CANADIAN TAX *Highlights*

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INDEX-LINKED DEBT

The CRA is currently reviewing its administrative position on the tax treatment of commodity- or stock-linked debt obligations. In particular, the CRA proposes to use secondary market pricing to determine the annual interest accrual to an investor. Previously, the CRA took the administrative position that annual interest accrual was not required because the maximum amount of interest payable for any given taxation year could not be determined until maturity.

In general, commodity- or stock-linked debt obligations (index notes), including principal-protected notes, do not provide a stated interest rate for any year that they are held, although some minimum rate of return may be guaranteed. An investor ultimately receives interest on maturity as a premium or bonus based on the principal amount of the debt and the increase in the relevant stock index or commodity.

If a taxpayer holds an interest in an investment contract, interest is accrued and included in the taxpayer's income on the anniversary day of the contract, even though the taxpayer may not have received any funds. Furthermore, deemed interest is accrued to a taxpayer who holds an interest in a prescribed debt obligation, which includes an obligation where the amount of interest to be paid pursuant to the obligation's terms and conditions depends on a contingency existing after the year-end. Any bonus or premium under a prescribed debt obligation is considered to be interest payable under the obligation. The deemed interest on a prescribed debt obligation is the maximum amount of interest that could be payable on that obligation.

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Index notes qualify as prescribed debt obligations because the amount of interest to be paid for any taxation year depends on a contingency existing after the year. In the past, the CRA did not require any annual interest accrual on such notes: the maximum amount of interest payable for any given taxation year cannot be determined until the notes' maturity, and thus the investor included interest in its income only at maturity. Where there is a secondary market for the sale of index notes before maturity by an affiliate of the issuer, the CRA may consider that the pricing on that secondary market can be used as the value of the notes before maturity to determine the investor's annual interest accrual. The CRA's review of accruals for index notes is reflected in the risk section of an information sheet for one financial institution's note issue:

> Changes in tax laws, regulations or administrative practices could have a material adverse effect on the Note Program and a Holder's investment in Deposit Notes including changes, if any, as a result of a current review by the CRA of its administrative practice in relation to the relevance of a secondary market for debt obligations such as the Deposit Notes in determining whether there is a deemed accrual of interest on such debt obligations.

We understand that the CRA is awaiting input from Justice before publishing its proposed interpretation.

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US INCOME TAX OVERPAYMENTS

The recent economic downturn has unexpectedly put US companies in a loss position or caused their taxable income to drop significantly. Many corporations calculated their 2008 estimated income tax payments on the basis of a healthier 2007 financial picture, and now find that they have overpaid their 2008 estimated income taxes. The first step for these companies is to stop making further overpayments; the next step is less straightforward.

Typically, a US corporation can recoup estimated tax overpayments in one of two ways: (1) file for a quick refund on form 4466 after the tax year-end or (2) request a refund when the tax return is filed (on September 15, 2009, because most March 15 filers file on the extended due date). In either case, the corporation must wait several months to recoup the cash it needs now. The IRS has no formal process for redirecting estimated income tax overpayments, but it has occasionally granted a request to transfer portions of estimated income tax payments to cover other tax liabilities, such as current payroll-related liabilities. Redirecting overpayments allows a company to immediately cover those other liabilities, and thus effectively acts as a refund, but without any delay. A company that otherwise would have required short-term financing to cover other tax liabilities is spared the cost of borrowing.

Redirection is not a routine event, and the IRS is not required to comply with a company's request. When requesting the IRS to redirect some of its estimated tax overpayments, a company must ensure that it has correctly re-estimated its 2008 income tax liability in order to avoid redirecting too much of the tax that it originally estimated and paid. A company is subject to penalties if it ends up with underpaid 2008 estimated income tax because it redirected to other liabilities too much of what was originally an overpayment.

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Tax-Free Savings Accounts

Effective after 2008, the new tax-free savings account (TFSA) program offers taxpayers an opportunity to earn a significant amount of investment income tax-free. Contributions to this new tax-assisted savings account are not tax-deductible, but investment income and capital gains earned on investments in the account are tax-free.

A taxpayer can contribute up to $5,000 per year to a TFSA starting in 2009, as long as he or she is 18 or older and resident in Canada. The $5,000 annual contribution limit is indexed to inflation in $500 increments, starting in 2010, and unused contribution room can be carried forward indefinitely. A taxpayer can hold more than one TFSA, subject to contribution limits. A TFSA includes an attractive feature for a family in which one spouse has more income than the other: the normal income attribution rules do not apply if the higher-income taxpayer gives funds to his or her spouse to establish a TFSA in the spouse's name.

As a result, with careful planning, spouses should be able to avoid paying tax on the income they earn on their first $10,000 of savings each year, starting in 2009, and on all the accumulated capital and income sitting in their TFSAs in subsequent years. Withdrawals from a TFSA are tax-free and can be made at any time. When a withdrawal is made, the whole amount withdrawn—including what was originally principal and accumulated income and gains—is added to the TFSA contribution room for the next year and can be recontributed in that or any future year.

Assume that a taxpayer contributes $5,000 in January 2009 and withdraws $4,000 in June 2009, leaving $1,000 in the TFSA. The taxpayer cannot recontribute the $4,000 in 2009, but he or she can make a recontribution in that amount in 2010, along with the new $5,000 contribution limit for 2010, for a total of $9,000. Withdrawals and recontributions of investment income earned in a TFSA work the same way. Assume that a taxpayer's $5,000 investment in 2009 earns $250 and the $5,250 is withdrawn in December 2009: the entire $5,250 can be recontributed in 2010, along with the new $5,000 contribution limit for 2010, for a total $10,250 contribution. Similarly, assume that a taxpayer invests his or her $5,000 TFSA contribution in the stock market, and this share investment appreciates rapidly to $20,000. The taxpayer can sell the shares and realize the $15,000 tax-free capital gain in the TFSA, and withdraw the $20,000 cash proceeds tax-free. The full $20,000 can be recontributed to the TFSA, in addition to any other unused and current TFSA contribution room, in the following year or later. As a result, a taxpayer's potential contribution to a TFSA can be significantly more than $5,000 annually, and thus earn more tax-free investment income. However, just as in the case of an RRSP, overcontributions are heavily penalized: a penalty of 1 percent of the excess contribution per month applies until the overcontribution is withdrawn. In addition, when choosing a particular TFSA, the taxpayer should consider whether the TFSA account has any annual administrative fee and any withdrawal fees.

TFSAs are generally allowed to hold the same qualified investments as RRSPs, such as cash, guaranteed investment certificates, term deposits, mutual funds, government and corporate bonds, publicly traded securities, and (in certain cases) shares of small business corporations. A taxpayer's TFSA cannot hold investments in non-arm's-length entities, which generally means companies in which either individually or collectively the taxpayer, his or her spouse, and other related persons own 10 percent or more of the shares. As with an RRSP, interest on funds borrowed and fees incurred to invest in a TFSA are not tax-deductible; but unlike an RRSP, a TFSA can be used as collateral for a loan. When choosing investments to hold in a TFSA, a taxpayer should remember that capital losses realized in a TFSA cannot be claimed against capital gains realized outside the TFSA account.

Various rules apply to special situations. For example, on the death of a TFSA holder, investment income earned in the TFSA account is no longer tax-exempt. (Special provisions apply if there is a surviving spouse.) A TFSA holder who becomes a non-resident of Canada can maintain his or her existing TFSAs. The investment income and withdrawals remain exempt from Canadian tax, but no new contribution room accrues as long as the account holder is a non-resident. A non-resident should also consider any foreign tax implications of TFSA income and withdrawals.

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EMPLOYMENT INSURANCE

The finance minister's economic and fiscal statement of November 2008 illustrates the strength of the employment insurance rate structure. As summarized in the table, EI revenues are expected to continue to cover all benefits paid out, even during an expected rise in the unemployment rate, and still show a surplus.

From 2007-8 to 2008-9, EI revenues are expected to decline by $58 million and payouts to rise by $1,117 million, to produce a surplus of $1,085 million. A similar increase in benefits in the following year will be partially offset by an increase in revenues of $850 million, reducing the surplus to $775 million. In subsequent years, payouts will grow more slowly so that the account will continue to record surpluses of more than $1 billion annually.

The original design of Canada's EI system assumed that rates would be set so that income would approximately equal outgo over the business cycle. The separation of the operations of the system from ordinary budgetary accounts reinforced this expectation; but over time the EI account was usually in a deficit, and the artifice of subsidizing the account became obvious. To simplify the program's accountability, the EI account was folded into budgetary accounts, with the account deficit forming part of the budgetary deficit. The recent performance of the EI program has changed, with consistent surpluses offsetting deficits in other parts of the budgetary accounts and now augmenting surpluses. If a significant economic decline fails to wipe out the EI surplus, the importance of EI premiums to the government's fiscal position is clear.

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Employment Insurance Account Projections, 2007-8 to 2013-14

Fiscal year	Premiums	Payouts	Balance
		millions of dollars	
2007-8 actual	16,558	14,298	2,260
2008-9	16,500	15,415	1,085
2009-10	17,350	16,575	775
2010-11	17,675	16,335	1,340
2011-12	17,670	16,325	1,345
2012-13	18,110	16,720	1,390
2013-14	18,690	17,250	1,440

A DREAM AND REOP?

Kaegi (2008 TCC 566) is good news for musicians, composers, and their backers and managers who deduct expenses along the road in pursuit of a dream. *Kaegi* concluded that a business existed, contrary to the analysis in *Graham* (2008 TCC 580). (See "A Dream but No REOP," *Canadian Tax Highlights*, November 2008.)

Mr. K and his wife were partners in a business venture designed to achieve musical fame and fortune, supported by a written agreement that apparently was destroyed in a house fire in 2001 and thus was not produced at trial. The spouses formally registered their partnership in 2004. Both were actively involved in the business: Ms. K was the creative artist and Mr. K was the financial and management force. The business comprised the creation, production, and distribution of Ms. K's compositions; the profit motive was to obtain royalties through the sale of CDs promoted by a major recording studio or the sale of particular songs to a major recording star. Mr. K estimated at the outset that it might take Ms. K, a singer-songwriter, 10 to 20 years to successfully launch her career. Mr. K's role was to act as her business manager and to pay all expenses, which he was to recoup from future revenues. After all expenses were fully recouped, the profits would be split 75-25 in Mr. K's favour. Mr. K claimed losses of about $200,000 over nine years. The lack of royalties and the damage done by the house fire contributed to the losses. The CRA allowed the early years' losses (commencing in 1997) but denied losses for the years 2003-2005, saying that Mr. K was motivated by a desire to keep his wife happy and that no business existed.

Mr. K managed his wife's career in a systematic, businesslike manner and, in particular, kept sufficient documentary evidence that he did so. He did his research, contacted all the right people, engaged professional promoters, produced CDs, contacted radio stations, created a Web site, advertised, prepared promotional material, and, in short, did much of what a business manager should do for his artist. Despite his efforts, Ms. K's career did not take off, and eventually she switched musical genres from country and western to historical folk music about ships that sailed the Great Lakes. Again, Mr. K did his research on the change in musical direction and promoted the music differently, including contacting reviewers and marinas that might represent potential income sources.

Ms. K gave performances, and the spouses even had a booth on the dock in the resort area of Parry Sound. Although Ms. K's songs were given air time (supported by various playlists), sales revenues from the first two CDs and royalties were minimal over the entire nine years. Taking an "enough is enough" position, the CRA said that too much time had elapsed to consider the endeavours in 2003-2005 to be in the startup phase.

The court determined that the CRA erred in denying that a business existed when there was overwhelming evidence of commerciality; nor did the Crown seem to fully appreciate the SCC's reasoning in *Stewart* ([2002] 2 SCR 645), the only case it relied on. The approach mandated in *Stewart* for exploring whether a business exists is first to determine whether the activity is commercial or personal in nature. When asked to identify the personal, non-commercial activity, the CRA could only point to the lack of revenue. The TCC said that Mr. K was still within the 10- to 20-year time frame that he had established at the outset of the business plan; Mr. K switched gears in 2004, although he had testified that he was prepared to fund the business for only a couple of years more.

The TCC cited former Chief Justice Bowman's decisions in *Donyina* ([2001] 3 CTC 2741) and *Tramble* ([2001] 4 CTC 2160), which were sympathetic to the CRA's dilemma in determining whether artists are indeed in a business, but said that the time for starting or abandoning a business is a business judgment not to be made by the court. Those cases outlined the special nature of disputes involving musicians because the nature of the endeavour usually involves a strong personal element and typically a long time horizon for success. The TCC said that Mr. K had a business that constituted a source of income and was carried on in partnership. The Crown was precluded from belatedly raising the question of whether all the expenses were reasonable. However, the TCC asked the parties for written submissions on how a finding of partnership might affect the allocation of losses, given that Mr. K's loss was reported as a proprietor.

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Distress Preferred Shares

Relief of a company in financial distress may be achieved by issuing distress preferred shares to creditors in exchange for existing debt. Because the CRA closely monitors the issuing of such shares and because the distressed corporation is subject to strict repayment obligations, a taxpayer may be well advised to seek an advance income tax ruling beforehand.

The issuer (or a non-arm's-length corporation) must use the proceeds of issuance to finance its business carried on in Canada. A distress preferred share is issued by a Canadian-resident corporation (1) as part of a court-approved proposal or an arrangement under the Bankruptcy and Insolvency Act; (2) when (substantially) all of the issuer's assets are controlled by a receiver, receiver-manager, sequestrator, or trustee in bankruptcy; or (3) when financial difficulty causes the issuer or a non-arm's-length Canadian-resident corporation to be in default (or to be reasonably expected to default) on an arm's-length debt for which the share was issued in exchange or substitution, in whole or in substantial part, directly or indirectly.

The distressed corporation must issue the shares, except that the financial difficulty category allows the transfer of a debt to a distressed corporation's sub. The financial distress category is flexible because the shares can be issued with no actual default; however, the default must be imminent, which the CRA says means within no more than three or four months.

A distress preferred share is not subject to the term preferred share rules for up to five years post-issue, nor is it a guaranteed share, collateralized share, short-term preferred share, taxable preferred share, or dividend rental arrangement. Thus, a financial institution can deduct dividends received on distress preferred shares even though they were acquired in the ordinary course of its business. A distress preferred share issue also converts an interest obligation—which the debtor in a loss position cannot deduct—into a dividend obligation that can reduce the obligation amount and thus immediate cash outflow. A structure that reflects the issuer's reduced payments and the creditor's lower tax rates can yield the creditor a comparable after-tax return on its investment. The structure can be unwound after five years if the issuer has returned to profitability, allowing the debtor to benefit from future interest deductions on the reconverted debt.

The issuing of distress preferred shares under the financial difficulty category often involves the transfer of distressed debt to the distressed corporation's sub, which allows the debt to remain intact and to be reacquired on the shares' redemption. The CRA usually requires that a single-purpose corporation be incorporated to facilitate the financial restructuring and wound up on the shares' redemption or cancellation. The sub can borrow funds through a daylight loan to be immediately repaid from the share subscription proceeds. The parent may need to make capital contributions to fund dividends on the shares and to finance their redemption after five years. To eliminate the shares as soon as possible, the CRA says that the issuer must apply all its cash flow in excess of that required for everyday business operations.

Distress preferred shares are subject to the debt forgiveness rules if they are redeemed, acquired, or cancelled for less than face value. Direct substitution of a distress preferred share for a debt qualifies for a rollover: the debt is deemed settled for the lesser of its principal amount and the PUC increase to the share class on issuance. A distress preferred share exchanged for debt or other (non-distress preferred) shares is deemed settled for the exchanged debt's or share's FMV; debt forgiveness may follow if that FMV is less than the distress share's principal amount. If one distress preferred share is substituted for another, the PUC increase of the second class is deemed to be the amount paid for the original distress preferred share. A distress preferred share that ceases to qualify as such is deemed settled at its FMV.

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PRE-IMMIGRATION PLANNING FOR US TRANSFER TAXES

In addition to very challenging income tax issues, an individual contemplating a move to the United States will encounter an entirely new and significant transfer tax regime—for example, the maximum US estate tax rate is currently 45 percent. Planning opportunities may be lost if appropriate steps are not taken before US residence is established.

The tests for establishing US residence differ for US income tax and US transfer tax purposes. For income tax purposes, with some exceptions, a person is a US resident if he has a permanent resident visa (green card), satisfies the "substantial presence" test, or makes a first-year election under Code section 7701(b)(1)(A). For the purposes of the US transfer tax (gift, estate, and generation-skipping transfer tax), "residence" means "domicile," which is determined by considering multiple factors, including (1) the time the person spent in the United States; (2) the value of his US residence; (3) the location of his "near and dear" items; (4) his affiliations with clubs, churches, and other organizations; and (5) his visa status. Often, no one factor is determinative.

Unlike a US resident, who is subject to transfer tax on transfers of any assets, a non-resident alien (NRA) is subject to US gift tax only on transfers of US-situs assets, which, for gift tax purposes, means real or tangible personal property situated in the United States at the time of the transfer. A gift of intangible property by an NRA is not subject to US gift tax. The generation-skipping transfer tax applies to taxable transfers that skip a generation (for example, a gift from an individual to his grandchild), unless US gift tax does not apply. Like the gift tax, US estate tax applies only to US-situs assets, but the definition is broader in this context: not all intangible property is exempt, and thus a USco's shares and the debt obligations of a US person, the United States, a state, or any political subdivision (with certain narrow exceptions) are deemed to have a US situs. Bank deposits are not deemed to have a US situs. Thus, an NRA has a window of opportunity before immigration to benefit from the transfer tax rules for NRAs.

An NRA can use various strategies to minimize US transfer taxes before becoming a US resident.

- An outright gift of non-US-situs assets may be attractive in its simplicity, but it may not be practical if, for example, the intended donee is a minor. Outright gifts to adult children or other donees have little downside from a planning perspective.
- An individual may create an irrevocable trust funded with assets in excess of what he thinks necessary for his personal needs and comforts. The settlor cannot be a beneficiary or hold any strings that would make the gift incomplete for gift tax purposes or cause the assets' inclusion in his estate under Code sections 2035 to 2038. The trust may be a grantor or non-grantor trust, foreign or domestic. From an income tax perspective, the benefits of a trust are limited, and thus professional tax advice is critical before a trust is settled; however, the gift, estate, and generation-skipping transfer tax benefits can be substantial.
- If, before immigration, an individual is a settlor, beneficiary, or fiduciary of a trust, he should consider renouncing any powers that may have unintended tax consequences. For example, if the individual has the right to remove a trustee and appoint any substitute, it is advisable to amend the trust instrument to require that the substitute be an independent trustee so that the trustee's powers are not attributed to the individual. If this change is made before the individual becomes a US resident, there should be no transfer tax consequences related to the amendment or disclaimer. Powers of appointment and beneficial interests should also be examined to minimize or avoid the inclusion of trust assets in the individual's estate for US estate tax purposes.

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SPOUSAL TRANSFER FOR VALUE

Many Canadians will react to the threat of tough economic times by seeking creditor protection for their most valuable asset—the matrimonial home. A spousal transfer of an interest in the home may seem the best way to maximize security, but section 160 of the Income Tax Act (and section 325 of the Excise Tax Act) creates joint and several liability for tax debts following a property's non-arm's-length transfer for inadequate consideration. Thus, where a tax debt is involved, a transfer of an interest in the matrimonial home is seldom effective as a shield against the CRA. In the recent TCC decision in *Cohen* (2008 TCC 550), however, it was.

Mr. C transferred his 50 percent interest in the matrimonial home to the appellant, Mrs. C. The issue was whether Mrs. Cohen gave consideration for the transfer sufficient to prevent section 160's application. The Crown said that the transfer took place without consideration; Mrs. C contended that the interest was transferred in return for the extinguishment of a pre-existing debt.

The putative debt arose from an agreement between the spouses to split household expenses evenly. Mrs. C paid a greater share of the down payment to acquire the house, and thereafter continued to pay more of the household expenses, despite the agreement to split expenses evenly. Mr. C apparently had ongoing financial difficulties; the spouses produced a running book of account recording the debt and testified that their intention was always for Mr. C to repay any shortfall. As the debt mounted, Mrs. C became concerned. The couple executed a promissory note. When the note was approaching default, they retained a lawyer to execute the transfer of Mr. C's interest in the home. Unfortunately, the transfer forms listed the consideration given as "nil," perhaps leading the CRA to pursue the matter all the way to trial.

In allowing the appeal, Bowie J noted that the paucity of documentation before the court made the case one of credibility, and the couple gave credible testimony that was unshaken on cross-examination. Although Mrs. C's documents were neither precise nor entirely consistent, the court said that they were genuine, and it supported the agreement between the spouses to share expenses.

Cohen is a good example of how to avoid section 160 assessments, and it offers a guide to the proper legal steps that should be taken in advance. However, a trial of the issues might have been avoided if more care had been given to describing the consideration given for the transfer.

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SR & ED Work Outside Canada

A 2008 federal budget proposal enacted in Bill C-50 implements an important tax policy change to the SR & ED ITC program. (The Budget Implementation Act, 2008 [SC 2008, c. 28] received royal assent on June 18, 2008.) Effective for taxation years ending after February 25, 2008, certain salary and wages of Canadian-resident employees who carry on SR & ED work outside Canada qualify for ITCs.

Previously, SR & ED work carried on outside Canada did not qualify for ITCs. However, as discussed below, the CRA administratively allowed certain expenditures for work outside Canada. The policy change allows salary and wages incurred by a taxpayer for SR & ED work carried on outside Canada to qualify for ITCs if (1) the salary and wages are in respect of Canadian-resident employees carrying on such SR & ED work, (2) the taxpayer directly undertakes the SR & ED work outside Canada, (3) the SR & ED is related to the taxpayer's business, and (4) the work is solely in support of SR & ED carried on by the taxpayer in Canada.

Claims for salary and wages for work outside Canada cannot exceed 10 percent of the total salary and wages that the taxpayer incurred for SR & ED carried on in Canada and must not be subject to an income or profits tax imposed by a foreign country. (Thus, Canada's income tax treaty with the country where the support work was carried out should be considered.) In addition, salary and wages for specified employees do not include remuneration based on profits or a bonus. The work performed outside Canada can involve any SR & ED work, but an ITC is available only for salary and wages for work solely in support of SR & ED carried on in Canada. A payment to a subcontractor or non-employee of the taxpayer does not qualify, because the work is not "directly undertaken" by the taxpayer.

Notwithstanding the previous general limitation that foreign work in support of SR & ED did not qualify for ITCs, certain expenditures were allowed administratively in respect of work that did not constitute SR & ED, including foreign travel expenditures (which might include salary and wages). (See paragraph 46 of IT-151R5, "Scientific Research and Experimental Development Expenditures (Consolidated).") Expenditures in respect of work carried on outside Canada that did not constitute SR & ED were allowed as overhead expenditures eligible for ITCs if the taxpayer used the traditional method (not the proxy method) for determining overhead and if the expenditures were for (1) the acquisition of equipment or materials used in SR & ED in Canada, (2) visits to foreign customers in respect of SR & ED carried on in Canada to update the customer on the status of the SR & ED project, or (3) training for SR & ED carried on in Canada. With the new change in tax policy that grants ITC eligibility to salary and wages incurred by the taxpayer in respect of SR & ED work performed outside Canada, these three restrictions appear to be no longer relevant for salary and wages. Under the new rules illustrated in the table, however, travel and other overhead costs can still be claimed only if the traditional method is used to account for such costs and the other requirements are met.

ITC Eligibility of Salary and Wages for SR & ED Work Carried On Outside Canada

	Taxpayer uses			
	Old rules		New rules[a]	
	Traditional method	Proxy method	Traditional method	Proxy method
SR & ED work of Canadian-resident employees	No	No	Yes[a]	Yes[a]
Work covered by administrative rule:				
Acquisition of equipment or materials used in SR & ED in Canada				
For a specific SR & ED project in Canada	Yes[c]	No[b]	Yes[a]	Yes[a]
Not for a specific SR & ED project in Canada	May qualify as overhead expenditure	No[b]	May qualify as overhead expenditure	No[b]
Visits in respect of SR & ED carried on in Canada to update foreign customers on the status of the SR & ED project	Yes[c]	No[b]	Yes[a]	Yes[a]
Training for SR & ED carried on in Canada				
Time spent outside Canada to study or research a new technology specific to an SR & ED project carried on in Canada	Yes[c]	No[b]	Yes[a]	Yes[a]
Training not specific to an SR & ED project in Canada	May qualify as overhead expenditure	No[b]	May qualify as overhead expenditure	No[b]

[a] A taxpayer must directly carry on, through Canadian-resident employees, the SR & ED work that is solely in support of its SR & ED carried on in Canada.
[b] Represented by the proxy amount.
[c] Qualifies as overhead expenditures.

The new rules thus permit ITC claims for any salary and wages incurred for work solely in support of the SR & ED carried on by the taxpayer in Canada, regardless of whether the proxy method or the traditional method is used. Whether the work is solely in support of the SR & ED is a question of fact; a case-by-case analysis is required. However, CRA policy and interpretations, including the comments made during the 2007 APFF conference in Montreal, suggest that any SR & ED work carried on outside Canada in support of an SR & ED project in Canada will meet the "solely" test. The change in tax policy embodied in Bill C-50 creates numerous other opportunities to claim support or other SR & ED work carried on outside Canada and should benefit many industries, including manufacturing, pharmaceuticals, renewable energy, automotive, aerospace, and agriculture (farm equipment).

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Transfer Pricing: Overpaid GST

Under section 218 of the Excise Tax Act, a Canadian resident must generally self-assess GST on services and intangible personal property acquired outside Canada for consumption, use, or supply in the course of an activity that does not exclusively involve the making of GST taxable supplies. For taxation years ending after November 16, 2005, January 2007 legislative proposals expand the self-assessment obligations of a Canadian-resident financial institution, making GST potentially payable on any outlay or expense incurred outside Canada and allowed to it as an income tax deduction, allowance, or allocation for a reserve.

Banks, insurers, securities dealers, pension plans, mutual fund trusts, and other financial institutions provide GST-exempt financial services. A Canadian-resident financial institution must thus self-assess GST on most services and intangibles acquired outside Canada. If a CRA audit generates a transfer-pricing adjustment that reduces the consideration paid or payable by the financial institution to a non-arm's-length supplier, the GST payable by it on the imported supply of the service or intangible may be reduced accordingly.

If a person paid or remitted GST in error, recovery of the tax requires filing a rebate application under ETA section 261. The limitation period for the claim is two years from the date when the tax was paid. Unfortunately, the income tax assessment limitation period for non-arm's-length international transactions was extended by three years beyond the normal three- or four-year period, leaving the GST rebate mechanism inadequate for GST overpayments on non-arm's-length cross-border supplies. A Canadian-resident financial institution undergoing a transfer-pricing audit may have to wait a long time for its resolution, particularly if the taxpayer requests competent authority assistance under a treaty's mutual agreement procedure article.

The taxpayer should consider taking appropriate measures to enhance the recoverability of any excess GST paid in error as determined by a transfer-pricing adjustment. For example, filing a waiver of the normal four-year GST

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assessment limitation period provides the CRA with the discretionary authority to reassess the amount of GST payable by the financial institution under ETA division IV. However, any waiver should be limited to the specified matter: determining the amount of GST payable on the specific services and intangibles that are the focus of the transfer-pricing audit. The taxpayer should also consider filing rebate applications to be held in abeyance pending a final determination of the transfer-pricing issues. If these measures prove inadequate, the taxpayer's final recourse may be to apply for a remission order under the Financial Administration Act.

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Allocating Share Value

Allocating a corporation's value to its various classes of issued shares can be challenging, particularly if the class that carries voting control is non-participating (freeze shares) and another class that is non-voting or lacks sufficient votes to control is fully participating (growth shares).

The corporation's en bloc FMV is the starting point for determining a share class's FMV. Valuation considers the rights, conditions, and attributes of each class through the eyes of a willing buyer and a willing seller who are both prudent, reasonably informed, and acting at arm's length in an open and unrestricted market and in their own best interests.

Voting and non-voting shares held by the same shareholder or group are likely to be sold together in order to maximize proceeds, and thus no minority discount applies to the non-voting shares. However, assume that Mrs. X retains de jure control in an estate freeze, either through voting, non-participating class A common shares (thin-voting shares); her children own class B non-voting common (participating) shares to which future corporate growth inures. The corporate structure may include exclusionary dividend shares—common shares that have dividend rights, but are excluded from the declaration and payment of dividends by the company's board (Mrs. X). But for their voting rights, Mrs. X's class A shares have negligible value limited to their (nominal) PUC on liquidation. The votes ensure her a reasonable salary—subject to the legitimate expectations of the other common shareholders—but their true value is in their access to the company's surplus: how much would the class B non-voting shareholders willingly pay—and a prudent and uncompelled class A controlling shareholder accept—for this access? Other considerations apply if voting preferreds hold control or have fixed annual dividends; retraction rights may also be in issue. Some exclusionary dividend shareholders have pursued company law oppression remedies, claiming denial of their legitimate expectations of dividends; the cases have been largely fact-driven.

The CRA's family and group control valuation policy in *Information Circular* IC 89-3 ("Policy Statement on Business Equity Valuations," August 25, 1989) considers pro rata values for minority shareholdings if all shares have equal rights and privileges; but for several classes of shares, "[t]he fair market value of each class of shares must be determined on its own merits according to the individual rights and restrictions of each class" (ITTN no. 38, September 22, 2008). The CRA indicates that a control premium of "some amount" may exist, depending on the facts and circumstances. Although some CRA valuators suggest a premium of 33 to 50 percent, depending on total corporate value, other valuators consider a premium of 10 to 15 percent to be more realistic. Any premium for control generally reduces the balance of the entity's FMV potentially attributable to the other share classes, representing a discount for lack of control.

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