CANADIAN TAX Highlights

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SAAR AND GAAR

The FCA in *Landrus* (2009 FCA 113) recently upheld the TCC decision that the triggering of a terminal loss was not a misuse or abuse of the terminal loss and CCA provisions and thus was not GAARable. The taxpayer was a partner in one of two limited partnerships that triggered a loss on the transfer of assets to a single new limited partnership comprising all former partners. The FCA concluded that a series of specific anti-avoidance rules (SAARs) created exceptions to the general policy of allowing terminal losses on the disposition of depreciable assets, but did not evidence an overall policy of prohibiting losses on a transfer between persons within "the same economic unit." The CRA has 60 days from March 26, 2009 to apply for leave to appeal to the SCC.

Mr. L was a limited partner in one of two partnerships that in the late 1980s acquired separate residential condominium buildings in London, Ontario. Not long thereafter, a downturn in the real estate market caused a precipitous drop in the value of the individual condominium units. In 1994, the partnerships were restructured: the two original partnerships transferred their assets to a new limited partnership and the original partners became the new partnership's partners, entitled to the benefits of ownership in both buildings. The original partnerships triggered terminal losses by the dispositions and allocated the losses out to their respective original members. The CRA initially said that there was no change in beneficial ownership to the investors, that subsection 85(5.1) applied, and alternatively that GAAR applied. Ultimately, the CRA proceeded only with the GAAR issue.

The TCC said, and the FCA agreed, that there was no misuse or abuse of the terminal loss provisions: the deduction of the losses was within the object, spirit, and purpose of those rules and the provisions of the Act as a whole. Furthermore, the TCC said that the existence of a series of specific provisions targeted at denying the deduction of losses underscored the fact that Parliament intended to generally allow losses to be deducted. The FCA agreed and said

> the fact that specific anti-avoidance provisions can be demonstrated not to be applicable to a particular situation does not, in and of itself, indicate that the result was condoned by Parliament . . . . However, where it can be shown that an anti-avoidance provision has been carefully crafted to include some situations and exclude others, it is reasonable to infer that Parliament chose to limit their scope accordingly.

The FCA also rejected the Crown's argument that the partnership property's continued availability to the limited partners after the disposition was sufficient reason to disallow their claims for terminal losses. The FCA noted that the position ignores the facts: a real disposition occurred. Furthermore, in accordance with the view of the majority in *Lipson* (2009 SCC 1), the FCA in *Landrus* said that although the overall purpose of transactions is not relevant, it is useful to consider whether the overall result is useful in understanding whether the result frustrates the object, spirit, and purpose of the terminal loss rules. The FCA stated:

> When the respondent made his [original] investment . . . it was in the expectation that the real estate market would improve over time. A significant downturn occurred resulting in an important decrease in the value of the two Roseland Buildings. At that juncture, it became clear that the buildings were under depreciated.
>
> The amount of the terminal loss which resulted in the disposition of the buildings at fair market value reflects a real economic loss and the cost at which [the new partnership] acquired these assets (again fair market value) reflects their true economic value. It follows that any CCA claimed thereafter had to be computed by reference to that cost, and any subsequent sale beyond this cost would be recaptured. I can detect no misuse or abuse in that result.

The FCA agreed that the transactions would arguably be abusive if they had given rise to a tax benefit, but the taxpayer's legal rights and obligations had otherwise been unaffected. The taxpayer ceased to be a partner of his original partnership and become a partner of and associated with the former partners of the two original partnerships as partners of the combined new partnership. "[H]e acquired an undivided interest in assets double the size

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and shared in an extended rental pool which accounted for the revenues generated by" the two original partnerships "These changes are material both in terms of risks and benefits." The minister failed to discharge his burden of establishing tax avoidance. The appropriateness of the result was also demonstrated by the fact that a terminal loss would have been realized if the partnership had been dissolved and the partnership assets had been distributed to the partners.

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Swiss Exchange of Information

In response to international pressure, Switzerland intends to adopt the OECD model treaty's exchange-of-information provisions in its new tax treaties. This is a significant departure from Switzerland's position in its current taxation treaties.

A comparison of the Canada-Switzerland treaty with the OECD model illustrates the significance of this change in Swiss policy. The Canada-Switzerland treaty does not require information exchange for the enforcement of domestic tax laws. Under article 25, the Canadian and Swiss authorities must exchange information that "is necessary for carrying out the [treaty's] provisions." Article 26 of the OECD model treaty includes a similar requirement and also requires the exchange of information "foreseeably relevant . . . to the administration or enforcement of the domestic laws concerning taxes of every kind and description imposed on behalf of the Contracting States." If the Canada-Switzerland treaty followed the OECD model, then, in certain circumstances, the CRA could gain access to information in Switzerland about Canadian residents and non-residents who are employed or carry on business in Canada or dispose of taxable Canadian property. It is not certain whether Canada will seek to renegotiate its treaty with Switzerland. As of the end of April 2009, Finance's list of the jurisdictions with which Canada is negotiating and renegotiating treaties included 14 jurisdictions, but not Switzerland.

The Swiss federal finance department stated that this change in policy is intended to increase the acceptance of Switzerland as a financial centre by its most important international partners; the change will have no effect on Swiss banking secrecy, since it relates to Swiss residents. The timing of the announcement—less than three weeks before the April 2, 2009 G20 summit in London that specifically addressed banking secrecy in relation to taxation—is also revealing. Contemporaneously with the G20 summit, the OECD released a progress report on the acceptance and implementation of the OECD tax information exchange standards. The timing of Switzerland's announcement thus allowed its categorization in the OECD's report as one of the jurisdictions that has committed to, but not yet substantially implemented, the OECD standard. The report indicates that the vast majority of jurisdictions identified by the OECD as tax havens have also agreed to commit to the OECD's information exchange guidelines.

Switzerland was not the only jurisdiction to move in 2009 into the OECD report's category of "committed but not yet implemented." Andorra, Austria, Belgium, Brunei, Chile, Guatemala, Liechtenstein, Luxembourg, Morocco, and Singapore also entered that category in 2009. In 2008, UBS AG, the Swiss banking giant, and the US competent authority agreed to the release of certain banking information from Switzerland in a deal brokered with the approval of the Swiss Financial Market Supervisory Authority—an organization independent of the government—and outside the mechanisms of the Switzerland-US treaty. (That treaty currently contains a very limited exchange-of-information provision.) Switzerland has a long history of banking secrecy, and for generations was considered politically and ideologically neutral. Switzerland's volte-face and acceptance of the OECD information exchange guidelines is symbolic of the irresistible force of international pressure and portends an era in which a resident of one country will not be able to evade taxation by hiding assets in another country.

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Privilege on Voluntary Disclosure

A recent Ontario Superior Court of Justice case provides a useful summary of factors to consider when determining whether solicitor-client privilege attaches to a document and whether it applies after a taxpayer seeks to make voluntary disclosure. *1496956 Ontario Inc.* (court file no. 2397/07; 2009 CanLII 12328) found that a taxpayer who applies for but is denied access to the voluntary disclosure program (VDP) can still claim solicitor-client privilege.

As part of its fraud investigation of 10 taxpayers, including Mr. W, the CRA executed search warrants at Mr. W's chartered accountant's office and at other locations on September 27, 2007. Mr. W claimed solicitor-client privilege on some seized documents; the CRA sought a court order to release any documents not protected by privilege. When determining whether solicitor-client privilege applies, all parties agreed that (1) solicitor-client privilege applies to all oral and written communication made in

the context of that relationship for the purpose of obtaining legal advice; (2) an original document that is not clothed with solicitor-client privilege does not acquire privilege simply because it is in the hands of a solicitor; and (3) the burden of proving solicitor-client privilege is on the party asserting the privilege.

Citing relevant jurisprudence, the court also found that (1) solicitor-client privilege may extend to the work and advice of an accountant who works as the client's agent or representative for the purpose of seeking, receiving, or implementing legal advice in conjunction with a lawyer; (2) solicitor-client privilege may attach to a lawyer's legal account that reflects a description of the services rendered; (3) privilege can only be claimed document by document, and each document must be examined to determine whether it meets the criteria; and (4) an existing document does not become privileged merely because a copy is deposited with a party's solicitor.

The court said that four conditions must be established in order for solicitor-client privilege to attach to a document: (1) there must be an oral or written communication; (2) the communication must be confidential; (3) the communication must be between a client (or his agent, such as an accountant) and a legal adviser; and (4) the communication must be directly related to the seeking, formulating, or giving of legal advice. On the facts, the court said, these conditions were met and thus some of the seized documents were protected by solicitor-client privilege.

Relying on *Visser* (89 DTC 5172 (PEI SC)), the CRA also argued that Mr. W's application for the VDP acted as a waiver of solicitor-client privilege on the disputed documents, because the program requires a full and frank disclosure of all supporting documentation. The court disagreed: in *Visser*, the taxpayer undertook voluntary disclosure and his solicitor attempted to claim privilege in order to protect certain sensitive matters between them. The court in *Visser* found that the solicitor-client privilege belonged to the client, who had already waived his privilege in an earlier hearing. In contrast, Mr. W did not enter into the VDP. After the CRA's fraud investigation began, he inquired about his eligibility for the VDP, and the CRA advised him that he was not eligible because the disclosure could not be considered voluntary after he was aware that the CRA had search warrants and that he was the subject of a fraud investigation. Thus, the court said that the CRA could not argue that Mr. W's participation in the VDP acted as a waiver of solicitor-client privilege on the disputed documents. However, the court agreed with the CRA that any documents that Mr. W had already disclosed, either directly or through his counsel or accountants, had lost the protection of solicitor-client privilege.

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PROJECTED DEFICITS

The recession has had a devastating impact on federal finances, as the 2009 budget attests. Provincial budgets for 2009 have been hit hard by the same factors—declining revenue, rising costs for income support, and contra-cyclical spending policies. The reversal of almost universal provincial surpluses mimics the change at the federal level. Local governments see less impact on their revenues and more stability on the spending side, but many of the major capital projects contemplated by the senior levels to create jobs are ultimately paid for with local government cheques, albeit by using funds from other sources.

Statistics Canada's analytical framework of government finances, the Financial Management System (FMS), provides a consolidation of revenues and expenditures for all levels, eliminating the effect of transfers between levels. The most recent data show a combined surplus of $16.6 billion for the fiscal years ending nearest to March 31, 2008, the fourth consecutive surplus in a 10-year period of surpluses or small deficits.

It is certain that the next few years will see much larger deficits. The table shows how the consolidated bottom line could change if provincial budgets follow the federal pattern over the next six years. The federal government will lead the way with a deficit of well over $30 billion in 2009-10; provincial governments will swell that figure to over $85 billion. The table shows clearly that the recovery could restore fiscal probity if the general outlook as spelled

Consolidated Government Finance, All Levels, 1999 to 2014

	Revenue	Spending	Surplus or deficit
Actual		*billions of dollars*	
1999	385.5	387.4	–2.0
2000	414.2	401.5	12.7
2001	447.0	424.6	22.4
2002	437.3	437.6	–0.3
2003	447.9	455.4	–7.6
2004	468.6	474.7	–6.2
2005	499.7	487.4	12.3
2006	531.1	514.0	17.2
2007	561.2	543.5	17.6
2008	590.7	574.1	16.6
Projected			
2009	567.1	608.5	–41.4
2010	547.3	632.2	–85.0
2011	581.0	669.8	–88.9
2012	631.4	671.7	–40.3
2013	663.8	698.3	–34.6
2014	707.3	720.6	–13.3

out in the federal budget is valid. By 2014, the consolidated deficit could shrink to $13.3 billion, and the trend evident could then soon bring surpluses in the range experienced in the early years shown in the table. Although the projections assume that the future rate of growth in spending will wind down, they do not imply that significant tax increases are needed to restore fiscal balance.

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UNINTENDED SECTION 143.3 APPLICATION

New section 143.3 was included in old Bill C-10 to deal with situations such as that in *Alcatel* (2005 DTC 387 (TCC)). Old Bill C-10 died on the order paper when the last election was called, but is considered substantively enacted for Canadian accounting purposes (except for the rules relating to FIEs and NRTs). In a nutshell, section 143.3 may deny a cost or an expense incurred on the issue of corporate shares (or options) in consideration for property transferred or services provided to the issuing corporation.

A recent ruling (2008-030010) issued in 2009 expresses the view that section 143.3 does not apply to deny a deduction of interest that is paid in kind via a share issue, because the amount of deductible interest equals the stated capital of the preferred shares issued. The ruling gives no analysis of how that conclusion was reached.

Inter alia, section 143.3 may unintentionally apply to triangular merger transactions in which shares are issued by a corporation in compensation for the issuance of shares of another corporation. Assume that Canco forms US Sub, which merges with US Targetco. On the merger, Canco issues its own shares to US Targetco's shareholders, and the surviving US entity (Mergeco) issues its own shares to Canco in compensation for Canco's issuance of its own shares. This structure is intended to ensure that Canco has cost base in the Mergeco shares. However, section 143.3 reduces Canco's cost of the US entity's shares if the Canco shares' FMV exceeds the FMV of property transferred to Canco in consideration for its share issuance.

The question is whether the US entity's shares issued to Canco are property transferred to Canco in consideration for its issuance of shares. A transfer of property implies a conveyance, a change of ownership, and a passage from one hand to another, all of which in turn imply previous possession or control. *Algoa Trust* (93 DTC 405 (TCC)) suggests that a transfer of property does not include an issuance of shares:

> The payment of a stock dividend is not a transfer of property. The shares authorized in a corporation's articles of incorporation are not assets of the corporation. When a person subscribes for the shares and pays the corporation for the shares, the shares are issued to that person and recorded in the share registry of the corporation. The payment is consideration for the shares. *The issue of shares is not a transfer since the corporation has not divested itself of its property: the shares were never owned by the corporation.* Assets are transferred for purposes of section 160 only at the time one person is divested of ownership of property and another person is vested in that property. Prior to issue and during issue the shares of a corporation are not property of that corporation. [Emphasis added.]

This is consistent with the strict interpretation of the meaning of "transfer of property" that the CRA has adopted for situations dealing with section 160 and for a corporation's charitable donation claim for issuing its own shares to a charity:

> One of the requirements necessary to the making of a gift for purposes of the *Income Tax Act* is the voluntary transfer of property. Where a corporation issues shares of its capital stock or grants a stock option, jurisprudence supports the view that there is no transfer of property by the corporation as the corporate assets are not reduced as a result of the issuance. As there is no gift in these circumstances, the charity should not issue a receipt notwithstanding that the shares or options will normally have value.

Proposed paragraph 94(2)(g) (also in old Bill C-10) deems an issuance of shares to be a transfer of property, further supporting the conclusion that a share issuance is not otherwise a transfer of property. It is hoped that Finance will amend section 143.3 to resolve the types of questions discussed above.

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FCA DENIES FAIRNESS RELIEF

The FCA in *Telfer* (2009 FCA 23) reversed the Federal Court's decision to allow the taxpayer's request for a judicial review of the CRA's refusal to grant relief under the fairness provisions. The FCA unanimously supported the CRA's decision not to waive interest accruing while the taxpayer's file was held in abeyance pending a TCC decision in another case: the CRA decision was not unreasonable and the Federal Court should not have intervened.

For each of the taxation years 1993-94 and 1996-99, the CRA reassessed Ms. T, denying losses from her investment in a limited partnership. Ms. T filed notices of objection in July 2000 and May 2001. In a letter, the CRA acknowledged receipt of the objections and indicated that

interest would continue to accumulate on the unpaid balances in dispute unless the taxpayer paid them pending final resolution. In another letter dated January 2002, the CRA informed Ms. T that it was holding her objections in abeyance because her issue was similar to that in another case that was then before the TCC (*Brown*, 2003 FCA 192). The letter also notified Ms. T that interest would continue to accumulate on the unpaid balances, but if her objections were successful the CRA would pay interest on the disputed amounts.

Following the SCC's 2004 denial of leave to appeal *Brown*, the CRA made a settlement offer, which Ms. T accepted; accordingly, the CRA confirmed the 1993-94 assessments and reassessed the 1996-99 taxation years. In September 2006, Ms. T requested interest relief of $10,000 on the basis of departmental delay by the CRA and financial hardship. The CRA again informed Ms. T that interest would continue to accumulate on any unpaid balance during a process that might take several months.

Following the CRA's denial of Ms. T's request in February 2007, the CRA denied her request for a second-level administrative review in May 2007. Ms. T then applied to the Federal Court for a judicial review of the CRA's May 2007 denial of an administrative review (2008 FC 218).

The Federal Court noted that factors to be considered in exercising the discretion to waive penalties and interest under subsection 220(3.1) are listed in paragraphs 23-27 of *Information Circular* 07-1, "Taxpayer Relief Provisions"; although the guidelines are not binding on the CRA, the court said that they are useful in assessing the reasonableness of the CRA's decision. Although Ms. T was fully informed of the potential for interest accruing during the TCC proceedings in the *Brown* case, and although she agreed to the suspension or delay suggested by the CRA, it was not fair that she bear all the interest accumulated during the period: Ms. T was not before the TCC in *Brown.* In fairness, the court said, Ms. T should pay only one-half of the accrued interest during the waiting period caused by the proceeding of *Brown* through the TCC. The Federal Court granted Ms. T's application for judicial review and referred the matter back to the CRA.

The FCA said that the issue was simply whether the Federal Court identified and applied the appropriate standard of review: was the CRA acting unreasonably when it denied Ms. T's interest relief request? The FCA must examine the Federal Court's decision-making process to ensure that it contains a rational justification and that it is transparent and intelligible. The delay was not caused by departmental delay as Ms. T claimed, but occurred because the review was held in abeyance pending the outcome of other litigation. The CRA's refusal to grant interest relief did not infringe Ms. T's rights or expectations; she was invoking the CRA's statutory discretion to grant her an exemption from a basic principle of the tax system. Although the CRA has a statutory duty to consider a taxpayer's objection "with all due dispatch" under subsection 165(3), "it will require circumstances more compelling than those in the present case to persuade a reviewing court that the [CRA] acted unreasonably in the course of deciding not to give to a taxpayer what would effectively be an interest-free loan." The FCA was thus not persuaded that the CRA's decision lacked "justification, transparency and intelligibility." An examination of the CRA's letter and the supporting documents made it clear that the CRA was well aware of all the relevant facts and could not be said to have excluded them from its consideration. The FCA concluded that the CRA's decision not to grant interest relief was not unreasonable, and it dismissed the taxpayer's application for judicial review.

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RESP Withdrawals Part 2

If an RESP beneficiary is not enrolled in a qualifying post-secondary educational program, the subscriber can withdraw the investment income (accumulated income payments, or AIPs). (RESP withdrawals for a beneficiary enrolled in such a program were discussed in "RESP Withdrawals Part 1," *Canadian Tax Highlights*, April 2009.)

A subscriber can receive AIPs only if he or she is a Canadian resident and (1) the RESP has existed for at least 10 years and all (past and present) plan beneficiaries (other than deceased individuals) are at least 21 years old and are not eligible to receive educational assistance payments; (2) the RESP has been terminated because it existed for 35 years (40 years for an individual plan whose beneficiary qualified for the disability tax credit); (3) all past and present beneficiaries are deceased; or (4) the minister has agreed that it is reasonable to expect that a beneficiary will not be able to pursue post-secondary education because he or she suffers from a severe and prolonged mental impairment. An RESP must be terminated by the last day of February in the year following the year of the first AIP.

An AIP is taxable as ordinary income (no dividend tax credit or capital gains treatment) to the RESP subscriber in the year of receipt, subject to regular income tax plus an additional 20 percent tax (for Quebec residents, 12 percent federal tax plus an 8 percent Quebec tax) intended to ensure that RESPs are not set up merely for tax-deferral purposes. The total of both taxes can be extremely high: for a subscriber in the top income tax bracket, the total tax rate can range from 59 to more than 68 percent, depending on the province or territory of residence.

Subject to certain limitations, the regular tax can be deferred and the additional tax can be avoided to the extent that the AIP is contributed to the subscriber's RRSP or to a spousal RRSP. To do this, the RESP subscriber must have sufficient RRSP contribution room to allow the deduction and must (1) be the original subscriber of the RESP or the spouse or common-law partner of a deceased original subscriber of an RESP that no longer has a subscriber; (2) make the contribution to his or her RRSP (or a spousal RRSP) in the year of receipt or in the first 60 days of the following year; and (3) deduct the RRSP contribution in the year in which the AIPs were received. However, tax must be withheld on an AIP by the RESP promoter unless the AIP is transferred directly to the RRSP.

A subscriber can contribute to an RRSP a maximum of $50,000 in AIPs ($100,000 if the subscriber and his or her spouse are joint subscribers to the RESP) and avoid the penalty tax. A subscriber who makes the contribution to an RRSP in the first 60 days of the year following the year of receipt cannot avoid the penalty tax if he claims an RRSP deduction for that following year: the RRSP deduction must be claimed in the year of the AIP's receipt. A subscriber who expects to receive AIPs in the next year or two should avoid making other RRSP contributions in those years to help build up RRSP contribution room to shelter AIPs. It may also be desirable to receive AIPs over two calendar years so that RRSP contribution room from two years is available.

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PART-TIME CCPCS AGAIN

A CCPC and its shareholders are entitled to certain tax benefits that require calculations or recognition of status at a particular time or for a taxation year. Thus, when a CCPC's shares are sold and its control is thus acquired, the application of deemed year-end rules can have special significance. A recent change threatens to upset the fine balance of deemings associated with a CCPC's year-end or status.

Subsection 249(4) deems a year-end to occur immediately before a corporation's acquisition of control (usually more than 50 percent of the votes); a new year starts at the time of acquisition. Share acquisition documents rarely specify an exact effective time in the day. In the absence of any other specific direction, an acquisition of control would likely occur midday, creating significant difficulties in determining the various amounts accrued or realized by the corporation up to the exact second of acquisition.

Subsection 256(9) sidesteps this problem by deeming an acquisition of control to occur—in the absence of an election—at the commencement (now the "beginning") of the day, not at the actual time of acquisition. The rule does not affect the time when the shares are acquired: only control is deemed to have been acquired at the day's beginning, a dichotomy recognized in the FCA decision in *La Survivance* (2007 FCA 129). In that case, the taxpayer was successful in arguing that the non-CCPC whose shares were sold to a CCPC became a CCPC at the day's commencement because its control was deemed to have been acquired at that time by a person who was not a non-resident or a public corporation. Thus, at the actual sale later in the day, what the taxpayer sold were CCPC shares, and it was able to claim an ABIL. By extension, however, if a CCPC shareholder sells its shares midday to a public company, the sub's control is deemed acquired at the day's commencement and it is thus no longer a CCPC when the actual sale occurs later in the day; the shareholder cannot claim a lifetime CGE on the sale. The 2009 federal budget unwinds this result by proposing that for acquisitions of control after 2005, the deeming rule in subsection 256(9) no longer applies for the purposes of determining whether a corporation is a small business corporation or a CCPC. The amendment is now in force, and the technical notes confirm that the rule does not apply for the purposes of determining such status from the beginning of the day to the actual time the shares are acquired.

There may be a problem with the interaction of the newly amended subsection 256(9), subsection 249(4), and subsection 249(3.1) (the last of which deems a year-end to occur immediately before the gain or loss of CCPC status). The last rule eliminates part-year CCPC status by the creation of a short year to satisfy the "throughout the year" test for the small business deduction and to simplify GRIP and LRIP calculations. Subsection 249(3.1) does not apply if subsection 249(4) applies, avoiding two deemed year-ends on the day of a share sale. On the day control was acquired, old subsection 256(9) provided a throwback to the day's commencement for acquisition of control and thus also for any change in CCPC or SBC status. Thus, the non-application of subsection 249(3.1) did not result in a part-year CCPC or SBC status. However, if the share sale transaction is signed and closed on the same day, amended subsection 256(9) no longer eliminates that potential for part-year status, because the deemed year-end at the day's commencement does not affect CCPC and SBC status determination; moreover, because subsection 249(4) applies, subsection 249(3.1) cannot apply to deem a year-end immediately before the share acquisition. Finance has confirmed informally that the amendment to subsection 256(9) creates the possibility of once again having a part-year CCPC that does not meet the "throughout the year" test for the small business deduction and must make part-year GRIP and LRIP calculations.

It may be possible to make a subsection 89(11) election to cease to be a CCPC at the start of the day of an acquisition of control, applicable for paragraph (d) of the CCPC definition in subsection 125(7), which applies for subsection 249(3.1) purposes. The electing corporation ceases to be a CCPC for certain purposes immediately before the start of the day, effectively overruling the amendment to subsection 256(9). It is prudent to request a ruling, or at least a written interpretation, on the election's efficacy.

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2004 FA Proposals' Transition

For several years, significant uncertainty has surrounded the applicability of certain foreign affiliate (FA) rules. At the root were myriad technical amendments, some of which were originally introduced in December 2002 and revised and expanded in February 2004 (the 2004 proposals). Further complication ensued from measures announced and then confirmed in the 2007 and 2008 federal budgets, respectively. Some 2004 proposals, modified to reflect the 2007 federal budget, were enacted in Bill C-28 on December 14, 2007. More of the 2004 proposals were enacted in the 2009 federal budget legislation, which received royal assent on March 12, 2009. The many remaining 2004 proposals are still in draft form; the 2009 budget stated that they will be re-evaluated in light of the recommendations of the Advisory Panel on Canada's System of International Taxation before a decision is made on whether and how to proceed with them. Amid this confusion, a March 19, 2009 Finance comfort letter may offer some relief to taxpayers seeking to rely on subsection 88(3), one of the many rules that the remaining 2004 proposals seek to modify.

The taxpayer had sought to confirm Finance's intention, set out in prior comfort letters, to recommend certain amendments to the subsection 88(3) proposals released in February 2004. The comfort letter stated that the 2004 subsection 88(3) proposals were still being reviewed and evaluated in light of the 2007 to 2009 federal budgets; further changes may yet be made. However, Finance also promised to recommend the introduction of transitional rules to ensure that any further modifications do not "impair any beneficial effect of those modifications for the period up to any announcement of the revisions of those modifications."

This assurance is welcome in light of the history of the 2004 subsection 88(3) proposals. Current subsection 88(3) applies on the liquidation of a first-tier controlled foreign affiliate (CFA) and provides for a rollover of shares of another FA distributed on the liquidation. (The taxpayer may elect to recognize a gain.) The 2004 subsection 88(3) proposals expand the rules to cover a liquidation of all first-tier FAs (not just CFAs) and to a broader range of distributions (including redemptions and dividends), but restrict the rollover to a distribution of another FA's shares that are excluded property. The 2004 subsection 88(3) proposals were controversial in many respects and, as a result, significant modifications were announced in a number of comfort letters and at the 2005 IFA Congress. Some of the more significant modifications include a rollover expanded to non-excluded property if the liquidating FA's ownership satisfies a "90 percent votes and value" test and the introduction of the concept of "foreign paid-up capital" (FPUC), which effectively allows a distribution to be treated first as FPUC and then as a dividend out of exempt, taxable, and pre-acquisition surplus.

The recent comfort letter focuses on the correct determination of the "relevant cost base" of non-treaty-protected TCP that is distributed in the course of an FA's liquidation for purposes of the rollover under the "90 percent of votes and value" test mentioned in earlier comfort letters. The relevant cost base may differ for FAPI and section 115 purposes, yielding to a Canadian taxpayer different proceeds of disposition for the distributed property (and different costs of the property in the future) for each of those purposes. To resolve these discrepancies, Finance is prepared to recommend that when an FA liquidation satisfies the 90 percent test, the Canadian taxpayer and its FA can jointly elect as the relevant cost amount of non-treaty-protected TCP an amount that does not result in any gain or loss in the computation of the FA's taxable income earned in Canada under section 115. The comfort letter further indicates that the election would preclude the creation of FAPI in accordance with paragraph 95(2)(f), without reliance on the carve-out in paragraph 95(2)(f.1), and thus the Canadian taxpayer's cost of the property is the same for all purposes of the Act.

Many taxpayers relied on the modifications proposed in earlier comfort letters for their tax planning and filed their tax returns accordingly. Further modifications to the 2004 subsection 88(3) proposals arising from the ongoing review of the remaining 2004 proposals could reverse the modifications proposed in the earlier comfort letters and thus unfairly and unduly penalize affected taxpayers. Finance's intention to recommend transitional rules to avoid that result and to ensure the continued beneficial effect of the modifications proposed in the earlier comfort letters is sure to be welcomed by both taxpayers and tax advisers. Nonetheless, one hopes that the review of the 2004 subsection 88(3) proposals and the other remaining 2004 proposals proceeds swiftly, because the most recent

comfort letter does not resolve all of the issues associated with the 2004 subsection 88(3) proposals. For example, a taxpayer cannot rely on draft proposals for financial reporting purposes because the law is not enacted.

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USRPI Roll to Partnership

A recent IRS ruling provides some new and welcome clarification on when a non-US person (such as a Canadian resident) can roll a US real property interest (USRPI) to a partnership in spite of a general rule that precludes a tax-free USRPI transfer by a non-US person. This is the first IRS ruling on the issue.

A non-US person is generally subject to US income tax at graduated rates on a gain realized on the disposition of a USRPI, with no treaty exemption. However, typically a USRPI-for-USRPI exception allows a rollover if four requirements are met: the non-US person transfers a USRPI; that person receives in exchange only another USRPI; the USRPI received is subject to US taxation immediately following the exchange; and certain filing requirements are met.

A USRPI is an interest in US real property and an interest in a US real property holding company (USRPHC). A USco generally ceases to be a USRPHC (and hence a USRPI) if it does not hold any USRPIs and all of its USRPIs were disposed of in fully taxable transactions. A non-US person's sale proceeds received on the disposition of a partnership interest are considered to be received from the sale of the partnership's USRPI to the extent that the sale proceeds are "attributable to" USRPIs. A partner is generally allocated a partnership's recognized built-in gains attributable to property contributed by that partner. The "remedial allocation method" generally ignores a "ceiling rule," so built-in gains cannot generally be shifted to non-contributing partners.

The taxpayers in the ruling were four foreign corporations (Cancos 1 to 4) that owned interests in USRPHCs (Subcorp 1 and other Subcorps). The Cancos proposed to contribute all their Subcorp shares (the contribution) to a newly formed foreign partnership in exchange for its units only. The Cancos represented that the partnership would adopt the remedial method of allocating to its partners gains recognized by it. As part of a prearranged plan, Subcorp 1 was to dispose of all its assets (including its US realty) in a fully taxable transaction shortly after the contribution and then undergo a taxable liquidation (the sale and liquidation).

The IRS ruled that the contribution met all the requirements for non-recognition treatment because (1) the Cancos held USRPIs (Subcorp shares) before the transfer; (2) the Cancos exchanged the Subcorp shares solely for foreign partnership interests, which were USRPIs; (3) the Cancos' interests in the Subcorps and in the foreign partnership immediately before and after the contribution, respectively, remained subject to US tax in the same amount because, at least in part, the Canadian partnership planned to use the remedial allocation method; and (4) the Cancos agreed to comply with necessary filing requirements. The IRS also ruled that the gain recognized by the Canadian partnership on the disposition of its Subcorp 1 shares on the taxable liquidation did not trigger a USRPI gain to it because the shares were not USRPIs at the time of liquidation: Subcorp 1 did not own any USRPIs and all of its USRPIs were disposed of in taxable transactions.

The ruling clarifies that a partnership interest can be treated as a USRPI (in whole or in part) for the purposes of applying US non-recognition rules, a conclusion that is not explicit in either the Code or the regulations. In the ruling, because the foreign partnership owned USRPIs only and it adopted the remedial allocation method, all its interests were USRPIs.

The ruling accepts without discussion or analysis that the determination of whether the USRPI received by the Cancos is subject to US taxation is made immediately after the transfer and is based on the transaction's form. There is no discussion of whether the step transaction doctrine may apply, even though, as a result of the prearranged sale and liquidation, part of the foreign partnership interest ceases to be "attributable to" a USRPI. Application of the step transaction doctrine would have raised the potential for both Subcorp 1 and the Cancos being required to recognize a taxable gain attributable to the same economic gain. Perhaps the IRS did not apply the step transaction doctrine because there is no evidence that Congress intended to impose materially different tax consequences merely because of the interposition of a partnership between the non-US taxpayers and the USRPI. In that regard, if Subcorp 1 had been owned directly by the Cancos, the sale and liquidation would have attracted only one level of tax (at the Subcorp 1 level). Of course, the IRS's view of the meaning of "immediately after" and the potential application of the step transaction doctrine might have been different if the subsequent (integrated) transaction had resulted in the USRPI gain's disappearance from the US tax system. Unfortunately, the ruling does not clarify the tax consequences if a partnership owns both USRPIs and non-USRPIs.

The ruling implies that the foreign partnership's adoption of the remedial allocation method is central to the IRS's conclusion, even though the regulations focus on the extent to which a disposition of a partnership interest is subject to US taxation, not on the extent to which a gain recognized by the partnership and allocated to a non-US

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partner remains taxable. It is unclear whether the IRS is trying to interpose another requirement—the use of the remedial allocation method—for the USRPI-for-USRPI exception or whether the use of the remedial method is sufficient to satisfy the exception. One hopes that another ruling will provide a clearer answer to this remaining question.

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Trust Interest Valuation

Valuations of a trust interest for family law and income tax purposes can produce vastly different results. A value for matrimonial purposes generally is the subjective value-to-owner and for income tax purposes is the objective FMV. Value-to-owner is what a prudent person would pay for an asset rather than be deprived of it; FMV is the price at which informed and prudent arm's-length parties would transact—the "willing buyer, willing seller" standard.

The FMV of an income beneficiary's interest is the present value of the projected future income stream (considering annual rates of return) that enures to the beneficiary, discounted for the time value of money, contingencies, risks, prior-ranking claims, and taxes. Risks include a trustee's bias to invest in capital (growth) assets. The FMV of a capital beneficiary's interest is the trust's total value net of the income beneficiaries' interests, any encroachment rights, contingencies, and other risk factors. The FMV of a trust interest also reflects the mix and composition of the trust's assets, vesting, the existence of contingent beneficiaries, marketability, etc. Actuarial input is often required. In England, life interests and reversionary interests have been sold by way of public auction.

A non-discretionary trust interest is valued by taking into account the value and mix of trust assets, rates of return, the beneficiary's life expectancy, the estimated timing and amounts of distributions, encroachment rights, the history of distributions, taxes, etc. For a discretionary trust one must also consider, inter alia, the trustees' fiduciary powers; the settlor's or testator's overall intentions; the history of distributions; the rights of other beneficiaries and their ages, health, and needs; the relationship between the beneficiary and the trustee; the obligation of the trustee to maintain an even hand; a testator's letter of wishes (if any); the availability of information from the trustee; and the possibility of change of trustee. In a discretionary trust, there is no definite economic interest in either an income or a capital interest unless the vendor happens to be the sole beneficiary in the trust income or capital; in any event, FMV is speculative at best.

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Foreign Tax News

United States

Congress's Joint Committee on Taxation issued "Tax Compliance and Enforcement Issues with Respect to Offshore Accounts and Entities," a report that discusses US withholding tax rules for non-residents and foreign corporations; the qualified intermediary withholding program, including know-your-customer rules; the impact of bank secrecy on that program and on securing offshore account information; and the conflicting interests underlying US treaties' exchange of information, including the attempt to develop consensus on the regulation of offshore financial centres.

United Kingdom

The 2009-10 budget contains a new disclosure opportunity until March 2010 for offshore account holders with unpaid tax or duties. Proposals allow HMRC to publish the names of any taxpayer who incurs a penalty for deliberately understating tax in excess of £25,000.

Russia

Finance proposed an alternative VAT refund procedure expected to be operational after June 2009, under which a claimant can receive a refund within 30 days of submitting a bank guarantee to the tax authorities. If the refund request is denied, the refund must be returned before the taxpayer can appeal the decision to the courts.

Argentina

A program designed to encourage consumers to require a receipt from vendors on the purchase of goods and services creates a lottery for which entrants must have collected 12 receipts.

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ADDENDUM

CRA: EMPLOYEE STOCK OPTIONS AND TFSAS

The valuation of an employee stock option for employee benefits purposes was addressed by the introduction of section 7. In light of a recent informal communication from Rulings officials, a legislative solution may be required to clarify and simplify the valuation of such options in the context of a contribution to a tax-assisted savings plan.

Tax practitioners often relied on two technical interpretations issued in 1995 and 1996 (nos. 9503445 and 9621975) as authority for using intrinsic value—the excess of the shares' current FMV over the option's exercise price—to value an employee stock option contributed to an RRSP. There seemed to be no reason why the TIs would not apply to value options contributed to the newly established TFSAs. However, senior Rulings officials now indicate informally that the TIs were misinterpreted and are not authority for using intrinsic value to value employee stock options for either RRSPs or TFSAs. The CRA says that the TIs simply assumed values to illustrate the interpretive issue under consideration.

The net effect of the tax imbalances associated with the contribution of an employee stock option to an RRSP was to discourage a taxpayer from making such a contribution. The assumption that the option's intrinsic value was its FMV resulted in a low deduction for the contribution, or perhaps no deduction if the option was not in the money. Moreover, double taxation could arise: the individual is first taxed at his level on the option's exercise in the RRSP and is then fully taxed on the distribution of the proceeds out of the RRSP. In the context of TFSAs, the low intrinsic value for a contributed option allows the plan's $5,000 annual limit to be readily skirted, but the contribution is not fettered by the possibility of double taxation. (For a fuller analysis, see Alan Macnaughton and Amin Mawani, "Contributions of Employee Stock Options to RRSPs and TFSAs: Valuation Issues and Policy Anomalies" ((2008) vol. 56, no. 4 *Canadian Tax Journal*, 893-922).

Senior officials in the Income Tax Rulings Directorate have now informally said that the FMV of a stock option, warrant, or similar right should be determined using a valuation method that is appropriate in the circumstances, such as the Black-Scholes model or another accepted valuation model, but not the intrinsic value. The journal article's comparison of Black-Scholes and subjective values with intrinsic values at various share price levels illustrates that the intrinsic value tends to undervalue an option. Thus, in the case of an employee stock option contributed to an RRSP, this latest CRA position may result in a higher FMV for the contribution and thus a higher deduction than suggested by the intrinsic value. Similarly, the use of a higher FMV results in the annual $5,000 TFSA contribution limit being reached more quickly. A taxpayer who relied on an option's intrinsic value as its FMV for TFSA contribution purposes may thus have over-contributed and be subject to penalties. However, the matter is far from clear: in *Henley*, the TCC suggested (perhaps in obiter) that the intrinsic value of warrants represented their FMV, and the FCA appeared to support other, but low, valuations (2006 TCC 347 and 2007 FCA 370, respectively).

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