Canadian Tax Highlights

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Volume 17, Number 1, January 2009

Advisory Panel: International Tax

In November 2007, the minister of finance created a panel of tax and business experts to evaluate Canada's international tax system and recommend ways to improve its efficiency, competitiveness, and fairness. The panel asked businesses and tax professionals for input on a number of specific issues, and examined other countries' approaches. After studying various submissions, the panel issued a report on December 10, 2008. The panel concluded that Canada's international tax system generally is fair and equitable, has served Canada well, and is not in need of any radical changes. However, it made a number of recommendations to improve key aspects of outbound and inbound taxation.

Outbound

■ The report says that the current exemption system should extend to all foreign active business income, whether or not earned in a treaty or TIEA country. The exemption should also include gains derived from the disposition of foreign affiliate (FA) shares that derive (substantially) all their value from active business assets. Both recommendations would simplify the system by eliminating the need to compute and track separate exempt and taxable surplus accounts for foreign active business income and FA share dispositions. The report notes that the current system imposes significant compliance and administrative burdens on taxpayers and the CRA, but produces little if any additional Canadian tax revenue.

■ The report also recommends section 18.2's repeal, even after the minister of finance said that the rule's reconsideration was not part of the panel's mandate. The recommendation is consistent with one made by the Competition Policy Review Panel, whose report was released in June 2008. (See "Compete To Win," *Canadian Tax Highlights*, July 2008.) Section 18.2 was passed (under protest from the business and tax communities) in December 2007, but it is not effective until 2012. The rule disallows interest deductibility on borrowings traceable to an interaffiliate debt whose interest is recharacterized as active business income and is thus not FAPI subject to Canadian tax.

■ The report's other recommendations include (1) a review of the FA definition with an eye to possibly raising the current threshold; (2) no changes in the taxation of foreign branch income (although it makes theoretical sense, the report said, to extend the exemption system to that income); (3) a review of anti-deferral regimes such as the FAPI, FIE, and NRT rules with a view to simplification and better coordination; (4) retention of the recharacterization rules in paragraph 95(2)(a); and (5) no additional rules to restrict interest deductibility for a Canadian taxpayer that borrows funds for FA investment (except in so-called debt-dumping transactions, discussed below.)

Inbound

■ The report recommends that the thin capitalization system be retained and not replaced with earnings-stripping rules or an arm's-length test, but recommends lowering the debt-to-equity ratio from 2:1 to 1.5:1, consistent with world standards and Canadian industry data. The report rejects an extension of the thin cap rules to arm's-length debt or debt guaranteed by a related party, but it does recommend further consultation on extending the rules to non-corporate borrowers.

■ Another significant recommendation involves the introduction of anti-avoidance rules targeting debt-dumping transactions in which a foreign parent transfers foreign subs to its Cansub for debt. The report views this type of transaction as particularly offensive when preferred shares are used so that the Cansub has an interest deduction but minimal potential for participation in any increase in the foreign subs' value. The report discusses two potential anti-avoidance mechanisms to address debt dumping and recommends further study: (1) the denial of interest expense on debt traceable to such transactions, and (2) the deeming of the shares' purchase price to be a dividend subject to withholding tax.

■ The report makes additional recommendations related to withholding taxes, administration, compliance, and the legislative process. Of particular interest on the administrative and compliance front are comments on

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the withholding tax requirements for the disposition of taxable Canadian property by non-residents. The report does not consider as sufficient the recent amendments to the Act intended to simplify clearance certificate requirements when a tax treaty applies; the report recommends the elimination of withholding tax on a non-resident's disposition of taxable Canadian property if the gain is treaty-exempt from Canadian tax. The report also recommends the exclusion of sales of publicly traded Canadian securities from section 116 notification and withholding tax requirements.

■ To avoid current burdensome compliance obligations, the report says that regulation 105 and 102 withholding tax requirements should be eliminated for a non-resident that receives income from services rendered and/or employment performed in Canada if the income is treaty-exempt from Canadian tax.

The report advocates increased transparency and consultation in the legislative process: confidentiality should be a resort in limited circumstances only. Furthermore, draft legislation that remains outstanding for long periods causes taxpayers uncertainty for both tax planning and financial statement reporting. Retroactive and retrospective legislation should thus be avoided, a recommendation that will undoubtedly be warmly received by taxpayers and tax professionals.

During its consultations, the panel received negative comments from various observers regarding the CRA's relationships with businesses. The report expresses deep concern about the potential for further deterioration that might jeopardize the ongoing viability of Canada's self-assessment system, which the report says must be based on mutual responsibility and cooperation and is critically important. The report recommends that the government take steps to reverse the current trend and improve the relationship and promote better two-way communication.

The panel should be commended for its hard work and delivery of a considered report. Given the recent political and economic turmoil, the 2009 budget will be delivered sooner than expected—on January 27, 2009—which makes it unlikely that the government will have time to evaluate the report's recommendations and address them in that budget. One hopes that Finance can provide its perspective on the recommendations soon after the budget is delivered.

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Prescribed Rate Drop Favours Income Splitting

For the first quarter of 2009 (January 1 to March 31), the CRA's prescribed interest rate is 2 percent on family loans and on taxable benefits for employees and shareholders from interest-free or low-interest loans—the lowest rate since the third quarter of 2004. Now is probably a good time to consider income splitting, locking in family loans at the 2 percent rate to achieve future tax savings. Where practical, it also may be worthwhile to restructure existing intrafamily loans that have a prescribed rate higher than 2 percent. An employee with a qualifying home purchase loan from an employer may also be able to reduce the related taxable benefit.

If an individual lends funds to his or her spouse, the attribution rules generally apply, and any income earned on the loaned funds is taxed in the individual's hands. However, if the loan is governed by a written agreement that stipulates repayment terms and an interest rate at least equal to the CRA's then-prescribed interest rate, attribution does not apply if the spouse or other family member pays the annual interest by the January 30 following each year.

The current economic conditions may not be ideal for investors. But if a family loan is locked in at the 2 percent rate and the family member invests the loaned funds at a higher rate, the current and future investment income earned can be shifted to another family member—including a spouse—who has little or no other income and will thus pay little or no tax on the income. If the plan is properly implemented, the individual can effectively arrange for all the related investment income over 2 percent to be taxed indefinitely at the tax rate of the lower-income-earning family member.

The current prescribed interest rate also presents a tax-saving opportunity for an employee who has entered into qualifying home purchase loans with his or her employer. By renewing a home purchase loan (for example, by repaying the old loan and taking out a new loan), an employee can ensure that the interest rate benefit for the next five years is capped at 2 percent. The new loan must meet specific conditions: an employee and employer wishing to take advantage of this opportunity should seek professional advice.

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Section 160 Surprise

The TCC in *Gambino* (2008 TCC 601) rejected a subsection 160(1) assessment related to cheques cashed by a mother for her son, relying primarily on a purposive interpretation of the rule.

Mrs. G's son, who was in his late forties and unemployed, had an $85,000 tax liability and a leg infection that prevented him from walking. On seven occasions, the son endorsed his disability cheque and asked his mother to cash it for him. Mrs. G walked to the bank, cashed the cheque, and returned to give her son the funds ($1,500). In one case, as instructed by her son, she took $500 to repay a loan that she had made to him, depositing the funds in her bank account. At no other time did the son's money find its way into Mrs. G's bank account. The Crown did not dispute the facts; did not challenge Mrs. G's credibility; asked few questions of her on cross-examination; and acknowledged that she was only a bare trustee for her son, never having had beneficial ownership of the funds.

When a tax debtor transfers property, a non-arm's-length transferee is jointly and severally liable for the tax debtor's tax liability up to the lesser of that amount and the FMV of the property transferred net of consideration given at that time. The Crown said that section 160 was very technical and must be strictly applied in non-arm's-length transfers—even if results were harsh—so as not to fetter the CRA in its collection of unpaid taxes from tax debtors. The Crown relied heavily on the following paragraph from *Livingston* (2008 DTC 6233 (FCA)):

> The deposit of funds into another person's account constitutes a transfer of property . . . [T]he deposit of funds . . . into the account of the respondent permitted [her] to withdraw [them] anytime. The property transferred was the right to require the bank to release all the funds to [her]. The value of the right was the total value of the funds.

The Crown viewed the son's giving of the endorsed cheques to his mother as a transfer of the right to require the bank to pay all of the proceeds to her. The Crown sought to extend *Livingston*—in which funds were actually deposited into another's bank account—to Mrs. G's cashing of seven endorsed cheques for her son, even though no funds, other than the $500 loan repayment, were deposited into her account. The Crown also said that *Livingston* supported a position that a transfer of bare legal ownership resulted in a subsection 160(1) liability for the entire value of the property transferred, unreduced by the funds that Mrs. G returned to her son after cashing the cheques.

Alternatively, the Crown relied on the UK Court of Appeal decision in *Balfour v. Balfour* ([1919] 2 KB 571) to say that agreements between family members do not give rise to contractual rights if the family members did not so intend, and thus Mrs. G's promise to return the cash, or the actual return of cash, to her son was not consideration in the contractual sense intended by section 160. Mrs. G had the burden of establishing the consideration's value and thus must also prove that the repayments were intended to be a contractual non-family arrangement. Similarly, the $500 loan repayment was not for valuable consideration, but for natural love and affection. Even if the cash returned by Mrs. G to her son was consideration, it was not given "at the time" the cheques were transferred to her.

The TCC said that *Livingston* was distinguishable on the facts because the parties there intended to hide the tax debtor's assets from creditors and to prejudice the CRA: the tax debtor deposited her cheques into the bank account of the transferee, but had sole access to the account via a bank card and blank cheques. The TCC noted that such a scheme was not a prerequisite to subsection 160(1)'s application, but the FCA in *Livingston* described it as a "crucial fact"; Mrs. G had no such knowledge or intention. The TCC referred to the FCA's description in *Livingston* of the rule's purpose: to preserve the value of a tax debtor's existing assets for collection by the CRA, and allowing pursuit of the transferee for the value of assets divested without consideration. That measure is not required if the transferee gives FMV consideration for the transfer: the CRA is not prejudiced, because the tax debtor still owns property of value. There was no intention to foil the collection of the son's tax debt, and the Crown was unable to describe how the CRA was prejudiced by Mrs. G's cashing her son's cheques for him. The CRA could have garnisheed the amounts of the cheques by issuing to the financial institution a requirement to pay, or it could have executed on the cash in the son's hands. The Crown's position was "completely lacking in common sense," because it would also result in Mrs. G's liability even if her son had used the cash to reduce his tax liability or had told her to take the endorsed cheques to the CRA's offices to pay down his tax debt. The son had no intention to gift amounts to Mrs. G, who provided sufficient consideration at the time of the transfer of the endorsed cheques. The TCC expressed "strong disappointment" that the government pursued the case to trial. (Unfortunately, Mrs. G agreed to costs in advance and thus could not be awarded special costs.)

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Vanishing Capital Gains

The federal and provincial budgets will be beset by a multitude of negative forces before the economy regains its strength of recent years. Because capital gains are taxed at least in part under the Income Tax Act, a review of recent personal income tax statistics is useful to assess the effect on government revenues of the decline in value of capital assets that normally give rise to capital gains.

The $19.3 billion claimed as taxable gains by individuals in 2006—the latest year for which information is available—represented 2.39 percent of all assessed income reported (as shown in the table), higher than the percentage recorded in any of the previous five years. The tax borne by those gains is not calculated separately and can only be surmised. If the gains were taxed at the average rate on all assessed income, federal tax would have amounted to $2.4 billion. But most gains are in fact taxed at federal marginal rates. If all capital gains were taxed at the lowest rate, 15 percent, the tax would have been $2.9 billion; at the highest rate, 29 percent, the tax would have been $5.6 billion.

A capital gain is taxed only when it is realized, and then only if it is held outside a sheltered investment vehicle. Thus, the massive stock market decline has no immediate tax consequence for holdings in RRSPs and pension plans. A taxpayer who owns assets outside a sheltered plan may choose to postpone their sale until values return to 2007 levels. The immediate tax consequence will then be a dramatic decline in tax from capital gains, due to the delayed selling of shares that have lost value relative to last year's levels. Further adding to this trend is the fact that winners in the average portfolio could be sold tax-free by offsetting losses from other transactions. Another concern is a buildup of tax losses that may be applied against possible future gains.

There is no doubt that the economic reversal of 2008-2009 will reduce tax collections in 2008 and future years. But the magnitude of gains normally included in income is small in the best of years, so the blow to the federal and provincial fiscs will not be devastating.

Federal Income Tax and Capital Gains, 2001-2006

Tax year	Taxable capital gains	Capital gains deduction	Federal tax paid
	percent of assessed income		
2001	1.36	0.33	12.68
2002	1.14	0.31	12.66
2003	1.31	0.29	12.61
2004	1.65	0.32	12.57
2005	2.12	0.32	12.27
2006	2.39	0.33	12.29

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GAAR Update: CRA Stats

At the Canadian Tax Foundation's 2008 annual conference, a Department of Justice official provided GAAR statistics updated to September 30, 2008. The statistics show that 806 cases were referred to the GAAR Committee since the rule's introduction in 1988; the CRA applied GAAR in 554 of those cases, 69 percent of all cases referred.

Of the 554 cases in which GAAR was applied, the rule was the CRA's primary assessing position in 262 cases (47 percent) and its secondary position in 292 cases (53 percent). The table summarizes the types of issues that gave rise to the 806 cases referred to the GAAR Committee. The most contentious cases are surplus stripping (96 cases), kiddie tax (47 cases), part I.3 large corporations tax (38 cases), and loss creation via stock dividend (35 cases).

In addition, the CRA said that the GAAR Committee reviewed and considered GAAR to apply as a secondary assessing position in 1,363 RRSP cases and 76 Barbados spousal trust cases.

GAAR Committee Statistics

Issue	GAAR applied	No GAAR	Total
Kiddie tax*	47	6	53
Offshore trusts	10	1	11
Cross-border lease	11	0	11
Part XIII tax	3	9	12
Losses, rental	11	2	13
Kiwi loan	14	0	14
Losses, stop losses	9	5	14
Charitable donations	14	10	24
Capital gain	19	8	27
Interest deductibility	17	17	34
Debt parking	17	7	24
Indirect loan*	28	3	31
Debt forgiveness	31	10	41
Losses, capital and non-capital	24	9	33
Loss creation via stock dividend*	35	0	35
Part I.3 tax	38	11	49
Provincial issues	0	2	2
Surplus strips*	96	29	125
Treaty exemption claim	1	1	2
Miscellaneous*	129	122	251
Total	554	252	806

* In the period between August 31, 2007 and September 30, 2008 the 54 new cases to which GAAR applied were in the following categories: kiddie tax, 27; indirect loan, 2; loss creation via stock dividend, 11; surplus strips, 6; miscellaneous, 8.

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Voluntary Disclosure

A severe blow was dealt recently to the Swiss banking giant UBS's client confidentiality by an ongoing US investigation into the offshore banking services it provided to wealthy Americans. UBS was forced into its own investigation; according to its chairman, it discovered "a limited number of cases of tax fraud under both US and Swiss law" and may disclose the names of some American clients to US tax authorities in an effort to settle or terminate the US investigation. UBS also appears to have maintained a "Canada desk" in its Zurich and Geneva offices, separate from its Canadian subsidiary, which it used to solicit and funnel an estimated $5.6 billion from wealthy Canadians into offshore bank accounts. The CRA apparently has refused to confirm or deny the launching of an investigation into the UBS Canada desk activities, but it has informally confirmed that a Canadian investigation has begun. Some US individuals are considering or seeking amnesty on US taxes via voluntary disclosure. Although the Canadian voluntary disclosures program (VDP) has existed for many decades, IC 00-1R2 (October 22, 2007) shows that the CRA now gives taxpayers less leeway in its use.

The IC notes that the VDP promotes compliance by encouraging taxpayers to voluntarily come forward and correct omissions: a taxpayer may be eligible for relief from penalty, prosecution, and interest on income and other taxes owed. Disclosure must be voluntary and complete, must involve the (potential) application of a penalty, must include at least some information that is one or more years overdue, or must correct a previously filed return. In a significant departure from the previous administrative position, a disclosure is considered not voluntary (1) if the taxpayer is aware of, or had knowledge of, an audit, investigation, or other enforcement action by the CRA regarding the disclosed information; (2) if the CRA or any other authority or administration initiated an enforcement action relating to the disclosure against the taxpayer (or a related or associated person) or against a third party in an action whose purpose and impact is related to the disclosure; and (3) if the enforcement action was likely to have uncovered the information disclosed. An enforcement action may include an audit, investigation, or other enforcement action by any authority or administration, such as a police force, securities commission, or provincial authority. Arguably, a Canadian taxpayer caught in the US UBS investigation may be aware of a relevant enforcement action.

VDP relief may cover, inter alia, claims for ineligible expenses on a tax return and failure to fulfill obligations under a taxing statute, report taxable income or GST/HST, remit source deductions, and file information returns. Although relief is available only for the 10 preceding years, a taxpayer who, for example, underreported for 15 years must disclose all underreporting to receive relief for the 10 years; there is no guarantee that the CRA will not require filings for the earlier years. The VDP does not provide relief regarding income tax returns with no taxes owing or refunds expected, elections for specific tax treatment, advance pricing arrangements on appropriate transfer-pricing methodology, rollovers, bankruptcy returns, and post-assessment requests for interest and penalty relief.

A taxpayer may disclose on a no-names basis, which allows it the flexibility to back out if negotiations sour, or it may disclose its name from the outset. The IC refers to no-names discussions with a VDP officer as "informal," "non-binding," and "general" in nature, and says that the CRA review of information is "without prejudice." Thus, the new position on no-names disclosure may effectively nullify the option by suggesting that the CRA can extricate itself from assurances made to an unnamed taxpayer. Furthermore, a final decision on a no-names disclosure is provided only after the taxpayer's identity is disclosed and the facts verified. The taxpayer's identity must be disclosed within 90 days of the effective date of a disclosure (when the CRA receives a completed and signed agreement form or a letter from the taxpayer), a period that may not be adequate to analyze the disclosure's benefits. The uncertainty now imposed by the CRA on no-names discussions may discourage the use of the VDP and lessen compliance impact.

A new IC condition says that a taxpayer is expected to remain compliant after using the VDP and cannot use it more than once, except, for example, in situations beyond a taxpayer's control. No concrete examples are given.

The VDP is an effective choice for a taxpayer who wishes to set his affairs in order with an eye to future compliance, and allows tax authorities to collect taxes otherwise unrecoverable because of a lack of personnel or enforcement resources. For example, it is virtually impossible for the IRS to prosecute all 20,000 Americans estimated to have funnelled funds into UBS. In an era of increased vigilance and international cooperation in tax enforcement, a VDP may allow taxpayers to avoid the sometimes disastrous consequences of reduced reporting or non-reporting of income, but the reduced flexibility in the Canadian VDP may decrease its attractiveness and thus its effectiveness.

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TFSA Penalties and Tax

Commencing in 2009, a Canadian resident aged 18 or older can contribute annually up to $5,000 (indexed) to a new savings vehicle, the tax-free savings account (TFSA). Qualifying investments are similar to those for an RRSP, such as GICs, government and public company bonds and debts, publicly traded securities, units or shares of mutual funds, and shares of a specified small business corporation (SSBC). Non-qualifying investments attract penalties, as do specifically prohibited investments such as loans to the TFSA holder, and shares or debt of a corporation, partnership, or trust in which the TFSA holder and/or non-arm's-length persons have a significant interest (generally, 10 percent or more).

Generally, an SSBC is a Canadian-controlled corporation in which substantially all of the corporate assets' FMV is attributable to (1) assets used principally in an active business carried on primarily in Canada, or (2) shares or debt of SSBCs connected to the corporation. The SSBC definition is based on the small business corporation definition, except that an SSBC need not be a CCPC; de facto control by one or more non-residents is the only prohibition.

Income earned in a TFSA is not taxable, except for income earned from carrying on a business and from non-qualifying investments (see table 1). Penalty taxes (see table 2) apply to non-qualifying and prohibited investments, and to overcontributions and to contributions made by non-residents (except for transfers from another TFSA of the holder and for some contributions on marriage breakdown or on the holder's death). An investment that is both non-qualifying and prohibited is treated as prohibited.

Table 1 Taxation of TFSA Income

Income source	Taxability	Taxpayer
Qualifying investments	Exempt	na
Prohibited investments	Additional penalty tax (table 2)	TFSA holder
Non-qualifying (not prohibited) investments	Tax at the top personal income tax rate, including full taxation of capital dividends and capital gains, net of capital losses	TFSA
Carrying on business	As above	TFSA

An anti-avoidance rule imposes a special penalty (see table 2) if the TFSA holder or another non-arm's-length person has an "advantage" with respect to the TFSA; this penalty is intended to catch transactions designed to circumvent the TFSA contribution limits or to artificially shift taxable income away from the TFSA holder and into a TFSA. The minister may waive penalties on overcontributions and non-resident contributions if they are due to a reasonable error and the holder withdraws them without delay. Moreover, in the case of non-qualifying or prohibited investments (the 50 percent of FMV penalty tax), or if the TFSA has an advantage, the minister may waive penalties if a waiver is just and equitable having regard to all the

Table 2 TFSA Penalty Taxes

	Quantum	Description	Waiver by minister?
Overcontributions	1% per month on excess	Similar to penalty on excess RRSP contributions, but applies to every dollar overcontributed, with no $2,000 de minimis rule.	Yes
Non-resident contributions	1% per month	Penalty accrues to the TFSA holder until the earlier of the date when contributions are withdrawn and the date when the TFSA holder resumes Canadian residence.	Yes
Non-qualifying or prohibited investments	50% of the property's FMV	A one-time tax payable when the property is acquired by the TFSA or a property later becomes prohibited or non-qualifying. The tax is refundable if the TFSA disposes of the property before the end of the calendar year after that in which the tax arose, unless it is reasonable to expect that the holder knew or should have known that the property was, or would become, non-qualified or prohibited.	Yes
Prohibited investments	Additional tax on income	Income includes the actual amount of dividends received (without reference to the dividend tax credit rules); the full amount of capital dividends; and the full amount of capital gains net of capital losses. Penalty applies at a rate of 43.5% (the 29% top federal personal income tax rate × 150%), ensuring that there is no provincial income tax advantage from holding a prohibited investment in a TFSA. Investments both non-qualifying and prohibited are deemed prohibited only.	No
TFSA holder has an "advantage"	FMV of the "advantage"	An "advantage" is any benefit, loan, or indebtedness that depends on the existence of the TFSA; exceptions include TFSA withdrawals; administrative or investment services in connection with a TFSA; loans and debt on arm's-length terms; and payments or allocations to a TFSA by the issuer, such as reasonable payments of bonus interest. An "advantage" may include an increase in the FMV of property held in a TFSA. The penalty equals the FMV of the benefit and/or the amount of the loan or indebtedness.	Yes

Note: Penalty taxes are imposed on the TFSA holder, but the issuer may be liable in certain TFSA "advantage" cases.

circumstances. A TFSA holder subject to penalties must file a part XI.01 return and remit any penalty tax (net of refunds) by the March 31 after the year-end (March 30 in a leap year). Trust returns for a TFSA subject to income tax have the same deadline.

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US Transfer Tax Update

The new year ushered in several noteworthy changes to US transfer taxes. Gift tax exclusions increased, as did estate tax and generation-skipping transfer tax credits.

Gift tax. For the 2009 calendar year, an individual's annual gift tax exclusion per donee increased from $12,000 to $13,000 (indexed for inflation). The exclusion amount can be doubled to $26,000 per donee for a married couple if the other spouse consents to split the gift and allocate his or her annual exclusion to it.

An unlimited gift tax marital deduction applies to transfers from one US-citizen spouse to another, but not to a non-US-citizen spouse. To compensate for the lack of a marital deduction, cross-border couples are given a larger annual gift tax exclusion. The annual gift tax exclusion for a gift to a non-US-citizen spouse increased from $128,000 to $133,000 in 2009.

Estate tax and generation-skipping gift tax. The most significant US transfer tax change is the increase in 2009 in the federal estate tax and the generation-skipping transfer tax (GSTT) exemption amounts for a US citizen and resident to $1,455,800, which shelters $3.5 million in assets from each tax. Because the Canada-US treaty allows a Canadian resident (other than a US citizen) to claim a prorated US estate tax credit based on the credit available to US citizens, the 2009 increase also increases the US estate tax credit available to Canadian residents.

The estate tax and GSTT exemption amounts gradually increased to $3.5 million under a schedule enacted in 2001. Under the schedule, the estate tax and the GSTT are repealed in 2010 and return in 2011 with a $1 million exemption amount. Most commentators believe that Congress will implement a new exemption schedule before the end of 2009 and do not expect the repeal to take effect. Some commentators expect Congress to legislate retention of the current $3.5 million exemption for at least 2010, a move likely supported by President Obama, who campaigned on a tax plan that included a $3.5 million estate tax exemption and a 45 percent estate tax rate.

Even if Congress fails to act by the end of 2009, it may retroactively reinstate the estate tax for 2010. The validity of retroactive legislation was upheld once before. On January 1, 1993, the maximum estate and gift tax rates decreased to 50 percent from 53 and 55 percent; later that year, President Clinton signed legislation that retroactively reinstated the higher maximum rates of 53 and 55 percent. Taxpayers unsuccessfully sued the government, arguing that the retroactive legislation was unconstitutional. Given that precedent, Congress may even wait until 2010 and attempt a retroactive change, thereby extending the estate tax uncertainty into the next decade.

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SR & ED Claims Filing

On November 17, 2008, the CRA released revised form T661, the related new T4088 guide, and several explanatory documents. The new form represents a major change for the preparation of SR & ED claims.

The CRA said that the changes were made to simplify the filing process for small businesses (which file 90 percent of all claims), but the new form applies to all taxpayers, effective for taxation years ending after 2008. The CRA also said that the revised form and guide do not represent any shift in policy.

Major changes include a new format for presenting the details of projects, the introduction of the notion of a technological obstacle, and an increased focus on documentation requirements. Other changes include the introduction of a requirement to file project descriptions for all projects—not just the top 20—and additional prescribed information. Filing details are provided for claims for partnerships, an area previously lacking in clarity.

■ The new format requires much more concise and precise wording for technical descriptions—especially for large multifaceted projects, whose descriptions can currently reach 8 to 10 pages. Under the new rules, a taxpayer must identify the project as experimental development or scientific research. For experimental development projects, the taxpayer must answer three questions, each of which is subject to a maximum word limit: (1) "What technological advancements were you trying to achieve?" (350 words); (2) "What obstacles did you have to overcome to achieve those advancements?" (350 words); and (3) "What work did you perform in the tax year to overcome these technological obstacles?" (700 words). For basic or applied research projects, details in two areas must be provided: (1) "Describe the scientific knowledge you were trying to advance" (350 words), and (2) "Summarize the work performed in the tax year, explaining how that work contributed to the advancement of scientific knowledge, and summarize the systematic investigation" (700 words).

■ The earlier form T661 merged into one question the goal of technological advancement and the problems or challenges faced by the taxpayer in seeking out the advance in underlying technology necessary to achieve its objective. Interestingly, the CRA has chosen the phrase "technological obstacle/uncertainty" rather than the phrase "scientific or technological uncertainty," which is used in the Act and in IC 86-4R3, May 24, 1991.

> Technological obstacles/uncertainties are shortcomings and/or limitations of the current state of technology that prevented you from developing the new or improved capability. These are the technological problems or unknowns that cannot be overcome by applying all of the methods that are within your current level of training and experience. Nor should the solutions to these problems be publicly and readily available. Publicly and readily available sources generally include published scientific papers, industry specific publications, journals, textbooks, and Internet-based information sources.

■ The new T4088 guide places greater emphasis on the need to maintain contemporaneous documentation and provides examples of supporting evidence. A table sets out a matrix of evidence to support the advances sought, the obstacles faced, the work performed, the project's start and end dates, and the personnel involved. For each project, a checklist on form T661 records the types of evidence supporting the claim.

The previous guidance recognized the importance of evidence but took a different approach. For example, the software/IT sector guidance focused on the nature of documentation and work product (evidence) that arises naturally from a claimant's development methodology. That guidance also recognized that evidence may differ in each of four project environments: distinct and well-defined individual SR & ED projects; dedicated R & D environments; early-stage and startup companies; and large or multi-year projects.

■ Other changes include a requirement to identify any other businesses collaborating on a project; a checklist of where work was carried out, such as at a lab or a commercial facility; identification of the project information's preparer; and identification of the three key people involved in the project and their qualifications. (The people described in the examples all have degrees or diplomas; previous guidance indicated that in many cases, years of experience can be more relevant than academic qualifications.) An overall checklist ensures that all required information is submitted. The form now also accommodates claims for salary and wages for Canadian employees working abroad on a Canadian project.

Taxpayers may need to adapt current information-gathering processes to support SR & ED claims, even a taxpayer with a December 31 year-end who is still eligible to file a claim on old form T661. It will not be easy to describe large multifaceted projects concisely within the word limitations, and larger taxpayers will bear the burden of filing descriptions for all projects. It is unclear whether the increased requirements for evidence will change audit practices. Furthermore, the potential impact of the new term "technological obstacle" on current audit practices is also unknown. The CRA may have achieved its goal of simplifying the filing process for small business claimants, but the impact on larger taxpayers is less certain. What is clear is that both industry and the screening and audit personnel of the CRA face a period of adjustment.

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PE Versus Nexus

US federal taxation. Under the Canada-US treaty, a Canadian business (Canco) has a PE and is subject to US taxation if it has a place of business in the United States that is fixed and through which the Canco carries on business, unless the activities are limited to certain auxiliary and preparatory activities (article V(6)). Absent a fixed place of business, a US PE exists if the Canco relies on a dependent agent in the United States who has authority to bind the Canco and habitually exercises that authority. The general PE rules, relatively unchanged since the treaty's inception in 1980, were substantially broadened by the treaty's recently approved fifth protocol. Now a Canco's provision of services to a third party in the United States gives rise to a US PE if either of two tests is met.

The first test—the single-individual test—deems a Canco to have a US PE if (1) it provides services in the United States through an individual who is physically present there for at least 183 days in any 12-month period, and (2) during the same period more than 50 percent of the corporate gross active business revenue is derived from those services (article V(9)(a)). Physical presence for the purposes of this test includes any presence, whether the individual actually works on a given day; the presence of more than one individual on a day counts as one day. The protocol's technical explanation (TE) defines gross active business revenue as gross revenue that is or should be charged by the enterprise for its active business activities, regardless of when billing occurs or when domestic tax law recognizes the revenue. The TE also clarifies that not only are active business activities related to the provision of services, they do not include passive investment.

The second test—the enterprise test—is likely to have a wider impact on Canadian businesses. It applies to any enterprise that sends employees (and possibly subcontractors) to provide services in the United States for at least

183 days in any 12-month period with respect to the same or a connected project for customers who are either US residents or who maintain a US PE in respect of which the services are provided. The TE clarifies that the 183-day presence test includes only days during which services are actually provided. Whether projects are connected is considered from the taxpayer's viewpoint, not the customer's, and depends on the facts and circumstances. Projects are a coherent whole, both commercially and geographically, and cannot be subdivided to avoid the 183-day threshold. Factors relevant to commercial coherence are (1) whether the projects would fall under a single contract absent tax-planning considerations; (2) whether the nature of the work in different projects is the same; and (3) whether the same individuals provide the services under the projects. Because article V(9) is subject to article V(3), a building site, construction project, or installation project must last at least 12 months in order to create a PE.

The protocol entered into force on December 15, 2008, and thus article V(9) becomes effective after 2009: days of presence, services rendered, and gross active business income earned before then are not counted.

US state taxation. Virtually any physical presence can cause a Canco to have nexus and thus subject it to state taxation, even absent a US PE. Individual states have significant autonomy in levying and collecting taxes, but the due process and commerce clauses of the US constitution constrain the unfettered state taxation of non-residents. Nexus can be defined as some definite link or minimum connection between a state and a potential taxpayer; the simplicity of the definition belies the many times that the term has been litigated as the states try to draw out-of-state and foreign taxpayers into their taxing jurisdiction. Moreover, the tests for nexus vary for each type of tax—sales and use tax, income tax, franchise tax, etc.—and often change over time as new methods of doing business across state boundaries arise and new taxing statutes are enacted (for example, in Texas, Ohio, and Michigan).

Sales and use tax nexus often requires mere in-state physical presence. Generally, physical presence exists when a taxpayer has present in the state one or more employees or agents (independent or not) or an office or place of business. An otherwise independent subsidiary or affiliate can create attributional nexus for a related out-of-state entity. States have found nexus when a company's only physical contact with a state was the in-state delivery of items in a company-owned vehicle. Prima facie, it is safe to assume that a Canadian business has nexus and is liable for the collection and payment of sales and use taxes in any state where it has any physical presence.

In contrast, income tax nexus for an out-of-state foreign business does not necessarily require physical presence in a state: some states now impose income tax solely on the basis of an economic nexus, such as having intangible property in a state. The US Supreme Court has so far refused to review cases involving economic nexus theories. Lower court rulings, some favourable to taxpayers, do not reveal identifiable factors for predicting future outcomes. Another difference in income tax nexus is beneficial to taxpayers. Under PL 86-272, a 1959 federal law, a company with physical presence in a state is immune from state income tax if its only business activity in the state is the solicitation of orders for sales of tangible personal property: all orders must be approved or rejected outside the state, and purchases must be delivered from outside the state. A business that provides services or sells intangible products or real estate is not protected by the law and thus may have income tax nexus. Once a company has income tax nexus in a given state, it has nexus there for all sales, even those otherwise protected by PL 86-272.

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FOREIGN TAX NEWS

Treaties

The secretary general of the **Gulf Cooperation Council** (GCC, comprising Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates) suspended negotiations, begun in 1988, for a free trade agreement with the **European Union**. More than once, announcements have been made that the agreement was close to final, but at the eleventh hour the European Union apparently retracted a planned signing by the EU president on a visit to Doha in November 2008.

The Indian Income Tax Appellate Tribunal ruled on October 20, 2008 in *Ms. Pooja Bhatt v. Deputy Commissioner of Income Tax* on fees received by an Indian-resident entertainer for a show performed in Canada. Article 18 of the **Canada-India** treaty says that such fees "may be taxed" in Canada. The tribunal ruled that India was precluded from also taxing the fees because article 18, unlike other articles, did not specifically clarify that the state of residence also enjoyed taxing jurisdiction.

The **Canada-Gabon** treaty, signed on November 14, 2002, entered into force on December 22, 2008 and is generally effective after 2008. Negotiations to update the **Canada-Poland** treaty will begin the week of January 19, 2009 in Warsaw; interested parties may send comments to the Department of Finance, 17th floor, East Tower, 140 O'Connor Street, Ottawa K1A 0G5.

Details of an **Estonia-Greece** treaty, signed on April 4, 2006 are now available. The treaty was concluded in

The editor of *Canadian Tax Highlights* welcomes submissions of ideas or of written material that has not been published or submitted elsewhere.
Please write to Vivien Morgan at vmorgan@interlog.com

Published monthly
Canadian Tax Foundation
595 Bay Street, Suite 1200
Toronto, Canada M5G 2N5
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Internet: http://www.ctf.ca
ISSN 1496-4422 (Online)

Estonian, Greek, and English; in cases of divergence the English text prevails.

United States

In response to many public comments, the Treasury and IRS made significant amendments before issuing temporary and proposed revised transfer-pricing rules for cost-sharing arrangements (CSAs), effective for CSAs entered into after January 4, 2009. Guidance is given on evaluating the arm's-length results of cost-sharing transactions and platform contribution transactions. To evaluate those transactions in the absence of comparable uncontrolled transactions, other methods may be used—for example, newly specified income, acquisition price, market capitalization, and residual profit split methods. The regs also address the material functional and risk allocations in a CSA context.

Final regs effective after 2008 state that a tax return preparer in the United States cannot disclose a taxpayer's social security number to a non-US-located preparer unless the taxpayer consents and disclosure is made with adequate data protection safeguards.

The IRS issued 2009 procedures for private letter rulings and other guidance.

Bulgaria

A new corporate income tax law entered into force after 2008. A tax holiday for investment, introduced late in the legislative process, allows a five-year corporate income tax exemption for profits from agriculture, processing, production, high-tech industries, and the building of infrastructure.

United Kingdom

A corporation tax bill, published in December 2008, is the fifth bill that rewrites UK direct tax law—and the first to rewrite corporate tax—in order to modernize it, clarify it, and make it more user-friendly.

China

Nine forms for the annual transfer-pricing disclosure of related-party transactions were issued for completion and filing with the new annual corporate income tax return due on May 31, 2009. The State Administration of Taxation also issued a notice regarding the tax treatment of partners, applicable after 2007.

Spain

New transfer-pricing regs for transactions with related parties and with entities in tax havens contain significant amendments, including simultaneous documentation requirements and penalties for failure to deliver such documents, a mandatory comparability analysis, and APA application procedures.

Chile

A new bill introduces decentralized tax and customs courts of first instance. Complete independence from the administrative arm should allow judicial freedom of legislative interpretation.

OECD

On November 17-18, 2008, the OECD consulted with business community representatives and senior government officials from member countries regarding the OECD transfer-pricing guideline discussion drafts on comparability and transactional profit methods (released in May 2006 and January 2008, respectively.)

OECD Revenue Statistics 2008 show that the average tax burden in the 30 OECD member countries as a percentage of GDP was 35.9 percent in 2006, near its historic high of 36.1 percent in 2000. Revenues from corporate income tax continue to rise: 3.9 percent of GDP in 2006 versus 2.2 percent in 1975. Since 1965, corporate income tax as a percentage of government revenue increased from 9 to 11 percent; social security charges increased from 18 to 25 percent. After rising in the 1970s and 1980s, the personal income tax share of government revenue is now below 1965 levels.

European Union

In *J.D. Wetherspoon PLC v. The Commissioners for Her Majesty's Revenue & Customs* (Case C 302/07), Advocate General Sharpston concluded that member states must determine the rules and methods of rounding for VAT purposes, observing the tax principles of neutrality and proportionality.

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