CANADIAN TAX *Highlights*

Editor: Vivien Morgan, LL.B.

Volume 17, Number 2, February 2009

ONTARIO PST SOFTWARE AUDITS

Ontario PST on software and related services continues to be a frequently encountered audit issue, with significant assessments raised against IT service providers and their customers. The rules are complex and the Ontario Ministry of Revenue's evolving interpretation has generally seemed to narrow the few exemptions. (See, for example, "Ontario PST on Software," and "Ontario PST on Software 2," *Canadian Tax Highlights*, July 2006 and June 2007, respectively.) Recently, however, the minister released a new interpretation on the nature of custom software.

Custom software is defined as a software program that was designed and developed solely to meet the specific requirements of a particular person and that is intended for its exclusive use. For several years, ministry auditors considered that a purchaser who had not acquired ownership of the underlying software code did not have exclusive use and thus had not acquired a custom program. However, in commercial practice a vendor develops the routine underpinnings of its programs by drawing on its library of codes and on code licensed from third parties. Signing over the underlying intellectual property rights inherent in such strands of code would eviscerate the vendor's business, but not doing so represented a hurdle to the Ontario PST exemption. Other provinces had similarly worded exemptions for custom software, but only Ontario took this commercially obstructive interpretation. Whether as a result of representations made, or because the ministry wished to enhance its audit simplicity and clarity, the new interpretation letter on custom software (CRS-0001, September 15, 2008) marks a shift in policy: "Provided the developer explicitly states (by way of a contract or other legal documentation) that the program being developed for the customer will be for the exclusive use of that customer, then such a program may qualify as a 'custom computer program' despite intellectual property rights being retained by the developer."

This new interpretation suggests that if the program's transfer in final form is properly documented as being for the exclusive use of the purchaser, then the exemption criteria may be satisfied without the transfer of ownership of the program's building blocks represented by individual strands of code. This position raises the question of whether two separate programs that each contain substantial blocks of identical code, with only minor additional unique strands to distinguish them, should qualify as custom programs under the spirit and intent of the legislation. Arguably, the requirement to document exclusive use, with its attendant legal implications, will temper any propensity to push the limits of this more lenient interpretation.

The protection afforded the ministry by the documentation requirement, combined with the need to achieve audit simplicity, suggests that the interpretive shift will benefit all interested parties. The change also bodes well for other areas of interpretive contention, such as the non-taxable status of certain component services that form part of a larger software installation project and the exemption for IT placement services. The latter are non-taxable "if the contract or arrangement between the placement agency and its client is for the supply of human resources and not for the provision of a taxable service," usually demonstrated by the fact that the IT consultant is not under the direction and control of the placement agency. This issue is raised with increasing frequency on audits, and taxpayers have experienced resistance from auditors in characterizing an arrangement as non-taxable IT placement services versus an outsourcing of taxable IT functions. Arguably, the former focuses on the secondment of qualified individuals to fill gaps within a customer's IT department, whereas the latter typically involves the service provider's assuming contractual responsibility for stipulated deliverables such as the development and/or implementation of software programs. The area is complex and the stakes are high, but it is hoped that the same productive spirit of reasoned compromise exhibited by the ministry in its resolution of the custom software issue will also be extended to other difficult interpretive issues as they arise.

Audrey Diamant
PricewaterhouseCoopers LLP, Toronto

In This Issue

SCC GAARs Lipson Spousal Attribution Plan

In its recently released decision in *Lipson* (2009 SCC 1), the Supreme Court of Canada—split 4:2:1—applied GAAR to deny a taxpayer's interest deduction following a series of transactions designed to convert non-deductible home mortgage interest payments into deductible interest payments on money borrowed to purchase shares. A bare majority of the SCC, in contrast to the two dissenting judgments, applied GAAR because the interest attributed to the taxpayer from his wife arose as part of an abusive series of transactions. The decision appears to provide welcome resolution of one set of GAAR issues, but many aspects of the three opinions rendered may in practice generate rather than reduce confusion.

Briefly, on the facts, Mr. and Mrs. L had contracted to purchase a house in the spring of 1994. Instead of directly financing the purchase, they undertook a series of transactions designed to use the equity Mr. L held in a family business corporation (the company) to provide the funding. In August 1994, Mrs. L borrowed funds from a bank, with a promise to repay the loan on the next day, and used the funds to purchase the shares that Mr. L held in the company. Mr. L then applied those sale proceeds toward the purchase of the house with Mrs. L. The couple obtained a mortgage in the same amount, secured by their joint pledge of their interests in the new house, and used the proceeds to repay Mrs. L's overnight loan. Mrs. L did not have adequate income to pay the interest on the unsecured loan and the bank extended the loan only because of the promise to repay it the following day.

The SCC considered the deductibility of the mortgage interest in the context of GAAR, both with and without reference to the application of the attribution rules. The CRA conceded that until the point in the series of transactions that triggered the attribution rules, GAAR did not apply. The SCC had relatively little difficulty concluding that the transactions were "unimpeachable" up to and including the point where Mrs. L used the overnight loan to purchase the shares and the couple purchased the house with the cash. Both dissents also accepted that the policy inherent in the interest deductibility rules contemplates a tracing of borrowed funds to their use, so that an abuse of that policy should not arise when a taxpayer structures his or her affairs to comply with that policy.

However, the majority concluded that GAAR applied once the transactions progressed to the point where Mrs. L's loss (generated by the interest deduction) was attributed to her husband. The majority provided its view of the attribution rules' purpose, but only in general terms and without providing any authority. The SCC then said, "It seems strange that the operation of [these rules] can result in the reduction of the total amount of tax payable by Mr. Lipson on the income from the transferred property. The only way the Lipsons could have produced the result in this case was by taking advantage of their non-arm's length relationship. Therefore, the attribution . . . qualifies as abusive tax avoidance." The segue from "strangeness" to "abuse" seems tantamount to a smell test, a long way from the careful analysis of the statutory scheme that the SCC mandated less than four years ago in *Canada Trustco* (2005 SCC 54).

The future impact of the *Lipson* decision appears to be mixed. On the one hand, there is welcome confirmation by all members of the court that, even under GAAR, the deductibility of interest is established by tracing borrowed funds to their use. The principle could well be extended to other provisions of the Act that depend upon a determination of the use of funds or property. On the other hand, the majority decision on the application of GAAR seems to have made more confusing the standard for finding abuse based upon violation of a statutory scheme. The majority appeared to say that a statutory scheme need only be established on a "balance of probabilities" and also appeared willing to rely on little more than a smell test in determining abuse; both positions are highly troubling.

It is plausible that this decision of a bare majority of the SCC, with little reasoning supporting its most troubling aspects, may ultimately be confined to its particular facts and the interaction of GAAR and the attribution rules. In that event, the factors emphasized by the entire SCC in *Canada Trustco* may yet be reasserted: the importance of consistency, predictability, and fairness in statutory interpretation and the requirement that the demonstration of an abuse under GAAR must be "clear." However, unless and until the impact of *Lipson* is confined to its facts, one significant legacy of the decision may be uncertainty and confusion.

Paul Hickey
KPMG LLP, Toronto

Mark Meredith
KPMG LLP, Vancouver

Downturn Begets PFIC Status

Not all of the negative fallout from the global financial downturn has galvanized the mainstream media's attention. For example, non-US public companies and their advisers should heed the potential for the severity of the current economic downturn to trigger passive foreign investment company (PFIC) status. Any investment by a

US investor in a non-US public company that is or may be a PFIC is made less appealing by the imposition of onerous tax rules.

A non-US company is a PFIC if at least 75 percent of its income, or at least 50 percent of its assets, is considered passive. The asset test may be particularly problematic because the current financial markets have depressed many a public company's market capitalization, the means usually used (after corporate liabilities are added) to value a public company's assets for PFIC testing purposes. Thus, the proportionate value of passive assets in a non-US public company may be much higher than it would be in a more normal marketplace, even for a company with an active business.

The PFIC rules were enacted in 1986 to discourage a US person from investing in a non-US company with passive investments (such as mutual funds) by imposing much higher taxes on a US shareholder who repatriates funds from such a company relative to the tax imposed on a US passive company subject to current US taxation. The ability to defer US tax continues under the PFIC rules, but the offset is that the investor is taxed at the highest US income tax rate and must pay an interest charge to reflect the deferral of US tax on certain distributions from, or dispositions of, stock in a PFIC. The US investor may mitigate these adverse US tax consequences by making certain tax elections reporting the company's financial information to the IRS, an option that the company may find burdensome and unappealing. Moreover, once a company is determined to be a PFIC vis-à-vis a US shareholder, it always retains that status for that shareholder, even if it actually meets the PFIC requirements for only one year.

Unfortunately, little legislative or administrative guidance exists to assess whether a non-US company's income and assets are deemed passive for the PFIC rules. Passive income includes interest, dividends, royalties, rents, annuities, and gains from the sale of property that produces passive income. For an active company, gross operating income for PFIC purposes includes revenue from sales less the cost of goods sold; usually such a company is thus unlikely to meet the income test for PFIC status as long as it is profitable on its sales. If the company is not profitable, it will have a PFIC problem if it has any passive income, even a small amount of interest income in a bank account. Passive assets are those that produce passive income; the value of passive assets is determined quarterly and averaged for the year. The IRS interpretation of which assets are passive is particularly problematic for a company (such as a service or high-tech company) that has few hard assets: cash on hand, even if it is committed to a particular purpose or held for working capital, is deemed passive under the PFIC rules. This characterization of cash on hand can also be problematic for a company engaged in raising money from investors, because money raised is often not deployed immediately and is deemed to be passive while it remains on the company's books.

At the heart of the PFIC asset test is the question of how to value a company's assets. More than a decade ago, a congressional committee said that a public company will "generally" value its total assets as an average based on its market capitalization at the end of each quarter, plus the corporation's liabilities. Market capitalization means the company's stock price multiplied by shares outstanding. In the present financial meltdown, however, the use of the market capitalization method may cause many previously unaffected companies to fall into PFIC status because, for example, the market value of the company is close to or even less than the amount of cash on hand. This unprecedented situation poses a challenge for a non-US public company that has or wishes to have a significant US investor base.

One possible solution is to consider an alternative to the market capitalization approach to establish a value for the company. The only legislative, administrative, or judicial guidance on the appropriate valuation method for a public company is the brief comment referred to above—that the market capitalization approach will "generally" be used. However, it is questionable whether in the current financial environment the market capitalization method can fairly determine a public company's value; other valuation methods may be more appropriate. Although it is not clear that the IRS will be receptive to a deviation from the market capitalization approach, it seems clear that in today's unusual financial markets the traditional approach produces results that are inconsistent with the PFIC rules' intent.

A non-US public company that is or may be a PFIC may need to disclose that status to investors; under US securities law, PFIC status may be a material factor requiring disclosure in securities filings. A non-US company and its advisers should carefully consider whether they need to address PFIC concerns, especially if the company has or wishes to have US investors. If PFIC status is a concern, consideration of alternative approaches to valuing the company may prove essential to ensuring the development and/or maintenance of a strong US investor base.

Carol A. Fitzsimmons
Hodgson Russ LLP, Buffalo

Falling Corporate Income Tax

The 2009 federal budget confirmed that the worldwide recession will hit federal revenues hard in the next two fiscal years. The table, which is derived from the budget's

Annual Growth in Federal Tax Collections

Fiscal year	Personal income taxes	Corporate income taxes	Total taxes
		percent	
2008-9	3.6	−21.9	−3.9
2009-10	−5.8	−16.9	−7.2
2010-11	6.9	16.6	7.8
2011-12	6.8	15.0	7.9
2012-13	8.1	2.4	6.4
2013-14	7.3	8.9	7.0

tables, shows that total tax revenues will fall by 3.9 percent in the current fiscal year and by 7.2 percent in 2009-10.

Much of the forecasted decline can be blamed on corporate income tax collections, projected to drop by 21.9 percent in the current fiscal year and by 16.9 percent in 2009-10, a decline of 35.1 percent over the two years. Personal income tax collections, on the other hand, are expected to fall by only 5.8 percent, and then not until 2009-10.

Two factors lead to the rapid and steep decline in federal corporate tax collections. First, the base drops dramatically because the recession will erase profits for many corporate taxpayers. In contrast, personal income will decline much less and more slowly, without the precipitous fall anticipated for profits.

Second, the mechanics of instalment payments mean that corporate tax collections will fall faster and further than federal tax from other sources. A corporation may choose as a base for its monthly tax instalments either anticipated profits in the current tax year or profits recorded in the previous tax year. If current profits begin to fall, the taxpayer will switch from the prior year's profit to an estimate of the (lower) current year, resulting in the immediate reduction in federal collections of corporate income tax. Personal income tax collections, on the other hand, will continue substantially unchanged, with payroll deductions providing stability. Furthermore, a corporation (and self-employed individuals) can carry back business losses and recover tax paid in prior years, further offsetting the corporate taxes collected and skewing the ratio to personal income taxes.

On the other side of the recession, as the economy begins to mend, the recovery will produce an increase, or at least stability, in wages and salaries, and will thus contribute to improved deductions of personal income tax at source. A corporation, like the self-employed, can use tax losses incurred during the recession to reduce future tax liabilities. This smoothing mechanism will slow the recovery in corporate tax collections.

Right now, the changes in the relative rates of corporate and personal tax collections are of interest only to federal and provincial officials concerned with cash flows. In future years, however, the resulting changes in the Canadian tax mix may raise problems of perception as the corporate share of income tax falls relative to the personal share.

David B. Perry
Toronto

New Section 116 Certificates

A non-resident who disposes of taxable Canadian property (TCP) is subject to Canadian tax absent a treaty capital gains exemption. To ensure collection of the tax, section 116 sets out a compliance procedure that includes a clearance certificate. Proposals revising requirements for those certificates have been enacted, and the CRA released a new form T2062C, Notification of an Acquisition from a Non-Resident Vendor.

A non-resident who proposes to or does dispose of non-excluded TCP may apply for a certificate of compliance from the CRA at any time before or within 10 days of the disposition. A certificate is required for actual and most deemed dispositions, whether the transaction is a tax-free rollover or triggers a gain. The certificate confirms that the vendor provided adequate security and has paid the related tax (25 percent of the gain, 50 percent in the case of inventory) or is entitled to a treaty exemption; the purchaser is thus relieved from remitting part of the proceeds to the CRA. If a clearance certificate is not obtained, a purchaser who does not withhold and remit a specified amount to the CRA is exposed to a penalty of 25 percent of the purchase price (50 percent in the case of inventory and depreciable property). Form T2062 must be completed for capital property; form T2062A is required for dispositions of Canadian resource property, Canadian timber resource property, non-capital Canadian real property, and depreciable TCP. A non-resident need not file a Canadian tax return if the disposition was excluded because there is no tax owing or a section 116 certificate was obtained.

Effective after 2008, a treaty-protected property is an excluded property for whose disposition a section 116 certificate need not be obtained. A property is treaty-protected if (1) after reasonable inquiry the purchaser concludes that the non-resident vendor is resident in a country covered by a Canadian tax treaty, and (2) that treaty and the vendor's residence status thereunder render the property a treaty-protected property, and the purchaser provides notice. The legal conclusion that the property is treaty-protected is not subject to the reasonable inquiry test applied to the purchaser's assessment of the vendor's residence status. If the transaction was vulnerable to a GAAR treaty-shopping attack, is the purchaser precluded from filing a notice or forced to make a treaty-shopping determination?

Form T2062C must be completed by a related purchaser of treaty-protected property and submitted within 30 days of the acquisition to the TSO where the property is located. Optional certification by the non-resident vendor may be included. An unrelated purchaser who wishes to reduce his potential for a withholding tax liability may also file form T2062C if after reasonable inquiry he determines the vendor's country of residence for treaty purposes and establishes that the Canadian property is treaty-protected property.

Part A of form T2062C requires characterization of the property as real property, business property, shares, partnership property, trusts, or designated insurance property, followed by a description of the property. In the case of shares, the name and street address of the corporation, the number of shares, their certificate numbers, and their par value or stated capital must be provided. For partnership property, the name, street address, and identification number of the partnership must be disclosed. The purchase price and date of acquisition must be set out.

Part B, the non-resident vendor information, includes the vendor's name, address, and country of residence for treaty purposes as established by the purchaser's reasonable inquiry.

Part C, the purchaser information, includes the purchaser's name and address, whether the vendor and purchaser are related, and the purchaser's tax entity status for Canadian tax purposes.

The purchaser signs the form certifying that the information in parts A, B, and C is correct and that it has concluded after reasonable inquiry that the vendor's country of residence for treaty purposes is as identified in part B. The general information portion of the form provides that in determining whether a property is treaty-protected, reference should be made to Canada's tax treaties.

Part D, the optional non-resident vendor certification (or in lieu thereof, an equivalent declaration by the vendor), will generally be accepted by the CRA to discharge the purchaser's obligation to reasonably inquire and take prudent measures to confirm the vendor's country of residence for treaty purposes. The non-resident vendor must disclose his or her social insurance number, its corporate business number, its trust account number, or its partnership identification number, as the case may be. The signature of the vendor or an authorized person certifies that the information is correct and complete. If the vendor is a hybrid entity or a partnership and the resulting income or gain is only partially tax-exempt, the CRA recommends that the purchaser withhold 25 percent of the pro rata portion of the purchase price unless the vendor obtains a certificate.

Concern has been expressed that it is too onerous to require that the purchaser determine the non-resident's exemption eligibility and that legal counsel for a purchaser may advise that a section 116 certificate be obtained and tax withheld. The changes will likely only reduce the number of section 116 certificates in related-party dispositions: an arm's-length purchaser may not accept the responsibility for verifying that the property is treaty-protected property and may continue to require a certificate. For example, assessing whether treaty relief for private company shares is available—where less than 50 percent of the foreign vendor's assets are Canadian real estate—involves an analysis of the balance sheet of the vendor or his company and a valuation of the assets. The residence of an arm's-length vendor may be difficult to ascertain if the vendor is a partnership or a company the majority of whose directors do not reside in the country where the vendor is claiming treaty protection. The notification procedure will be of assistance in a corporate reorganization that is tax-free under Canada's domestic rules because no tax arises.

Jack Bernstein
Aird & Berlis LLP, Toronto

Cash Not Property for Stop-Loss Rules

A recent technical interpretation (document no. 2008-0280111I7, January 6, 2009) confirms that a subsection 39(2) capital loss realized on foreign currency is not suspended by the stop-loss rules (subsections 40(3.3) and 40(3.4) and subparagraph 40(2)(g)(i)) because for those purposes cash is not property.

The TI involves a financing CFA that lends to and holds shares in a Canco's other FAs. The CFA puts its excess US-dollar cash in US-dollar term deposits or leaves it in a bank account, which is assumed to be held on capital account and not to be excluded property. The CFA offsets its FAPI by realizing accrued foreign exchange losses on its US-dollar funds.

The TI confirms that when the CFA uses its US-dollar cash to invest in the term deposits, or when the deposits are rolled over or converted back to cash, it need not report any gain or loss for FAPI purposes; this conclusion is consistent with *Interpretation Bulletin* IT-95R ("Foreign Exchange Gains and Losses," December 16, 1980), which says (at paragraph 13), that foreign currency funds are not disposed of when they are used to purchase non-negotiable instruments such as term deposits and GICs. (However, the TI indicates that when the CFA's US-dollar cash is used to make further loans or to pay dividends to Canco, the CFA has disposed of the cash, and any foreign exchange gain or loss realized relative to the Canadian dollar is included in its FAPI.) The fact that the CFA subsequently receives cash within 30 days does not mean that the cash was not initially disposed of; however, the question is raised whether any foreign exchange loss otherwise included in the CFA's FAPI is suspended by subsections 40(3.3) and (3.4).

The TI reiterates the CRA's longstanding position that on a disposition of property, section 40 (including all its stop-loss rules) applies to determine whether a taxpayer made a gain or sustained a loss. Section 39 then applies to compute the gain or loss; if it arose solely because of currency fluctuations, subsection 39(2) applies. (For example, see document no. 922257, January 12, 1993.) The TI acknowledges that the subsection 248(1) definition of property includes money. Thus, when the US-dollar cash is used by the CFA and within the 60-day period the CFA or a related person acquires US-dollar cash, arguably subsections 40(3.3) and (3.4) apply to suspend the foreign exchange loss, and to do so indefinitely until no person in the group holds US-dollar cash. Nevertheless, the CRA takes the view that cash is not considered property for the purposes of the section 40 stop-loss rules, and thus the foreign exchange loss is not denied.

This may be an administrative position for which the TI provides no technical analysis or reason, but arguably the currency loss is determined under subsection 39(2) and thus section 40 does not apply. First, subsection 39(2) applies where a taxpayer "has made a gain or sustained a loss," suggesting an economic gain or loss, not a gain or loss computed for dispositions of particular property under subdivision c (of which section 40 is a part) and covered by subsection 39(1). Second, the preamble to subsection 39(2) states that it applies notwithstanding subsection 39(1), indicating that a subsection 39(2) gain or loss is not computed in accordance with subdivision c and not otherwise captured. Statutory interpretation principles dictate that the words of a provision should not be read into redundancy, which would be the result of assuming that the foreign exchange gain or loss is first calculated as a disposition of property under section 40 before subsection 39(2) applies.

Paul Barnicke and Melanie Huynh
PricewaterhouseCoopers LLP, Toronto

Creditor Proofing Is Fraudulent Conveyance

In *Braydon Investments Ltd.* (2008 BCSC 1547), the Supreme Court of British Columbia found that a section 85 rollover to creditor-proof a corporation that had entered into a risky partnership venture was a fraudulent conveyance to defeat creditors' claims. The decision was based in part on a plan of reorganization letter from the corporation's solicitors indicating that the rollover was undertaken to creditor-proof the corporation. The business went bankrupt, and because the creditor-proofing plan was ineffective, the transferor corporation's assets were exposed to the creditors of its failed business venture. *Braydon* is neither a tax case nor a decision of a federal court, but it may have broad implications for parties to an estate plan that uses a tax-free rollover as part of a creditor-proofing strategy.

Mr. B was the directing mind of Opco, which existed for many years prior to the transactions, and of Holdco, which was incorporated in October 2005. Mr. B and his family trust were the shareholders of both corporations. In 2004, Opco sold a real estate asset for a substantial profit and realized a large capital gain; in 2005, the proceeds were invested in a new car leasing business, partnership A. Partnership A began operations on September 1, 2005 and was expected to generate capital cost allowance (CCA) that Opco, as a general partner, could use to obtain refunds of the capital gains tax that it paid in 2005. To be entitled to a CCA claim, Opco's major source of income must be from partnership A's income; if Opco held investment properties, the car-leasing business would not be its sole source of income. By October 2005, Opco had accumulated equity in real property worth approximately $20 million, which far exceeded what Mr. B wanted to invest (and risk). Consequently, two months after partnership A commenced operations, Holdco was incorporated on October 25, 2005 and Opco rolled its excess assets to Holdco under section 85. At that time, Opco had several significant creditors. By May 2006, partnership A had failed, with operating losses of more than $5 million. By May 2007, both Opco and partnership A were assigned into bankruptcy. Creditors' claims exceeded $20 million. The creditors (the plaintiffs) subsequently argued that there was effectively a disposition of $12 million in shareholders' equity in Opco, which emerged on Holdco's balance sheet.

After analyzing the relevant jurisprudence, the court found that that the term "creditors and others" in the British Columbia Fraudulent Conveyance Act includes present creditors, future creditors, and those who may become creditors of a debtor. Thus, a creditor who attempts to set aside a conveyance does not need to establish that he was the transferor's creditor when the impugned transaction occurred. The court said that a fraudulent conveyance is a transfer of an interest made with the intention and having the effect of hindering or impairing the right of a creditor. The absence of lying or deceit does not absolve the defendant. Furthermore, the word "defraud" in section 1 of the Fraudulent Conveyance Act—which voids a disposition "made to delay, hinder or defraud creditors"—"is not used in a technical, legal sense, and certainly not in any criminal sense." The court said that Mr. B's testimony and Opco's solicitors' letter outlining the reorganization plan provided direct evidence of the intent to defeat or delay creditors, and thus the court must find that the section 85 rollover was a fraudulent conveyance. The court also cited one of its earlier decisions and said that "[i]t is noteworthy . . . that the defendants [there] . . . were acting on general advice to make oneself creditor-proof, and that such an intent . . . was 'not *bona fide*' because it was made for a purpose of avoiding future claims of creditors."

The court said that its finding did not place judge-made restrictions on a taxpayer's right to a section 85 rollover: "These statutory provisions do not provide a license to engage in transactions which are counter to the *Fraudulent Conveyance Act*. The purpose of the Act is to prevent insolvent individuals from sheltering assets from the legitimate claims of creditors by assigning them to a convenient friend."

The court noted that the Fraudulent Conveyance Act does not apply if property is transferred for good consideration, lawfully, and in good faith to a person who at the time has no notice or knowledge of collusion or fraud. But on the facts this defence was not available because

1) there was no good consideration (unfortunately, the court did not explain why the promissory note that Holdco gave Opco was not good consideration);
2) the section 85 rollover was not in good faith, because the intent was to creditor-proof the assets; and
3) Mr. B was the directing mind of both Opco and Holdco and, as a result, the transferee must have had notice and knowledge of the fraud.

Despite Mr. B's lack of dishonest intent, the court concluded that Opco engaged in a fraudulent conveyance: "A transaction which is the result of an honest intent to defeat one's creditors is precisely one of the situations caught by the *Fraudulent Conveyance Act*." The court conceded that incorporating an enterprise as a separate legal entity is a legitimate means of limiting the assets that are put at risk in a business venture in order to protect personal wealth from the subsequent claims of creditors. On the facts, however, Opco did not do that. It entered into a partnership, and "[a]s a partner . . . was responsible for all debts incurred by the partnership." At that time it had substantial assets, but later it acted to shelter them from creditors by transferring them to a related company for little or no consideration. Thus, the court found that Opco had engaged in a fraudulent conveyance.

Jim Yager
KPMG LLP, Toronto

Home Renovation Tax Credit

The 2009 federal budget proposed a temporary 15 percent home renovation tax credit (HRTC) for contracts entered into after January 27, 2009 for work performed or goods acquired thereafter and before February 1, 2010. The maximum $1,350 HRTC may be claimed only on an individual's 2009 income tax return and for a maximum $9,000 of eligible expenditures exceeding a $1,000 threshold (an upper limit of $10,000 of expenses).

Expenditures incurred must be integral to a dwelling property eligible to be a principal residence under section 54, including a house, cottage, and condo unit. Receipts are required to support claims. A taxpayer's entitlement to the HRTC is not affected by other credits, grants, or other programs, including the medical expense tax credit program.

A family is limited to one HRTC on their pooled expenditures. A family includes an individual, a spouse or common-law partner, and minor children. If an individual cannot use the entire HRTC, the balance may be transferred to family members. If two or more families share ownership of an eligible dwelling, each can claim its own HRTC, as if it alone owned the dwelling.

An HRTC may be claimed for renovations and alterations of an enduring nature to a dwelling or land on which it sits, including finishing a basement or remodelling a kitchen. Incidental expenses, building permits, professional services, and equipment rentals are also eligible. Ineligible expenses include routine repairs normally performed annually or more frequently (such as cleaning, lawn fertilization, and snow removal), financing costs, and expenditures for goods or services provided by a non-arm's-length person who is not registered for GST/HST purposes. Furniture, appliances, audio-visual electronics, and construction equipment are not eligible. The budget enumerated some other examples:

1) Eligible expenditures: installing new carpet or hardwood floors; building an addition, a deck, a fence, or a retaining wall; installing a new furnace or water heater; painting a house's interior or exterior; resurfacing a driveway; and laying new sod.

2) Ineligible expenditures: the purchase of furniture and appliances such as a fridge, stove, or couch; the purchase of tools; carpet cleaning; and maintenance contracts, such as those for furnace cleaning and pool cleaning.

To determine whether an expense brings into existence an asset of enduring nature or is simply a repair or maintenance expense, a taxpayer can also ask whether the expenditure substantially changes the character of the asset or whether it merely restores the asset to its original state in order to maintain its use. The distinction is sometimes blurred because expenses incurred in a project can have a dual nature, partly restoring the asset to its original state and partly improving it. Sometimes the difference is merely one of degree. When the expenditure's qualification for the HRTC is in doubt, it may be prudent to examine the general guidance outlined in *Interpretation Bulletin* IT-128R or to seek clarification directly from the CRA.

John Jakolev and Graham Turner
Jet Capital Services Limited, Toronto

Choice of Court Crucial

The intersection of two or more pieces of legislation with divergent appeal routes may make it difficult for an aggrieved taxpayer or importer to choose the proper appeal route. Choosing incorrectly may leave the litigant with no opportunity to argue its case on the merits if the court denies having jurisdiction over the matter and limitation periods have expired. The recent decision in *Spike Marks Inc.* (2008 FCA 406) exemplifies the challenges.

Spike Marks imported flavoured cigars in individual plastic containers from the United States. The Canada Border Services Agency (CBSA) conducted a compliance verification review on the tobacco products and issued detailed adjustments statements (DASs) to Spike Marks under the Customs Act for failing to use proper tariff classification on the goods' importation and requiring the payment of additional excise and additional duties under sections 42 and 43 of the Excise Act.

Pursuant to section 60(1) of the Customs Act, Spike Marks requested a redetermination of the DASs by the CBSA. The CBSA upheld the DASs, and Spike Marks made further submissions: it objected to the tariff reclassifications and to the calculation of the additional duties, and it also raised the question of whether the CBSA had jurisdiction to assess the additional duties under the Excise Act. The CBSA again confirmed its decisions.

Spike Marks appealed the CBSA's final decisions to the Canadian International Trade Tribunal (CITT) under section 67(1) of the Customs Act. But instead of arguing its case on the merits, Spike Marks asked CITT for a declaration that it lacked jurisdiction to hear the appeals. (Apparently Spike Marks argued that the duties were excise duties over which CITT had no jurisdiction, and the Crown argued that they were customs duties calculated by reference to the Excise Act, making CITT the appropriate forum.)

CITT agreed that it had no jurisdiction and ruled in favour of Spike Marks; neither Spike Marks nor the Crown appealed that decision.

Spike Marks then applied to the Federal Court for judicial review of the CBSA decisions. The applications judge of the Federal Court held that section 18.5 of the Federal Courts Act precluded the court's review of the decisions because section 67(1) of the Customs Act granted an appeal to CITT.

The Federal Court of Appeal ultimately upheld the applications judge's finding, leaving Spike Marks with no further appeal recourse. The FCA concluded that Parliament could not have intended a complicated and inefficient mechanism whereunder an aggrieved importer must pursue two appeal routes: an appeal to CITT in respect of tariff reclassification under the Customs Act and an appeal to the TCC in respect of duties assessed under the Excise Act. Section 44 of the Excise Act stated that the duties on imported tobacco products were to be paid and collected under the Customs Act as if they were duties under that act; the FCA concluded that this provision empowered the CBSA to assess and collect the duties as if they were customs duties, not just to collect excise duties that had been assessed under the Excise Act.

Spike Marks is an interesting case that reveals the danger of urging CITT (or any court) to rule that it has no jurisdiction. Spike Marks might have been better advised to appeal to CITT on a precautionary basis and hold those appeals in abeyance pending applications for judicial review to the Federal Court. That strategy might have allowed Spike Marks to resurrect the CITT appeals in the event that the Federal Court also declined jurisdiction.

Robert G. Kreklewetz and Jenny Siu
Millar Kreklewetz LLP, Toronto

RESPs Re-Enhanced

Recent federal enhancements to the rules governing RESPs make these plans even more attractive than they already were. (For enhancements that applied commencing in 2007, see "RESPs Enhanced," *Canadian Tax Highlights*, November 2007.)

Commencing in 2008, RESP time limits are extended by 10 years. Thus contributions can be made to an RESP for 31 years (formerly 21 years) following the year when the plan was entered into, but a family plan's beneficiary must be younger than 31 years (formerly 21). An RESP must be terminated by the end of the calendar year that includes the 35th anniversary (formerly the 25th) of the plan's opening. (When the beneficiary of an individual RESP qualifies for the disability tax credit, there are an extra four contribution years and an extra five years before mandatory termination.) The extended time limits allow the use of RESP funds throughout a student's undergraduate studies and on into postgraduate studies. A family plan is now more appealing because its required termination is less likely to occur before the youngest child in the family begins his or her post-secondary education.

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
Telephone: 416-599-0283
Facsimile: 416-599-9283
Internet: http://www.ctf.ca
ISSN 1496-4422 (Online)

The requirements are relaxed for distributing educational assistance payments (EAPs) to finance an RESP beneficiary's post-secondary education. Commencing in 2008, an EAP paid up to six months after a student ceases to be enrolled in a qualifying program still qualifies as such if it would have qualified had it been made immediately before the student's enrolment ceased. The previous requirement that an EAP could be received only while the student was enrolled in a qualifying post-secondary program prevented a graduate of a post-secondary institution from receiving any remaining funds from his or her RESP as EAPs.

To ease the administrative burden for RESP promoters, commencing August 12, 2008, the CRA no longer expects promoters to assess the reasonableness of a beneficiary's expenses supporting his or her annual EAP requests for up to $20,000 (indexed). However, that threshold does not override the maximum EAP that can be distributed in certain circumstances.

Louis Provenzano and Angela Ross
PricewaterhouseCoopers LLP, Toronto

Michigan Tax Relief for Canadian Businesses

Recent changes to the Michigan business tax (MBT), retroactive to January 1, 2008, may reduce the tax burden for Canadian companies with Michigan sales and generate refunds for some companies that paid estimated MBT in 2008. The changes flowed from efforts by Canadian businesses and governments to convince Michigan to effectively reinstate prior tax rules that were more favourable to Canadian businesses.

The MBT, enacted in 2007, replaced the old single business tax (SBT) with a tax regime that includes a business income tax (BIT) and a modified gross receipts tax (GRT). The BIT is a traditional income-based tax imposed at a rate of 4.95 percent on income apportioned to Michigan based on sales. The GRT is imposed at a rate of 0.80 percent on gross receipts apportioned to Michigan, using the same method. The MBT applies to taxpayers with Michigan-apportioned gross receipts exceeding US$350,000. An additional surtax applies to the MBT liability.

The MBT applies to US and foreign entities, including a Canco. The change from the old SBT to the MBT adversely affected many Cancos because the sourcing rules governing the tax treatment of their sales to Michigan customers changed under the MBT. Under the old SBT, a Canco that had nexus in Michigan often had no tax liability. When title to goods sold by a Canco seller to a Michigan buyer (USco) passed in Canada, the sale was sourced as a non-Michigan sale for the apportionment required to determine the SBT base, even when the USco purchaser brought the goods back to Michigan. Thus, for example, a Canadian auto parts manufacturer likely had no SBT liability if title passed in Canada for all the goods it sold to its Michigan customers.

The MBT sourcing rules that were originally enacted in 2007 required Canco to source income receipts on a destination basis—whether the goods were ultimately destined for Michigan—and not where their title passed. As a result, many Cancos with Michigan-destined sales for which title passed in Canada were required to make substantial 2008 estimated MBT payments.

Recently enacted MBT amendments effectively reinstate the favourable sourcing rules that prevented a Canco from having an old SBT liability. The amendments clarify that the MBT applies only to the US business activities of a foreign entity and thus excludes from a Canco's tax base any proceeds from sales for which title passes outside the United States. The legislation also clarifies that both the BIT and GRT bases include only items of income and adjustments that relate to US business activity.

The new legislation implements special sales allocation rules for foreign persons, including Canadian service providers who perform services for US-located customers, both in Canada and in the United States.

A reciprocity exemption is included in the new legislation. Michigan will not impose MBT on a foreign person (such as a Canco) that has a US presence and is domiciled in a sub-national jurisdiction (such as a province), provided that the province would not impose an income or other type of business tax on a similarly situated person (such as a USco) that was domiciled in Michigan and had the same presence in Canada that Canco has in the United States.

Jeffrey Brown and Naomi Cutler
KPMG LLP, Toronto