CANADIAN TAX Highlights

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ENTITY CLASSIFICATION EVOLVES

A recent internal technical interpretation (CRA document no. 2008-0266251I7, April 15, 2008) highlights the CRA's evolving methodology for classifying foreign structures. The TI concludes that a Liechtenstein foundation (stiftung) is treated as a trust for Canadian tax purposes.

Interpretation Bulletin IT-343R ("Meaning of the Term Corporation," September 26, 1977) sets out the CRA's longstanding position on entity classification: an entity with a separate legal identity and existence was considered to be a corporation. However, the TI and ITTN no. 38 (September 22, 2008) acknowledge that separate legal entity status is no longer a distinctive feature of corporations alone. The TI describes the CRA's new two-step approach for classifying foreign entities for the purposes of domestic taxation: (1) determine the characteristics of the foreign entity under the foreign legislation, and (2) compare those characteristics with those of recognized categories under Canadian commercial law.

The TI's analysis of the Liechtenstein foundation revolved around whether it was a corporation or a trust for Canadian tax purposes. A stiftung has some features similar to a trust or corporation in common-law jurisdictions, but other features are not present in either structure. Under the relevant foreign legislation, a stiftung's creator, its founder, provides its initial assets. A stiftung is a legal person that owns the assets supplied by the founder, subject to its stated purposes. It is operated by a council, or board of directors. It has no shareholders, and no one owns a property interest in the foundation; instead it has "beneficiaries," which "may be named or described in the foundation documentation but customarily are not. The founding (and registered) documents will certainly be silent on the subject." The TI reveals few details of the particular stiftung's structure: its object is to provide support to various families, including "natural and juridical persons outside the family circle," and its beneficiaries are named in separate by-laws.

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The CRA applied the two-step approach to the stiftung and concluded that, on balance, the entity was more like a trust than a corporation, and thus should be treated as a trust for tax purposes: the founder's endowment that creates a stiftung is similar to a settlor's settlement of property to a trust. A stiftung also has beneficiaries, just like a trust; the beneficiaries, or at least an ascertainable class, are usually named in the stiftung's by-laws at its formation, similar to a trust indenture, and a stiftung's beneficiaries do not pay for their interests and are not entitled to vote. The stiftung board acts in the same way as trustees to protect the stiftung's capital and to follow the founder's wishes; the stiftung's board exercises considerable decision and control powers over the stiftung assets, similar to a trustee's powers over trust assets; a stiftung can be compared to a trust; and the creation of a foundation can be inter vivos or testamentary. Moreover, a stiftung cannot perform commercial activities unless they serve its non-commercial purpose or unless the type and scope of the participation held requires the facilities of a commercial business.

The TI's two-step approach categorizes an entity for Canadian tax purposes according to the type of recognized common-law entity or relationship—corporation, partnership, or trust—that it resembles most, rather than according to whether it has the fundamental characteristics of the entity or relationship. A foreign entity is assumed to be one of a trust, a corporation, or a partnership under Canadian law, and is forced into one of these categories if need be. The CRA's approach is questionable absent a legislative deeming rule that categorizes a foreign entity on the preponderance of its resemblance to one common-law entity or relationship. For example, the SCC in *Backman* (2001 DTC 5149) unanimously concluded that a partnership created under Texas law was not a partnership for Canadian tax purposes:

> The term "partnership" is not defined in the Act. Partnership is a legal term derived from common law and equity. . . . As a matter of statutory interpretation, it is presumed that Parliament intended that the term be given its legal meaning for the purposes of the Act. . . . It follows that even in respect of foreign partnerships, for the purposes of s. 96 of the Act, the essential elements of a partnership that exist under Canadian law must be present.

Backman suggests that the foreign entity must have the essential elements of the particular common-law

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structure before it can be categorized and taxed as such. A *Backman*-based two-step approach for classifying foreign entities would require (1) identification of the foreign entity's characteristics and (2) a determination of whether they matched the essential elements of a recognized structure under Canadian commercial law; if no match was found, then the foreign entity would not be subject to the tax rules applicable to the recognized structure. In contrast, the TI based its conclusion on a finding that a stiftung more closely resembled a trust than a corporation, but it did not find that the stiftung had the essential elements of a trust under Canadian law. Arguably, it may be difficult for a Canadian court to find that a stiftung is a trust. Some stiftung attributes are similar to a trust—in particular, the functions performed by its directors and those performed by a trust's trustees are similar in some respects. But in many of its characteristics—especially its separate legal personality—a stiftung differs from a trust, which at common law has no separate legal personality and is merely a relationship between a trustee and beneficiary in respect of property. However, the CRA's approach to foreign entity classification incorporates a purposive interpretation of the Act, and it may be appropriate to extrapolate from categories of entities and relationships—like trusts—that are well defined in Canadian law, to capture foreign structures not specifically addressed in the Act. Ever since the SCC's GAAR analysis in *Canada Trustco* ([2005] 2 SCR 601), the courts have been inclined to apply a purposive interpretation to all of the Act's provisions.

An interesting aspect of the CRA's two-step approach is that it appears to permit classification of an entity as a trust in one context and a corporation in another. ITTN no. 38 says that "[the CRA] cannot always reach a general position for a particular foreign entity. In certain situations, we have reached a conclusion after an analysis not only of the foreign legislation under which an entity was formed but also of the agreements like articles of incorporation and contracts between parties that governed it." If a contractual arrangement permitted a stiftung's beneficiaries to select its board of directors, would the CRA conclude that it was a corporation? If the CRA's new approach can lead to different classifications for one type of entity, practitioners will have to go beyond the foreign entity's name and delve into all related legal relationships when advising clients on its Canadian tax effects.

The TI states that a case involving the classification of an Austrian private foundation is currently before the TCC; the TI's author declined to give the case's name and indicated that the case has not been heard.

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RDTOH ON BUTTERFLY

In distributions under a butterfly reorganization (paragraph 55(3)(b)), generally each shareholder receives a pro rata share of each type of property owned by the distributing corporation immediately before the distribution. The CRA says that tax accounts or other tax-related amounts such as RDTOH are not property of the distributing corporation: RDTOH is a contingent asset, and it becomes an actual tax refund claim only when the corporation pays sufficient taxable dividends. A distributing corporation with significant investment assets that generate material investment income may have a significant RDTOH balance. CRA document 2007-0237361R3 suggests an approach that may permit an allocation of a share of the RDTOH to a departing shareholder in a single-winged butterfly.

The non-recognition of RDTOH as property represents a challenge on a single-winged butterfly. Assume that a distributing corporation (D Co) has three equal corporate shareholders, one of which, the transferee corporation (T Co), wants to leave the venture via a single-winged butterfly. T Co sets up a wholly owned subsidiary to receive its pro rata share of D Co's property and to avoid a circular computation of RDTOH. Upon the single-winged butterfly, T Co's shares in D Co are redeemed or repurchased, and T Co is deemed to receive a taxable dividend, triggering a refund of RDTOH to D Co and a corresponding part IV tax liability to T Co, but T Co cannot shelter its part IV tax liability with any of D Co's RDTOH refund.

In the example given in the ruling, on the day before the butterfly transactions, D Co increased the PUC of its common shares held by its three corporate shareholders in order to move D Co's RDTOH balance on a proportionate basis to its shareholders. The resulting deemed dividend crystallized D Co's RDTOH into property, a receivable, part of which can be distributed by D Co to T Co. In proceeding by way of a PUC increase, there is no "transfer" and thus no "distribution" to which section 55 can apply. A dividend paid by D Co on its common shares to clear its RDTOH account would be a transfer that the CRA would view as being part of the butterfly reorganization; it is not certain whether such a dividend would be a "distribution" as defined in subsection 55(1).

A related issue addressed in the ruling arises because part IV tax and dividend refunds are computed in respect of RDTOH at year-end: any RDTOH generated after the PUC increase and before the year-end creates a potential problem. The ruling states that the acquisition of control of D Co by the group composed of its remaining shareholders (subsection 256(9)) triggers a year-end between the PUC increase and the butterfly transactions. D Co chose a new year-end at the end of the day of the butterfly transactions, so that no material aggregate investment income was generated during that one-day taxation year in which the butterfly occurred, thus minimizing any possibility that RDTOH would be generated after the PUC increase.

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Luxembourg Tax Proposals

To optimize their global taxation, many multinational companies use foreign holding companies in jurisdictions such as Luxembourg, which has a favourable holding and financing company regime. In May 2008, Luxembourg proposed to abolish its 0.5 percent capital duty; in October 2008, draft bills were introduced that include measures designed to further enhance Luxembourg as the preferred jurisdiction for investment. The legislation is expected to be enacted by, and effective in, 2009.

The main October proposals include abolition of withholding tax on dividends paid to a recipient resident in a country with a tax treaty with Luxembourg; reformation of the Chamber of Commerce contribution; reduction of the corporate income tax rate; exemption from the net worth tax for income from intellectual property (IP) rights; introduction of principles relating to fair value accounting; and tax reductions and other incentives for individuals.

■ Dividends distributed to a company resident in a treaty country are currently subject to a reduced treaty withholding tax rate (generally 5 percent). A number of planning techniques can mitigate Luxembourg withholding tax, including the ownership of shares of a Luxembourg company through a Luxembourg branch of a company resident in a treaty country. The proposals eliminate withholding tax on dividends paid to an investor corporation that is resident in a treaty country and has at least 10 percent of share ownership of the Luxembourg company or at least a €1.2 million investment (or commitment) in the Luxembourg company for a 12-month period.

■ A number of court cases challenged the legality of the Chamber of Commerce annual contribution, which applies to all Luxembourg taxpayers that carry on commercial, financial, or industrial activities in Luxembourg. The contribution equals 0.2 to 0.025 percent of the taxpayer's taxable profits. The proposals set a ceiling of €3,000 for companies principally carrying on holding activities in Luxembourg; for losscos, a minimum contribution of €200 applies to a tax-transparent entity owned by individuals (€500 for entities subject to corporate income tax). The proposals clarify that the contribution requirement applies to any commercial company that has a statutory seat or a central place of administration in Luxembourg and to any Luxembourg branch of a foreign company that carries out commercial, industrial, or financial activities.

■ Following an earlier announcement this year, the corporate income tax rate is proposed to fall gradually from 22 percent to 21 percent. The aggregate effective corporate income tax and municipal business tax rate becomes 28.59 percent and ultimately 25.5 percent.

■ Changes made in 2007 to the partial exemption of income derived from IP rights are clarified. Currently, 80 percent of income and capital gains derived from specific IP rights are exempt. The proposals expand the scope of the exemption to include domain names, and IP rights are exempted from the 0.5 percent net worth tax calculation based on a company's net asset value. Specific guidelines on this "IP box regime" are expected to be issued in the near future.

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Government Spending

All levels of government in Canada have shown remarkable fiscal stability and have recorded surpluses over the past five years. Data from Statistics Canada's financial management compilations indicate that spending was held below the growth of the economy as a whole, measured as a percentage of gross domestic product. Revenues, on the other hand, showed strong growth despite tax rate reductions at the federal and provincial levels.

As shown in the table, spending by all levels of government, excluding transfers between levels, dropped from 39.1 percent of GDP in 2004 to 37.4 percent in 2008, according to current estimates. There is no clear evidence that the majority of public sector spending is directly related to economic growth during periods of prosperity. A brief review of the performance of certain key spending categories, accounting for two-thirds of the total, confirms this. Health-care spending stayed roughly constant at 7.5 percent or less over the period. As a result, it increased to over 20 percent of all spending in 2008. Education spending moved slightly in the other direction, dropping from 6.1 percent of GDP in 2004 to 5.9 percent in 2008. Social services also dropped from 10.0 percent to 9.6 percent in the same period. Debt charges fell from 4.1 percent of GDP in 2004 to 3.1 percent in 2008.

The fact that total spending fell as a percentage of GDP indicates that inflation and population growth increased more slowly than GDP over the period. Because tax collections followed economic performance, the inevitable result was a continuing and often growing surplus.

What will happen if economic growth slows? Revenues, particularly tax revenues, will grow more slowly, but

All Government Spending as a Percentage of GDP, 2004 to 2008

	2004	2005	2006	2007	2008
Total spending	39.1	37.8	37.4	37.5	37.4
Health	7.4	7.3	7.2	7.4	7.5
Education	6.1	6.0	6.0	6.0	5.9
Social services	10.0	9.7	9.6	9.6	9.6
Debt charges	4.1	3.7	3.4	3.3	3.1

spending will not. Health-care spending, for example, is determined by the number of citizens needing services and the inflation inherent in those expenditures. With increased unemployment, spending on social services will rise faster than GDP. The pressure on spending and the faltering revenue performance will reduce surpluses and create deficits for some levels of government, unless fiscal policy at the federal and provincial levels changes drastically.

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Eligible Dividend Designation

Owner-managers determining their optimal salary-dividend mix (See "Owner-Manager: Year-End Tips," *Canadian Tax Highlights*, October 2008) may choose to receive eligible dividends, which are subject to lower personal tax rates. A CCPC with a sufficient year-end balance in its general-rate income pool can pay eligible dividends, but failure to designate the dividend properly can be costly.

The corporation must notify each of the dividend's beneficiaries—even those who, like non-resident and non-taxable shareholders, cannot benefit from the enhanced dividend tax credit—that the dividend is an eligible dividend for tax purposes. The notification must be in writing and made when the eligible dividend is paid. No prescribed forms or documents need be filed with the CRA or provincial tax authorities. The CRA has confirmed that a valid notification includes a letter to the shareholders that identifies the eligible dividend, a notation on the dividend cheque stubs, or a reference in the corporate minutes (if all shareholders are directors).

It has become common practice for a non-public corporation to prepare a separate formal notice informing its shareholders of the eligible dividend designation. The CRA has provided administrative relief for public corporations, which would otherwise bear the burden of a notification process involving hundreds or thousands of shareholders: posting a notice on the corporation's Web site or in shareholder communications is an acceptable designation method. The notice can simply state that all dividends paid are eligible dividends unless otherwise indicated.

Eligible dividend designations cannot be late, and once made cannot be cancelled or amended. As a result, the notice to the shareholder must clearly establish that its delivery was simultaneous with the dividend payment: the issuance of a letter to a shareholder referring to a dividend paid earlier the same day is not likely to meet the stringent requirements. The designation must also cover the whole dividend amount, except in the 2006 taxation year, to which special administrative relief applied. Thus, a corporation cannot designate only a portion of a dividend as an eligible dividend.

Although the rules regarding designation of dividends are relatively new and generally straightforward, some concerns have already been identified. In the context of private corporations, the CRA has indicated that the designation should specify the amount of the eligible dividend; defining the amount of a dividend by a formula should be avoided. Because of the timing requirement discussed above, the CRA says that the excess portion of a capital dividend—deemed to be a taxable dividend following an election to avoid part III tax—cannot be designated as an eligible dividend. In addition, because a public corporation's subsidiary does not benefit from the administrative relief for a public corporation, any dividend paid to the parent and not properly designated is considered a non-eligible dividend that increases the recipient's low-rate income pool.

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2007 Round Table Bonus

The CRA Round Table published in the Canadian Tax Foundation's 2007 Annual Conference Report includes 11 additional questions not discussed at the conference. Two of those questions are highlighted below.

Voting non-participating share value. Asked about its position on the value of a private company that is attributable to voting non-participating shares, the CRA responded that it did not have an established position on valuing different types of property. *Information Circular* 89-3 ("Policy Statement on Business Equity Valuations," August 25, 1989) outlines the valuation principles and policies that the CRA generally considers and follows with respect to the valuation of securities and intangible property of closely held corporations for income tax purposes. The IC discusses, in general terms, the approaches applicable to closely held or private corporations, recognizing that the facts and circumstances of each case will determine FMV. The valuator must use reasonable judgment and objectivity in the selection and analysis of the relevant facts of each case. Therefore, the CRA does not intend to write a policy or state a formal position regarding this issue.

When the CRA values different classes of shares in a company, it generally determines the en bloc FMV and then allocates it to each class of shares in isolation. The FMV of each class must be determined on its own merits, according to each class's rights and restrictions. In other words, the CRA considers what a hypothetical arm's-length purchaser would be willing to pay for a particular class of shares on the basis of the rights, restrictions, and conditions that ultimately affect the economic benefits derived from ownership. Thus, many factors may influence the value of voting control.

The CRA is not aware of any case law that deals specifically with the allocation of value among various classes of shares where voting rights are separated from participation. In the CRA's opinion, a hypothetical purchaser would be willing to pay some amount for the voting control of a company, but it is difficult to ascertain what a pure voting right would be worth. However, the CRA said that the answer depends on the facts and circumstances of each case.

Employee stock option deduction. The introduction to this question stated that royalty and income trusts are generally expected to make regular (monthly or quarterly) distributions to unitholders; theoretically, the value of a trust unit should accordingly decrease by the distributed amount, as should an option to acquire a unit. However, because of market influences, there may be no direct evidence of a visible market price decline that coincides with a distribution and a reduction in the exercise price. In such a case, what indicia of a reduced FMV will the CRA accept to justify a reduced exercise price under proposed subsections 110(1.7) and (1.8) for the purposes of the paragraph 110(1)(d) deduction?

The CRA responded that the proposed legislation is intended to ensure that an employee who exercises an employee security option is entitled to a deduction where the exercise price payable by the employee under the option has been reduced and certain conditions are met. Specifically, the deduction applies (1) if the employee would not otherwise have qualified for the deduction if the option had been exercised immediately after the reduction in the exercise price had been made, and (2) if the exchange-of-options rule in subsection 7(1.4) would be satisfied, at the time of the exercise, had the reduction in the exercise price been effected through an exchange of options.

The exchange-of-options rule contemplates an exchange of old options for new and generally requires the determination of the FMV of the underlying securities both immediately before and after the exchange. Decline in FMV is a matter of professional opinion, determined by undertaking appropriate due diligence procedures in accordance with generally accepted valuation principles and by performing the appropriate calculations leading to a valuation opinion. These due diligence procedures are determined case by case. Therefore, the observable facts of each case should be considered when determining whether a distribution has negatively affected the units' FMV in order to determine whether an exercise price reduction is warranted.

The Headquarters Valuation Section of the CRA offers a pre-valuation inquiry service to provide comfort on a proposed transaction regarding the appropriate scope of review, the methodology to employ, the elements to consider, and the procedures to follow in a valuation assignment. These services do not include expressing any kind of opinion on the valuation conclusion itself, or providing commentary on the valuation or appraisal conclusions prepared by a taxpayer.

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CONTIGUOUS COUNTRY ELECTION REVOKED

A USco that owns or controls, directly or indirectly, 100 percent of a corporation that is organized under the laws of a contiguous country such as Canada and is maintained solely for the purpose of complying with that country's laws on title and operation of property may elect to treat that forco as a USco for federal income tax purposes (Code section 1504(d)). This election allows the forco to join its owner in the filing of a US consolidated income tax return. Revocation of the election can trigger tax consequences.

On the facts in PLR 200835020 (August 29, 2008), the common parent of a US affiliated corporate group that filed a consolidated federal income tax return had elected to treat one of its foreign subs (Forsub 1) as a domestic corporation that is viewed as conducting 100 percent of its activity through a non-US branch. Parentco now seeks to revoke that election, which would result in a constructive transfer by Forsub 1 (from the foreign branch of a deemed USco) of all of its assets and liabilities to a foreign corporation (Forsub 2). A section 1504(d) election revocation is unusual: revocation results in a member's leaving a US consolidated group, with the potential for negative tax consequences such as the triggering of deferred intercompany gains and excess loss accounts.

The IRS granted Parentco permission to revoke its election to treat Forsub 1 as a domestic corporation, and ruled that the resulting deemed transfer of Forsub 1's assets to Forsub 2 would generally be treated as a tax-free reorganization under section 368(a)(1)(F). However, the IRS noted that the revocation triggers a gain or loss under section 987 (the branch functional currency translation rules) and recapture under section 904(f) (relating to prior years' branch net losses and their interaction with foreign tax credits allowed), and it also requires the recapture of any dual consolidated losses incurred by the branch.

On the basis of the representations made, the IRS ruled that Forsub 1 ceases to be a member of Parentco's group at the end of the day on which the election is revoked, and its tax year ends on that date because the revocation caused a domestic-to-foreign section 368(a)(1)(F) reorganization. Normally, outside of the consolidated return context, the tax year of a corporation undergoing an F reorganization does not terminate. Forsub 2's tax year closes when Forsub 1's tax year would have closed but for the revocation.

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US Inversion Concerns

In a number of transactions in the late 1990s and early 2000s, USCos (or their assets) became subsidiaries of (or the businesses were taken over by) foreign shell corporations (forcos). These inversions may yield US tax benefits by removing the foreign operations from the US taxing jurisdiction when the forco assumes ownership of the foreign business or USco from the former US parent. The potential for abuse may not be present when the forco acquiror is in a high-tax jurisdiction such as Canada, but the transaction is often captured by the breadth of the inversion rules, especially if the forco is a Canadian shell company.

In a typical shell corporation transaction, a Canco acquires a US business operation. The Canco raises funds from its founders and the public for use in the acquisition. The USco shareholders usually exchange their shares for Canco shares, an exchange squarely within the US inversion rules' framework. In recent months, there has been an increase in Canadian shell companies interested in acquiring US businesses; apparently the participants are often unaware of the impact of the US inversion rules.

An inversion has occurred if the forco acquiror meets the following conditions: (1) the forco acquires "substantially all" the properties of the US business (either ownership interests or assets); (2) after the acquisition, the "expanded affiliated group," including the forco, does not have substantial business activities in the foreign country where the forco was organized; and (3) after the acquisition, at least 60 percent of the forco's shares (determined by vote or value, and subject to special rules) are held by former owners of the US business. Although an inversion occurs at a 60 percent threshold, ownership of 80 percent or more of the forco's shares triggers more extreme tax consequences.

The first condition is usually met if all of the target is acquired. In the case of an acquisition of a USco by a Canadian shell company, the second condition is generally met because the shell company does not have substantial business activities in Canada. The third condition is more difficult to ascertain: one must determine how much of the forco's stock, determined by vote or value, is held by the former USco shareholders after the acquisition. This condition is not as straightforward as it may seem, because any stock sold in a public offering related to the US business's acquisition is generally disregarded in testing for the 60 percent ownership threshold that triggers an inversion. For example, the IRS may take the position that there has in fact been a 100 percent inversion if a Canco acquires all of a USco's stock and thereafter the former shareholders are acquiring Canco's only shareholders (other than shareholders via a public offering). The situation is less clear if the USco was a public company and issued shares to founders or in a private placement before or around the same time as the acquisition. The inversion rules also include a two-year lookback and lookforward provision under which certain transactions in that period are treated as undertaken pursuant to a plan or related series of transactions; a transaction outside the four-year period may still result in an inversion because the four-year period is not exhaustive.

Even if the former USco shareholders receive only exchangeable shares in a newly formed US subsidiary of the Canco acquiror and not shares in itself, they will likely be treated as having exercised the rights under the exchangeable shares and thus will be considered owners of the Canco shares for the purposes of inversion testing.

If the inversion rules deem the former USco shareholders to acquire between 60 and 80 percent (exclusive) of the acquiror, it continues to be treated as a forco for US tax purposes, but any applicable corporate-level "toll charges" (such as recognition of a gain in appreciated assets) for establishing the inverted structure cannot be offset by tax attributes such as net operating losses or foreign tax credits. If the inversion involves the acquisition of USco shares (not assets), there may not be any immediate tax consequences, because there is no corporate-level asset transaction against which those tax attributes could be used. The IRS has not issued any guidance on this point.

In an inversion in which the former USco shareholders acquire at least an 80 percent interest in the forco, the forco is treated as a USco for all US tax purposes. The forco is thus fully taxable in the United States on its worldwide income; presumably any foreign tax is not creditable against US tax if some of the forco's income is deemed to be US-source. Moreover, dividends from the forco to its non-US shareholders are treated as dividends paid by a USco to non-resident shareholders and thus are likely subject to US withholding tax. For example, a Canco acquiror must withhold US withholding tax on dividends paid to non-US shareholders. Presumably Canada would view the dividends as Canadian-source and thus would not allow a foreign tax credit to the non-US shareholders for the US withholding tax. Similarly, the US shareholders are subject to Canadian withholding tax on dividends, which the IRS would likely consider to be US-source because they are paid by a USco; thus, it is likely that the IRS would not allow the US shareholders any foreign tax credit for US tax purposes.

At the corporate level, the inverted entity may also face double taxation due to a mismatch of foreign tax credits, and at the very least must juggle disparate rules in the United States and the foreign jurisdiction where it resides. Moreover, non-US shareholders may also face US estate tax on death, because the stock of the forco is a US-situs asset for US estate tax purposes. Therefore, upon the death of a Canadian shareholder of an inverted company, his or her estate is exposed to US estate tax that is based on the value at that time of the Canadian-deemed-US shares.

A US business owner may contemplate becoming a public company listed on a Canadian or other foreign stock exchange in a transaction that involves being acquired by a forco, swapping its ownership interests in a USco tax-free for a similar interest in the forco, and achieving access to a public marketplace. Although US tax rules such as Code section 367 generally impose current US tax on a US shareholder who exchanges USco shares for forco shares, a swap that amounts to an inversion does not trigger gain recognition. That result is initially beneficial for the former USco shareholders, but in the long run it may result in double taxation on dividends and on the sale of the business. Moreover, non-US owners of the forco may suffer similar results under the US inversion rules.

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Joint Committee: SIFT Legislation

The CBA-CICA Joint Committee on Taxation released a 12-page response to the conversion rules for specified investment flowthrough (SIFT) entities and the treatment of foreign-currency-denominated debt on an acquisition of control, both included in July 14, 2008 draft legislation. Highlights of the joint committee's recommendations follow.

SIFT partnership. The joint committee is concerned about whether the definition of a "security" is broad enough to cover lower-tier trusts and partnerships, such as a partnership whose majority interest partner is a publicly listed corporation. The joint committee says that the definition of "excluded subsidiary entity" does not sufficiently address this concern, and it recommends that the proposed definition be renamed "excluded subsidiary trust"; a new definition should be created for an "excluded subsidiary partnership" to alleviate restrictions on a partnership that is structured so that its majority interest is held by a public corporation and other partners are individuals or non-residents.

Issues affecting securitization trusts. A securitization trust has no publicly traded equity, and its only beneficiaries are charitable organizations. The joint committee recommends that the proposed definition of "publicly traded liability" be amended to include "a right which may reasonably be considered to replicate a return on, or the value of, a security of the entity." The current definition may not apply adequately in a tiered structure.

In addition, the joint committee recommends that the test of 90 percent ownership by non-affiliates in the proposed definition of "unaffiliated publicly traded liability" be extended to include a trust's publicly traded liabilities that are held by a majority interest beneficiary (or a member of a group of such beneficiaries) that is exempt from tax. This change is intended to provide certainty regarding the status of securitization trusts.

The joint committee also recommends an amendment to the definition of "contributor," which includes a person who has made a loan to the trust unless the person is at arm's length with the trust and the loan was made at a reasonable rate of interest. The definition should exclude a debt (such as commercial paper) issued at a reasonable yield when expressed as a rate of interest. This change should prevent the characterization of a lender as a contributor with the potential affiliation of two securitization trusts to whom the same lender issued debt for which a low or no interest rate was stipulated.

Tax consequences of conversion. The draft legislation allows for a SIFT entity conversion into a corporation by one of two methods: (1) a unit-for-share rollover followed by a windup of the acquired SIFT entity into the acquiror corporation, or (2) a distribution of a corporation's shares to SIFT unitholders on the winding up of the SIFT entity and redemption of its units. The joint committee believes that the tax consequences should be the same for both conversion methods, and it recommends adjustments to the draft legislation to ensure that the methods are treated consistently. Specifically, (1) withholding tax should not apply to a redemption of a trust's units held by a non-resident; (2) the tax attributes of a trust should be transferable to the continuing corporation under either conversion method (not just the unit-for-share exchange method); (3) as in the case of a unit-for-share exchange, a share distribution should allow for a rollover for holders of the debt obligations of the converting SIFT entity that are assumed by the taxable Canadian corporation; and (4) debt forgiveness relief should be provided if a corporation's debt is capitalized or extinguished under a share distribution.

Rollover for unit-for-share exchange. The joint committee recommends specific changes to the proposed rules for rollovers on SIFT unit-for-share exchanges so that the rules will more closely align with the existing share-for-share exchange rules.

Other matters. The joint committee's submission also addresses listed SIFT partnership units and section 116 excluded-property rules, SIFT trust windup events and tax-deferred distribution, capital gains on the windup of a corporation or trust, and acquisition of control and losses. The submission also deals with matters of foreign currency debt on acquisition of control, such as debt obligations held on account of income, multiple advances under a single debt obligation, and functional currency reporting.

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A Dream but No REOP

Live your dream, but don't expect to deduct it: the case of *Graham* (2008 TCC 580) is a cautionary tale for baby boomers on the brink of retirement and a second career along a path not previously taken. Unfortunately, the taxpayer, a would-be rock musician, failed to establish that his part-time activity constituted a business pursued for profit in a commercial manner.

Eddie Graham was a full-time employee at a major Canadian bank, but he had once been in a "large and successful" band that generated losses in most years and very modest profits in a few years. The band broke up. After a few years, Eddie decided to resume his career as a solo artist and disc jockey. He took care of all the formalities necessary to establish a business (registration, business licence, separate phone, and business cards); he apparently owned professional-quality music equipment; he was a capable and qualified performer; and he rehearsed regularly. However, he apparently did not pay much attention to the financial side of his musical career: he did not keep track of profits and losses, he did not know how often he needed to perform to break even financially—"he said he did not look at his activities that way"—and he did not appear to keep track of his expenses. Nevertheless, he claimed annual business losses averaging a little over $10,000 for the period 2003-2005, although he could produce annual receipts for only about $2,300. His testimony on a number of issues relating to his musical adventures seemed inconsistent and unsatisfying. The taxpayer represented himself at the TCC.

The court had to decide whether the taxpayer's musical activities constituted a business pursued for profit in a commercial manner or whether it was a personal endeavour in the nature of a hobby. This approach was mandated by the SCC decision in *Stewart* (2002 DTC 6969), which highlighted the criteria and the badges of trade to be considered. The approach requires a two-step analysis in determining whether the taxpayer's activities are a source of income for tax purposes. First, is the activity undertaken solely for profit, or is it a personal endeavour? If there is no personal element and the activity is clearly commercial (which was the case in *Stewart*), then there is no need for further inquiry. Second, if the activity contains a personal element, is it carried on in a commercial manner so as to constitute a potential source of income?

The taxpayer's sloppy bookkeeping and inconsistent explanations were troubling. He gave inconsistent statements to the court and the CRA about whether he was carrying on a music business in several of the years in question, and he said that he gave up his musical activities when his losses were challenged by the CRA. Although the taxpayer claimed that a broken finger and the general damage to the hospitality industry as a result of the SARS outbreak affected his business, he did not adapt his marketing and business strategy. Even when the taxpayer was a member of the band, the band did not make large or frequent profits. The expensive equipment appeared to have been purchased for the taxpayer's band work long before his solo career was launched. An explanation of why the accountant might have claimed a large number of unsubstantiated expenses was not forthcoming. Moreover, "[i]t is one thing not to have a formal written business plan in cases such as these; it is another to maintain one both believed and intended the pursuits to be profitable without ever considering the revenues needed to cover the expenses being incurred." Accordingly, the TCC disallowed all claims for business losses on the basis that there was no business pursued by the taxpayer in a commercial manner.

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Loss Utilization

The global stock market meltdown has created a renewed interest in loss utilization as taxpayers consider ways to generate some offsetting tax benefits before the taxation year-end. A few planning tips and traps are discussed below.

■ The stop-loss rules prevent a taxpayer from triggering a tax loss via a property's disposition temporarily or to an affiliated person. A person may be related and affiliated (such as an individual and his spouse or common-law partner) or related but not affiliated (such as a parent and his child or his siblings).

■ A loss is denied if non-depreciable property is transferred by a corporation, partnership, or trust and, within 30 days before or after the transfer, the transferor or an affiliated person acquires the same or identical property or a right thereto. It may be possible to crystallize a loss by transferring the property from a family investment company owned by a parent to an adult child, who must pay for the shares to avoid a shareholder benefit or loan problem.

■ A superficial loss arises when a capital property is disposed of and, within the 30 days before or after the disposition, the transferor or an affiliate acquired the same or identical property or a right to acquire such property. The denied loss is added to the substituted property's ACB. A superficial loss does not arise on a disposition to a parent, sibling, a child, or a trust in which the transferor and his spouse are not discretionary beneficiaries. Moreover, in TI 2003-0017075 (May 27, 2003), a taxpayer who did not have offsettable capital gains transferred shares with an accrued loss to his wife for the purpose of her claiming the superficial loss against her capital gains. The wife used her own funds to acquire the shares either from the taxpayer or on the open market, and she then sold them after the original 61-day period elapsed. The CRA agreed that the taxpayer had effectively transferred his unrealized capital loss to his wife. In TI 2001-0080385 (November 22, 2001), the CRA said that the superficial loss rules applied where an investor disposed of units of one index fund (such as the TD TSE 300 Index Fund) and purchased units of another index fund (such as the CIBC TSE 300 Index Fund), because the units of both funds are identical properties.

■ A rollover is denied if it is a part of a series of transactions and it may reasonably be considered that one of the main purposes was to benefit from a deduction, expense, or exemption of another person (generally other than a pre-series affiliate) on a subsequent disposition for which arrangements are made before three years expire (subsection 69(11)). The CRA can assess tax, penalties, and interest outside the normal limitation period.

Assume that parent, a 50 percent shareholder in a capital lossco, plans to buy his child's 50 percent share interest so that he can roll appreciated shares into the lossco to shelter the gain on their immediate sale. The transfer of the shares by the child does not adversely affect the loss carryforwards, because the parties are related before the transaction (subsection 256(7)), but the rollover is denied because the parent was not affiliated with the lossco immediately before the series.

■ A transfer to an RRSP of which the transferor or his spouse is an annuitant cannot trigger a loss for a taxpayer. TI 2003-0182755 (May 7, 2003) said that GAAR applies if a taxpayer tries to circumvent this rule by transferring the loss property to his holdco, which immediately transfers the property to the RRSP to avoid the superficial loss rules.

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FOREIGN TAX NEWS

Russia

The Russian Federal Tax Service issued further assistance to taxpayers for evaluating the risk of their businesses' being included in a tax audit. The criteria focus on the due diligence to be applied in relations with business partners: obtaining documentation confirming the powers of the counterparty's general manager and representatives and copies of their original identity documents; personal contact during discussion of delivery terms and the signing of the contracts; and obtaining information about the counterparty's physical address, storage, production area, and sales premises and its registration with the Unified State Register of Legal Entities. The order provides a template for self-reporting of due diligence deficiencies on a revised tax return, but there is no guarantee of immunity from prosecution.

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