CANADIAN TAX Highlights

Editor: Vivien Morgan, LL.B.

Volume 16, Number 9, September 2008

CRA's Broad Investigative Powers

In *Redeemer Foundation* (2008 SCC 46), the SCC recently decided (4:3) that the CRA was entitled to request, without judicial authorization, information about the identity of a registered charity's donors. The CRA was found to be entitled to the donor information necessary to determine whether the charity's receipts provided grounds to revoke its charitable registration.

Redeemer Foundation, a registered charity, operated a forgivable loan program that financed students' education at an affiliated college. In October 1998, the CRA audited the 1997 taxation year of both the charity and the college. During the audit, the CRA suspected that many contributions to the charity were not valid charitable donations because they appeared to be made by parents of students attending the college in the expectation that the contributions would finance their children's education. The charity was unable to provide the CRA with completed transmittal forms identifying the donor and the student who was to receive credit for the donation.

In 2001, the CRA resumed its audit for the 1998-2000 taxation years. Again, the charity said that it had not kept the relevant transmittal forms for those years. The CRA served the charity with a requirement to maintain proper records as required under subsection 230(3). In 2003, after an oral request, the charity provided donor information to the CRA for its 2001 and 2002 taxation years. The CRA advised the charity that there might be grounds for revoking its charitable status and reassessing its donors. Notices of reassessment were sent to some donors.

In 2004, the charity refused to provide the information to the CRA for its 2002 and 2003 taxation years on the grounds that under subsection 231.2(2) the CRA must first obtain an order from the Federal Court for judicial authorization to obtain information about unnamed persons. In 2005, the charity applied for a judicial review of the CRA's 2003 oral request for donor information, with which the charity had already complied by providing the CRA with the 2001 and 2002 donor lists and related information. The charity sought a declaration that the request was improper, that the information be returned, and that the CRA could not act on the information by, for example, reassessing donors so identified. The Federal Court found that the CRA's use of the information obtained from the charity to contact donors about their reassessments rendered the request improper because it was made without prior judicial authorization. The donor information should thus be returned to the charity and the CRA be prevented from acting thereon to reassess donors.

The FCA set aside the FC's order and dismissed the application for judicial review. The FCA unanimously concluded that the donor information was within the scope of the records specifically required to be kept by a charity under subsection 230(2). That provision, combined with subsection 231.1(1), gives the CRA broad powers to examine a taxpayer's records, and the CRA had sufficient authority for its 2003 request.

The SCC dismissed the charity's argument that section 231.2 (requiring judicial authorization to obtain an unnamed person's information) serves no purpose if section 231.1 is read as authorizing the CRA to obtain information on unnamed third parties during the audit of a taxpayer. The SCC noted that any other conclusion would require the CRA to obtain judicial authorization whenever it attempts to reassess unnamed persons. The SCC said that the CRA requested the donor list in order to investigate the legitimacy of the charity's registered charity status, and it clearly had a valid purpose in requesting and using the information to complete its audit.

The SCC said that the charity's donor list was clearly the type of record required to be kept under subsection 230(2). The court concluded that it would be illogical to require a charity to keep records to enable the CRA to verify the legitimacy of its donations, but then require the CRA to obtain judicial authorization in order to review those records. Furthermore, the unnamed persons requirement in subsection 231.2(2) should not apply to situations in which the requested information is required to verify the compliance of the taxpayer being audited. The SCC also said that a person who contributes to a charity can reasonably expect that if the charity is audited, the donor's contribution may be examined and the possibility exists

In This Issue

that the donor will then be investigated and ultimately reassessed. The CRA was thus entitled to the donor information through the combined effect of the charity's record-keeping requirement in paragraph 230(2)(a) and the CRA's powers to inspect records in section 231.1, and was not required to obtain judicial authorization before requesting the information.

Paul Hickey
KPMG LLP, Toronto

Predecessor's Unpaid Amounts

The FCA decision in *Dow Chemical Canada Inc.* (2008 FCA 231) held that a predecessor's previously deducted interest expense that was accrued but unpaid can be included in the amalgamated corporation's income.

If a taxpayer owes a deductible outlay or expense to a party who was not at arm's length when the expense was incurred and at the end of the second taxation year following, when the amount still remains unpaid, the amount is included in the taxpayer's income for the third taxation year following that in which the outlay or expense was incurred (paragraph 78(1)(a)). Subsection 87(7) states that the Act applies to an amalgamated entity as if it had incurred its predecessors' debts or other obligations when the predecessors incurred them under the relevant agreement.

On the facts in *Dow*, on December 28, 1998, Union Carbide borrowed funds from its direct or indirect parent (a related corporation), which then assigned the interest in the obligation to another related corporation, Finco. In its 2000 taxation year ending December 31, 2000, Union Carbide deducted approximately $31 million as accrued interest, which was not paid to Finco in the material period. The Dow ultimate parent acquired control of Union Carbide's parent on February 6, 2001, which triggered a year-end for Union Carbide at that time. Union Carbide then amalgamated on October 1, 2001 with the Dow Cansub to form the Amalco Dow, triggering another year-end for Union Carbide immediately before that time. Amalco's first taxation year was deemed to commence at the time of amalgamation; for that year, which ended December 31, 2001, the minister reassessed Amalco and included in its income under subsection 78(1) the interest expense accrued and deducted by Union Carbide for its third taxation year preceding.

The TCC concluded that Amalco and Finco were related immediately before the amalgamation; but in order for subsection 78(1) to apply, they must also have been related in the 2000 taxation year when the interest expense was incurred. However, the court said that there were no rules that deem Amalco and Finco to be related in the 2000 taxation year, when the interest expense was accrued, and thus subsection 78(1) did not apply.

The FCA unanimously concluded otherwise. The FCA noted that the continuation of rights and obligations of predecessors into amalgamated corporations is a common thread throughout section 87. Unlike the TCC, the FCA found no ambiguity in section 87: paragraph 87(7)(d) places an amalgamated corporation in the predecessors' shoes vis-à-vis previously incurred debts from the time that the predecessors incurred them. Because Union Carbide was not at arm's length with Finco when the obligation to pay the interest was incurred, Amalco was thus not at arm's length with Finco at that time. Furthermore, Amalco was deemed related to its predecessor, Union Carbide, at the end of its second taxation year following the year in which the interest was accrued, just before the amalgamation (subsection 251(3.1)). Because Union Carbide and Finco were also related at that time—they were controlled by the Dow parent—Amalco and Finco were also related at that time. Thus, as required by subsection 78(1), Amalco and Finco were related when the expense was incurred and at the end of the second taxation year following that event. The FCA also rejected the TCC's conclusion that it was contrary to the object and purpose of section 78 to include the interest in Amalco's income because two 12-month tax years had not elapsed; the FCA noted that subsection 78(1) refers to "taxation years," not "12-month periods."

The TCC said that Amalco's first taxation year could not be regarded as Union Carbide's third taxation year because the two were distinct corporations according to *Pan Ocean Oil Ltd.* (94 DTC 6412 (FCA)). However, the FCA in *Dow* said that the three taxation years in subsection 78(1) need not belong to one taxpayer; on an amalgamation, the amalgamated company stands in its predecessor's shoes in respect of the interest expense. Thus, Union Carbide's last two taxation years were treated as if they were Amalco's.

The TCC also noted that subsection 78(2) specifically provides for an income inclusion to the parent of previously deducted debts of corporations that are wound up, but not for those that are amalgamated. The FCA said that a similar provision is not required for amalgamated companies because, unlike companies that are wound up, they do not cease to exist.

Dow confirms that for the purposes of subsection 78(1), subsection 87(7) places an amalgamated company in its predecessors' shoes vis-à-vis debts and obligations. Although the FCA decision in *Pan Ocean* concluded that predecessors and an amalgamated corporation were distinct corporations, the FCA in *Dow* concluded that subsection 78(1) did not require that the taxation years in question correspond to a single taxpayer. *Dow* also highlights the difference between amalgamations and windups: the absence of parallel provisions governing each combination may not result in a different tax treatment. *Dow* also recognizes that the term "taxation years" may refer to periods of less than 12 months.

Parveen B. Esmail
Thorsteinssons LLP, Toronto

CANADA-US TREATY TECHNICAL EXPLANATION

On July 10, 2008, the US Treasury Department released its technical explanation (TE) to the Canada-US treaty's fifth protocol. The TE was drafted by Treasury, but Canada was given an opportunity to review and comment on the document, and, concurrent with its release, Finance endorsed the TE in a press release. The TE may thus be regarded as representing the mutual views of Canada and the United States on the protocol's contents. However, the TE is silent on some issues for which further guidance was both desirable and expected, leaving taxpayers and tax advisers with some uncertainty about the treaty's application. The following discussion reviews some TE comments on hybrid entities, the limitation-on-benefits (LOB) provision, and interest withholding tax.

Hybrid entities. The protocol's new articles IV(6) and IV(7) deal with the treaty's application to a hybrid entity, considered fiscally transparent by only one of the states. At first, it was not clear whether an S corporation was fiscally transparent for these purposes; as announced at the IFA round table in May 2008, the TE confirms that S corporations are treated as fiscally transparent for US, but not Canadian, tax purposes. Under article IV(6), a US resident that derives Canadian-source income through an S corporation is considered for treaty purposes to be the person that derives the income; because the S corporation is not fiscally transparent for Canadian tax purposes, Canada grants treaty benefits to the S corporation itself.

The TE clarifies that Canada continues to regard an LLC that derives Canadian-source income as the taxpayer and imposes all compliance requirements on the LLC. However, in determining the LLC's Canadian tax liability, the extent to which any LLC member is entitled to treaty relief under article IV(6) can be taken into account. The TE notes that the CRA will provide more guidance on this provision's practical application.

The TE provides guidance with respect to the determination of whether a treaty-country resident is the beneficial owner of income derived through a fiscally transparent entity. The TE says that the determination of who derives the income should be made by the residence state, and the source state should determine whether that person beneficially owns the income. This allocation of responsibility implies that the relevant definition of the term "beneficial ownership" is that under the source state's domestic law, not the international fiscal (OECD) meaning of the term.

Protocol article IV(6) is relieving in nature, providing treaty relief in certain circumstances for hybrid entities. However, new articles IV(7)(a) and IV(7)(b) deny treaty benefits in some cases where income is derived through a fiscally transparent entity. None of the several examples in the TE that illustrate the application of article IV(7) are particularly helpful from an interpretive standpoint. Informally, both Treasury and Finance officials have indicated that the application of article IV(7)(b) to dividend payments from reverse hybrids (such as ULCs) likely goes beyond the scope of what was intended. The possibility of a sixth protocol to address the issue has been raised, but the TE does not raise the possibility of future negotiations to resolve the issue. Given the time involved in negotiations for the fifth protocol, it is hoped that negotiations will begin soon for any new protocol intended to address this issue.

LOB. For the first time, the LOB provision applies to treaty relief provided by Canada as well as by the United States. Canada's application of the LOB provision may be quite challenging because there is a lack of Canadian guidance on many of its terms. Terms such as "disproportionate class of shares," "qualifying person," and "derivative benefits" have been clarified in the TE, but other terms, such as "in connection with" and "incidental to," remain unclear. It is not certain to what extent the CRA and the Canadian courts will adopt US interpretations and positions that appear in the ample US guidance and history.

As expected, the TE states that the LOB provision is not to be construed as restricting any contracting state from applying its domestic anti-abuse provisions to deny treaty benefits where the application of the treaty would otherwise result in treaty abuse.

Given the retroactive application of the reduced withholding tax rate on related-party interest payments, the LOB provisions are also effectively retroactive.

Interest withholding tax. The TE confirms that the protocol's changes to the interest withholding tax article apply retroactively to the beginning of the calendar year in which the protocol enters into force. If entry into force occurs in 2008, the 0 percent withholding tax rate on unrelated-party interest and the 7 percent on related-party interest apply retroactively to payments after 2007. The lower 4 percent rate and the 0 percent rate on related-party interest apply after 2008 and 2009, respectively. The TE does not comment on the meaning of the term "related" in this context.

The TE's release is welcome. It provides examples and adds clarity to the protocol, and it indicates that the United States is one step closer to ratifying the protocol. US ratification is expected in 2008. However, the TE does not fully clarify all issues and uncertainties, and further guidance from the CRA would be much appreciated.

Albert Baker and Tanvi Vithlani
Deloitte & Touche LLP, Vancouver

Regional Impacts of Federal Tax Initiatives

The federal government introduced a number of personal income tax initiatives first effective in the 2006 tax year. The latest release of personal income tax statistics from the CRA, available at http://www.cra-arc.gc.ca/gncy/stts/ntrm-eng.html, provides information on the regional distribution of the beneficiaries of some of these initiatives.

The CRA data identify universal child-care benefits, which began on July 1, 2006. As the table shows, the 715,670 families who received a total of $536.4 million in 2006 were distributed across the country in almost the same pattern as all taxable returns. The child-care benefit is added to taxable income, so the measure has an automatic impact on provincial income taxes and is also distributed roughly in the same pattern as all taxable returns.

The federal non-refundable tax credit for employment expenses, on the other hand, does not change the provincial tax level unless a province chooses to introduce a parallel measure. Not surprisingly, 12.5 million of the 15.7 million taxable returns filed in 2006 claimed this credit, producing a reduction in federal tax of approximately $475 million. The distribution among the provinces was close to that shown for all taxable returns.

The federal non-refundable tax credit for monthly transit passes was not distributed in the same pattern. The credit was reported on only 679,790 returns and resulted in federal tax savings of less than $50 million. The four Atlantic provinces accounted for only 1.2 percent of such credits but for 7.5 percent of all taxable returns. The credits claimed in the three Prairie provinces claimed only 13.0 percent of the credits for transit passes, but accounted for 17.6 percent of all taxable returns. Ontario residents made up 38.0 percent of the returns claiming the credit but 48.3 percent of the amount claimed, in contrast to that province's 40.0 percent share of total income. Quebec made up 23.7 percent of all credits and 30.6 percent of the value, but accounted for only 21.2 percent of all income on taxable returns.

Percentage Distribution of Taxable Personal Income Tax Returns, 2006 Tax Year

	Universal child-care benefits	Credit for employment expenses	Credit for transit passes	All taxable returns
NL	1.6	1.6	0.1	1.6
PE	0.5	0.4	0.0	0.5
NS	2.8	2.8	0.9	2.9
NB	2.3	2.4	0.2	2.5
QC	24.7	24.4	34.6	23.7
ON	38.9	37.3	38.6	38.0
MB	3.5	3.5	1.9	3.5
SK	2.9	2.9	0.8	3.0
AB	11.1	11.7	10.3	11.1
BC	11.5	12.7	12.6	12.9

David B. Perry
Canadian Tax Foundation, Toronto

Waiver by Agent

In *Ackaoui* (2005 TCC 416), the TCC dealt with whether a waiver of the limitation period for reassessment can be signed by either the taxpayer or his agent. The case explored some indicia to establish agency for these purposes and the scope of any duty resting on the CRA to ascertain the authenticity of the signature on a waiver. The issue was simple: whether a reassessment was statute-barred or whether a waiver executed by the accountant had kept the reassessment period open.

In 1986, on the advice of his accountant, the taxpayer invested in an R & D tax shelter. In 1990, the accountant executed a waiver for the 1986 taxation year. The accountant had acted for the taxpayer for a number of years, and the taxpayer had left to the accountant essentially all issues relating to taxes, including signing tax returns and dealing with the CRA. The inevitable reassessment for 1986 did not materialize until 1994, and the taxpayer objected on a timely basis; however, the objection did not refer to the limitation period's expiry. The notice of confirmation arrived in 2002, by which time the merits of the tax shelter had been decided by a number of test cases. Needless to say, the cases had gone against the taxpayers, and Mr. Ackaoui was reduced to arguing that the 1990 waiver was invalid.

The taxpayer himself had signed documents (presumably form T1013) authorizing the accountant to be his representative for all relevant tax years and authorizing the

CRA to disclose information to the accountant. In fact, the accountant had even signed tax returns on behalf of the taxpayer. In the waiver, the accountant signed the taxpayer's name—not his own name with some indication that he was acting as agent or under a power of attorney. The taxpayer testified that he knew nothing about this waiver, although he admitted that he and the accountant had discussed many tax issues, including ones relating to the tax shelter. The accountant testified that he had discussed the waiver and its merits with the taxpayer at the time.

The taxpayer argued that the accountant had no specific mandate to sign the waiver and therefore it was invalid. Moreover, the accountant had signed the name of the taxpayer, and the CRA had a duty to ensure that the signature was genuine and to prove that the waiver form had actually been received by the taxpayer or his legal representative. The Crown submitted that the authority given to the accountant by the taxpayer over his affairs was broad enough to enable the accountant to execute the waiver and that in all the relevant situations the accountant was the taxpayer's agent. The Crown denied that the CRA had a duty to investigate the background of the waiver.

The court preferred the accountant's evidence concerning discussions with the taxpayer about the waiver and concluded that the waiver was valid because the accountant was the taxpayer's legal representative in any dealing with the CRA concerning his income tax returns, and the accountant had a sufficiently broad mandate to sign a waiver extending the limitation period. However, the court said that even if the taxpayer did not know of the waiver, he had chosen not to be involved in the management of his financial affairs and could not now insulate himself from the consequences of that choice. The TCC also noted that the accountant had not tried to forge or replicate the taxpayer's signature: the signature was "an irregularity or defect of form that does not constitute an extraordinary act in the management of the [taxpayer's] fiscal affairs because the waiver and its attendant consequences were actually favourable to the [taxpayer]." The *Loyens* decision ([2003] 3 CTC 2381) was distinguished because in that case the waiver was signed by someone other than the legal representative. The court also said that given the number of waivers and other documents submitted to the CRA, it would be absurd—in the absence of exceptional circumstances that alerted the CRA and caused it to doubt the waiver's authenticity—to impose a duty on the CRA to verify the authenticity of the signature on all waivers.

Even though the taxpayer tried to argue otherwise, it is prudent for an accountant acting in a capacity similar to the accountant in *Ackaoui* to ensure that the taxpayer is sufficiently involved in his own affairs. The taxpayer's involvement in the process will help to ensure that any documents executed on the taxpayer's behalf by the accountant are respected by the relevant taxation authorities.

John Jakolev and Graham Turner
Jet Capital Services Limited, Toronto

CRA Attacks Business Judgment

In *Jolly Farmer Products* (2008 TCC 409), the TCC recently allowed a deduction for CCA on houses and certain facilities provided on site by the farmco taxpayer for its employees. The court admonished the CRA for denying valid business deductions because it did not agree with how the taxpayer chose to run its business.

The farmco ran an agriculture business in New Brunswick. It was incorporated in 1995 to carry on a greenhouse horticultural operation and agricultural operations consisting of raising beef cattle, pigs, sheep, and chickens and producing dairy products. The farmco's financial statements indicated that sales grew from $5,900 to over $20 million from 1995 to 2003. The articles of incorporation indicated that shareholders must "willingly submit to the disciplines of the commandments of the Lord Jesus Christ and . . . make their permanent residence in one of the communities established by the Corporation (the 'Community') in accordance with above disciplines." A group of houses made up the Village, and the Commons was a building used by shareholder-employees and for storage and processing.

The CRA argued that the cost of keeping the shareholder-employees on site by providing them with the Village and the Commons was not a cost of property acquired for the purpose of gaining or producing income, and therefore was not eligible for CCA. The TCC noted that the CRA seemed to view the shareholder-employees as a "quasi-monastic religious organization whose purpose in living on the farm is in furtherance of their religious beliefs and practices and not for commercial reasons"; the court noted that religious beliefs and practices were not inconsistent with commercial motivation.

The TCC said that the CRA was "fixated" on two points: that the employees were shareholders, and that they professed and adhered to certain basic Christian beliefs. The court concluded that these two facts were of no significance, and that the farmco's provision of living and other facilities to its employees was a normal and ordinary cost of carrying on its business. The court further noted that the farmco was successful in part because the shareholders, who were all employees and who were paid salaries, lived on site where they could take care of the horticultural operation. The shareholder-employees paid rent and were assessed for taxable benefits for the use of the homes. The TCC found that providing housing and facilities was a business decision that was also commercially advantageous. Further, the TCC said that once the conclusion is reached that it was the farmco's business decision to house the shareholder-employees in company-owned houses and to provide other facilities, neither the courts nor the CRA can question that decision.

> This case is an excellent example of the CRA's seeking to substitute its business judgment for that of the taxpayer. The alternatives suggested by the [CRA] would have made the operation far less profitable. The way in which [the farmco] chooses to carry on its highly successful commercial operation is a business decision and the [CRA] has no right to substitute [its] business judgment and advance other alternatives that are more palatable to [it].

Moreover, even if the on-site houses and facilities provided no economic benefit to the farmco, the TCC said that it still would have held that the farmco's business decision must be respected. In essence, the TCC says that a deduction does not depend on whether there is in fact a profit, but rather on whether the purpose of incurring an expense is to earn income from the business. As a result, the TCC allowed the taxpayer to deduct CCA for the relevant taxation years.

Jim Yager
KPMG LLP, Toronto

Dividend Rates and Investment Income

Eligible and non-eligible dividend tax rates are revised to help achieve better integration of corporate and personal taxes on active business income. (For changes to eligible and non-eligible dividend rates, see "Federal Eligible Dividend Rate," *Canadian Tax Highlights*, May 2008, and "Non-Eligible Dividend Rates," *Canadian Tax Highlights*, June 2008.) However, these changes also affect the integration of corporate and personal taxes on investment income. Tables 1, 2, and 3 show the income tax deferral or prepayment if portfolio dividends, capital gains, or interest is earned and retained in a corporation instead of being earned directly by an individual. The tables also show the tax cost if the after-tax corporate income is paid out as a dividend to the shareholder.

Table 1 shows that in 2009 the income tax prepayment for portfolio dividends earned through a corporation increases in Alberta and Ontario because of their increased eligible dividend tax credit rates, and decreases for British Columbia because of its decreased eligible dividend tax credit rate. After 2009, the prepayment decreases in all jurisdictions because of decreases in the federal eligible dividend gross-up factor and tax credit rate; the former also affects most provincial and territorial eligible dividend tax credit rates. After 2011 in Nova Scotia, the receipt of portfolio dividends in a corporation results in a tax deferral. In all cases of dividends earned through a corporation, there is no tax cost or saving when they are subsequently paid out to the individual shareholder, compared with portfolio dividends earned directly.

Table 1 $10,000 Investment Income from Portfolio Dividends Initial Deferral (Prepayment) with Holdco

	2008	2009	2010	2011	After 2011
			dollars		
Alberta	(1,733)	(1,878)	(1,722)	(1,471)	(1,248)
British Columbia	(1,486)	(1,341)	(1,188)	(942)	(722)
Manitoba	(950)	(950)	(824)	(659)	(521)
New Brunswick	(1,015)	(1,015)	(861)	(615)	(396)
Newfoundland and Labrador	(522)	(595)[a]	(456)	(254)	(79)
Northwest Territories	(1,508)	(1,508)	(1,352)	(1,100)	(872)
Nova Scotia	(498)	(498)	(353)	(133)	61
Nunavut	(1,109)	(1,109)	(969)	(761)	(577)
Ontario	(937)	(1,027)	(968)	(800)	(659)
Prince Edward Island	(889)	(889)	(738)	(497)	(283)
Quebec	(364)	(364)	(265)	(148)	(52)
Saskatchewan	(1,298)	(1,298)	(1,145)	(900)	(681)
Yukon	(1,610)	(1,610)	(1,453)	(1,199)	(969)

Note: The tables assume that (1) the individual is taxed at the top marginal income tax rate, which remains at 2008 levels (2009 levels for Newfoundland and Labrador); (2) the portfolio dividends are designated eligible dividends; (3) the capital gains deduction for qualifying small business corporation shares or qualified farm and fishing property is not available; and (4) a full refund of the refundable tax is generated on payment of the taxable dividend ($10,000 in the case of portfolio dividends, $4,000 for capital gains, and $8,000 for interest).

[a] The top combined federal/Newfoundland and Labrador rate declines after 2008 because of a decrease in the provincial top rate, increasing the income tax prepayment in 2009.

[b] British Columbia's general corporate income tax rate is assumed to decrease to 10 percent after 2010.

Tables 2 and 3, respectively, show that the tax cost of an individual's earning capital gains or interest through a corporation increases in Alberta and British Columbia in 2009 because their non-eligible dividend tax credit rates decrease. For British Columbia, however, lower corporate tax rates (in 2009 and 2011) partly offset the

Table 2 $10,000 Investment Income from Capital Gains Initial Deferral (Prepayment) with Holdco/ Overall (Cost) with Holdco

	2008	2009	2010	After 2010
		dollars		
Alberta	(283)/(8)	(283)/(58)	(283)/(58)	(283)/(58)
British Columbia	(123)/(53)	(98)/(73)	(98)/(73)	(48)/(23)[b]
Manitoba	(88)/(251)	(38)/(233)	(13)/(208)	(13)/(208)
New Brunswick	(35)/(118)	(35)/(118)	(35)/(118)	(35)/(118)
Newfoundland and Labrador	(183)/(183)	(208)[a]/(183)	(208)/(183)	(208)/(183)
Northwest Territories	(155)/(8)	(155)/(8)	(155)/(8)	(155)/(8)
Nova Scotia	(120)/(109)	(120)/(109)	(120)/(109)	(120)/(109)
Nunavut	(308)/(133)	(308)/(133)	(308)/(133)	(308)/(133)
Ontario	(113)/(34)	(113)/(34)	(113)/(34)	(113)/(34)
Prince Edward Island	(164)/(296)	(164)/(357)	(164)/(417)	(164)/(478)
Quebec	108/(13)	83/(38)	83/(38)	83/(38)
Saskatchewan	(158)/(58)	(133)/(33)	(133)/(33)	(133)/(33)
Yukon	(363)/(250)	(363)/(250)	(363)/(250)	(363)/(250)

Notes: See table 1.

Table 3 $10,000 Investment Income from Interest Initial Deferral (Prepayment) with Holdco/ Overall (Cost) with Holdco

	2008	2009	2010	After 2010
		dollars		
Alberta	(567)/(17)	(567)/(117)	(567)/(117)	(567)/(117)
British Columbia	(246)/(106)	(197)/(147)	(197)/(147)	(97)/(47)[b]
Manitoba	(176)/(501)	(76)/(466)	(27)/(417)	(27)/(417)
New Brunswick	(72)/(237)	(72)/(237)	(72)/(237)	(72)/(237)
Newfoundland and Labrador	(367)/(367)	(417)[a]/(367)	(417)/(367)	(417)/(367)
Northwest Territories	(312)/(17)	(312)/(17)	(312)/(17)	(312)/(17)
Nova Scotia	(242)/(220)	(242)/(220)	(242)/(220)	(242)/(220)
Nunavut	(617)/(267)	(617)/(267)	(617)/(267)	(617)/(267)
Ontario	(226)/(66)	(226)/(66)	(226)/(66)	(226)/(66)
Prince Edward Island	(330)/(594)	(330)/(715)	(330)/(836)	(330)/(957)
Quebec	215/(26)	165/(76)	165/(76)	165/(76)
Saskatchewan	(316)/(116)	(267)/(67)	(267)/(67)	(267)/(67)
Yukon	(727)/(499)	(727)/(499)	(727)/(499)	(727)/(499)

Notes: See table 1.

increased tax costs in 2009, and reduce both the income tax prepayment at the corporate level and the tax cost on payout to the individual. In Manitoba, the income tax prepayment at the corporate level and the individual's tax cost relative to earning the income directly decrease in 2009 and 2010 because of corporate tax rate reductions. However, in 2009 a decrease in the non-eligible dividend tax credit rate partly offsets the decrease in the individual's tax cost. For Prince Edward Island, the individual's tax cost increases from 2009 to 2011 because of decreases to its non-eligible dividend tax credit rates. In 2009 in Saskatchewan, income tax prepayments in the corporation and the individual's tax costs decrease because of lower corporate tax rates, but in Quebec the corporation's income tax deferral decreases and the individual's tax cost increases because of higher corporate tax rates. In all cases, the payout from the holdco to the individual shareholder yields a tax cost compared with earning the income directly.

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

Departure Tax Security

If an individual private-company shareholder provides adequate security when he ceases to be a Canadian resident, he may elect to defer the payment of tax (without interest and penalty) on the consequent deemed FMV disposition of the shares. There is little guidance on the meaning of "adequate security," although public and private company shares may be accepted.

The adequacy of the security is assessed annually. If the CRA concludes that the security originally accepted has become inadequate, it must notify the taxpayer. The security provided then secures only the amount for which it is adequate at that time, and interest accrues on the unsecured balance. However, if the individual provides additional security within 90 days of the notification and the addition is accepted, the security is deemed to have been continuous and no interest accrues.

The backgrounder and technical notes to the draft legislation on taxpayer migration released by Finance on December 23, 1998 indicated that the CRA may be prepared to accept a collateral assignment of private company shares as security for the tax arising on their deemed disposition on a taxpayer's emigration if "the shares' value can be ensured." The explanatory notes state that "the Minister will not exclude the possibility of accepting some or all of the shares as security." At the 1999 Conference for Advanced Life Underwriting, the CRA indicated that each case must be reviewed on its facts and declined to provide specific criteria for accepting private company shares as security for departure tax.

The CRA has apparently developed internal guidelines dealing with the posting of security, although at least one tax services office appears to be unaware of the guidelines. Most TSOs across Canada have a regional migration team responsible for accepting security for departure tax; the Toronto East TSO, for example, has provided tax practitioners with an outline of its procedures for posting security. The outline discusses three types of security acceptable to the CRA: a pledge of shares (private or public corporations), a letter of credit, and a bank letter of guarantee. Although the matter is not entirely clear, it appears that some TSOs may never have accepted shares of private companies as security. In one situation, the Toronto TSO failed for three years to accept private company shares as security; the file has recently been transferred to the Vancouver TSO, which apparently has more experience in accepting such security. (Interest has been waived because of the CRA's undue delay.)

The federal Department of Justice has developed pro forma security agreements for posting shares as security with the CRA (for private corporation shares and for publicly traded shares) that cover most situations. The CRA accepts minor changes to these agreements, but major changes must be negotiated. Shares of a publicly held corporation posted as security are held by a securities broker. The taxpayer must advise the CRA of shareholder meetings, information regarding dividends, etc. Dividends paid on the shares are remitted to the taxpayer except in the event of a default. The broker must advise the CRA of any sale or redemption of the shares.

The pro forma security agreement for private corporation shares is more elaborate, and it essentially transfers, mortgages, pledges, and assigns the shares to the CRA. The shares must be delivered to the CRA and remain in its possession; no sale, mortgage, lien, or pledge of the shares is permitted unless the CRA authorizes it. The CRA is given full power of attorney to take all necessary actions with respect to the shares. The CRA collects dividends paid on the shares and remits them to the taxpayer; any default under the security agreement entitles the CRA to withhold the dividends as payment for the tax liability. The shares' pledge does not hinder the voting power and the control exercised by the taxpayer over the shares. If all or some of the shares are redeemed or sold, the departure tax becomes due and payable and the CRA has first priority to claim the proceeds for payment of the departure tax. To ensure that the secured shares retain their value, the corporation must obtain written consent from the CRA before new shares can be issued. The corporation must provide the CRA with a copy of its financials in a timely manner.

In a case of undue hardship, the CRA may accept security different from, or of lesser value than, what otherwise would be required. In the September 10, 1999 backgrounder ("Taxpayer Migration and Trusts: Technical Backgrounder"), Finance commented that an individual's only significant property may be shares of an unlisted Canco that he cannot pledge because of a shareholder agreement's restrictions. Alternatively, the shares' value may already have been given to the bank as security for a business loan: the shares thus cannot constitute adequate security for departure tax. In such cases of undue hardship, the backgrounder noted that the minister of national revenue may accept a lesser value of security or a different kind of security from what he would normally consider adequate, and in the extreme case he may accept "very modest security." To qualify for special treatment, the individual must be unable, without undue hardship, to pay the tax or to provide fully acceptable security and cannot reasonably arrange to have another person, such as a corporation controlled by him, pay the tax or provide security.

Jack Bernstein
Aird & Berlis LLP, Toronto

US-Malta Treaty Signed

On August 8, 2008, the United States and Malta signed a new income tax treaty, which on ratification will replace an earlier treaty terminated on January 1, 1997 over concerns about exchange of information and treaty shopping. Malta has addressed these concerns by changing its secrecy laws and repealing its offshore company regime. The treaty further addresses these concerns through a very stringent limitation-on-benefits (LOB) provision.

The treaty is consistent with the general approach of the 2006 US model treaty and other recent US tax treaties. For example, the treaty addresses the treatment of fiscally transparent entities. However, unlike recent US tax agreements with Germany, Belgium, and Canada, the treaty does not include a mandatory arbitration provision. In addition to the rigorous LOB requirements, highlights of the treaty include a 5 percent withholding tax rate on dividends to 10 percent shareholders; a 10 percent withholding tax rate on interest and royalties; a 0 percent withholding tax rate on dividends and interest paid to certain pension funds and on interest paid to the US or Maltese government; and a 10 percent withholding tax rate on items of income not otherwise dealt with in the treaty.

For withholding taxes, the treaty takes effect for amounts paid or credited on or after the first day of the second month following the entry-into-force date. For other taxes on income, the treaty has effect for any tax year beginning on or after January 1 of the calendar year following entry into force. Before the treaty enters into force, it

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
Canadian Tax Foundation
595 Bay Street, Suite 1200
Toronto, Canada M5G 2N5
Telephone: 416-599-0283
Facsimile: 416-599-9283
Internet: http://www.ctf.ca
E-mail: vmorgan@interlog.com
ISSN 1496-4422 (Online)

must be ratified by each country, which must then notify the other that ratification has occurred and exchange instruments of ratification.

The treaty's very comprehensive LOB article is similar in approach to other recent US agreements, but it is significantly more restrictive: nearly all persons seeking treaty benefits must satisfy a base erosion test, except for individuals, pension funds, and tax-exempt organizations. That test requires that less than 25 percent of the person's gross income, as determined in that person's state of residence, be paid or accrued, directly or indirectly, to persons that are resident in neither state. Like similar tests in the 2006 model treaty and other recent US protocols, this provision excludes arm's-length payments "in the ordinary course of business for services or tangible property." The base erosion test's general language follows the 2006 model treaty, but the 25 percent threshold is a significant departure: the model treaty's base erosion threshold is 50 percent, making the Malta treaty test much more difficult to satisfy.

Even when a person meets the other LOB requirements, the treaty requires, where applicable, that the person satisfy a triangular provision in order to be eligible for treaty benefits. When a resident derives income attributable to a PE in a third jurisdiction, treaty benefits otherwise available are lost to that income if the combined tax actually paid on that income in the state of residence and the third jurisdiction is less than 60 percent of the tax that would have been payable in the state of residence if the income was not attributable to a third-jurisdiction PE. Like the recent US-Germany protocol, the treaty does not limit the types of income to which it applies (for example, to interest and royalties only), and it can eliminate the availability of all treaty benefits for certain types of income. For dividends, interest, and royalties otherwise subject to the triangular provision, instead of excluding them from treaty benefits, the treaty provides for a 15 percent withholding tax rate.

Steve Jackson
Ernst & Young LLP, New York

Elizabeth Canizales
Ernst & Young LLP, Washington

FOREIGN TAX NEWS

China

A law to promote recycling, effective after 2008, aims to boost sustainable development through energy saving and reduced pollution. Tax incentives encourage the importation of technology and equipment to conserve water, energy, and materials and restrict exports of goods produced in processes that use high levels of energy or cause pollution.

United States

Proposed regulations were issued regarding cross-border reorganizations, effective 30 days after the regs are finalized.

An internal IRS manual on withholding examinations covers policies, procedures, instructions, and guidelines for the IRS.

IFA

The Brussels IFA conference held seminars covering, inter alia, tax risk management, foreign court rulings in treaty interpretation, the indirect taxation of public bodies, and the impact of the EC treaty non-discrimination rule that prohibits "all restrictions on the movement of capital between Member States and between [them] and third countries."

United Kingdom

UK treaty priorities for the current fiscal year include the conclusion of treaties with Ethiopia, Libya, the Netherlands, and Thailand, and tax information agreements with Brazil, the British Virgin Islands, Guernsey, the Isle of Man, and Jersey. UK negotiations will proceed with Belgium, China, Hungary, Luxembourg, Spain, and the United States, and will begin with Australia, Canada, Israel, and Spain.

Germany

A draft bill prevents the purchase of 25 percent or more of a German company's voting shares by investors based outside the European Union or the European Free Trade Association if the purchase is considered a threat to public order or security. The acquisition can be prohibited or limited within three months after, for example, a sale is concluded.

Vivien Morgan
Canadian Tax Foundation, Toronto