not call expert evidence to rebut the reliability of the cost-plus method, and largely left the Crown's expert evidence unchallenged on cross-examination. In contrast, the transactional net margin analysis relied on by the taxpayer as a secondary pricing method was rejected as unreliable because of the choice of comparators and the insufficiency of evidence.

The court upheld the CRA's transfer-pricing assessments, subject to a $25 per kilo adjustment to compensate for the fact that the taxpayer purchased granulated ranitidine and not the non-granulated ranitidine purchased by the generic drug companies. Part XIII tax assessments were also upheld because the UK parent directed, or concurred with, the payment of excess amounts for ranitidine to the clearing-house affiliate in Switzerland. The interplay of subsection 56(2) and paragraph 214(3)(a) resulted in the deeming of a dividend paid to the UK parent, subject to 10 percent withholding tax at the reduced Canada-UK treaty rate. The SCC in *Neuman* ([1998] 1 SCR 770) held that an implicit entitlement requirement exists in subsection 56(2), which is thus inapplicable in the case of dividends; however, the TCC concluded that that requirement was not present in this context, because the legislation deemed a dividend to have been paid and provided a complete scheme for the taxation of the excess amounts paid to the clearing house. Alternatively, the TCC concluded that even if the entitlement requirement applied, it was satisfied because the excess amounts paid to the clearing house were ultimately paid to the UK parent.

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Provincial Move to Carbon Tax

Many jurisdictions are looking at ways to limit or reduce emissions through new taxes and incentives. Quebec was the first Canadian province to implement a carbon tax on energy producers and energy-consuming industries such as mining, steel, and cement; the approximately $200 million to be generated is earmarked to fund renewable energy sources. The much heralded British Columbia carbon tax, effective July 1, 2008, is the world's first revenue-neutral carbon tax.

The British Columbia carbon tax applies to 19 fuel types (including gasoline, diesel, natural gas, heating fuel, propane, and coal), and 3 types of combustible products (peat and shredded and whole tires) used to produce energy or heat. Every dollar raised will be returned to individuals and businesses through a mix of personal and corporate tax reduction and a $100 climate action dividend to be paid to every resident of British Columbia. The minister of finance faces a legislated financial penalty if revenue neutrality is not achieved.

The tax is a consumer tax imposed on all businesses and individuals who, in British Columbia, purchase or use fossil fuels or burn combustibles for heat or energy. Designated parties collect the tax using a system of security and reimbursements. The tax rates increase annually until 2012 and vary by fuel type and carbon dioxide emissions released on combustion. The 2008 rates include 49.66 cents per gigajoule for natural gas, 2.34 cents per litre for gasoline, and $20.77 per tonne for coal. Some fuel sources such as biodiesel, ethanol, biomass, pulping liquor, and wood are not taxed; exemptions are based on (1) the intended use of the fuel, such as non-energy use, feedstock, or purchases for export; (2) the type of business purchasing the fuel, such as certain interjurisdictional businesses, registered air and marine services, and refineries selling to other refineries in British Columbia; (3) the fuel's purchaser, such as on-reserve native Indians, visiting military forces, diplomats and consular corps, and registered consumers; and (4) miscellaneous items such as fuel prepackaged in sealed containers of up to four litres, and some quantities imported in supply tanks for non-commercial use. Any person who produces, manufactures, or imports fuel and combustibles for his or her own use, or who purchases fuel for a taxable purpose, must self-assess tax not otherwise paid. Transitional rules apply for inventory on hand as of July 1, 2008.

Businesses will experience increased compliance in the form of providing security, establishing data collection processes, filing returns, and self-assessing where required. Many Canadian provinces are watching with interest as British Columbia's carbon tax unfolds; the urgency of going green may seem sufficient to outweigh the incremental burden to businesses. However, increases in the world oil price since the carbon tax's announcement may have shifted the populace's primary focus somewhat from the threat of global warming to that of higher fuel costs and may effect a cooling of the carbon tax's reception.

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Corporate Rate Update

Combined corporate rates declined in 2008 in all jurisdictions because of federal corporate rate cuts and the elimination of the federal surtax on January 1, 2008. In their 2008 budgets, only Alberta, British Columbia, and Manitoba changed corporate income tax rates; rate changes in other jurisdictions were announced earlier. Table 1 shows 2007 and 2008 combined general, M & P, and small business rates.

The federal general (and the M & P) rate, including surtax, decreased on January 1, 2008 from 22.12 percent to 19.5 percent, representing the federal surtax's elimination (1.12 percent) and the general rate's reduction (1.5

Table 1 Combined Corporate Income Tax Rates (December 31 Year-End)

	General (and M & P)		CCPC small business	
	2007	2008	2007	2008
	percent[a]			
Federal	22.12	19.50	13.12	11.00
Alberta	32.12	29.50	16.12	14.00
British Columbia	34.12	31.00	17.62	15.00
Manitoba	36.12	33.00	16.12	13.00
New Brunswick	35.12	32.50	18.12	16.00
Newfoundland and Labrador	36.12/27.12	33.50/24.50	18.12	16.00
Northwest Territories	33.62	31.00	17.12	15.00
Nova Scotia	38.12	35.50	18.12	16.00
Nunavut	34.12	31.50	17.12	15.00
Ontario	36.12/34.12	33.50/31.50	18.62	16.50
Prince Edward Island	38.12	35.50	17.69	14.47
Quebec	32.02[b]	30.90[b]	21.12	19.00
Saskatchewan	35.62/32.12	32.00/29.50	17.62	15.50
Yukon	37.12/24.62	34.50/22.00	17.12/15.62	15.00/13.50

[a] When two rates are shown, the lower rate applies to M & P income.

[b] The Quebec rates do not apply to non-insurer financial institutions and oil-refining companies.

percent). The federal general (and the M & P) rate continues to decline in stages from 19.5 percent to 15 percent by January 1, 2012. The federal government's target is a combined federal/provincial and federal/territorial tax rate of 25 percent, a goal that Alberta will and British Columbia intends to achieve and for which only New Brunswick has indicated general support. British Columbia and Manitoba general (and M & P) rates decreased in 2008 and are expected to further decline thereafter. Saskatchewan's general rate also decreased in 2008. Quebec's active rate increased from 9.9 percent to 11.4 percent on January 1, 2008 and will further increase to 11.9 percent on January 1, 2009, except for non-insurer financial institutions and oil refiners. Alberta's long-term goal is to reduce its general (and its M & P) rate from 10 to 8 percent at an unspecified date.

The federal small business rate, including surtax, declined on January 1, 2008 from 13.12 percent to 11 percent because the small business rate dropped 1 percentage point and the federal surtax was eliminated. Three provinces reduced their 2008 provincial small business rates: British Columbia's fell from 4.5 percent to 3.5 percent on July 1, 2008 and will fall to 2.5 percent by 2011; Manitoba's fell from 3 percent to 2 percent on January 1, 2008 and will fall to 1 percent on January 1, 2009; and Prince Edward Island's fell from 5.4 percent to 4.3 percent on

Table 2 CCPC Small Business Taxable Income Threshold

	From	To	Effective date (after January 1, 2007)
	dollars		
Federal (all provinces and territories except Alberta, Ontario, and Saskatchewan)	400,000	400,000	Unchanged
Alberta	400,000	430,000	April 1, 2007
	430,000	460,000	April 1, 2008
	460,000	500,000	April 1, 2009
Ontario	500,000	500,000	Retroactive to January 1, 2007
Saskatchewan	400,000	450,000	July 1, 2007
	450,000	500,000	July 1, 2008

April 1, 2007 and will fall 1.1 percent annually, on April 1 of each year, to reach 1 percent on April 1, 2010. Without specifying an effective date, Alberta says that its tax rate on income that falls between the federal and its small business thresholds (table 2) will increase from 3 percent to 10 percent if the after-tax amount is distributed as an eligible dividend.

Federal and provincial and territorial small business taxable income thresholds remain at a minimum of $400,000 in 2008. Only Alberta, Ontario, and Saskatchewan have thresholds above $400,000. Alberta and Saskatchewan thresholds increased during 2008, and Alberta's will also increase in 2009. Ontario's thresholds retroactively increased from $400,000 and $1,128,519 to $500,000 and $1,500,000 on January 1, 2007. Changes to small business thresholds are outlined in table 2.

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Customs AMPS Penalties

The administrative monetary penalty system (AMPS) implemented in 2002 under section 109.1 of the Customs Act establishes graduated civil monetary penalties for customs contraventions, up to a maximum of $25,000 per penalty. The courts have yet to decide whether the compliance failures are strict liability offences and thus subject to the due diligence defence under the principles in *R v. Sault Ste. Marie* ([1978] 2 SCR 1299). In *Samson* (2007 FC 975), the Federal Court found it unnecessary to decide because the plaintiff's actions did not meet the heavy burden of due diligence.

Samson was the importer of a package that was marked "Educational Materials" and contained stamps and an invoice for over $1,000 (the higher amount). The examining

CBSA officer sent an information request to Samson, demanding that he declare the goods correctly and provide proof of payment. Through his broker, Samson provided an invoice showing a value of about $300 and declared that value (the lower amount); he also declared an incorrect tariff classification of the stamps. After receiving a second request for information, Samson re-amended his declaration to indicate the correct tariff classification and re-provided the same invoice for the lower amount. On a third request for information, Samson provided the correct invoice for the higher amount, and the goods were released. The CBSA officer concluded that Samson had not made a true, accurate, and complete declaration in response to two requests for information, thus committing an offence (section 7.1). A $2,000 penalty assessment was issued. As a technical matter, neither the incorrect tariff classification originally disclosed (educational materials) nor the correct classification (stamps) attracted duty at either the higher or the lower amounts disclosed.

Samson testified that AMPS should not apply because he acted with due diligence: he thought he had provided true and complete information, and had no intention of doing otherwise. However, the CBSA argued that the defence of due diligence did not apply, because the alleged offence was an absolute liability offence, and in any event the burden of proving due diligence was not met. The court agreed that Samson acted in good faith, but it also agreed that the due diligence defence was not met. Although he gave evidence that may have explained his declaring a lower amount, he failed to act immediately when he received clarifying information. In the interim, unfortunately, the broker re-sent the inaccurate information. In the court's view, a duly diligent person would have acted differently.

It is unfortunate that the court did not expressly confirm that the due diligence defence applies to AMPS penalties, as suggested by the preponderance of jurisprudence on tax penalties. Given the increased frequency with which the CBSA is now imposing AMPS penalties, some certainty on the application of the due diligence defence is needed.

Samson is also an important reminder of the procedure involved in appealing an AMP. Upon request, the CBSA issues reasons for the AMP, and the subject person can then file the appeal to the CBSA Appeals Branch within 30 days. If the person does not agree with the Appeals Branch determination, he or she can then file an appeal to the Federal Court. Alternatively, after receiving the reasons for the AMP, the person may notify the Appeals Branch that it will not file an appeal with the CBSA, and request confirmation of the AMP so that an appeal can be filed directly with the Federal Court.

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Employee Incentive: Scholarships

Recent amendments increase the attractiveness of a corporate scholarship plan for employees and their families. Scholarships may now be granted for elementary, secondary, and post-secondary education, and if the plan is properly structured there is no taxable benefit to the employee, no income inclusion for the student, and a deduction for the employer.

Paragraph 6(1)(a) includes in income the value of benefits of any kind whatever received or enjoyed by the taxpayer in respect of, in the course of, or by virtue of an office or employment. The wording is sufficiently broad to characterize as an employee benefit an employer-provided scholarship to an employee's dependant, but the CRA does not assess on this basis. The CRA considers that such a grant or award is included in the parent-employee's income, unless it is a scholarship or bursary and can be included in the child's income because a limited number of candidates are selected on the basis of scholastic or other achievements, particularly if they are selected by a board or committee (such as one made up of teachers) not connected with the employer (IT-75R4, June 18, 2003, at paragraph 9). The CRA has also said that the selection criteria must be objective, must focus on the child's accomplishments, and must be set higher than the minimum entrance requirements for most post-secondary institutions so that not every candidate qualifies. Successful candidates must represent a low enough proportion—always a question of fact—of eligible candidates, so that "most employees could not expect their dependants to be selected. Collectively, these criteria will ensure that the merit of the dependant is prevalent in the employer's selection rather than the employee's relationship with the employer" (CRA Views 2006-0215701E5, September 17, 2007).

In some contrast, the CRA issued an interpretation approving a scholarship for post-secondary education where the minimum average under the scholarship program was 70 percent, which is generally the minimum requirement for entrance into most post-secondary schools (TI 2004-0095101E5, December 1, 2004). The 2007 federal budget proposes that after 2006 an individual can exclude from income the total scholarships and bursaries received in connection with his or her enrolment in an elementary or secondary school. It is unclear what criteria apply to an elementary or secondary school scholarship.

After 2005, a scholarship, bursary, etc. includible under paragraph 56(1)(n) that relates to an educational program eligible for the education tax credit under section 118.6 enjoys a full exemption (subsection 56(3)). However, the payer must still file a T4A information return and provide the student with a T4A slip. A foreign university's courses in which the student is enrolled may qualify for the education tax credit if they last for 13 or more consecutive weeks and lead to a degree; many US colleges and universities have 10-week semesters that do not qualify for the exemption.

In two recent decisions, the TCC concluded that a scholarship paid to an employee's child was taxable to the child. In *DiMaria* (2008 TCC 114), an employee received $3,000 under his employer's award program established to recognize the academic achievement of eligible employees' children and to financially assist in their post-secondary education. The student was required to have a minimum average of 70 percent in the high school graduating year; a maximum was set of 100 awards per annum. If the student maintained good academic standing, the award was renewable for up to four years. The payment did not reduce the employee's pay. The TCC said that a scholarship may relate to non-academic achievements or qualities such as age (mature students), sports, extracurricular activities, cultural or artistic activities, and community relations or involvement. The court did not accept the CRA's challenge to the 70 percent average threshold and noted that the University of Waterloo's entrance scholarship had the same threshold. Similarly, in *Okonski* (2008 TCC 142), the TCC rejected the CRA's argument that a minimum academic average on an employer-provided award to the employees' child was too low a threshold.

Given the high cost of tuition at private elementary and secondary schools and universities, more companies are sure to adopt scholarship plans. The exclusion available for awards related to elementary and secondary schools, which indicates the government's intention to encourage these plans, will increase the number of eligible recipients. It may prove more difficult to develop academic criteria in the case of an award related to elementary school tuition. However, a parent in Ontario who incurs $15,000 to $20,000 in a private elementary school tuition fee can save 46.4 percent of the tuition fee if it is paid by the employer. The tuition fee must be paid by virtue of employment and not of a shareholding: a plan only for the benefit of the owner-manager's children is likely to be challenged.

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Acquisition Merger Not Tax-Free

The IRS ruled (in Rev. rul. 2008-25, 2008-21 IRB 986) that a plan that included the acquisition of a target corporation's shares in a US statutory merger, followed by the target's liquidation, was not a tax-free reorganization.

Assume that Parentco, unrelated to the target, forms a wholly owned subsidiary X to acquire all of the target's shares—wholly owned by an individual—in a statutory merger for consideration comprising 90 percent Parentco voting stock and 10 percent cash. As part of an integrated plan, the target is then liquidated into Parentco but not via a statutory merger. Parentco continues to conduct the target's business.

The IRS noted that the acquisition merger on its own was a stock acquisition that qualified as a substantially tax-free reorganization for both the vendor and the buyer. However, the target's complete liquidation renders inapplicable the regulation 1.368-2(k) safe harbour exception from the step transaction doctrine. Thus, when the acquisition merger and the liquidation are evaluated together, the combined transaction does not qualify as a tax-free reorganization because at the conclusion—after the liquidation—the target does not hold substantially all of its properties and the properties of the merged corporation.

A detailed analysis in the ruling determined that the transaction does not qualify as any type of tax-free reorganization. Following an earlier ruling (Rev. rul. 90-95, 1990-2 CB 67), the IRS ruled that the acquisition of the target's shares is a fully taxable qualified stock purchase by Parentco, followed by the target's liquidation.

Rev. rul. 2008-25 affords corporate buyers greater certainty in planning acquisitions of shares of an unrelated target corporation and its dissolution shortly thereafter. However, if the target shares' vendor seeks a substantially tax-free transaction, the vendor must determine the buyer's plans for the target: clearly, those plans affect the vendor's tax results. A vendor should obtain both a representation from the buyer that it has no plan or intention to liquidate the target, and an indemnification from the buyer against the eventuality of the representation's breach.

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Foreign Tax News

OECD

The OECD Committee on Fiscal Affairs released a public discussion draft on the model treaty article 7 (Business Profits). The committee also agreed on the draft 2008 model treaty update; the OECD Council was expected to approve it on July 17, 2008.

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

Published monthly
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ISSN 1496-4422 (Online)

United States

The IRS obtained a "John Doe" summons from the US District Court for the Southern District of Florida to gain access to information from a Swiss bank about unknown US taxpayers who may be using the bank's Swiss accounts to evade federal US income taxes.

The Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations issued subpoenas for a formal investigation on reporting and tax payment in connection with Liechtenstein accounts.

The US District Court for the Western District of Washington ordered the IRS to produce statistical audit data under the Freedom of Information Act, and found it not in compliance with 1976 and 2006 consent orders. The court gave the IRS 30 days to comply.

The Department of the Treasury and the IRS requested public comments by September 8, 2008 on the elective worldwide method of allocation and apportionment of interest expense by a US member of a corporate group (IRS Notice 2008-54).

European Union

The Seventh International Tax Law Summer Conference in Austria explored some unaddressed technical issues under the groundbreaking EU initiative for a consolidated corporate tax base. A panel also discussed anti-avoidance jurisprudence in the treaty context, including Austrian, German, Canadian, and UK cases.

A newly published proposal extends the list of goods and services for which a member state may reduce its VAT rate effective after 2010.

A report titled *Taxation Trends in the EU* contains detailed statistical and economic analyses of the EU member states' tax systems, including tables that allow comparison of individual states and averages. Each country's tax system, revenue trends, and recent policy changes are overviewed.

Japan

The definition of "permanent establishment" was amended to exclude an independent agent and bring domestic law into line with the OECD model treaty and the US-Japan treaty, in order to eliminate a competitive disadvantage for local investment fund managers.

Treaties

A **France-UK** treaty was signed to replace the 1968 treaty. The treaty signed in 2004 will never enter into force.

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