CANADIAN TAX Highlights

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More Than Five Employees

In *489599 BC Ltd.* (2008 TCC 332), Campbell J found that the "more than five full-time employees" test in the personal services business definition in subsection 125(7) is met when the taxpayer employs five full-time employees and one or more part-time employees.

The CRA relied on the FCTD decision in *Hughes & Co. Holdings Ltd.* (94 DTC 6511). In *Hughes*, Muldoon J held that the phrase means at least six full-time employees, and said that part-time employees were not contemplated. Muldoon J concluded that "full-time employees, more than five" had the same meaning as "more than five full-time employees" because he was not adding any words, only rearranging. Furthermore, there was no reference to part-time employees, and thus the sixth employee must also be full-time. The TCC in *489599* disagreed and concluded that Muldoon J's rearranging of the words served to support his foregone conclusion that the word "more" modified "full-time employees."

The TCC said that Muldoon J also erred when he relied on a criminal case, *Shenowski* ([1932] 1 WWR 192), in which the court concluded that "more than 14 days" meant "at least 15 days." Campbell J noted that Muldoon J neglected to quote "the most relevant" portion of the *Shenowski* decision, which made it clear that the court was applying a well-established practice of counting only full days when dealing with the computation of days falling between two events.

The TCC also quoted *Burton* (2005 TCC 762), in which "more than" was not interpreted to mean only a whole number: "more than two years" was interpreted to include two years and two months. Furthermore, IT-497R4, paragraph 9, states that "more than six consecutive months" means "six months plus one day." The response of the lower court in *Lerric* (99 DTC 755 (TCC)) to the CRA's argument that more than five means at least six was also cited: "As a pure matter of mathematics this is not correct. Five point two is more than five . . . the presumption of consistent expression must apply. Where Parliament has not used the term 'at least' . . . an interpretation should [not] elevate the phrase 'more than five' to mean 'at least six.'"

Campbell J also referred to two recent tax cases that purported to agree with *Hughes*, but noted that the comments in *Raedarc* (98 DTC 1218 (TCC)) were obiter because on the facts there were only four full-time employees, and *Woessner* (99 DTC 1039 (TCC)) did not consider the issue of part-time employees. *489599* also cited the FCA in *Lerric*, which said (also in obiter) that it doubted the correctness of the conclusion in *Hughes*—that six full-time employees were required. Moreover, the TCC in *489599* said that the comments in *Hughes* were obiter because the court there had already concluded that there were only four full-time employees.

The TCC also said that if Parliament meant "at least six" full-time employees, it simply would have said that. There are many other provisions within the Act where the phrase "at least" is employed. Parliament's intent was to carefully, consistently, and accurately delineate the use of the phrases "more than" and "at least" within the Act, and these terms should not be considered interchangeable. The TCC was also of the view that this interpretive approach supports Parliament's obvious recognition that Canada's workplace today is composed of both full-time and part-time employees. Moreover, even if there was an ambiguity in the expression "more than five full-time employees," the TCC noted that jurisprudence establishes that any such ambiguity must be resolved in the taxpayer's favour.

In *Shenowski*, established practice dictated the inclusion of whole days only in interpreting the phrase "more than 14 days." The reference to that case in *Hughes* was not entirely without merit. The cases are not parallel, however, because the phrases are grammatically different. If the prescriptive phrase in *489599* read "more than five employees," that phrase clearly would have the same meaning as "at least six employees," because there are only whole employees. Unlike Muldoon J, however, Campbell J answered the real question—does "more than" refer to "five full-time employees" or to "five . . . employees"?—by reference to the employment realities that Parliament was presumed to have in mind when it drafted the provision.

Tax practitioners will find *489599* of interest: the expression "more than" is used over 200 times in the Act

In This Issue

and has been considered by the courts on many different occasions. The case has obvious application not only to the small business rules, but to a wide range of tax practice areas, including the "investment business" definition relevant to the foreign affiliate rules.

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Retractable Preferred Share Value

Retractable preferred shares—often issued in conjunction with an estate freeze or corporate reorganization—are intended to have an issued FMV equal to their stated retraction amount. Generally, CRA policy has recognized that value. But a retraction right is not a foolproof guarantee of a specific FMV for the shares, whether for a controlling or a minority shareholder. That failing may become evident at a later date—for example, upon a retraction demand or in the course of a reorganization or other disposition of the shares. On the facts in the recent decision of the Ontario Superior Court in *Itak International Corp. v. CPI Plastics Group Ltd.* (2006 CanLII 22117 (Ont. SCJ)), the corporation refused a demand for retraction even though the corporate law solvency rules were not an impediment to redemption.

FMV is an objective standard that considers the price at which arm's-length, informed, and uncompelled purchasers and vendors would transact. Thus, a valuation of retractable preferreds must consider, for example, the rights and conditions such as votes and dividends attaching to the retractable shares and whether the corporation has sufficient liquidity to pay the retraction amount and remain solvent. A notional purchaser who does not control the issuer of the preferred shares would also consider potential risks and impediments associated with his or her future exercise of the retraction right. In *Itak*, the court held that CPI's refusal to honour Itak's retraction request was not a valid business decision and was oppressive to the preferred shareholder. In refusing Itak's request, the board of CPI—a public company traded on the Toronto Stock Exchange—considered the impact that a redemption might have on CPI's banking covenants and on the other shareholders in light of potential adverse market conditions, including the rising cost of raw materials, exchange rate fluctuations, and the seasonality of its business. CPI concluded that at present it could not redeem any of Itak's preferred shares.

Itak was wholly owned by an individual who had controlled and was president of CPI's predecessor. In 1997, it was decided that the predecessor would go public via a reverse takeover of an existing public company. The individual ultimately agreed to exchange his shares for $4 million in CPI common shares and, instead of an equal amount in cash, $2 million in cash and $2 million in retractable preferred shares. The preferred shares were subject to a condition that the corporation may not be permitted to retract because of "insolvency provisions or other provisions of applicable law, or otherwise." The court applied the ejusdem generis rule and said that the words "or otherwise" suggest that the financial risk involved must be sufficient to threaten insolvency before a retraction may justifiably be postponed or not honoured. The court rejected CPI's attempt to rely on the business judgment rule test, saying on the facts that little judgment was brought to bear. For example, there was no dialogue with the shareholder, no offer to make partial payment, and no schedule for payment. The court also considered it noteworthy that "almost on the eve of . . . this Application" and without any explanation, CPI paid 10 percent of the amount in contention. Furthermore, the reasonable expectations of the preferred shareholder, as reflected in the share conditions, must prevail.

Although the shareholder's retraction right was vindicated by the court, *Itak* illustrates the possibility that an informed and uncompelled non-controlling holder of retractable shares may face delays and heavy legal costs in enforcing its retraction right, especially in an adverse economic climate. This eventuality would thus be considered in pricing the shares.

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Unreported Imports

Most Canadians returning from vacation abroad are generally aware that they must declare goods purchased in a foreign country. However, the vast majority are not aware of the full ramifications should they fail to report those goods, nor are they aware of possible obligations to report some items that actually originated in Canada, such as the expensive watch or diamond ring purchased in Toronto by the returning vacationer several years ago.

Section 12(1) of the Customs Act obliges each person entering Canada, including a returning resident, to report all goods accompanying him or her; technically, these goods are being imported into Canada. The provision aims to ensure that all goods properly subject to duties and/or taxes are reported and then accounted for. Failure to properly report goods can result in the seizure of the goods (section 110) or the imposition of other sanctions and penalties (such as section 109.1).

Cross-border shoppers are generally aware of these obligations and sanctions for failing to report goods recently acquired abroad. However, the application of the rules to goods previously purchased or acquired in Canada or to goods previously imported into Canada is not so transparent. Unfortunately, the Customs Act does not differentiate between these situations for reporting purposes, obliging all persons entering Canada to declare all goods being imported–including Canadian goods being returned to Canada (section 12(3.1)).

In practice, the CBSA usually pays little attention to Canadian goods returned, largely because section 12(7) also exempts unreported Canadian-origin goods from seizure if the following conditions are met: (1) the goods have not been advanced in value, improved in condition, or combined with other articles abroad; (2) the goods are in the actual possession of a person arriving in Canada; (3) all prior duties on the goods were paid; and (4) the importation of the goods is not otherwise prohibited, controlled, or regulated. However, the general practice of ignoring the non-reporting of those goods can change if other non-compliance factors exist–for example, the CBSA's discovery that recently purchased items were not declared. In these instances, the CBSA has been known to seize expensive Canadian-origin goods and put the onus on the importer to demonstrate (later) that the goods were acquired in Canada or that the goods were previously properly imported and duties were paid at that time. This requirement may present a problem, especially in the cash-deal jewellery business or where prior importations of the items in question were not processed to the exact letter of the law.

If a seizure occurs, the CBSA takes control of the goods seized and generally issues the importer either a seizure receipt or a formal form K128. Certain appeal provisions may then apply; for example, the person subject to the seizure may request a decision by the minister (section 129). A person with an interest in the goods (other than the person in possession when they were seized) may make a third-party claim for a decision of the minister (section 138). The section 129 request for the minister's decision must be filed within 90 days of the seizure. If the seizure is improper, the minister may order the seized goods returned; if the seizure is proper, the minister has broad powers to deal with the seized goods. Beyond these administrative actions, an appeal may be made to the Federal Court (section 135).

Border guards like the CBSA have some of the strongest powers of any law enforcement agency, including the right to compel truthful answers to "any question asked by an officer with respect to [imported] goods" (section 13). Crossing international borders is thus a very serious matter, and the recommended practice is to fully and accurately report all goods imported, including their proper values, so as to avoid seizure and any other enforcement action.

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None of Your Business

Under the Canada-US treaty, a US corporation can have a Canadian PE either by carrying on business through a fixed place of business in Canada (article V(1)) or by having a dependent agent (not an independent agent acting in the ordinary course of his own business) who habitually exercises in Canada an authority to contract on the principal's behalf (articles V(5) and V(7)). In *Knights of Columbus* (2008 TCC 307), Miller J held that a US treaty-resident life insurer serving its Canadian members through a network of Canadian individual agents did not have a Canadian PE: the agents' homes did not constitute a fixed place of business of the Knights of Columbus (KOC) and the agents did not habitually exercise the authority to conclude contracts for it. (Miller J arrived at similar conclusions in *American Income Life Insurance Company Limited* (2008 TCC 306).)

To determine where the contracts were made, Miller J examined the roles and responsibilities of each agent and US employee. KOC, for example, rejected outright about 10 percent of the applications that the agents submitted and made counteroffers on many more for the agents to relay to the customers; KOC also carried out in the United States extensive health and other background checks before finalizing any deals. KOC's activities were sufficient to warrant a finding that it concluded in the United States all its insurance contracts with its Canadian members. The TCC did thus not need to opine on whether the agents were dependent.

The TCC in *Knights of Columbus* quickly concluded that the agents' homes were places of some permanence and places of business: the agents routinely organized their business activities, arranged for solicitation meetings with potential applicants, kept records, completed reports, etc. The court struggled with the final test of a fixed place of business: whether KOC carried on its business in the agents' homes. The court relied on the testimony of three expert witnesses and the OECD commentary to the model treaty, which refers to a place of business being "at the disposal" of the enterprise, and concluded that the crux of the issue is to distinguish the agents' business activities from KOC's. "If sufficient [KOC] business activities are carried on at the agents' home offices, then the condition of the premises being at [KOC's] disposal would be met."

In obiter in *American Income Life Insurance*, Miller J said that the existence of a dependent agent indicates that the principal carries on business from a fixed place; effectively, the dependent agent carries on the principal's business, not his own. The court did not articulate the next step—that a dependent agent carries on not his own but his principal's business in his home, which is thus at the principal's disposal and is its PE. (These comments were obiter: the agents were found to be independent and carrying on their own business in their own homes.) However, in further obiter in *American Income Life Insurance*, Miller J toyed with the "interesting possibility" that an independent contractor—as the parties agreed the agents were—might be a dependent agent carrying on his own business. In light of these two obiter comments, it is not clear whether an independent contractor/dependent agent may carry on only his principal's business or both his own and his principal's business. The latter allows *Knights of Columbus* and *American Income Life Insurance* to be more easily reconciled, but in *Knights of Columbus* Miller J further muddied the waters by saying, "Once it has been determined that the [agents] are independent contractors . . . [as] has been agreed [and thus] . . . are in business on their own account, then it is illogical to find that [the business activities] they conduct at home [are] anything other than . . . their own business." In any event, the court in *Knights of Columbus* did not have to decide whether the agents were dependent, and thus any further musings would have been obiter. However, one is left with the unfortunate obiter in *American Income Life Insurance* that only independent agents are in business for themselves.

In the end, Miller J concluded that it was each agent's and not KOC's business that was conducted in the homes: KOC officers, employees, and directors never visited the homes and had no access; no KOC staff was employed there; and KOC was not identified with the homes.

There is little in the cases to promote clarity in distinguishing the dependent/independent agent dichotomy (a distinction relevant for the treaty but not for domestic law) from the independent contractor/employee dichotomy (a distinction relevant for domestic law but not for the treaty). *Knights of Columbus* and *American Income Life Insurance* appear to stand for the proposition that the two distinctions are not analogous. An employee is not in business for himself and, if an agent, is always a dependent agent. However, an independent contractor by definition carries on business for himself; but contrary to what may be popular wisdom, an independent contractor may nevertheless be a dependent agent. For treaty purposes, using an employee or an independent contractor (who may also be either a dependent or an independent agent) may yield significantly different results, but deciphering the facts may be problematic because the alternatives may be distinguished by only the most subtle of differences at the operational level.

The Crown in *Knights of Columbus* failed to call expert witnesses, and the taxpayer gathered a formidable triumvirate of witnesses with extensive credentials. But clarity was not achieved in distinguishing between the agents' and the principals' fixed place of business. Nevertheless, the conclusion appears sound. A contrary finding would lead to an intolerably high degree of uncertainty and a potential impediment for any non-resident using agents to conduct business in Canada, and would no doubt have required the CRA to push for further clarity on the issue.

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Corporate Attribution Derails Estate Freeze

The CRA recently stated that the corporate attribution rule in subsection 74.4(2) applied in three different scenarios posited for an estate freeze reorganization (TI 2007-0243191C6). Each scenario reflected a different trust indenture modification intended to avoid the corporate attribution rule when a corporation loses its small business corporation (SBC) status.

When an individual transfers or lends property to a corporation through a trust or by any other means, the attribution rules may include in the individual's income interest at the prescribed rate on the transferred or loaned property. These rules apply if one of the "main purposes" of the transfer or loan is to reduce the individual's income and directly or indirectly benefit a "designated person" that is a "specified shareholder" of the corporation. A designated person is an individual's spouse or common-law partner or niece or nephew, or a minor not at arm's length with the individual; a specified shareholder owns no less than 10 percent of the corporation's issued shares of any class.

Corporate attribution does not apply if the corporation is an SBC throughout the taxation year. A main-purpose-test exception applies if three conditions are satisfied, including the requirement that under the trust's terms the designated person may not receive or otherwise obtain the use of any of the trust's income or capital while the person is a designated person in relation to the individual lender or transferor. Furthermore, when a beneficiary's share of the trust income or capital depends on whether a discretionary power is exercised, the beneficiary is deemed to own each of the corporation's shares then owned by the trust. (In contrast, a non-discretionary trust beneficiary is deemed to own the trust's shareholdings only in proportion to his or her beneficial interest in the trust.)

In the TI, a discretionary trust is created as part of an estate freeze involving Opco. A trust indenture is prepared for the trust, which will hold Opco's non-voting participating shares; an individual (Mr. X) holds Opco's voting and non-voting non-participating shares. Mr. X's spouse, Mrs. X, is the trust's beneficiary. It is impossible to know with certainty whether Opco will retain its status as an SBC during the time that the trust holds the participating shares. Thus, each of the three scenarios presented to the CRA describes a method whereby the taxpayer seeks to prevent the attribution rules' application.

1) The trust is discretionary with respect to Mrs. X's entitlement to its income and capital. However, if the corporation loses its SBC status for more than 30 days in a calendar year, the trust indenture provides that Mrs. X's trust interest is modified so that she then has no right to the trust income or capital during the life of Mr. X, the transferor. However, the CRA says that the purpose test exception does not apply because, under the trust indenture, the designated person may receive income or capital while he or she was a designated person in relation to the original transferor (Mr. X). Furthermore, Mrs. X is a specified shareholder from the trust's creation until Mr. X's death. Despite the change to the trust indenture, the CRA notes that Mrs. X's share of the trust income or capital still depends on the exercise of a discretionary power and concludes that this trust indenture modification does not prevent the attribution rules from applying when Opco loses its SBC status.

2) The trust is discretionary with respect to Mrs. X's entitlement to its income and capital. However, when Opco loses its SBC status for 30 days in a calendar year, the trust indenture modifies Mrs. X's interest so that she holds only a fixed and non-discretionary income and capital interest of 9.9 percent before and after Mr. X's death.

3) Mrs. X's trust interest is limited to a fixed income and capital interest of 9.9 percent until Mr. X's death, at which time the interest becomes discretionary. If Mr. X is alive at the end of a year, Mrs. X's income and capital interest is limited to 9.9 percent.

The CRA considered that the attribution rules also applied to both the second and third scenarios. In the third scenario, for example, the CRA found it difficult to imagine that a capital trust interest of 9.9 percent is considered fixed for a particular period if at a later specified date it becomes totally discretionary. Thus, none of the proposed scenarios for the estate freeze produced the taxpayers' desired result.

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Owner-Manager: Year-End Tips

Optimal Salary-Dividend Mix

■ Determine the optimal salary-dividend mix for the owner-manager and for family members that will minimize overall taxes. Consider the individual's marginal tax rate, the corporation's tax rate, and provincial health and payroll taxes, and consider maximizing the RRSP contribution room and CPP contributions.

■ To be deductible, salaries and bonuses must be accrued before the business's year-end and paid within 179 days thereof. Payment of a reasonable salary to a spouse or child who provides services to the business and is in a lower tax bracket may be beneficial.

■ Consider distributing dividends in the following order: (1) eligible dividends that trigger a refundable dividend tax on hand (RDTOH) refund; (2) non-eligible dividends that trigger an RDTOH refund; (3) eligible dividends that do not trigger an RDTOH refund; and (4) non-eligible dividends that do not trigger an RDTOH refund.

■ If the CCPC has a positive general rate income pool (GRIP) and RDTOH, consider distributing before year-end eligible dividends that trigger a dividend refund. However, eligible dividends may increase a shareholder-manager's alternative minimum tax exposure.

■ A corporation in Alberta, British Columbia, Manitoba, or Prince Edward Island may wish to accelerate to 2008 the distribution of discretionary non-eligible dividends that can trigger a dividend refund in order to access lower non-eligible dividend tax rates in 2008.

■ A corporation in British Columbia may also wish to accelerate to 2008 the distribution of any discretionary eligible dividends that can trigger a dividend refund in order to access a lower eligible dividend tax rate in 2008.

■ Conversely, a corporation in Alberta or Ontario may wish to defer the payment of discretionary eligible dividends to 2009 in order to benefit from decreases in those provinces' eligible dividend tax rates in 2009.

■ A corporation in Newfoundland and Labrador may wish to defer to 2009 the payment of salary and/or eligible or non-eligible discretionary dividends in order to benefit from lower 2009 personal tax rates.

■ Forgoing bonus payments and/or dividend distributions out of excess cash may place in doubt whether substantially all of a CCPC's assets are used in an active business and thus jeopardize the CCPC's share status as QSBC shares.

■ Tax is deferred if a corporation retains income when its tax rate is less than the individual shareholder-employee's rate. The table shows the income tax deferral if active business income is retained in the corporation and not

Determining the Optimal Salary-Dividend Mix (December 31, 2008 Year-End and $10,000 ABI)

	Eligible for small business deduction		No small business deduction, no M & P deduction		No small business deduction, M & P deduction	
	Deferral	Saving	Deferral	Saving/(cost)	Deferral	Saving/(cost)
			dollars			
Alberta	2,500	225	950	(178)	950	(178)
British Columbia	2,870	186	1,270	(4)	1,270	(4)
Manitoba	3,452	199	1,452	(144)	1,452	(144)
New Brunswick	3,095	122	1,445	(119)	1,445	(119)
Newfoundland and Labrador	3,008	208	1,258	(611)	2,158	36
Nova Scotia	3,225	448	1,275	(553)	1,275	(553)
Ontario	3,093	476	1,393	(200)	1,593	(48)
Prince Edward Island	3,290	157	1,187	(389)	1,187	(389)
Quebec	3,133	189	1,943	(109)	1,943	(109)
Saskatchewan	2,850	245	1,200	(184)	1,450	15
Northwest Territories	3,005	485	1,405	146	1,405	146
Nunavut	2,750	289	1,100	(423)	1,100	(423)
Yukon	2,740	148	790	(339)	2,040	696

Note: It is assumed that the individual is to be taxed at the top marginal income tax rate. Only federal and provincial income tax, the employer portion of provincial health tax, and the employee portion of payroll tax (for the Northwest Territories and Nunavut) are considered. The SBD figures for Yukon assume that the rate on non-M & P ABI applies; if the M & P ABI rate applies, the tax deferral and savings are $2,890 and $253, respectively.

paid out as salary to the shareholder-employee, and the subsequent tax saving (or cost) when the corporation pays out the after-tax income as a dividend.

Corporate Income

■ A corporation subject to the small business rate in British Columbia, Manitoba, and Prince Edward Island may benefit from decreases to those rates if it defers income until after 2008 by maximizing 2008 discretionary deductions such as CCA. The small business threshold in Alberta and Saskatchewan increases after 2008.

■ A corporation subject to the general corporate income tax rate may wish to defer income by maximizing discretionary deductions in 2008 to benefit from staggered federal rate reductions from 19.5 percent in 2008 to 15 percent in 2012. After 2008, general rates also decline in British Columbia, Manitoba, and Saskatchewan.

■ In contrast, a corporate taxpayer in Quebec may wish to minimize discretionary deductions in 2008 to maximize its income subject to the lower Quebec income tax rate on active business income in excess of $400,000; the 2008 11.4 percent rate rises to 11.9 percent in 2009. (An 11.9 percent rate for non-insurer financial institutions and oil-refining companies had already been proposed to start June 1, 2007.)

■ In order for a corporation to claim CCA on a depreciable asset, it must purchase the asset by its year-end and the asset must be available for use at that time. The annual CCA deduction is enhanced for M & P equipment, from a 30 percent declining balance to a 50 percent straight-line deduction for purchases made before 2010, and to a 50 percent declining balance for purchases made after 2009 and before 2012.

■ Additional reserves for doubtful accounts receivable or inventory obsolescence should be identified by and claimed at year-end.

■ Various strategies reduce provincial taxable capital. Capital tax is eliminated or reduced in Ontario for certain manufacturing or resource companies retroactive to January 1, 2007; Quebec proposes to do the same for certain manufacturing companies for taxation years ending after March 13, 2008. Capital tax is eliminated in Manitoba on July 1, 2008 for certain M & P companies and in Saskatchewan on new capital acquired after June 30, 2006 and for most capital on July 1, 2008.

■ Commencing for taxation years ending after December 31, 2008, Ontario corporations file a combined federal and provincial income tax return. Consequential changes include elimination of the Ontario addback for non-arm's-length payments to non-residents and the introduction of a new 4.5 percent non-refundable R & D tax credit; transitional rules adjust Ontario tax attributes—such as tax depreciation pools and SR & ED pools—to the federal amounts. The impact of these changes on the business should be assessed.

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Late-Filed Form 5471 Penalty

Any US citizen or resident (corporate or non-corporate) whose shareholdings in certain foreign corporations exceed specified thresholds must file with the IRS an annual form 5471 disclosing certain information. In some cases, US officers and directors must also file. The IRS has indicated that after 2008 it will automatically impose penalties on any corporation that late-files the form. This signals a change from the current IRS policy, which generally imposes penalties only on a discretionary basis and at the audit level. The change is also another step toward the IRS's goal of increased review and scrutiny of outbound reporting by US residents and citizens of their interests in foreign entities, including corporations, partnerships, disregarded entities, and trusts. It is not clear whether the automatic penalty procedure also applies to non-corporate US residents, and whether the penalty applies not only to late-filed returns but also to timely filed returns that are incomplete or inaccurate. As a practical matter, the assessment of a penalty in the latter case may require an examining agent's input to determine incompleteness or inaccuracy.

Failure to timely file a form 5471 can result in significant potential penalties: (1) a $10,000 penalty for each form 5471 that is filed after the due date (including extensions) or that does not contain complete and accurate information (Code section 6038(b)(1)); (2) a potential failure-to-file or failure-to-pay penalty equal to 5 percent of the tax required to be shown on the return for each month during which it is delinquent (up to 25 percent of the tax due) (section 6651(a)(1)); and (3) a potential 10 percent reduction in available foreign taxes otherwise creditable under sections 901, 902, and 960 (section 6038(c)). A taxpayer that establishes reasonable cause for its failure to file on time can generally avoid penalties.

The change to automatic penalties was set out in letters recently sent to taxpayers by the IRS Large and Mid-Size Business Division. Similar filing obligations and IRS forms are required for disclosure of information with respect to ownership interests and transfers of property by US persons to certain foreign partnerships (form 8865), foreign disregarded entities (form 8858), and foreign trusts (form 3520); it seems likely that the IRS will adopt a similarly strict approach if those forms are late-filed. In light of the IRS's increased scrutiny and aggressive approach, taxpayers are well advised to ensure that they comply with filing obligations for all these forms.

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Options Do Not Disqualify QSBC

The TCC released the recently translated cases *Alain Chartier* (2005-1235(IT)G) and *Claudet Nadeau* (2005-1258(IT)G); the two cases were heard on common evidence on November 6, 2006, and judgments were rendered on April 18, 2007 (2007 TCC 37). The TCC held that a purchaser's option to acquire shares of a Canco was not to be considered when determining its qualified small business corporation (QSBC) status, because rights referred to in a purchase and sale agreement are excluded under paragraph 110.6(14)(b). As a result, each vendor-taxpayer was able to offset an enhanced capital gains deduction against his or her taxable capital gain of more than $230,000 that arose on the purchaser's exercise of the options and the sale of the Canco shares in 1999.

The shareholders of Targetco wished to sell Targetco's shares to another Canco, Purchaseco. Purchaseco was owned by a US corporation; thus, the sale was structured in two stages to enable the minority individual shareholders, including Mr. C and Ms. N, to apply the enhanced capital gains deduction against their taxable capital gains arising on the sale of their Targetco shares. Targetco's other shareholders were two Cancos.

In 1997, Purchaseco bought some of Targetco's shares from the Cancos under a purchase and sale agreement, including 49 percent of the voting shares. An option agreement gave Purchaseco options to purchase the remaining shares held by one Canco and the shares held by the minority shareholders, and it gave the minority shareholders the right to sell (or put) their Targetco shares to Purchaseco any time after January 1, 1999. In 1999, Purchaseco exercised its options and purchased the remaining Targetco shares. Mr. C and Ms. N each reported the resulting taxable capital gain of more than $230,000, fully offset by an enhanced capital gains deduction.

To qualify for the enhanced capital gains deduction, a share must be a QSBC share when disposed of (subsection 110.6(2.1)). The definition of a QSBC share relies on several other definitions, such as "small business corporation" (subsection 248(1)) and "Canadian-controlled private corporation" (subsection 125(7)), which must not be "controlled, directly or indirectly in any manner whatever, by one or more non-resident persons." For the purposes of determining that control, "where at any time a person has a right, under a contract, in equity or otherwise, either immediately or in the future and either absolutely or contingently to, or to acquire, shares of the capital stock of a corporation . . . the person shall . . . be deemed to have the same position in relation to the control of the corporation as if the person owned the shares at that time" (paragraph 251(5)(b)). For the purposes of determining QSBC share status, an exception is provided for "a right under a purchase and sale agreement relating to a share of the capital stock of a corporation" (paragraph 110.6(14)(b)). Because Purchaseco held options in the Targetco shares and it was controlled by a USco, the issue was whether the options were rights provided under a purchase and sale agreement, and therefore governed by the exception. If the answer was yes, the options could be ignored when determining whether Targetco was a CCPC (and a QSBC) when the minority sold their shares.

The TCC said that it must decide whether the option agreement could trigger the exception, not whether the option agreement was a "purchase and sale agreement." The TCC also noted that the parties' intention was clearly to sell all Targetco's shares under two separate agreements so that the minority shareholders could access the enhanced capital gains deduction.

The TCC reviewed selected sections of the sale agreement, such as the section that referred to "collateral instruments and agreements," which included, inter alia, a specific listing. That list did not include the option agreement—apparently a drafting error, because other sections of the sale agreement indicated that the option agreement was listed in that section. The exception in paragraph 110.6(14)(b) requires that the option right be "under a purchase and sale agreement," and in the French version reads "un droit prévu par convention d'achat-vente." The TCC concluded that the right need only be "imagined" or "envisaged" by the agreement, based on the French dictionary definition of "prévu."

Concluding that there was an apparent drafting error, the TCC held that "the Option Agreement was referred to, and therefore envisaged, in the Purchase and Sale Agreement" and was thus "under" the sale agreement and therefore was an integral part of it. The fact that the option agreement and the sale agreement did not involve the same parties or the same subject matter did not change this determination, because there is nothing to prevent the parties of one contract from providing that they will have to comply with another contract that other parties will sign in the future. Thus, the option agreement was covered by the exception, and was not considered when determining whether Targetco was a CCPC. Mr. C and Ms. N were thus entitled to the enhanced capital gains deduction.

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Corporate Continuance

A corporate continuance may be a useful tool in tax planning—for example, if a US purchaser wishes to convert an Ontario company to a Nova Scotia unlimited liability company. To that end, an amalgamation of the Ontario corporation with a Nova Scotia corporation requires that both corporations be governed by the same corporate statute; thus, the migration or continuation of the Ontario company into Nova Scotia is required. From a tax perspective, it is critical that there be no deemed disposition of the continuing corporation's assets and debts. In Canada, the jurisprudence and administrative positions indicate that a continuance does not result in a deemed disposition for the continuing corporation.

A corporate continuance has been described as "in very general terms . . . a process by which a corporation [ceases to be] governed by the corporate laws of a particular jurisdiction . . . and becomes governed by the corporate laws of another jurisdiction (or . . . by different corporate laws of the same jurisdiction) . . . [so as to preserve] intact the legal personality of the (un)affected corporation." (See 2006 Conference Report, at 14:3.) The Canadian tax consequences of corporate continuance are considered both in the Act and in CRA administrative pronouncements. Paragraph 250(5.1)(a) states that a corporation incorporated in a particular jurisdiction and continued into another is thereafter deemed to have been incorporated in the latter. A corporation continued abroad is subject to Canadian departure tax.

The first CRA position on the issue, *Advance Ruling* TR-1 (June 24, 1974), examined the continuance of a corporation from Ontario to Alberta. The ruling was withdrawn, but the underlying position has been confirmed in subsequent administrative documents: if the governing corporate law allows for the continuance and deems the continued corporation to be the same corporation as, and a continuation of, the continuing corporation, the continuance does not give rise to any Canadian tax consequences. The ruling said that this administrative position was based on the view that "the continued corporation is the same corporation as a matter of non-tax law in every material respect (except for its new governing law)."

In the context of a continuance from one foreign jurisdiction to another, the CRA has concluded that there are no Canadian tax consequences if the governing foreign legislation provided for the continuance and it did not alter the basic corporate characteristics of the continued corporation, its assets or liabilities, or the rights and obligations of its shareholders. The advance ruling noted that the continuance of a foreign affiliate from one foreign country to another did not result in a disposition of its assets or its outstanding indebtedness for Canadian tax purposes, based on (1) the preservation of the corporation's existence; (2) the lack of any material change with respect to its shares (including the fact that no new classes of shares were created); (3) the fact that there was no exchange, redemption, cancellation, or disposition of the shares; and (4) the fact that there was no change in stated capital.

The general thrust of these and other similar issued rulings and interpretations in the domestic and foreign context appears to be that a continuance does not result in Canadian tax consequences (and, one might add, there is no Canadian reporting obligation) in the absence of a disposition of property. Subsection 248(1) contains an extensive definition of "disposition" that specifically notes that a transfer of property that does not result in a change in beneficial ownership is not a disposition (except in enumerated circumstances). The TCC decision, affirmed by the FCA, in *MIL (Investments) SA* (2007 DTC 5437) held that the continuance to Luxembourg of a Cayman company, in order to access the benefit of the Canada-Luxembourg treaty, did not result in a disposition of the continuing corporation's substantial holding of Canco shares or any of its other assets.

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Tax Incentives To Go Green

Federal and provincial governments are pushing the green agenda: taxes on the use of fossil fuels that create harmful carbon dioxide emissions and fees on various products—printing and packaging materials, e-waste, and hazardous waste—that affect the environment. In addition to the many existing federal and provincial tax credits available to promote SR & ED, new incentives also aid in the reduction of greenhouse gases and pollution.

Federal government incentives—such as accelerated income tax deductions for Canadian renewable and conservation expenses (CRCE)—encourage investment in renewable energy sources and projects that promote sustainable development. Qualifying expenditures include costs of certain engineering services, clearing land, building temporary roads, and training and feasibility studies. Up to 100 percent of the CRCE pool is deductible, and benefits may flow through to a principal business corporation's shareholders via flowthrough shares, similar to the mechanism used in the mining industry.

Other accelerated federal income tax deductions are available for certain assets used in green projects. Wind energy conversion, high-efficiency co-generation, and other thermal energy systems may qualify for a 30 percent CCA deduction under class 43.1 on a declining-balance basis (subject to the half-year rule), or a 50 percent CCA deduction on a declining-balance basis (subject to the half-year rule) under class 43.2, provided, for example, that the assets were purchased after February 22, 2005 and before 2012.

In addition to incentives offered by other provinces, Ontario provides a one-time deduction from Ontario taxable business income for 30 percent of the cost of equipment used to reduce or eliminate water or air pollution. British Columbia refunds up to 100 percent of its paid corporate taxes on eligible patents related to wind, solar, tidal, and other natural sources of power generation.

Funding, grants, and financing may be available from governments and utilities (such as BC Hydro and Hydro-Quebec) to assist in the development and marketing of clean energy technology solutions. For example, the federal government's ecoENERGY technology initiative is a $230 million investment directed at increasing clean energy supplies and reducing energy waste, and British Columbia's clean tech innovation venture capital program provides annual tax credits to investors in early-stage clean technology companies operating in that province.

A number of provincial retail sales tax initiatives encourage consumers to shift to renewable energy sources via exemptions and rebates for (1) items used to prevent building heat loss; (2) energy-efficient household appliances; (3) renewable energy systems (solar, wind, micro-hydroelectric, and geothermal energy); and (4) alternative fuel vehicles.

The many incentives available to individuals and businesses to either go green or invest in green technologies are not always easy to identify. However, investing some time in research may result in both environmental and financial benefits.

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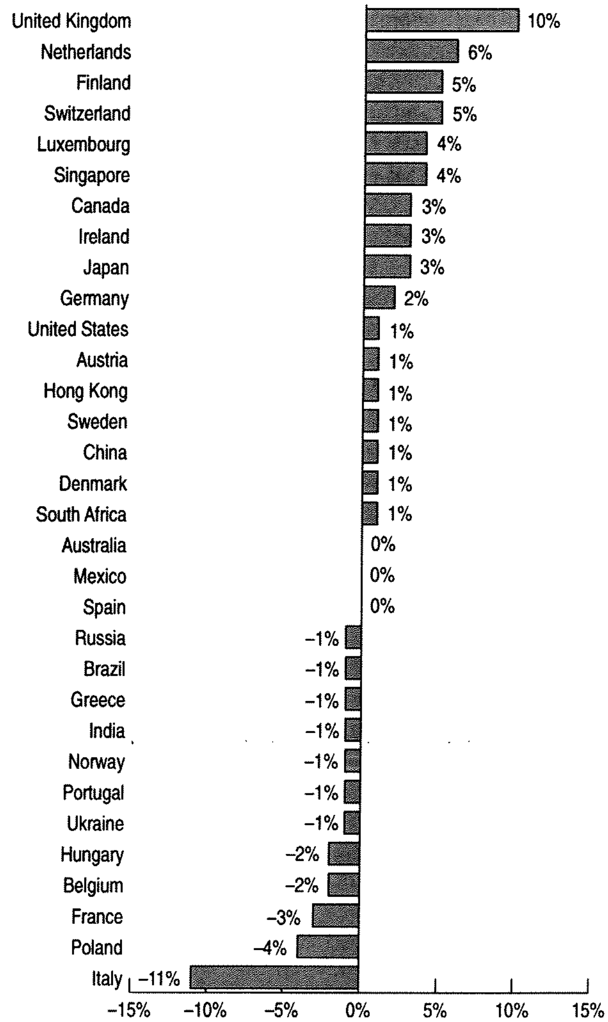
GST System in Top 10

Among indirect tax systems in 32 countries (including the United States), Canada's GST system ranks 7th in ease of doing business, according to a KPMG-commissioned survey of senior finance professionals at more than 500 large corporations around the world. The research also helps to confirm the increasing importance of indirect taxes for global businesses as corporate income tax rates decline. The accompanying chart illustrates the respondents' ranking of countries' VAT-friendliness. The United Kingdom's indirect tax system was rated as most friendly, followed by those of the Netherlands, Finland, Switzerland, and Luxembourg. Italy's system was rated the most difficult, while the US system ranked 11th.

Seventy-five percent of respondents believe that governments will rely more on indirect taxes in the future. Sixty-four percent of the Canadian respondents agreed, despite

Net Percentage of Respondents Saying VAT System Is Easy



the recent reduction in the GST rate to 5 percent. When asked about income tax and VAT compliance risks, 45 percent of all respondents rated errors in VAT compliance as the top global tax risk for their organizations. In Canada, 35 percent of respondents were more concerned about risks in indirect tax than about corporate income tax risks.

The survey also provides evidence of the amount of VAT/GST managed daily by global organizations: 82 percent of respondents indicated that their organization's annual VAT throughput (tax collected on sales plus tax paid on purchases) was between US$200 million and US$1 billion. Of Canadian respondents, 86 percent said that their annual GST/VAT throughput fell into that range, and 10 percent reported that it exceeded that range.

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FOREIGN TAX NEWS

Treaties

On September 11, 2008, an executive report of the US Senate Committee on Foreign Relations recommended the fifth **Canada-US** treaty protocol to the full Senate for ratification subject to the condition that the US Treasury issue reports to Congress on the mandatory arbitration provision in the US treaties with Canada, Belgium, and Germany. For example, before each treaty's first arbitration Treasury should submit the relevant arbitration board's rules of procedure, including conflict of interest rules, to the US Senate committees on finance and on foreign relations and to the US Joint Committee on Taxation; Treasury should report on the operation, application, and safeguards of the arbitration mechanism after the tenth arbitration and then annually for five years. The US Senate approved the protocol on September 23, 2008, subject to such reporting conditions. The president's signature and the required exchange of instruments of ratification are expected before 2009.

A **UK-Netherlands** treaty and protocol were signed September 26, 2008. A **UK-Isle of Man** tax information exchange agreement was signed, along with an agreement to amend the two countries' 1955 income tax treaty.

European Union

In compliance with the *Marks & Spencer* judgment (case C-446/03) by the European Court of Justice (ECJ), the United Kingdom enacted legislation that dealt with cross-border loss compensation for a non-resident subsidiary that had exhausted all possibilities for loss relief in its home state. The European Commission has requested that the United Kingdom properly implement the ECJ judgment, saying that the existing UK legislation makes it virtually impossible for a taxpayer to benefit from UK relief.

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