CANADIAN TAX Highlights

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The Double Edge of Fraud

Bernie Madoff's $50 billion-plus Ponzi scheme caught the world by surprise. The next unpleasant surprise for victims of fraud may be the tax consequences of the so-called investment: it appears that there may be no Canadian deductions for the losses because no investment was made.

Madoff's plea allocution indicated that he represented to clients that he would invest their money in common shares, options, and other securities of well-known corporations; profits and principal would be returned on request. He also promised to hedge the investments. The representations were fraudulent: since the early 1990s, funds were never invested in securities but were merely deposited in a bank account. If clients requested payment of profits that they believed they had earned or repayment of principal, Madoff withdrew from the bank account funds that belonged to them and/or other clients. The victims included individuals, charitable organizations, trusts, pension funds, and hedge funds. Taxable investors paid tax on their purported income.

On March 17, 2009, the IRS issued Revenue ruling 2009-9 and Revenue procedure 2009-20, dealing with the US tax treatment of losses arising from Ponzi schemes. The IRS permits loan losses arising from theft to be treated as ordinary losses, not capital losses. The "theft loss" equals the investment plus the previously reported income for all years minus any cash withdrawals and any claims for which there is a reasonable chance of recovery. The reasonable chance of recovery test is challenging, but an IRS safe harbour permits the deduction of 95 percent of the loss net of any actual recovery in the year of discovery and net of any potential recovery from insurance (the Skadden Memorandum, dated March 24, 2009). The losses may be carried back up to 5 years (normally 3 years) and forward 20 years.

Canadian victims of Madoff and other frauds are not so fortunate. There is no administrative guidance, and the jurisprudence is not favourable. The basic issues are whether there was a disposition of property owned by the taxpayer and whether any business was carried on. The most favourable result is a capital loss—not a non-capital loss—on a disposition of investments, but if no property was acquired, there is no loss. Nor is there any source of income from which a taxpayer can claim a deduction if the money is lost in a fraudulent scheme. Income previously reported is not eligible for loss treatment, at least not in the current year. In the case of a purported partnership investment, the CRA has successfully argued that in a fraudulent scheme there is no partnership because there is no business. Similarly, a direct investment in a fraudulent business is not deductible as a non-capital loss.

In *Zakrzewski* (2008 TCC 385) an individual was denied a loss when he was apparently swindled on his investment in a joint venture promoted by his financial adviser. There was no credible evidence that the loss was incurred in a business. *Vankerk* (2006 FCA 96) dealt with a scheme to defraud investors by soliciting investments in fake partnerships. The taxpayers honestly believed that they had invested in partnerships that were carrying on business: they were presented with business plans that appeared to be reasonable, and they relied on reputable lawyers, accountants, investment advisers, and bankers. The FCA pointed out that evidence of due diligence was irrelevant: this was not a case of a business that suffered losses because it was ill conceived or poorly managed and the tax authorities then second-guessed the business acumen of the taxpayer. On the facts, there was no business and thus no business expenses and no factual foundation for any of the deductions claimed.

In contrast, *Interpretation Bulletin* IT-185R, paragraph 2, provides that losses incurred through theft, robbery, and shoplifting by strangers are an inherent risk of most businesses, and losses of trading assets from such causes in circumstances where the loss is reasonably incidental to the income-earning activities of the business are normally deductible in computing income from a business. For example, in *Parkland Operations Ltd.* ([1991] 1 CTC 23), the FCTD allowed losses that were part of normal revenue-receiving activities. Money came out of operating funds, and there was no question that there was a business in place. The TCC in *Agnew* (2002 DTC 2155)

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allowed deductions for $1 million misappropriated by a business's general partners for their personal expenses.

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Ontario PST Harmonization

Ontario's 2009 budget ended speculation over when and whether it will harmonize the PST with the federal GST (see "Planning for Harmonization," *Canadian Tax Highlights*, January 2008). Effective July 1, 2010, a single 13 percent HST replaces the 5 percent GST and the 8 percent Ontario PST. The Ontario component, the Ontario VAT (OVAT), is similar to components in the harmonized system in three Atlantic provinces, but it also reflects some elements of the long-harmonized Quebec sales tax.

The OVAT will be administered by the CRA and filed under a single return. The base for calculating the OVAT will effectively mirror the GST, but point-of-sale rebates will exist for books, children's clothing and footwear, children's car seats and car booster seats, diapers, and feminine hygiene products. All those products are currently exempt from Ontario PST and thus will be subject to only the 5 percent federal component of the harmonized tax; the vendor's overall ability to claim input tax credits (ITCs) is not reduced. An 8 percent sales tax on the same types of insurance currently taxed under the Ontario PST will continue with no ITC available.

As is the case under the QST, large businesses with annual taxable sales in excess of $10 million and financial institutions will not be able to claim ITCs for the OVAT exigible on energy (except if purchased by a farm or used to produce goods for sale); telecommunications services (other than Internet access fees or charges for toll-free numbers); automobiles and other road vehicles weighing less than 3,000 kilograms, and parts, fuel, and certain services for such vehicles; and food, beverages, and entertainment expenses. These restrictions apply from July 1, 2010 to June 30, 2015; an ITC is phased in over the subsequent three years. Under the QST, a taxpayer who opts to use a prescribed factor receives a percentage recovery for QST paid in relation to the above expenses; it remains to be seen whether a similar alternative will be available for the OVAT.

Various rebates, at different rates from the GST, continue into the OVAT, including MUSH sector and new housing rebates. Curiously absent from the budget documents is a rebate for new residential rental property. Financial institutions face an increased tax burden under the OVAT; no mitigating measures are currently proposed.

With more than a year to go before implementation, and after having dealt with some of the same transitional issues when the GST rate was reduced on each of July 1, 2006 and January 1, 2008, some taxpayers will be tempted to defer any action until 2010. However, systems modifications may be required, including some to deal with the ITC restrictions noted above. Thought should also be given to managing purchases around the implementation date, subject to transitional rules that may be issued. For example, taxpayers not entitled to claim full ITCs for an OVAT may want to consider advancing the purchases of PST-exempt goods or services; other taxpayers may wish to delay the purchase of big-ticket items that are taxed under the current Ontario PST but are eligible for full ITCs under the OVAT. Vendors should review their contractual responsibility to pass any savings to their customers when the Ontario PST is eliminated. Purchasers should ensure that the savings from the PST's elimination are passed on by vendors, particularly in the case of real property, IT outsourcing, and telecommunications contracts. The impact on budgeting for capital acquisitions, tax-included pricing, and funding formulas should also be reviewed. Long-term leases, equipment rentals, and fixed-price contracts should be analyzed in the light of the transitional rules, which should be released in the next few months. Although the pros and cons of the OVAT will no doubt continue to be hotly debated, the countdown to harmonization has begun.

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US Focus on Offshore Activity

Offshore voluntary disclosure. The IRS and Treasury continue to devote substantial attention to US persons' offshore activities, especially offshore financial accounts. Failure to file the recently revised form used by US persons (and others) to report a financial interest in or signature authority over one or more financial accounts in a foreign country (Form TD F 90-22.1, "Report of Foreign Bank and Financial Accounts") can trigger not only significant civil monetary penalties, but also criminal prosecution. (See "FBAR Uncertainties," *Canadian Tax Highlights*, March 2009.) Moreover, US persons must make various disclosures regarding interests in foreign entities; failure to do so attracts penalties. To encourage compliance with this offshore financial account and entity reporting, the IRS announced a voluntary disclosure offer: from March 23, 2009 to September 23, 2009, US persons have a six-month window to voluntarily and timely disclose unreported offshore accounts and assets. At the end of that period the IRS will re-evaluate its options.

A US person who meets the terms of the voluntary disclosure offer must pay applicable back taxes and interest on newly disclosed assets for six years, and must pay either a 20 percent accuracy or a 25 percent delinquency penalty on any unreported income for all six years. No reasonable-cause exception is available. A one-time 20 percent penalty also applies on the highest total annual value in the unreported account or entity in the six-year period. However, that penalty is reduced to 5 percent if (1) the taxpayer did not open the account or form the entity, (2) there has been no activity in the account or entity during the period that it was controlled by the taxpayer, and (3) all applicable US taxes have been paid on the principal in the account or entity and only the earnings therein have escaped US taxation.

Though the accuracy or delinquency penalty coupled with the 20 percent or 5 percent penalty may seem punitive, the IRS views this as a taxpayer-favourable outcome because it will forgo other potentially applicable penalties—for example, for fraud (75 percent of unpaid tax), for failure to file various information returns, and for willful failure to file the FBAR (the greater of $100,000 and 50 percent of the foreign account balance), all of which apply annually. Moreover, those who come forward during the six-month voluntary disclosure window mitigate their risk of criminal prosecution. Before the voluntary disclosure offer was in effect, an individual who wished to come forward and comply with his US tax obligations, including FBAR reporting, was often uncertain about, for example, what penalties the IRS would apply and to what extent; how many years of back returns might be required to be filed or amended; and whether criminal prosecution was possible. The voluntary disclosure offer provides some certainty on those issues. In announcing the initiative, IRS Commissioner Schulman warned that "the situation will only become more dire" for a US person who does not take advantage of this limited-time offer.

Although the voluntary disclosure initiative appears to be a response to the highly publicized problems with US persons and Swiss banks, its scope is broader and it may apply to US-citizen or resident non-filers who are resident in Canada and wish to come forward. In the past, the IRS provided additional guidance on the scope and application of its voluntary compliance initiatives, and one hopes that it will also do so in this context.

Congress addresses offshore evasion. While the IRS and Treasury focus on offshore financial account reporting, several Congressional legislative proposals also address perceived offshore tax evasion. One bill of particular interest to tax practitioners on both sides of the border is the Levin bill (S 506; see also its companion House Bill HR 1265). The bill is at a preliminary stage, and if it is enacted its ultimate form may be significantly different; however, some parts of the proposal may be relevant to Canadian companies with activities in the United States.

For example, one provision treats a foreign corporation as a US corporation if the "management and control of the corporation occurs, directly or indirectly, primarily within the United States," but only if the foreign corporation is either publicly traded or has an aggregate asset value of $50 million during the current or any previous taxable year. An exception exists for certain CFCs, so long as the US parent conducts a substantial active US business. This management and control test completely overrides the general US tax rule that a corporation is resident in the jurisdiction where it is chartered. The proposal's relevant factors for residence depend on whether substantially all of the senior officers and executive management who exercise day-to-day responsibility for making decisions involving the strategic, financial, and operational policy of the corporation are located primarily within the United States. The Levin bill also addresses foreign-based investment structures that use US-based managers: the management and control of a corporation that primarily holds investment assets being managed on behalf of investors is deemed to occur where the investment decisions are made. The provision is currently proposed to be effective for taxable years beginning on or after the date that is two years from the date of enactment.

It is too soon to tell whether the Levin bill will ultimately become law and, if it does, whether it will include the provisions noted above. The Obama administration has indicated support for the Levin bill, and President Obama co-sponsored a predecessor version when he was a senator. On the other hand, days after the Levin bill was introduced, the Senate Finance Committee issued its own preliminary draft legislation addressing offshore tax havens, with the notable absence of a provision that treats as US corporations certain foreign corporations with US management and control. To some commentators, the absence of such a provision in the Senate draft indicates that, at the very least, this provision in the Levin bill will not survive the US legislative process. Nonetheless, Congress, the IRS, and Treasury are all focusing significant attention on offshore tax issues whose development is being monitored closely by tax practitioners on both sides of the border.

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Tax Returns by Income

In 2006, Canadians filed 23.1 million personal income tax returns, but only 15.7 million, or 67.9 percent, reported

2006 Taxable Personal Income Tax Returns by Income

Taxable returns (dollars)	Taxable returns	Reported income	Federal tax payable	Provincial tax payable
		percent		
Under 10,000	1.8	0.3	..	..
10,000 to 20,000	14.9	4.5	1.4	0.9
20,000 to 30,000	19.0	9.2	4.6	4.1
30,000 to 50,000	30.8	23.5	17.0	16.0
50,000 to 100,000	26.8	35.5	36.5	35.6
100,000 to 150,000	4.2	9.7	12.1	12.9
150,000 to 250,000	1.6	5.9	8.5	9.0
Over 250,000	1.0	11.5	19.9	21.5

.. Less than 0.01 percent.

tax payable. In that year, 82.4 percent of the non-taxable returns reported income of less than $15,000; many of those returns were filed in order to qualify for refundable federal or provincial tax credits and for other income support programs that use a tax return to determine eligibility.

As shown in the table above, returns with tax payable and income of less than $10,000 accounted for only 1.8 percent of all taxable returns and contributed less than 0.1 percent of federal and provincial tax. Those with incomes from $20,000 to $30,000 made up a further 19.0 percent of taxable returns and 9.2 percent of reported income, but paid only 4.6 percent of federal tax and 4.1 percent of provincial taxes. Returns with income of $100,000 or more represented 6.8 percent of all taxpayers and 27.1 percent of all income. The progressive tax system ensured that this group contributed 40.5 percent of federal tax and 43.4 percent of provincial tax. The very wealthy—those with incomes of $250,000 or more—represented only 1.0 percent of all taxpayers, but 11.5 percent of all reported income. Those 153,560 comfortable taxpayers provided 19.9 percent of all federal income tax and 21.5 percent of provincial taxes in 2006.

The figures show much the same distribution as in earlier years, and illustrate the public sector's dependence on the middle-class Canadian taxpayer. Those taxpayers at the very bottom end of the income scale paid a very small proportion of the total tax take, and those few at the top end were too small a group to support the public sector by themselves. Thus, the 57.6 percent in the middle provided 53.5 percent of federal tax and 51.6 percent of provincial tax; this group, with income from $30,000 to $100,000, reported 59.0 percent of all income shown on tax returns.

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No Transaction: Statute-Barred

In *Blackburn Radio Inc.* (2009 TCC 126), the TCC recently ruled that the CRA had not met the tests to be able to reassess beyond the normal limitation period and deny a company an almost $8 million deduction for an employee bonus for the 1999 taxation year. The TCC examined the three-year extension of the normal reassessment period for a transaction between the taxpayer and a related non-resident (subparagraph 152(4)(b)(iii)).

The taxpayer (Canco) was a Canadian private equity investment management corporation. On August 1, 1993, Canco created a wholly owned US Holdco, to which it transferred its US corporations, including US Subco. US Holdco's board of directors had "no independent decision-making authority with respect to the companies whose shares it held"; decisions were made by Canco's board of directors.

Canco employed Mr. G, a Canadian resident, whose duties included "finding profitable ways" for Canco to sell its investments. On September 1, 1993, Canco entered into an agreement with Mr. G to provide his supervisory services to US Holdco's corporate group. In addition to an annual salary and benefits, the agreement entitled Mr. G to short- and long-term incentive compensation triggered by events such as the sale of shares of a US Holdco group member.

On November 2, 1993, Canco entered into a management services agreement to provide US Holdco with general management and related services. Canco provided these services through Mr. G and another Canco executive for a maximum fee of $190,000 annually. The services agreement did not specify a charge related to Canco's liability to pay compensation to Mr. G under his long-term incentive plan. On the same day, 35 percent of US Subco's shares were sold to an arm's-length purchaser. On July 30, 1999, US Holdco sold its remaining US Subco shares to the same purchaser, triggering an almost $8 million long-term incentive bonus to Mr. G. Canco deducted the bonus from its taxable income; Mr. G reported and paid tax on the bonus.

On April 13, 2004, the CRA reassessed Canco's 1999 taxation year and denied a deduction for the bonus, saying that it was paid on behalf of a related non-resident corporation, and "should be allocated to and reimbursed by" US Holdco or US Subco. The CRA also said that the contract to provide Mr. G's services to US Holdco's and US Subco's management teams was made on terms or conditions that differed from those made between persons dealing at arm's length, for the purposes of paragraph 247(2)(a).

The 1999 taxation year ending on August 31, 1999 was originally assessed on March 24, 2000, and thus the original limitation period expired on March 24, 2003. To validate the reassessment made on April 13, 2004, the CRA relied on subparagraph 152(4)(b)(iii), which extends the allowable period for a reassessment for an additional "three years after the end of the normal reassessment period," if the reassessment was "made as a consequence of a transaction involving the taxpayer and a [non-arm's-length] non-resident." The extension applies only in relation to such transactions.

The CRA said that the relevant transaction was the arrangement for Canco to provide Mr. G's services to US Holdco. Subsection 247(11) states that section 152 and other rules apply to part XVI.1 (transfer pricing) "with such modifications as the circumstances require." For the purposes of section 247, subsection 247(1) defines the term "transaction" to mean "an arrangement or event"; the CRA argued that the incorporation by reference of section 152 into section 247 expands the meaning of the term "transaction" in section 152 by applying the definition of that term for the purposes of section 247.

The TCC disagreed. Although subsection 247(11) ensures that the assessment provisions in part I apply to part XVI.1, "[i]ts reference to sections in Part I . . . does not import all of the defined terms in section 247 into those sections in Part I." On the basis of a textual, contextual, and purposive approach, including a review of the general definition of "transaction" as "a piece of commercial business done," the TCC held that a "transaction" as contemplated in subparagraph 152(4)(b)(iii) did not include an "arrangement," nor did it include a "series of transactions." Furthermore, Mr. G was not a non-resident, and he and Canco were at arm's length. Thus, in the only 1999 transaction to which the taxpayer was a party—the payment of the bonus—the other party was an arm's-length resident. As a result, the TCC found that the reassessment did not meet the criteria in subparagraph 152(4)(b)(iii) and was not valid. Because the reassessment was statute-barred, the TCC did not comment on whether Canco was entitled to deduct the bonus.

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Post Mortem RRSP and RRIF Loss Relief

New relieving RRSP and RRIF rules announced in the 2009 federal budget should be considered when terminal tax returns are prepared. Relief is provided if the FMV of assets held in a deceased's RRSP or RRIF declines after the individual's death, and then the RRSP or RRIF is disbursed to the beneficiaries within the tax-exempt year following the annuitant's year of death.

Generally, the FMV of RRSP assets must be included in an annuitant's income on death. An offsetting deduction is allowed on a tax-deferred rollover to an RRSP of the deceased's spouse or other qualifying beneficiary. If no rollover is available, an increase in the RRSP assets' FMV after an annuitant's death is included in the beneficiaries' income. However, if the RRSP asset value declined after death, the old rules provided no loss relief to the deceased or the beneficiaries.

The new RRSP and RRIF rules were included in Bill C-10, which received royal assent on March 12, 2009. RRSP losses incurred after the annuitant's death can now be carried back and deducted against the year-of-death RRSP income inclusion if two conditions are met: (1) the RRSP is wound up within its tax-exempt period (the year after the year of death), and (2) the RRSP has not held non-qualified investments post-death. The new RRIF rules are similar. The rules generally apply to RRSPs and RRIFs wound up after 2008. For an individual who died in 2008, the new rules apply only if the last payment out of the RRSP or RRIF occurs after 2008.

Income-splitting update. The CRA's prescribed interest rate applicable to family loans and taxable benefits for employees and shareholders from interest-free or low-interest loans has fallen to a historic low of 1 percent for the second quarter of 2009 (April 1-June 30) from 2 percent for the first quarter. Despite the current economic climate for investors, this low rate makes it a good time to consider income splitting by locking in family loans at the 1 percent rate to achieve future tax savings. An employee with a qualifying home purchase loan from an employer may also be able to reduce the related taxable benefit. (See "Prescribed Rate Drop Favours Income Splitting," *Canadian Tax Highlights*, January 2009.)

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New US-France Protocol

A new US-France treaty protocol signed in January 2009 amends the 1994 treaty (modified by an earlier protocol). The new protocol updates the treaty and aligns it more closely with the 2006 US model treaty and other recently negotiated US tax treaties; for example, the treatment of fiscally transparent entities is updated. Other significant amendments include a reduction of dividend and royalty withholding taxes, changes to the limitation-on-benefits (LOB) clause, the introduction of an arbitration provision, and changes to the exchange-of-information provision.

The US-France withholding tax regime is amended significantly: the protocol exempts dividend withholding for payments from companies owned at least 80 percent directly or indirectly by certain qualified residents. In contrast, the Canada-US treaty reflects the 2006 US model treaty and maintains 5 percent as its lowest dividend withholding tax rate. Consistent with the 2006 US model treaty, the US-France protocol reduces the withholding tax rate on all royalty payments from 5 percent to 0 percent. The Canada-US treaty, in contrast, still retains a 10 percent rate for some royalty payments (such as those for trademarks).

For withholding taxes, the protocol takes effect retroactively for amounts paid or credited on or after January 1 of the year in which it enters into force. For other taxes on income, the protocol has effect for any tax year beginning after the calendar year of entry into force, when each state has notified the other that their respective constitutional and statutory requirements for ratification have been satisfied. In the United States, that process includes a public hearing before the Senate Foreign Relations Committee, a two-thirds majority vote for ratification in the Senate, and the president's signature.

The protocol's new LOB clause expands the definition of "active conduct of a trade or business" to include activities conducted by connected persons. Companies are connected if one has control of the other or if both are under the control of the same persons. The protocol revises the triangular provision in the treaty's LOB clause. A triangular provision denies or reduces benefits for certain income earned through a third-country PE that suffers less than 60 percent of the tax that would be levied on that income if earned directly. US tax treaties with a triangular provision include those with Belgium, Sweden, and the Netherlands, but not the treaty with Canada.

Like the recent Canada-US protocol, the US-France protocol introduces a mandatory arbitration provision, but, uniquely, the treaty articles eligible for arbitration are not limited. Thus, it appears that any issue accepted for competent authority assistance is eligible for arbitration if the competent authorities do not agree to preclude it. Arbitration is available for cases under consideration by the competent authorities as of the date when the protocol enters into force, and for all cases arising subsequently.

The US-France protocol updates the exchange-of-information provision to make it consistent with the 2006 US model treaty and the Canada-US treaty. Most significantly, the provision now requires contracting states to supply information even if held by a bank, financial institution, nominee, or person acting as an agent or in a fiduciary capacity.

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Bankruptcy and Garnishment

Although the minister has special powers to recover debts, a recent Alberta case (*Mutter (Re)*, 2009 ABQB 28) is a timely reminder of the limits that bankruptcy places on the minister's garnishment powers.

The debtor was an undischarged bankrupt under the federal Bankruptcy and Insolvency Act (BIA) whose principal residence was sold under court order by the trustee in bankruptcy. The minister sought to recover post-bankruptcy tax debts by issuing to the trustee requirements to pay (RTPs) under garnishment provisions (ITA subsection 224(1) and ETA subsection 317(3)). The trustee applied to the Alberta Court of Queen's Bench for advice and direction respecting the distribution of proceeds from the principal residence's sale.

The court (Registrar of Bankruptcy) considered the following issues: (1) Does the BIA permit garnishment exemptions? (2) Do the ITA and ETA permit garnishment exemptions while the debtor is bankrupt? (3) Do provincial exemptions generally apply to garnishment under the ITA and ETA?

First, the court noted that the BIA prohibits property exempt under provincial law from being distributed to creditors. The minister is bound by the BIA and must respect the $40,000 exemption. The minister is a creditor as defined under the BIA and thus cannot pursue any remedy against the debtor or his property, including issuing RTPs.

Second, the court noted that both the ITA and the ETA garnishment provisions refer to a person liable to make a "payment" to a tax debtor. Although the debtor loses the ability to dispose of or deal with his or her property, the property remains the debtor's even in the trustee's hands. In the court's view, the property representing the exemption amounts was thus always the debtor's property; the trustee's transfer of funds back to the debtor did not constitute a payment under the garnishment provisions, and the minister cannot use RTPs to redirect the $40,000 exemption amount to him. The court also noted that the ETA garnishment provision applies "despite . . . any enactment of Canada other than" the BIA and is therefore subject to the prohibition against distributing exempt amounts.

Third, although the court had already disposed of the matter, it said that although the ETA and ITA provisions governing seizure and sale specifically mention exemptions while the garnishment provisions do not, a conclusion that exemptions can be garnished would render ineffective the exemption from seizure and sale: the minister could simply garnishee the sale proceeds. The minister cannot use a garnishment remedy to do indirectly what he cannot do directly. Furthermore, the Alberta Civil

Enforcement Act (CEA) exemption is mandatory, while the ETA and ITA garnishment provisions are permissive: the minister "may" issue RTPs. Any conflict between the provincial CEA and the federal ITA and ETA can be reconciled by reading an exception into the ITA and ETA that prohibits the minister from issuing RTPs to garnishee debtors' exemption amounts. The court held that the RTPs were invalid and directed the trustee to pay to the debtor $40,000 from the sale proceeds of his principal residence.

The minister may enjoy broad garnishment powers under the ETA and the ITA, but *Re Mutter* confirms that the powers are subject to important exemptions under provincial law that allow a debtor the opportunity of financial rehabilitation. Any other decision would result in a net asset transfer from taxpayers to creditors as the debtor's economic viability is destroyed. The $40,000 principal residence exemption in *Mutter* is a creature of Alberta law, but other provinces have their own exemptions that operate similarly against the minister.

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Functional Currency and FAs

On November 10, 2008, Finance released draft amendments to the functional currency election rules in section 261. A NWMM of February 2, 2009 (now enacted as part of Bill C-10) added new subsection 261(6.1) that effectively subjects FAs to the same computation rules as the electing Canco for the computation of FAPI and, presumably, taxable surplus. The new subsection applies to taxation years that begin after December 13, 2007, section 261's effective date.

If a Canco elects under the functional currency rules, each of its FAs for that year (and subsequent years while the Canco is under the functional currency rule) must also apply section 261 from the beginning of the FA's first affected taxation year. Like the electing Canco, the FA must recalculate the tax cost of its assets and liabilities in its first taxation year under the Canco's elected functional currency. For assets, the historic Canadian-dollar tax cost is converted using the spot rate at the end of the year preceding the year under the new functional currency. For liabilities denominated in a currency (the debt currency) other than the elected currency, the principal amount at the end of that preceding taxation year is converted using the spot rate at that time. To the extent that a settlement of a liability at this conversion time would otherwise result in a currency gain or loss computed using the Canadian dollar, that hypothetical currency gain or loss is converted to the functional currency at the spot rate and deferred and realized proportionally as the principal amount of the liability is settled.

New subsection 261(6.1) rectifies anomalies and may eliminate planning opportunities. Assume that the US dollar is a Canco's elected functional currency for its 2008 taxation year. Prior to that year, Canco had lent US dollars to its US subsidiary (FA), which FA used to acquire non-excluded property; Canco has an accrued currency loss on the loan and FA has an accrued currency gain (using the Canadian dollar). In the absence of subsection 261(6.1), Canco could roll the accrued loss into the loan's ACB; the accrued FAPI gain in FA would never be recognized because FA would not have a gain in US dollars.

If a Canadian multinational, along with its subsidiaries, transacts mainly in a single currency such as the US dollar and elects that as its functional currency, the group's effective tax rate may experience less volatility for accounting purposes because the calculations are not exposed to fluctuating exchange rates relative to the Canadian dollar. Additionally, the Canco MNC can generally freely enter into cross-border US-dollar loan or share transactions with its US subsidiaries without incurring foreign exchange gains or losses. Also, the US subsidiaries' US-dollar transactions generally do not give rise to a currency gain or loss that is FAPI.

However, the application of section 261 to FAs is expected to add to the compliance burden, complexity, and anomalies. Taxpayers must track suspended gains or losses on obligations and bring them into FAPI/taxable surplus as the loans are repaid. Accrued currency gains and losses related to assets held before the functional election year are rolled into a special cost amount for FAPI (and hence taxable surplus) purposes. Because some assets may phase in and out of excluded property status, a taxpayer may want to track most assets' cost bases under section 261. Some portion of these gains and losses under section 261 may be reduced or eliminated on the basis of the interaction with the pre-acquisition gain and loss rules under paragraph 95(2)(f.1). For example, if a Canco elects the US dollar as its functional currency and then mid-taxation year acquires a subsidiary that disposes of an asset with accrued FAPI/FAPL locked in at the beginning of the FA's taxation year, the portion of the FAPI/FAPL that accrued before the FA's acquisition is carved out.

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Justice Denied Is Justice Indeed

In our experience, the TCC and its administrators tend to give a taxpayer a fair amount of leeway on procedural matters, particularly if a taxpayer is self-represented.

However, there are limits to the court's tolerance, as illustrated in the extreme example of a misbehaving taxpayer in *MacIver* (2009 FCA 89).

Mr. M was a 75-year-old lawyer. He had amassed some money, but he apparently had an aversion to paying tax on his income. He was convicted of tax evasion and several related counts of perjury. He was also convicted of perjury and obstruction of justice in a non-tax matter: he swore a false affidavit, gave false testimony, and intentionally wrote a misleading letter to his trial judge.

His most recent case involved the assessment of tax on the income for which he had already been convicted of evasion. Apparently, Mr. M refused to answer questions on discovery, refused to fulfill undertakings or produce relevant documents, and frequently gave inappropriate, evasive, and abusive responses to questions from Crown counsel.

Some of his responses will no doubt become classics of tax lore. For example, he maintained that without his knowledge, a Swiss bank had forwarded funds to his credit-card issuer to pay off his outstanding balance. At examination for discovery Crown counsel said, "That seems to be quite a spectacular allegation, that a bank would, without instructions from you, transfer specific sums to your credit cards." Mr. M replied, "I don't know anything about Swiss banking, any more than you do."

As a result of his egregious conduct, Mr. M's tax appeal was dismissed without benefit of a trial. He then appealed that dismissal to the FCA, which agreed that dismissal of a tax case without trial was an extreme measure and appeared to show some sympathy for Mr. M's age and perhaps his mental state. The FCA noted, however, that throughout all proceedings, he had made no effort to fulfill undertakings, and that at every stage of the examination process information obtained from him was inconsistent, contradictory, and deceitful, and his conduct was disrespectful. Even at the FCA, he had disregarded a specific ruling on appeal procedure and filed material that the court had ruled should be excluded. As a result, the FCA concluded that the trial judge had correctly applied the law, and the appellant's extreme conduct had met the high threshold necessary to dismiss without trial his appeal from assessment. In the circumstances, it is difficult to see how the court could have decided otherwise.

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RESP Withdrawals Part 1

The tax consequences of withdrawing funds from a registered education savings plan depend on whether the beneficiary is enrolled in a qualifying post-secondary educational program at the time of the withdrawal. (See table 1.)

Table 1 Tax Consequences on Withdrawal

	Is child enrolled in a qualifying post-secondary educational program?	
Source of funds	Yes	No
RESP contributions	Tax-free to recipient subscriber or beneficiary.	Tax-free to recipient subscriber or beneficiary.
Investment income	Constitute EAPs. Taxable to child at his or her marginal tax rate.	Called accumulated income payments (AIPs). Taxable at subscriber's marginal tax rate, plus an additional 20% tax (for Quebec residents, 12% federal plus 8% Quebec tax).
CESGs	Constitute EAPs. Taxable to child at his or her marginal tax rate.	If not used for a sibling's education ($7,200 lifetime limit per recipient), must be returned to the government.
CLBs	Constitute EAPs. Taxable to child at his or her marginal tax rate.	Must be returned to the government.

A qualifying post-secondary educational program includes an apprenticeship and a program offered by a trade school, CEGEP, college, or university. Distance education courses, such as correspondence courses, can qualify. Qualifying part-time programs must require at least 12 hours per month spent on courses and must last three consecutive weeks or more; the student must be at least 16 years old. Qualifying full-time programs at an educational institution in Canada must require at least 10 hours of instruction and/or work each week and must last three consecutive weeks or more (13 consecutive weeks or more for an educational institution outside Canada).

When withdrawing funds from an individual or family RESP to fund the beneficiary's post-secondary education, the RESP subscriber must specify what portion of the withdrawal is from contributions and what portion is an educational assistance payment (EAP). An EAP is a combined distribution—investment income earned in the RESP, Canada education savings grants (CESGs), and Canada Learning Bonds (CLBs)—used to fund a beneficiary's post-secondary educational costs. The RESP promoter tracks the source of withdrawals and can advise the subscriber of the source of remaining funds. For group plans, the promoter usually determines the mix of contributions and EAPs withdrawn, with limited discretion available to the subscriber. An EAP is taxable as ordinary income (no dividend tax credit or capital gains treatment) to the RESP beneficiary in the year of receipt. (For enhancements to EAP distribution requirements, see "RESPs Re-Enhanced," *Canadian Tax Highlights,* February 2009, and "RESPs Enhanced," *Canadian Tax Highlights,* November 2007.)

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Group RESPs may be automatically revoked if contributions are withdrawn before the beneficiary attains a certain age or attends post-secondary school. For individual or family RESPs, contributions can be returned tax-free to the contributor at any time. However, if the RESP beneficiary is not enrolled in a qualifying educational program when contributions are withdrawn, CESGs must be repaid concurrently. The CESG repayment requirement is the lesser of (1) the CESG balance immediately before the withdrawal of contributions and (2) the proportion of that balance that the contributions withdrawn that attracted CESGs are of the balance immediately before withdrawal of all contributions that attracted CESGs. CESG repayments may also be required if property is transferred to another RESP. In addition, because the CESG was first introduced in 1998, the withdrawal of pre-1998 RESP funds before the RESP beneficiary attends post-secondary school is penalized to ensure that RESP contributors do not use withdrawal privileges to tap into CESGs (by contributing, withdrawing, and then recontributing the same RESP contribution). Contributions are best retained in the RESP until the child starts post-secondary school.

The withdrawal of investment income from an RESP in the event that the beneficiary does not enroll in a qualifying post-secondary educational program ("accumulated income payments") will be discussed in a forthcoming issue of *Canadian Tax Highlights*.

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Foreign Tax News

United States

The IRS 2008 annual report on APAs says that 68 APAs were completed in 2008, including 51 bilateral and 3 multilateral APAs; 24 APAs were renewed. In 2008, 123 new applications were filed; 303 new and renewal requests were pending at year-end. The average APA request completion time is 34.7 months.

Netherlands

A second press release from the State Secretary of Finance on April 6, 2009 indicates that the initiative announced earlier that day—to require individual tax evaders to pay a minimum 300 percent penalty of additional tax due—is still in the proposal stage.

Switzerland

A US law firm hosted a webinar on "Dealing with Undeclared Funds in Switzerland." Switzerland exchanges information with competent authorities on tax fraud and now tax evasion. To obtain a link to the recording, contact jane.maclellan@lawincontext.com.

Treaties

Negotiations for a **US-Switzerland** treaty protocol affecting tax information sharing begin April 28, 2009 in Berne, Switzerland. The parties intend to bring the treaty in line with the OECD model treaty.

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Accounting for FIEs and NRTs

"Accounting for FIEs and NRTs" (*Canadian Tax Highlights*, March 2009) reported that the general consensus of large accounting firms was to still view old Bill C-10's draft FIE/NRT legislation as substantively enacted for 2007 and 2008. On April 6, 2009, the CICA's Emerging Issues Committee released a decision summary of its March 24, 2009 meeting; it is understood that the large accounting firms are now of the view that the FIE and NRT legislation is no longer substantively enacted.

The FIE and NRT issue was not specifically on the agenda, but the summary comments on the interpretation of "substantively enacted" and emphasizes the high threshold to be met before a change in law or rates is considered substantively enacted. In particular, there must be persuasive evidence that the government is committed to enacting the proposed change in the foreseeable future.

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