CANADIAN TAX Highlights

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Quebec Targets "Aggressive Tax Planning"

Quebec Finance recently released a 109-page consultation paper (Finances Québec, *Aggressive Tax Planning*, January 30, 2009) on recommended strategies to combat aggressive tax planning (ATP). The recommendations include a mandatory early disclosure mechanism and GAAR amendments such as a three-year extension of the normal GAAR limitation period. Comments may be submitted only until April 1, 2009 (extended from March 1). Although this is a Quebec initiative, the other provinces and the federal government are expected to watch the development carefully and possibly adopt similar programs.

The paper generally defines ATP as a tax-avoidance transaction that reduces the effective tax rate on a particular source of income to a level below the rate sought by fiscal policy. The paper notes that except for the resulting tax benefits, the economic justification of an ATP "scheme" is limited and may not even exist.

The paper further notes that ATP often

> exploits shortcomings or weaknesses in one, if not more, tax laws at a time. It frequently involves circular movements of funds, shell companies or the use of financial instruments or entities that are treated differently depending on the tax jurisdictions. . . .
>
> Lastly, an ATP scheme usually involves a substantial discrepancy between the financial risk assumed by the taxpayer and the tax benefit expected from the scheme.

The paper goes on to say that

> a favourable risk/reward ratio for the taxpayer and the development of a new business model based on designing and distributing off-the-shelf tax products, were among the factors with the most influence on the proliferation of ATP and on which the tax authorities can act. It was also shown that certain characteristics inherent in Québec's tax system have an impact on the development of ATP schemes.
>
> Moreover, it was mentioned that certain contextual factors have a major influence on fiscal policy in terms of fighting against ATP, in particular Canadian fiscal federalism and the high degree of harmonization of provincial tax systems.

Under Quebec's recommended approach, if a transaction is subject to a confidentiality agreement between a taxpayer and a tax adviser, or if the tax adviser's fee is contingent on obtaining a certain result, early disclosure would be required within 30 days after the transaction commences. Recommended penalties for non-disclosure range between $10,000 and $100,000, and the limitation period to attack the transaction would be suspended until the filing of the prescribed disclosure form.

Concerning the application of GAAR, the paper states that the "examination of the legislative tools used in Australia, New Zealand, and Ireland indicates that the application of the GAAR can be strengthened by introducing a penalty regime and by extending the period of limitation." Thus, the paper recommends an extension of the normal limitation period by three years, unless the taxpayer discloses the transaction to Revenue Quebec under optional preventive disclosure rules or in the course of mandatory disclosure. As well, taxpayers may incur a penalty equal to 25 percent of the additional tax resulting from GAAR's application, and the promoters may suffer a related penalty equal to 12.5 percent of their fees for implementing the transaction. The GAAR penalty may be avoided by a taxpayer who successfully raises a due diligence defence or who complies with mandatory disclosure rules or chooses to meet preventive disclosure rules; in such cases, the promoter is relieved of the related 12.5 percent penalty.

The paper also recommends expanding the definition of an avoidance transaction in line with amendments that other provinces have made.

The paper follows Quebec's 2008 budget announcement of Revenue Quebec's intention to intensify its fight against aggressive tax-planning strategies, notably by pursuing collaboration with other tax authorities in Canada. The budget allocated $5.3 million per year for the next three

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years to Revenue Quebec to "set up a team specializing in managing, detecting and shutting down ATP schemes."

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Reg 400 Surprise

Buried in the massive 2009 budget bill tabled on February 6, 2009 is an obscure regulatory amendment with far-reaching consequences. For example, the change may increase the provincial tax burden of certain US-owned Nova Scotia unlimited liability companies (NSULCs) by 60 percent and their overall tax bill by 20 percent.

The bill adds new regulation 400(2)(e.1) to the "permanent establishment" definition, effective for the 2009 and subsequent taxation years. Generally, a PE cannot exist unless a business is carried on, but the new rule provides that "if, but for this paragraph, a corporation would not have a [PE], the corporation is deemed to have a [PE] at the place designated in its incorporating documents or bylaws as its head office or registered office." Thus, under section 124 every corporation formed in Canada—whether or not it actually carries on a business in a province—is entitled to the 10 percentage point abatement of its corporate tax rate, and any corporation with a registered office in a province whose system is harmonized with the federal corporate tax system (all provinces except Quebec and Alberta) is subject to provincial taxation. A corporation carrying on business through a traditional PE is not affected. But the change does affect a corporation that is a holdco or owns very few passive investments and thus currently pays the unabated federal tax rate and no provincial tax, because it has no PE under regulation 400(2) (subject to the facts and the rebuttable presumption that every corporation has a business).

The change significantly alters the interaction between the federal and provincial corporate tax systems. First, tax revenues levied on passive corporations shift from the federal government to the provinces, perhaps reflecting why the federal government first committed to the change in the 2006 Canada-Ontario Memorandum of Agreement Concerning a Single Administration of Ontario Corporate Tax.

Second, the amendment should resolve certain double-tax issues. For example, a similar rule in the Alberta Corporate Tax Act deems a PE to exist "in the place where [a corporation] has its registered office or in a place designated in its articles, charter or by-laws as its office or registered office." Double tax arises if the 10 percent abatement is not available and Alberta corporate tax applies. Section 12 of the Quebec Taxation Act deems a corporation to have an establishment in each province where it owns rental real estate. The proposed amendment fixes a double-tax issue for a Quebec-formed corporation by deeming it to have a Quebec PE and thus allowing an abatement, but a corporation not formed in Quebec may pay tax in both Quebec and its province of formation.

Third, the new regulation may significantly increase the tax burden on some holdcos—another blow to NSULCs, which are routinely used by US residents as Canadian investment holdcos and whose distributions may be denied treaty benefits under the new Canada-US treaty article IV(7)(b). A completely passive investment-holding NSULC does not currently have a Nova Scotia PE under regulation 400 and is thus taxed only at the unabated federal rate (29 percent in 2009). The new reg exposes that NSULC to a combined Nova Scotia-federal rate of 35 percent in 2009, a 60 percent increase in its provincial tax burden, and a 20 percent tax increase overall. Nova Scotia will likely see an exodus of holdcos to lower-tax provinces.

Finally, the change may increase corporate tax competition between Canadian provinces. If New Brunswick adopts the 5 percent rate that it is considering, it may become the holdco location of choice in Canada. However, no Canadian province currently has a corporate rate less than 10 percent (the abatement rate). Quebec may be the exception because it does not piggyback on the federal system and does not have a deemed-PE rule similar to the proposed new rule. Thus, overall tax is reduced for a Quebec-formed company that does not carry on business and has no PE for Quebec taxation purposes: it seems entitled to the abated federal rate of corporate tax under the new reg and is not subject to provincial tax.

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Holdco Beneficial Owner 2

The FCA has upheld the landmark TCC decision in *Prevost Car Inc.* (2009 FCA 57) that a Dutch holdco was the beneficial owner of dividends paid by a Canadian opco and thus entitled to the benefits of the Canada-Netherlands treaty (see "Holdco Beneficial Owner," *Canadian Tax Highlights*, May 2008).

Prevost Car, a Canadian-resident corporation that manufactured and serviced buses and related products in North America, paid dividends to its sole shareholder, a Netherlands-resident holdco. In 1995, the Swedish-resident Volvo and the UK-resident Henleys acquired Prevost via a Dutch holdco (51 and 49 percent, respectively). They wanted a non-UK, non-Swedish holdco that was resident in a less expensive European jurisdiction where business could be conducted in English; the Netherlands was chosen on Arthur Andersen's advice.

Under a shareholders' agreement between Volvo and Henleys (but not the holdco), not less than 80 percent of the holdco profits were to be distributed as dividends as soon as practicable up to the year-end; the holdco's board must take reasonable steps to ensure that Prevost took all action necessary to enable the holdco's payments. Some documentation was inconsistent with the holdco's owning the Prevost shares, such as minutes of an early shareholders' meeting that referred to Volvo and Henleys as shareholders.

The Canada-Netherlands treaty allows 5 percent withholding on dividends paid by a Canco to a Dutch-resident corporation that is the beneficial owner and meets shareholding thresholds. The term "beneficial owner" is not defined in the treaty or in the OECD model treaty; model treaty commentary said that the reduced rate was not available to an intermediary (such as an agent or nominee). Under Dutch law, the holdco was the beneficial owner: it was not legally obliged to pass on dividends to its shareholders—but it must fully distribute profits subject to solvency and reserve requirements and the corporate articles.

The FCA said that the TCC made no palpable or overriding error in its findings. Thus, the holdco was not an agent, mandatory, nominee, or conduit that had "absolutely no discretion as to the use or application of funds" and that had "agreed to act on some else's behalf [and their] instructions without any right to do" otherwise. The corporate veil should not be pierced. There was no evidence of a predetermined or automatic flow of funds to the shareholders. The holdco was a statutory entity carrying on business operations and corporate activity according to the constating Dutch law. The holdco was not a party to the shareholders' agreement and thus was not liable for failure to follow the dividend policy. The holdco's constating document did not oblige it to pay a dividend; any dividend must be paid per Dutch law. The holdco paid for and owned the opco shares; the dividends were its property and available to its creditors until a dividend declared by its board was approved by its shareholders.

The FCA decisions in *MIL Investments* (2007 FCA 236) and *Prevost* buttress the notion that under Canada's treaties a foreign recipient of dividends, interest, or royalties that has the discretion to deal with them is their beneficial owner. However, the court's comments on the use of OECD documents to interpret the model treaty raise concern. The FCA said that contrary to inferences that some have drawn from *MIL Investments* and to comments made in *Cudd Pressure* (98 DTC 6630 (FCA)), the latter decision recognized that the 1977 OECD commentary to the 1972 model treaty "can provide some assistance" in interpreting a 1942 treaty because it followed the "same moral principles" as the 1972 OECD model. The FCA said that the model treaty is a widely accepted guide to the interpretation and application of bilateral treaties, as are later commentaries "when they represent a fair interpretation" of the model treaty's words, when they are not inconsistent with commentaries existing when a particular treaty was signed, and when neither partner to the treaty objected to the new commentary. The FCA quoted the OECD's introduction to the 2003 model convention, which invites members to interpret treaties in accordance with the commentary "as modified from time to time" and "in the spirit of the revised Commentaries," which are intended to clarify, not change, the articles' and commentaries' meaning. The FCA concluded that the OECD Conduit Companies Report (1986) and the OECD 2003 amendments to the 1977 commentary are a "helpful complement" to earlier commentaries, provided that they do not contradict views previously expressed. However, it is difficult to imagine that the sovereign state parties to a treaty, a contractual arrangement, can contemplate and concur with subsequent commentary. Clarifying rules often overstep their stated intention, and the need for clarification suggests that the contracting parties may have had a different intention.

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Retroactive PST Change in British Columbia

A surprise retroactive PST change in the February 17, 2009 BC budget affects national businesses and organizations that mail administrative materials into the province. Although the term is not legislatively defined, the BC Ministry of Finance describes "administrative materials" as including account statements, invoices, purchase orders, business forms, financial reports, prospectuses, and annual reports.

Since 1986, a *Tax Interpretation Manual* (TIM) ruling has set out the province's assessing position: PST did not apply to administrative materials mailed individually to BC recipients. The ruling benefited businesses operating nationally as well as charities, professional firms, and other organizations that sent mass mailings prepared outside British Columbia to residents across Canada, sparing them from the need to track the costs attributable to the BC portion of the mailout. The ruling took a different stance on businesses that mailed administrative materials from inside British Columbia to individual recipients in any location: BC PST must be paid on the mailing's costs, with no reduction for out-of-province addressees.

The ruling appeared to be a reasonable interpretation of the Social Service Tax Act. At various times, the BC courts had considered the PST's application to promotional materials, but they had not opined on administrative materials or otherwise cast doubt on the TIM ruling. More recently, however, a taxpayer filed a refund claim when a PST auditor pointed out that it was not liable for the tax it had paid on administrative materials it mailed into the province. The claim was denied: in spite of the existence for 20 years of a clear and uncontroversial ruling, the province said that the tax was not paid in error and was not refundable. The province then marked the ruling in the TIM as "under review."

The ministry has now completed its review, and the result will cost some taxpayers and benefit others. On February 19, 2009, the ministry issued "Notice to Businesses—PST on Administrative Materials" (*Notice* 2009-002), which clarified the application of PST to administrative materials and completely reversed the PST impact of the earlier policy. Now PST applies to administrative materials mailed individually into British Columbia and no longer applies to a mailing made from a place inside the province to individual recipients outside the province. Moreover, the notice applies retroactively. A business that relied on the longstanding ruling and thus did not pay PST on mailings into the province is now required to self-assess the tax on those past mailings. The notice says that interest and penalties will be waived if payment is made before June 23, 2009, but warns that the ministry "may conduct an audit to review your records up to a four year period." For an entity such as a large retailer or financial institution that mailed account statements into the province over the four-year audit period, the newly discovered liability may amount to millions of dollars. The budget documents indicate that the associated legislative change will be revenue-neutral.

The negative impact of the retroactive change in policy will no doubt be tempered by the refund that the ministry is prepared to pay to businesses that paid tax on mailouts from British Columbia to recipients in other jurisdictions. But given the relatively small percentage of national offices in the province, it seems difficult to conclude that this offsetting refund entitlement will outweigh the tax liability created. Also, substantially more PST is raised by requiring its self-assessment on inbound mailings, including the postage costs: the post office does not charge PST on outbound mail. A government is free to change its administrative policy, but fairness suggests that the change should only be prospective if it will have a significant negative financial impact on taxpayers. Although the change is described in the notice as a "clarification" of the law, a legislative amendment was made to impose the tax on administrative mailings into the province (section 33 of Bill 2, Budget Measures Implementation Act, 2009). In effect, the amendment imposes a tax with retroactive effect back into the four-year assessment period; for the taxpayer whose refund claim triggered the review of the original policy, the change is effectively retroactive to 2000, the start of its refund claim period.

Unfortunately, a business assessed for tax unpaid in accordance with the TIM ruling cannot find relief in the provincial Taxpayer Fairness and Service Code. Originally, the code contemplated relief for a taxpayer who relied on "written information" from the ministry that was "incorrect or misleading." Now the code requires reliance on a "written ministry tax ruling," which ministry officials have clarified as meaning a taxpayer-specific ruling. Reliance on the longstanding TIM ruling, which appears to have been in accordance with law, will not be accepted as a defence at the audit level.

Retailers, service providers, financial institutions, charities, and others should determine whether they have been mailing into or out of British Columbia. Either they will have a refund claim, or they will have reason to pursue with the minister of finance the excising of the proposed administrative materials change from Bill 2 before it is passed.

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International Tax Comparisons

The Organisation for Economic Co-operation and Development (OECD) recently released its annual analysis of tax collections in its 30 member countries. In 2006, the latest year for which complete information is available for all members, Canada's total tax collections were equivalent to 33.3 percent of gross domestic product (GDP), the 19th highest tax burden in the OECD.

The table shows that Canada's ratios have been consistently lower than the OECD average since the turn of the century, and well below the average for the European members. Unfortunately, tax collections in Canada have been consistently higher than those in the United States, our closest neighbour and major trading partner. The table also highlights the change in the Canadian ratio since the federal government slipped out of deficit. The combination of tax reductions and strong growth in the national economy enabled us to lower taxes as a percentage of GDP from the 35 percent range to the 33.3 percent recorded for 2006 and in the preliminary results for 2007. Interestingly, the ratio in the United States has been rising over the past four years.

These tax comparisons must always be interpreted with care. The relationship between tax collections and measures of national income provides no insight into the competitiveness of each national economy. The different effects of reliance on taxes on income, consumption, or natural resources can influence economic growth. The purposes to which tax collections are devoted may also

Tax Collections as a Percentage of Gross Domestic Product, Selected Years

	1995	2000	2005	2006
Canada	35.6	35.6	33.4	33.3
United States	27.9	29.9	27.3	28.0
OECD average	34.8	36.1	35.8	35.9
OECD Europe average	37.1	38.4	38.0	38.0

cloud the comparisons; taxes devoted to health care may divert funds from the public sector to the private, for example, and thus provide an edge for Canadian companies that compete with US companies that themselves provide private insurance to their employees.

Unfortunately, the past is of little use in predicting the future. The reductions realized in Canada occurred when economic growth was strong. As the international economic crisis unfolds, the reaction of governments here and abroad to ballooning deficits may change not only the levels of taxation, but also the relative positions of each country.

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Accounting for FIEs and NRTs

The 2009 federal budget contained several interesting and positive international tax developments, including the repeal of section 18.2 (the so-called double-dip rule), and a promise to consider the December 2008 recommendations of the Advisory Panel on Canada's System of International Taxation relating both to foreign affiliate measures announced in February 2004 and to the proposed rules dealing with foreign investment entities (FIEs) and non-resident trusts (NRTs). The last item raises the question of the proper tax accounting under Canadian GAAP for investments in FIEs and NRTs. (US GAAP differs and takes only enacted legislation into account.)

A full decade has passed since the federal government announced its intention to prevent tax deferral and avoidance vis-à-vis offshore investment income of Canadian residents. To address perceived deficiencies in the existing rules, the 1999 federal budget proposed new measures for the taxation of FIEs and NRTs, and a series of legislative drafts ensued. Both the proposals' technical complexity and the myriad revisions created considerable interpretive and compliance challenges for practitioners and taxpayers alike. Once enacted, the revised rules were expected to be effective for taxation years beginning after 2006.

The latest version of the FIE and NRT legislation (old Bill C-10, not to be confused with the Budget Implementation Act, 2009, which is Bill C-10 for the current session of Parliament) received third reading in the House of Commons on October 29, 2007, and was referred to the Senate for final approval. Passage in the House meant that the legislation was "substantively enacted" under Canadian GAAP and its impact must be reflected in financial statements at that date. After second reading in the Senate, however, the bill went to the Senate Standing Committee on Banking, Trade and Commerce, which contemplated amendments. Owing to the September 7, 2008 call for a Canadian general election, Parliament was dissolved and all unfinished government business ceased; without royal assent, old Bill C-10 died on the order paper.

To date, the minister of finance has not reintroduced the proposed FIE and NRT legislation in the House of Commons. The budget's endorsement of the advisory panel's recommendation—that the government review the legislative proposals in light of Canada's anti-deferral regimes as a whole—contained no further details. No draft legislation on FIEs and NRTs is currently pending, but the rules proposed in old Bill C-10 are still substantively enacted for Canadian GAAP. The CICA Emerging Issues Committee says that a substantively enacted proposal that died on an election call continues to be viewed as substantively enacted for accounting purposes unless the government lost the election and its successor indicates that it will not reinstitute the proposed change.

The re-elected minority Conservative government plans to re-examine the long outstanding FIE and NRT proposals: its most recent budget expressed continued support for the policy objectives underlying the proposals. Accordingly, despite the uncertainty about the future form and status of the new FIE and NRT regimes, the general consensus reached among the large accounting firms is that old Bill C-10's draft legislation should still be viewed as substantively enacted for 2007 and 2008. If and when the government makes further announcements on the proposals, their Canadian GAAP treatment will then be revisited. Surprisingly, some CRA officials have indicated that taxpayers should file tax returns as if the FIE rules were enacted.

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Ontario Demand Loan Limitation Period

On November 27, 2008, in an omnibus bill re-enacting all or parts of more than 100 pieces of legislation, Ontario passed into law amendments to effectively reverse the impact of *Hare v. Hare* (2006 CanLII 41650 (Ont. CA)) regarding the limitation period applicable to demand promissory notes. The new start date for that two-year limitation period is the first day on which there is a demand to rectify any failure to perform under the debt (such as failure to pay). The amendments are retroactive to January 1, 2004, when the 2002 Limitations Act entered into force. Thus, for some promissory notes, limitation periods that previously expired because of *Hare v. Hare* have been retroactively revived or have not yet started to run.

The 2006 Ontario Court of Appeal decision in *Hare v. Hare* held that the two-year limitation period applicable to a demand promissory note (or other demand obligation) set out in the 2002 Ontario Limitations Act began to run when the loan was delivered, and not, as one might expect, on the date when a demand for repayment (or other performance) was made. The Ontario Bar Association asked that the law be amended to clarify that the limitation period of a demand note commences on the date when a default in making repayment occurs (provided that all other loan conditions are met), not on the date when the demand loan is made. (See "Demand Loan: Statute-Barred" *Canadian Tax Highlights*, May 2008.)

The latest legislative amendments do not affect demand obligations dated before 2004, when the 2002 law was originally effective; those obligations continue to be subject to the six-year limitation period commencing from the date when they were entered into (or a payment under or acknowledgment of the indebtedness was made). Thus, a 2003 demand loan obligation becomes statute-barred by its 2009 anniversary, unless some action is taken to restart the limitation period. Because demand promissory notes are frequently used for tax purposes, tax practitioners should carefully note the changes to these rules. The expiry or deferral of a limitation period can be either mitigated or refreshed by taking an action on the note, such as acknowledging the debt or having the debtor make a partial payment of principal or interest. Note that deemed interest for tax purposes, such as under section 80.4, is not a payment under common law.

Many family loans involve related parties and thus are not exposed to the negative tax consequences associated with the debt forgiveness rules, notwithstanding the commercial consequences of the lender's no longer being able to enforce payment. However, the specific rules for the application of section 80 apply only to commercial debts that have gone statute-barred if the debtor and creditor are either arm's-length or non-arm's-length and unrelated.

Tax practitioners may wish to review client situations that involve demand promissory notes subject to Ontario law. Previous tax filings should be reviewed in light of the legislative revival of a demand loan's enforceability. Pre-2004 demand loans that may expire should also be targeted for any necessary action to maintain enforceability.

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EI Premiums Invalid Tax

The SCC in *Confédération des syndicats nationaux* (2008 SCC 68) recently considered the constitutional limitations on taxes in a challenge to the premium-setting mechanism under the federal employment insurance system. The taxpayer also unsuccessfully challenged several other aspects of the EI system.

Numerous premium-setting mechanisms have been used since the EI system's inception. Effective in 1996, rates were set by the Employment Insurance Commission pursuant to section 66 of the Employment Insurance Act, which mandated a relatively stable rate to accumulate adequate reserves. In 2002, 2003, and 2005, the governor in council set the rate under a new premium-setting mechanism in sections 66.1 and 66.3, which omitted legislative criteria to guide the setting of rates.

In *Confédération des syndicats*, the taxpayer sought a declaration that the premium-setting mechanisms adopted since 1996 were invalid because, inter alia, they lacked sufficient connection with the regulatory framework of the EI system and therefore imposed a tax rather than a regulatory charge. Furthermore, the taxpayer argued that the imposition of that tax represented an unlawful exercise of the federal taxing power because it contravened the principle of parliamentary control over taxation under section 53 of the Constitution Act; the Crown countered that the federal taxation power exercised was valid pursuant to a clear and complete delegation of authority by Parliament. The taxpayer was unsuccessful before the Quebec Superior Court and the Quebec Court of Appeal, and was granted leave to appeal to the SCC.

On the issue of whether the premiums were taxes, the SCC said that prior law suggested that the premiums starting in 1996 were regulatory charges because they possessed sufficient connection to a regulatory scheme (*Westbank First Nation*, [1999] 3 SCR 134, and *620 Connaught Ltd.*, [2008] 1 SCR 131). Even though substantial surpluses had accumulated in the EI account since 1996, the rate was subject to the section 66 guidelines, which connected the premium to the EI program's expenditures and revenues. However, the provisions that were relied on in the setting of the premium rates in 2002, 2003, and 2005 omitted the legislative guidelines. In the court's view, this omission "radically altered" the analysis because the legal connection between the premiums and the regulatory scheme disappeared: in those years, the premiums became "a levy on payrolls and wages," and were effectively "transformed into a tax."

Having determined that the premiums were a tax in several of the years under review, the court then considered whether the requirement under section 53 of the Constitution Act had been met: that only Parliament can impose a tax. The court noted that Parliament's power to impose a tax may be delegated only if the legislation provides expressly and unambiguously for the delegation (*Ontario English Catholic Teachers' Assn.*, [2001] 1 SCR 470, and *Eurig Estate (Re)*, [1998] 2 SCR 565). A properly empowered delegate may exercise his power to establish the details and mechanisms of taxation. However, the provisions in question did not state that Parliament was delegating taxation authority to the governor general in council, and thus the nature of the levy was "ambiguous." It was not clear whether Parliament still considered that it was exercising authority to impose a regulatory charge. Accordingly, sections 66.1 and 66.3—applicable in 2002, 2003, and 2005—were declared invalid vis-à-vis the imposition of a tax, and thus the employment insurance premiums in those years "were collected unlawfully." Following its usual practice, however, the court suspended that declaration for 12 months "to allow the consequences of that invalidity to be rectified."

Although the court reached the rather striking conclusion that federal EI premiums were collected unlawfully without legislative authorization for a number of years—which would presumably give rise to a constitutional right to recovery under the *Kingstreet Investments Ltd.* (2007 SCC 1) doctrine— what will happen next is unclear. If the federal government uses the next year to effectively "rectify" the situation and, for example, enact retroactive legislation, the SCC's conclusions on the invalidity of the EI premiums are substantively muted. The use of retroactive legislation in this manner (as in *Air Canada v. British Columbia*, [1989] 1 SCR 1161) raises some troubling issues: it is arguably contrary to the rule of law and undermines taxpayers' faith in the judicial system as an effective avenue for challenging questionable tax measures.

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First-Time Homebuyer's Credit

The tax credit in the 2009 federal budget for first-time homebuyers, which may have been overshadowed by the new home renovation tax credit, is broader than proposed in the government's 2008 election campaign. The budget also increased from $20,000 to $25,000 the amount that a first-time homebuyer can withdraw tax-free from an RRSP after January 27, 2009 to purchase or build a new home.

The non-refundable first-time homebuyer's credit is available for a qualifying home purchase that closes after January 27, 2009. The maximum credit is $5,000 times the lowest personal income tax rate for that year (currently 15 percent), or $750. The election campaign proposal set the same maximum credit, but it was tied to the closing costs on a new home purchase and was phased in over four years.

An individual or his or her spouse or common-law partner can claim the new credit. Neither partner can have owned and lived in another home in the year or the four previous years. A qualifying home is eligible for the homebuyers' plan, and the individual, spouse, or common-law partner must intend to occupy it as a principal place of residence not later than one year after its purchase. The credit is also available for certain home purchases by or for the benefit of a disabled family member who is eligible for the disability tax credit.

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US Branch Profits and Hybrids

The new fifth protocol to the Canada-US treaty denies treaty benefits to certain hybrid entities. Article IV(7)(a) applies if a resident of one country receives payments or derives amounts through a hybrid that is recognized as a separate taxpayer by that country but is disregarded by the other country. This rule will significantly affect certain structures used by Canadian residents to invest in the United States, such as a Canco's limited liability company (LLC).

Typically, a Canco-owned LLC carries on business operations in the United States. US tax applies to Canco as if it operated a US branch, either because the LLC has a single owner and is disregarded for US tax purposes or because the LLC has multiple owners and is engaged in a US business activity. Article IV(7)(a) denies the Canco treaty benefits because its US income is earned through a hybrid entity (US LLC) that is recognized in Canada as a separate taxpayer but is disregarded or treated for US purposes as a flowthrough entity. Thus, the reduced 5 percent branch profits tax treaty rate does not pre-empt the 30 percent Internal Revenue Code rate.

Alternatively, the LLC may be converted into a US limited partnership, maintaining the branch structure and qualifying for the 5 percent reduced branch profits tax rate on profit distributions to Canco. Other possible alternatives include having the LLC check the box to be treated as a US corporation or to reincorporate Canco in the United States, but FIRPTA may trigger US tax if the LLC owns a US real property interest. Restructuring may result in additional US tax consequences, such as a deemed distribution to Canco if US partnership rules deem a change in its share of the hybrid's liabilities. Canadian tax implications must also be considered.

The new hybrid rules may pose significant problems for Canadian members of US LLCs. Other hybrids are also affected. For example, a US citizen or resident who owns shares in a Canadian hybrid—say, an unlimited liability company—may face increased Canadian taxation. Any structure using a Canadian or US hybrid entity should be reviewed to assess any adverse impact from the new rules, and the tax issues on both sides of the border arising from the restructuring alternatives must be considered. The new hybrid rules are effective January 1, 2010, giving practitioners some time to modify existing structures.

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CCPC Federal Budget Changes

Bill C-10 implements the 2009 federal budget's tax relief for CCPCs via an increase in the federal CCPC small business limit from $400,000 to $500,000, retroactive to January 1, 2009, and clarifies the rules relating to the timing of a corporation's acquisition of control. (The Budget Implementation Act, 2009 received royal assent on March 12, 2009.)

The **enhanced small business limit** means that a CCPC subject to the small business tax rate saves up to $8,000 in federal tax in 2009. Higher savings are achieved in Newfoundland and Labrador, Northwest Territories, Nunavut, and Prince Edward Island, where the provincial and territorial CCPC limits are harmonized with the federal limit. Ontario and Saskatchewan already have a $500,000 limit, and Alberta's limit increases from $460,000 to $500,000 on April 1, 2009. British Columbia's 2009 budget did not change its small business limit, which remains at $400,000. The other four provinces and the Yukon have not announced whether they will harmonize with the $500,000 limit. The table shows the 2009 combined CCPC small business rates on active business income up to $500,000.

Combined CCPC Small Business Income Tax Rates (for a 12-Month Year Ended December 31, 2009)

	Active business income of CCPCs	
	Up to $400,000	$400,000 to $500,000
	percent	
Federal	11.00	11.00
Alberta	14.00	15.73 (14.00)[a]
British Columbia	13.50	22.00
Manitoba	12.00	23.50
New Brunswick	16.00	24.00
Newfoundland and Labrador	16.00	16.00
Northwest Territories	15.00	15.00
Nova Scotia	16.00	27.00
Nunavut	15.00	15.00
Ontario	16.50	16.50
Prince Edward Island	13.37	13.37
Quebec	19.00	22.90
Saskatchewan	15.50	15.50
Yukon	15.00 (13.50)[b]	26.00 (13.50)[b]

[a] Because Alberta's CCPC threshold increases from $460,000 to $500,000 on April 1, 2009, the lower rate applies to a CCPC's active business income between $400,000 and $460,000. [b] For Yukon, the lower rate applies to M & P income.

The higher small business limit may allow more CCPCs to pay their balance of corporate income tax owing three months (rather than two months) after the end of the taxation year: after 2008, a CCPC with taxable income of up to $500,000 (formerly $400,000) is eligible for the extended deadline. Also, commencing with the 2009 taxation year, a CCPC with taxable income of up to $500,000 (formerly $400,000) may be eligible to pay quarterly rather than monthly instalments. The $3 million SR & ED expenditure limit applicable to a CCPC that earns ITCs at an enhanced rate of 35 percent is reduced when its taxable income for the previous year (ending after 2008) reaches the CCPC limit of $500,000 (formerly $400,000) and is eliminated when its taxable income reaches $800,000 (formerly $700,000). (A reduction in the expenditure limit may also be based on taxable capital; that reduction threshold, set in the 2008 federal budget, remains unchanged.)

Because Alberta's CCPC limit no longer exceeds the federal CCPC limit, Alberta's overintegration tax is effectively negated. (Alberta Bill 48, Alberta Corporate Tax Amendment Act, 2008, received royal assent on December 2, 2008.) That tax applies if a corporation pays eligible dividends out of income earned after 2008 that qualifies for the Alberta, but not the federal, small business deduction.

In the absence of an election, **acquisition of control** of a corporation was deemed to occur at the beginning of the day when control was acquired, instead of at the actual time that the share transfer took place. The time difference between the deemed acquisition and the actual acquisition resulted in anomalies. For example, in *La Survivance* ([2007] 1 CTC 189), the FCA said that a public corporation realized an allowable business investment loss on the sale of its subsidiary to a private corporation because the purchaser was deemed to control the subsidiary at the time of the actual share transfer. However, an extension of that decision might deprive an individual of the lifetime capital gains exemption on the sale to a public corporation or non-resident of shares of a CCPC that was a small business corporation (SBC). Bill C-10 ensures that this deeming rule does not apply for the purposes of determining whether a corporation is an SBC or a CCPC in respect of acquisitions of control occurring after 2005, except for acquisitions occurring before January 28, 2009 and for which the taxpayer files an election. To avoid excessive administration, a taxpayer is deemed to have so elected if it relied on the *La Survivance* interpretation in a filing before January 28, 2009.

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Thin Cap Calculation

A recent CRA technical interpretation (TI) revisits the meaning of the words "beginning of a calendar month that ends in the year" in clauses 18(4)(a)(ii)(B) and (C) (document no. 2008-028661, October 29, 2008). Although the TI reiterates certain well-established CRA positions on the interpretation of these words, it also raises new and interesting questions about how a company's equity and debt should be calculated for thin capitalization purposes if its taxation year begins or ends in the middle of a month.

On the TI's facts, a company (A Co) was incorporated on June 3, 2007 and elected to have its first taxation year end on June 15, 2007 (year 1). A Co's next taxation year began on June 16, 2007 and ended on June 15, 2008 (year 2). This fact situation is not uncommon in cross-border acquisitions, where, for example, a Canadian acquisition company incorporated to acquire a Canadian target amalgamates with the target mid-month. For the purposes of computing A Co's contributed surplus and paid-up capital (clauses 18(4)(a)(ii)(B) and (C), respectively) for June 2007 in year 2, the TI opines on whether the words "beginning of a calendar month that ends in the year" mean the earliest moment of the day on June 16, 2007.

The TI first confirms the CRA's well-established view that the "beginning of a calendar month" means the earliest moment on the first day of the calendar month, and that therefore equity invested at any other time on that day does not qualify for that month. At the Foundation's 2007 annual conference round table, however, the CRA departed slightly from this position and said that for a newly incorporated company, the phrase "beginning of the calendar month" means the date of incorporation. The published version of the CRA's comments (*Income Tax Technical News* no. 38, September 22, 2008) reveals the underlying logic; the beginning of the first calendar month cannot precede the date of incorporation because the company's first fiscal period only begins then. The CRA's position is reasonable: because subsection 18(4) applies for the purpose of computing a Canco's income "for a taxation year," the relevant equity amounts should be confined to those extant in that taxation year.

The parties requesting the TI sought to confirm a more general statement of that supposition: that for any taxation year the relevant beginning of the first calendar month that ends in the year is the first moment in that year—not necessarily on the first day of that month—and conversely that the relevant end of the last calendar month in the taxation year is the last day of that year. However, the TI adopts a different approach that seems to deviate from the logic of the 2007 conference response. According to the TI, the beginning of a calendar month that ends in a taxation year can be a moment that precedes the beginning of that taxation year: on the TI's facts, the beginning of the first calendar month ending in year 2 is June 3, 2007, the date of incorporation. Furthermore, the TI indicates that the last day of the last calendar month in year 2 (June 2008) does not fall in that taxation year—year 2 ends on June 15, 2008—and accordingly no equity is included in the year 2 thin cap calculation for that month. Nor is there any such equity in the calculation for the year 1 stub period, June 3 to June 15, 2007. Interestingly, the CRA concludes that similarly under subparagraph 18(4)(a)(i) there is no debt outstanding in respect of the last month of year 2, because June 2008 is not a "calendar month that ends in the year." Nor is there any debt amount for the year 1 stub period.

The CRA's approach seems to be based on a strict and inflexible interpretation of the term "calendar month." Arguably a more textual, contextual, and purposive interpretation of subsection 18(4) confines the relevant equity and debt amounts to those arising in the particular taxation year and results in a more consistent, appropriate, and coherent application of the rule. Assume that X Co has a June 29, 2008 year-end. If X Co expects to generate significant earnings in the current year, it can increase its debt to specified non-residents on June 1, 2008 to increase its interest deduction for the year ending June 29, 2008, and then use its 2008 year-end retained earnings to offset the increased debt in the next year. In effect, X Co uses its 2008 retained earnings to at least partially increase its thin capitalization room for that year, which seems contrary to clause 18(4)(a)(ii)(A). Limiting the relevant figures for the thin cap calculation to those that fall within the particular taxation year would eliminate such inconsistencies.

The CRA may be motivated by concern that a different approach may result in the averaging of year 2's equity over 13 months. However, nothing in subsection 18(4) suggests that the calculation must be made over a maximum 12 months, and a 13-month calculation period is possible under the approach taken at the round table. For example, if a company incorporated on June 28, 2007 has its first taxation year-end on June 30, 2008, the equity (and debt) for that year is averaged over 13 months.

The TI also appears to modify (or perhaps clarify) the CRA's round table response by suggesting that the "beginning of a calendar month" for a newly incorporated company is the first moment in time on the date of incorporation: what was said at the round table was that the beginning of that first month is the "date of incorporation." Although the logistics seem improbable, the TI went on to say that in consequence "an advance of equity at the earliest moment on the date of incorporation will qualify for the debt-to-equity computation." That new gloss seems to dilute significantly the scope of the administrative relief provided by the CRA's round table response. Perhaps the TI comment is meant to clarify that equity must be advanced at the earliest moment possible after incorporation, and not necessarily the first moment on that day.

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FBAR Uncertainties

Any US person with a financial interest or signature authority over one or more financial accounts in a foreign country must file IRS form TD F 90-22.1 (the foreign bank account report, or FBAR) if the aggregate value of the accounts exceeds $10,000 at any time in a calendar year. The FBAR is due on June 30 following the year in which the filing requirements are met. No filing extension is available; the form's instructions indicate that a taxpayer should not file the FBAR with his or her federal income tax return. In October 2008, Treasury updated and substantially changed the form, effective after 2008, to require more detailed disclosure from a broader base of filers.

One major change is definitional: a US person now includes "a person in and doing business in the United States." The reach of this language is less than clear, and thus without IRS guidance many non-resident aliens may file an FBAR as a precautionary measure. The definition of a "financial account" is also expanded to include debit card and prepaid credit card accounts. However, the form's instructions now state that the term does not include individual bonds, notes, or stock certificates held by the filer, or an unsecured loan to a foreign trade or business that is not a financial institution.

The definition of "financial interest" also now extends to accounts "for which the owner of record or holder of legal title is a trust, or a person acting on behalf of a trust, that was established by such United States person and for which a trust protector has been appointed." A US person now has a financial interest in a corporation's bank or other financial account if he owns more than 50 percent of its shares' voting power, a test that was formerly based only on the shares' value. Similarly, a financial interest in a partnership's bank or other financial account is now attributed to a person who owns an interest in more than 50 percent of the partnership capital, a change from the previous test based solely on the person's profit percentage.

The penalties for not filing an FBAR are stiff. A civil penalty may rise to $10,000, but for willful violations, for each year an account is omitted, the penalty may be $100,000 or 50 percent of the balance in the unreported account(s), whichever is greater, and criminal penalties may apply. There is no reasonable-cause exception for a willful violation. Two US senators recently proposed a law to enhance Justice's ability to prosecute tax evasion by applying the international money-laundering statute against a taxpayer who fails to file an FBAR. Recent case law and policy changes in Justice's tax division also heighten the risk of money-laundering charges for tax offences.

A taxpayer who believes that he should have filed an FBAR in a previous year and has not yet been contacted by the IRS should consider voluntary disclosure of the omission. Voluntary disclosure is typically viewed favourably by the IRS and Justice when they consider criminal prosecution, but it is no guarantee of immunity from prosecution and probably offers no relief from civil penalties.

UBS Switzerland's February 18, 2009 agreement with the Justice Department to release the names and account information of some of its US-person account holders, including some who failed to file an FBAR, provides even more incentive for taxpayers to file the form. When it admitted to helping numerous US persons conceal taxable assets by hiding income in offshore accounts, UBS agreed to pay the United States $780 million under a deferred prosecution agreement. Although the Swiss banking authority approved the disclosure of the client data, UBS's cooperation has been slowed, and may be prohibited, by Swiss bank secrecy laws. However, the United States has already filed a motion in US district court seeking enforcement of the IRS summons against UBS for the client data. The information of those clients deemed to have committed tax fraud under Swiss law is already subject to disclosure under article 26 (exchange of information) of the US-Switzerland tax treaty.

Whether or not the United States is successful in obtaining information on more UBS US account holders who

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failed to file an FBAR, Canadians (including US citizens living in Canada and possibly certain non-US citizens doing business in the United States) should be wary of the increased scrutiny of FBAR reporting and the willingness of banks to comply with IRS requests for banking information disclosure. If there is any chance that a taxpayer should file an FBAR, he or she should be sure to do so on time and should consider voluntary disclosure of any past failure to file. One hopes that the IRS will issue guidance that clarifies ambiguities in the revised form's expanded scope.

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Foreign Tax News

Gulf Cooperation Council

Member states (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates) approved (but did not sign) a monetary union agreement for the setting up of a monetary council to, inter alia, establish a GCC central bank and to issue a new currency by 2010.

United States

Rev. proc. 2009-7 updates lists of international tax issues for which private letter rulings and determination letters will not be issued, or will not be issued ordinarily in the absence of unique and compelling reasons. As in 2008, the 2009 lists include the questions whether a taxpayer is eligible for benefits under a limitation-on-benefits provision; whether a foreign individual is an NRA; whether a foreign taxpayer is engaged in a US trade or business or has a US PE; whether income is effectively connected with or attributable to the business or PE, respectively; issues pending request for competent authority under a US treaty; and certain issues regarding conduit financing arrangements.

OECD

An OECD consultative group issued a report on treaty benefits for income of collective investment vehicles for consideration by the Committee on Fiscal Affairs. Comprehensive recommendations are made regarding the extent to which the vehicles and investors should enjoy treaty benefits. A second report for the committee's review recommends improvements to the making and granting of claims for treaty benefits for intermediated arrangements. Comments are invited on both reports by March 6, 2009.

A report was released by the Tax Crimes and Money Laundering Sub-Group of Working Party no. 8. The report, which relates to the abuse of charities for money laundering and tax evasion in 19 countries, was based on a May 2008 questionnaire. The report sets out the common methods of abuse and attempts to quantify the risks in the various sectors affected. The report also includes detection strategies developed and red-flag indicators useful in training tax personnel who process or assess tax returns and audit or investigate taxpayers.

Treaties

Effective after 2008, the 1957 **Denmark-France** treaty was terminated by Denmark because negotiations for a new treaty had stalled over the taxation of pension income in particular. The notice of termination states that fundamental freedoms under the EU treaty are adequate to provide double taxation protection for businesses; other situations are not addressed. Negotiations for the new treaty continue. A **Switzerland-Japan** free trade agreement, the first European free trade agreement with Japan, was signed on February 19, 2009. A **UK-Isle of Man** tax information exchange agreement and a protocol to the 1955 tax treaty were ratified on February 11, 2009. A **Netherlands-Korea** agreement on mutual administrative assistance in customs matters, based on a model agreement of the World Customs Organization, entered into force on February 1, 2009, almost two years after it was signed. The agreement does not cover Aruba and the Netherlands Antilles.

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