CANADIAN TAX Highlights

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2009 Auditor General's Reports

Two auditor general's reports issued in 2009 comment on the CRA's handling of taxpayers' advance deposits and of audits for small and medium-sized businesses.

■ The May 12, 2009 report says that the CRA incurred at least $90 million in unnecessary interest costs over the last three years on amounts deposited with it. Administratively, the CRA allows taxpayers to pay amounts in advance to minimize interest costs where there is a bona fide risk of reassessment. According to the AG, however, the CRA has recognized for years that certain corporations might be leaving large balances in their CRA accounts to take advantage of favourable interest rates. The AG estimates that the difference between the government's borrowing rate and the interest rates paid on advance deposits represents at least $90 million over three years in unnecessary interest.

The report says that over the years the CRA has unsuccessfully attempted to refund as many of these balances as possible; but if a corporation did not choose to withdraw its balance, the CRA accepted the decision. The CRA does not have a process for checking to see whether a reassessment is in process and whether the amount of an advance deposit is in line with any likely reassessment and is thus an appropriate protective tactic to guard against exposure to excessive interest costs. Furthermore, the CRA does not require taxpayers to follow its published guidance on advance deposits in its *Corporation Instalment Guide*; for example, taxpayers often fail to identify the tax year to which the deposit relates.

According to the report, as of the end of the federal government's three fiscal years ending in 2006-2008, the CRA held more than $4 billion in advance deposits from corporate taxpayers—about 10 percent of 2008 corporate tax revenues—and only some of the deposits were made by corporations likely to have reassessments. Some of the larger deposits amounted to hundreds of millions of dollars and were made by only a small number of corporations; in each of the three fiscal years under review, the same 50 corporations accounted for about two-thirds of advance deposits.

To remedy this situation, the AG recommends that the CRA inform Finance so that it can assess whether legislative or regulatory change is required; regardless of the result of that assessment, the CRA should develop and consistently apply a robust administrative policy framework for managing advance deposits.

■ The March 31, 2009 status report stated that the CRA has made unsatisfactory progress on improving how it assesses the risks of non-compliance with tax laws and how it targets small and medium-sized businesses to audit for unreported income. This status report follows up on recommendations made in the AG's 1999 and 2004 reports.

The 2009 report says that the CRA audited a far higher proportion of low-risk tax returns than returns rated high-risk by its computerized risk assessment system. Of the 87,000 small and medium-sized enterprise files audited over a two-year period starting in 2006, the CRA designated only 13 percent of the files as high-risk; those files earned 41 percent of total tax recoveries from the program. About 56 percent of the 87,000 audits were designated as zero-risk or low-risk, but they earned 39 percent of total recoveries.

The AG concludes that the CRA needs to (1) improve its systems for assessing and addressing the risks of non-compliance in the small and medium-sized enterprise sector; (2) strengthen its random audit program to produce reliable information that provides new insights into risk factors and the underlying causes of non-compliance; and (3) address the AG's finding that most CRA audits are of taxpayers that the CRA's system had not identified as high-risk or priority.

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In This Issue

Excess Capital Dividend Annulled

The Superior Court of Quebec recently decided in favour of the taxpayer in *Felix & Norton International Inc.* (2009 QCCS 919). As a form of rectification, the court annulled a resolution to declare a capital dividend payable (but never paid) that exceeded the taxpayer's capital dividend account (CDA). The calculation of the CDA balance and the elected amount neglected to consider a prior year's capital loss. The rectification order prevents the CRA from applying the punitive part III tax on excessive elections.

If a corporation pays a capital dividend in excess of its CDA balance, the excess is subject to a 75 percent part III tax. (Proposed legislation lowers the rate to 60 percent for payments after 1999.) Penalty relief is available if the corporation elects under subsection 184(3) to deem the excess to be a separate taxable dividend paid to the particular shareholders.

On July 7, 2006, a resolution of the board of Felix & Norton (Canco) declared a $950,000 capital dividend payable on July 31, 2006, but Canco's lack of funds precluded the dividend's payment. A CRA audit of the CDA calculation determined that a significant 1999 capital loss had not been taken into account, and thus the capital dividend declared exceeded the CDA balance by $200,000. (Canco changed accountants in 2000; in calculating the CDA, the new accountants were not aware of the information in the 1999 income tax returns and did not take it into account.) The CRA assessed $150,000 part III tax. To minimize its tax liability, Canco and its shareholders elected to treat the excess dividend as a separate taxable dividend, subject to the outcome of a judgment that could annul the capital dividend. The court was asked to determine whether it could annul the board's resolution declaring a capital dividend and whether the capital dividend election precluded an annulment.

The court found that the shareholders and the accountants were all reliable witnesses and that the shareholders had been misled; Canco had been unable to confirm its CDA balance with the tax authorities, although the accountants and administrators made reasonable verifications before proceeding. A declaration of a dividend must originate from a free and informed consent; if that consent was tainted by an error in one of its essential elements, the resolution must be declared annulled and the parties restored to their previous situation.

The court confirmed that the subsection 184(3) election is only one option open to a taxpayer to correct an excessive capital dividend election. The separate dividend election can mitigate the punitive tax, but it does not close other avenues and does not render the entire civil law inapplicable; more importantly, it does not reverse the principle that tax follows civil law. The tax authorities must recognize a legally declared annulment because the operation of tax legislation depends on the existence of a transaction or event according to civil law. The court cited three cases in which a capital dividend was annulled in identical circumstances.

Because Canco and its shareholders elected under subsection 184(3) solely to mitigate damages in the event that the capital dividend was not annulled, the court said that the election does not prevent the court from declaring the resolution annulled. The court annulled the capital dividend resolution, and declared the dividend to be null and void and never to have existed. The case demonstrates that a subsection 184(3) election may not be the only remedy for an excess CDA designation. Although *Felix & Norton* involves civil law, court orders have also been rendered in common-law jurisdictions to rectify situations that did not reflect the parties' intention. (See, for example, *Juliar v. Attorney General of Canada*, 93 DTC 5743 (Ont. SCJ); aff'd. 2000 DTC 6589 (Ont. CA).)

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Pensions in Transition

A recent study released by Statistics Canada showed that the traditional form of retirement funding has changed. Defined benefit pensions, funded in whole or part by employers and providing a pension related to years of service and earnings while employed, have decreased in relative importance. More common now are defined contribution pensions, plans that base the level of pension that can be purchased with the funds accumulated at retirement, leaving the employee to bear the risk or enjoy the benefit of changing interest rates during the accumulation of funds and at retirement.

The table shows how the trend from defined benefit to defined contribution plans has changed the pattern of retirement savings in Canada. Data used in the study exclude RRSPs and group RRSPs sponsored by employers. In the group of employees covered by formal pension plans, private sector employees enrolled in defined benefit plans dropped from 26.2 percent of all employees in 1991 to only 17.2 percent in 2006. Public sector employers continue to rely on defined benefit plans. Equally dramatic is the decline in the percentage of all private sector employees enrolled in formal pension plans, from 30.6 percent in 1991 to 23.7 percent in 2006.

Of public policy concern is the level of retirement income produced by defined contribution pensions. After an extensive period of low interest rates, the funds available to

Employees Enrolled in Pension Plans, 1991 and 2006

	1991	2006
	percent	
Public sector		
Defined benefit	86.3	78.2
Defined contribution	2.8	4.1
Total employees covered	89.1	82.3
Private sector		
Defined benefit	26.2	17.2
Defined contribution	4.4	6.5
Total employees covered	30.6	23.7

purchase pensions may be lower than would be the case after a period of high rates. The sponsor of a defined contribution plan has avoided the risk inherent in defined benefit plans, but the employee could retire with less income, thus putting more pressure on the Canada and Quebec pension plans because they are both essentially defined benefit plans. A lengthy period of dramatically lower interest rates also increases reliance on the old age security system, with its basic universal pension and the supplementary payments for low-income seniors and their dependants. Originally, it was hoped that the need for the universal OAS system would be reduced by a combination of public plans and a more extensive network of private pensions that were becoming available to a broader portion of the working population. Prudent members of defined contribution plans will turn increasingly to individual RRSPs, increasing the tax cost of retirement savings to both federal and provincial governments. The financial weakness recently evident in private sector pension plans only serves to exacerbate these concerns.

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IFA Round Table

On May 21, 2009, the CRA and Finance participated in a round table as part of the 2009 IFA International Tax Seminar in Toronto. The following summarizes some highlights from that session; the CRA intends to provide a written record of its responses.

■ Finance announced that Canada has begun negotiating tax information exchange agreements (TIEAs) with several countries, including Jersey, Isle of Man, Guernsey, Netherlands Antilles, and Bermuda. In Finance's view, the interest of non-treaty countries in TIEAs demonstrates that its new policy linking exempt earnings status with TIEAs is effective as an incentive for tax information sharing. The designated treaty country definition in regulation 5907(11) was recently amended to extend exempt surplus status to ABI earned in a country with which Canada has entered into a comprehensive TIEA. Finance confirmed that confidential TIEA negotiations are in progress with other countries that do not yet wish to be named.

■ No new developments were announced with respect to foreign investment entities and non-resident trusts. Finance confirmed its 2009 federal budget promise to re-examine the longstanding proposals, but noted that the draft legislation (with a 2007 effective date) has not been withdrawn. Finance could not say whether the proposals would ultimately be withdrawn or whether they would be reintroduced either more or less intact or substantially altered. Finance hopes to announce the results of its legislative review by year-end. The CRA said that it appreciates the proposals' history and the resulting uncertainty, but encourages taxpayers to file based on the draft legislation because one cannot assume that relief will be granted from arrears interest if the proposals are enacted in current form.

■ In response to a question about whether a comprehensive limitation-on-benefits (LOB) clause such as the one in the Canada-US treaty's fifth protocol will be a common feature in Canada's future treaties, Finance said that that the LOB did not reflect a change in policy. Finance also said that the elimination of withholding tax on non-arm's-length interest was at the root of the LOB clause in the Canada-US treaty. Canada has no plans to eliminate withholding tax on interest, dividends, and royalties generally, and thus does not intend to include comprehensive LOBs in other treaties.

■ The CRA said that it was not prepared to interpret Canada-US treaty article IV(7)(b) to grant treaty benefits for a back-to-back dividend paid from a Canadian opco to its Canadian unlimited liability company (ULC) parent and then to the ULC's US parent on the basis that the US treatment of the specific amount was the same whether or not the ULC was fiscally transparent from a US perspective. The CRA sympathized with the fact that the denial of treaty benefits in these circumstances may not be appropriate; the CRA suggested that it may be open to a structure that streamed dividends away from the ULC, perhaps by having the US parent invest directly in a special class of shares of the Canadian opco.

■ The CRA noted problems in determining when an amount's treatment is considered "the same" for the purposes of article IV(7)(b), and it discussed several cross-border financing and royalty structures that arguably should not be denied treaty benefits even though they involve payments from a ULC to a US resident. The examples given relied, for the most part, on the amount being treated the same in the United States regardless of the fact that it was received from a fiscally transparent ULC.

The CRA indicated that it was unable to provide definitive answers because it had not yet determined how it would interpret “the same” in these circumstances, but it anticipates publishing its position later this year.

■ Under Canada-US treaty article XXIX A(3), a US resident that is not otherwise a qualifying person is entitled to treaty benefits on income derived from Canada and connected to an active trade or business that is conducted in the United States and that is substantial in relation to the income-generating activity. Given the lack of domestic precedents for the term “substantial,” the CRA said that it is forced to rely heavily on the technical explanations to the protocol and the 2006 US model treaty, and acknowledged that many taxpayers must rely on article XXIX A(3) in order to obtain treaty benefits. The US business must be substantial relative to the Canadian activity to prevent treaty shopping. The CRA indicated that the US business need not be as large as the Canadian business, but must be more than a very small percentage of its size. Relevant factors include income, assets, payroll, and the size of the relevant markets.

■ The CRA discussed the phrase “in connection with” in article XXIX A(3). The CRA had previously confirmed that a treaty exemption based on the active trade or business test may be available for a capital gain on the disposition of a Canco’s shares by a US-resident parent if the shares’ value was attributable to a connected business carried on by the Canco; the gain is proportionally exempt if some of the share value is attributable to an unconnected business. The CRA said that similar treatment is accorded to dividends, and it considers dividends to have been paid first from the connected business’s earnings. Royalties may be sourced to the connected business if the underlying property was used therein; interest is connected if the borrowed money was used to acquire assets for use in the connected business.

The CRA has not yet concluded whether the use of borrowed money to acquire shares of a foreign subsidiary that carries on a connected business in another country renders the interest as sourced to the connected business; if it is so sourced, then dividends and gains sourced to the foreign business should presumably also be eligible for treaty benefits. The CRA said that if it concludes that the foreign business is part of the connected business for this purpose, then likely the foreign business should also be taken into account in determining the substantiality of the US business under article XXIX A(3).

■ In the fall of 2009, the CRA plans to release further written guidance on the protocol with a view to consolidating its guidance and updating it as developments occur.

■ When a non-resident assigns or otherwise transfers an obligation (not an “excluded obligation”) to a Canadian resident, subsection 214(7) may deem any excess of the assignment or transfer price over the original issue price to be a payment of interest on the obligation by the Canadian resident to the non-resident. A conversion of a debenture is deemed to be an assignment of the obligation pursuant to subsection 214(14). The CRA was not in a position to comment on exchangeable debentures, but confirmed that no withholding tax arises upon a conversion under a traditional convertible debenture (for which the CRA has nine criteria).

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US Crackdown on Offshore Tax Abuse

President Obama’s 2010 budget proposes further changes to US international tax rules to curb offshore tax planning that, in some cases, do not require the very public process of congressional approval. The proposals are a road map for potential changes of major import to both companies with cross-border operations and US individuals, including US citizens who live abroad but remain subject to US tax on worldwide income. Since taking office, President Obama has launched a number of initiatives designed to stop the use of offshore accounts or foreign entities by US persons to avoid the payment of US taxes. The recent budget proposals continue the trend; at least some of them are likely to be implemented and will further the tax system’s complexity.

■ **Check-the-box rules.** A significant proposal restricts the check-the-box rules for some foreign entities. For US federal tax purposes, any foreign entity that is not a per se corporation (listed in regulations and including a Canadian federal or provincial corporation) may check the box to elect US federal tax classification as a disregarded entity, a partnership, or a corporation. The change proposes that a foreign eligible entity with a single owner can elect disregarded entity status only if it and its owner were created under the law of the same country; otherwise, the entity is treated as a corporation for US federal tax purposes.

Exceptions apply, such as that for a first-tier foreign eligible entity wholly owned by a US person (and not deemed to have been created for US tax avoidance). The administration’s goal is to require corporation-status treatment for some foreign eligible entities, and thus there is no impact on a foreign eligible entity that checked the box to be classified as a corporation. The proposal is much narrower than some anticipated. Unlike most of the budget proposals, however, the change does not require congressional approval to become law because the check-the-box rules are regulatory and not legislative. The check-the-box proposal could conceivably be implemented at any time and catch unawares many companies with cross-border structures that use the check-the-box rules.

■ **Earnings-stripping limitations.** The earnings-stripping rules are designed to limit the amount of a corporation's US tax deductions for expenses (especially interest) on a debt obligation to a related party if the debtor's debt-to-equity ratio is more than 1.5:1 and the related party pays reduced or no US income tax on the interest's receipt (such as interest on a debt owing from a USco to a Canco). A related party's guarantee of debt owing to an unrelated party may also trigger the rules if the debt-to-equity ratio test is met. Currently, affected interest cannot exceed 50 percent of the corporation's adjusted taxable income (generally adjusted upward for net interest expense, depreciation, and amortization), but a disallowed expense may be carried forward indefinitely.

Several proposals in Congress in recent years sought to broaden the earnings-stripping rules—for example, by reducing the adjusted taxable income limitation to 35 percent and by not allowing carryforwards. The new proposal is narrower than expected and applies only to certain expatriated entities. As defined (in Code section 7874), an expatriated entity is generally one into which a US parent company inverts and its top-tier position is thus assumed by a foreign parent as a result of the acquisition by the US parent's former shareholders of at least 60 percent of the foreign corporation's shares at the time it acquires the US parent. The inversion rules commence to apply to an expatriated entity at a 60-percent-plus inversion threshold, but are different for an 80 percent or more inversion. Cross-border mergers and acquisitions of US companies by foreign entities often trigger the expatriation entity rules, to the dismay and surprise of participants and tax planners.

The proposals limit the deductibility of the relevant interest only on related-party debt to 25 percent of an expatriated entity's adjusted taxable income. The carryforward for disallowed interest is also limited to 10 years. However, the proposals do not apply if a foreign parent is treated as a domestic corporation for US tax purposes because it undertook an 80 percent or greater inversion, presumably because it remains taxable on its worldwide income. One curious aspect of the proposal requires that section 7874, enacted in 2004, be read as if it applied to tax years beginning after July 10, 1989 when determining whether the proposal applies.

■ **Foreign financial accounts and trusts.** A significant number of the budget initiatives are designed to combat US taxpayer abuses of offshore accounts and foreign trusts, and many enhance reporting requirements for foreign intermediaries that make payments to US citizens or US entities. These proposals are in large part aimed at compelling foreign financial institutions to report to the IRS the identity of and other information about their US account holders. The proposals are not surprising in light of the aggressive measures already taken by the administration against companies such as UBS and other financial institutions that refused to cooperate with US government demands for information about the accounts of US persons.

Taxpayers who have interests in foreign financial accounts or foreign trusts are also exposed to newly proposed initiatives, such as a significantly increased penalty on the understatement of income in an offshore account and a new minimum $10,000 penalty for failure to make proper foreign trust reporting. The proposals also increase the limitation period from three to six years in some cases—for example, for certain information returns and tax return disclosures by taxpayers with foreign activities.

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TIEAs Emerging

The controversial March 2007 federal budget proposed to grant exempt surplus status for ABI earned by Canadian multinationals in a non-treaty country that entered into a tax information exchange agreement (TIEA) with Canada—in effect, trading tax benefits for tax-relevant financial information respecting Canadian taxpayers. Moreover, if a country is approached but does not conclude a TIEA with Canada within five years, ABI earned by a foreign affiliate there is taxed on an accrual basis in Canada. The budget documents said that Canada will give public notice of its invitations for TIEA negotiations. The program was shrouded in secrecy until a May 2009 announcement by Bermuda confirmed that it has concluded a TIEA with Canada (see "TIEA Agreements Reached with Canada," http://www.plp.bm/node/1943).

Many TIEAs have been signed between "onshore" countries (such as the United States and EU member countries) and "offshore" countries (principally in the Channel Islands and the Caribbean). Bermuda has signed 15 TIEAs and the British Virgin Islands has signed 12. With the exception of the Canadian TIEA program, no tangible benefits are offered to the offshore party, which imposes no tax on its residents and thus has no need for the foreign bank account information accessible to it under a TIEA. Some commentators suggest that the pressure imposed by OECD and G20 member countries on offshore countries can be heavy-handed and is not tailored to meet specific circumstances. "White-list country" status is given to offshore jurisdictions that enter into at least 12 TIEAs, even though, for example, the British Virgin Islands not only has no bank secrecy laws like Switzerland's, but also has more rigorous know-your-client rules for those doing business there than most "onshore" jurisdictions.

Some offshore jurisdictions such as the British Virgin Islands have gratuitously and voluntarily implemented the EU Savings Tax Directorate program, committing to provide to an EU member country either information respecting bank accounts held by its residents or a cash payment equal to a percentage (phased in from 15 to 35 percent) of interest income earned on those bank accounts. Both this program and the TIEA program were spawned by a 2002 OECD initiative that listed 38 "uncooperative tax havens" and encouraged them to adopt OECD transparency and exchange-of-information standards. A May 27, 2009 OECD report said that the last 3 of those original 38 jurisdictions—Andorra, Liechtenstein, and Monaco—had been removed from the blacklist and were now on a grey list, as highlighted at the April 2009 G20 meeting in London.

On the Canadian front, Canada has yet to confirm that it has concluded a TIEA with Bermuda, although at the May 2009 IFA seminar Finance broke its silence and said that negotiations are under way with Bermuda, Guernsey, and the Isle of Man (which publicly announced the negotiations), and with Jersey and the Netherlands Antilles. Canadian-based multinationals, which will benefit from a TIEA under extended exempt surplus rules, are generally already fully compliant and in full disclosure of all relevant information to the CRA and have shown little interest in the TIEAs' contents; those for whom a TIEA's content raises concerns are likely to move their affairs to a non-TIEA country.

July 2008 draft amendments to regulation 5907(11) added an in-force TIEA to the qualifying characteristics of a designated treaty country to unlock the exempt surplus system for TIEA countries. The amendment was brought into force by the unusual procedure of enactment, as part of Bill C-10, on March 12, 2009. The punitive side of the TIEA-related rules—annual accrual and taxation in Canada of ABI earned in a country that refuses to enter into a TIEA—was enacted in December 2007 as part of Bill C-28.

The December 10, 2008 final recommendations of the advisory panel on Canada's international tax law advocated the adoption of a full exempt surplus or territorial system, which would obviate TIEA-status benefits, and also recommended the elimination of FAPI treatment. If Canada adopted that practice, like other countries it would not be able to offer tax benefits to a prospective TIEA partner. Finance representatives at the IFA seminar may have been signalling that the panel's recommendations may not be adopted soon.

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LLCs and Canada-US Protocol

The recently ratified fifth protocol to the Canada-US treaty addresses the treatment of fiscally transparent entities for Americans—but not for others—who invest in Canada through US limited liability companies (LLCs). Issues arise because an LLC is disregarded or fiscally transparent for US tax purposes, but Canada does not regard it as a US resident for treaty purposes.

New article IV(6) provides that an amount of income, profit, or gain is considered derived by a resident of a contracting state if its home state's tax law considers it to have derived the amount through a fiscally transparent entity that is not a resident of the other state and the treatment of the amount under that state's tax law is the same as if the person had derived it directly. Thus, a Canadian making a payment to an LLC must now determine the US tax treatment of both the entity and the payments; the rule does not treat a US LLC as a US-resident person, but deems the payment to be derived by a US LLC member. A non-US-resident LLC member is not entitled to treaty relief even if he resides in a country with which Canada has a treaty. For example, if a US-resident individual and a UK-resident individual each own 50 percent of an LLC that owns a private Canco's shares, dividends paid by the Canco are subject to 20 percent withholding tax (50% × 15% + 50% × 25%). Only half of the gain on a share sale is eligible for the treaty's capital gains exemption; the UK resident suffers by owning Canco indirectly.

The CRA says that a Delaware corporation's conversion to an LLC does not trigger a disposition of its assets (such as taxable Canadian property); the two corporations are regarded as the same entity on the basis of governing Delaware LLC legislation that deems the newco to be a continuation. But the conversion of an LLC to a partnership is a taxable disposition of the LLC's TCP (document no. 2004-0104691E5); treaty relief depends on the type of property and whether all LLC members are US residents qualifying under the limitation-on-benefits article.

Canadian compliance issues arise because an LLC's Canadian status as a corporation requires it to file a Canadian return if it carries on business in Canada through a branch or disposes of TCP. A non-resident that disposes of TCP must generally provide the purchaser with a section 116 certificate. The protocol's technical explanation says that the LLC is still the return filer, the only visible taxpayer from a Canadian perspective; the LLC shareholders need not file. The CRA is expected to supply additional practical guidance regarding required filings, including instructions for seeking an entitlement to a treaty benefit.

Because an LLC is not a US resident under the treaty, it was taxable in Canada if it carried on business here even with no PE. Fortunately, the technical explanation says that article IV(6) also determines whether a person has a PE in a state, providing a lookthrough to the fiscally transparent entity's owner. Assume that a US-resident individual owns an LLC that carries on business in Canada with no PE. Before 2009, the LLC was taxable in Canada on its Canadian business profits, but the protocol says that the US resident, who has no PE, carries on the business and thus the LLC profits are not taxable in Canada; if some LLC members are not US residents, only the LLC's income attributable to them is taxable in Canada.

The tower structure was formerly a popular double-dip structure for Canadian residents investing in the United States. Assume that a profitable Canco owns the shares of a US C corporation carrying on a US business. To deduct the interest on financing the C corp, Canco and a Cansub form a US partnership (the hybrid), which checks the box to be treated as a USco for US tax purposes. Canco earns 99.9 percent of the hybrid's profits or losses. The hybrid forms a Canadian ULC, which forms a US LLC. Canco may borrow in Canada to invest in the hybrid, or the hybrid may borrow from a US bank. The hybrid invests in shares of the ULC, which invests in the LLC, which lends to the C corp. For US purposes, the C corp deducts interest paid to the LLC; dividends are distributed to the ULC and on to the hybrid, which pays interest. For US purposes, the LLC and the ULC are disregarded entities and the hybrid is treated as a USco. If Canco has borrowed the funds, article 7(a) denies treaty benefits and the interest attracts 30 percent US withholding. If the hybrid borrows from a US bank, the interest paid does not attract withholding. (Section 18.2, which would have denied a Canadian deduction for the interest, was repealed in the 2009 budget before it became effective.) For Canadian tax purposes, interest paid by the C corp to the LLC is recharacterized as ABI. Neither the dividend paid from the LLC (out of exempt surplus) nor the dividend on-paid out of the ULC (an intercorporate dividend) is taxable in Canada. The hybrid is a partnership that has deductible interest expense and tax-free dividends, creating a loss deductible by Canco.

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US ODC Tax Revived

The IRS recently increased audit activity relating to excise taxes on the importation into the United States of products that contain or use ozone-depleting chemicals (ODCs), such as CFCs, halon, carbon tetrachloride, and methyl chloroform. Under Code section 4681, imported taxable products are subject to excise tax if they contain or use ODCs in their manufacture and are imported for consumption, use, or warehousing.

The list of excisable products, found in reg. section 52.4682-3, affects a wide range of industries, including electronics, medical, technology, retail, and automotive. The listed products include some medical products (surgical staplers, inhalants); refrigerators and freezers; foam chairs and sofas; electronics (calculators, laptops, notebooks, pocket computers, cellphones, printers); printed circuits; and populated cards for digital processing. If the IRS identifies the importation of a listed product, an assessment is raised for excise tax based on the weight of the ODCs that the IRS believes are incorporated into the product, released into the atmosphere in the process of manufacturing the product, or otherwise used during manufacturing. For example, ODCs were historically, and may still be, used to clean and remove soldering residue from electronic circuit boards. An excise tax liability arises if a product containing a circuit board washed in a solution containing ODCs is imported into and sold in the United States.

The IRS applies the excise tax to the exact weight of the ODCs used in the manufacturing process; if that information is not available, the IRS uses a predetermined weight that is linked to the particular product. The predetermined weights, listed in a table in the regulation, are derived from information on industry processes and usage dating back to the 1990s. The excise tax for a particular product not linked to a predetermined weight is calculated under a default rule based on 1 percent of the imported product's value.

Given the many changes in manufacturing processes since the 1990s, importers may disagree with the predetermined weight used. The onus is then on the importer to substantiate a lower weight using actual data, which are often difficult to extract from the manufacturing process. The excise tax is substantially reduced if the importer relied on alternative manufacturing processes that minimized or eliminated ODC use or emissions, but obtaining the necessary proof may be time-consuming.

The increased focus on and imposition of the US excise tax has caught many importers off guard—the tax is generally not well known, and enforcement to date has been inconsistent. With greater focus and audit effort by the

IRS, it behooves all importers to understand their obligations and accumulate the data necessary to prepare for, and if need be to defend against, a potential assessment.

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Corporate Rate Update

The decline in the federal general (and M & P) corporate rate from 19.5 to 19 percent after 2008 caused combined 2009 corporate rates to fall in all jurisdictions except Quebec. The federal rate continues to drop in stages to 15 percent by 2012. The federal government's goal for a 25 percent combined federal-provincial and federal-territorial tax rate by 2012 will be achieved by Alberta, British Columbia, and New Brunswick, and on July 1, 2013 by Ontario. New Brunswick's combined rate will drop further to 23 percent by July 1, 2012.

Previously announced changes resulted in an increase in the 2009 general (and M & P) rate in Quebec (exceptions apply) and in a decrease in British Columbia, Manitoba, and Saskatchewan (general rate only). The 2009 budgets for British Columbia, New Brunswick, and Ontario reduced general (and M & P) rates in stages after June 2009 in New Brunswick and after 2009 in British Columbia and Ontario. Nova Scotia's May 4, 2009 budget may not proceed: the minority government was defeated and an election called. Table 1 shows 2008 and 2009 combined general, M & P, and small business rates.

For 2009, the federal small business rate did not change, but provincial small business rates declined in British Columbia, Manitoba, and Prince Edward Island. British Columbia announced that its rate will drop "to the lowest rate in Canada by April 1, 2012." Manitoba's rate will decline in stages to 0 percent by December 1, 2010; Prince Edward Island's will reach 1 percent on April 1, 2010. On July 1, 2010, Ontario's rate will decrease from 5.5 to 4.5 percent, and its small business clawback will disappear. After 2008, income subject to Alberta's small business rate was to see a rate increase to 9.7 percent if the income qualified as an eligible dividend on distribution, but the

Table 1 Combined 2008 and 2009 Corporate Income Tax Rates (December 31 Year-End)

	General (and M & P)		CCPC small business (and M & P)		
			2008	2009	
	2008[a]	2009	Up to $400,000[a]	Up to $400,000	$400,000 to $500,000
			percent		
Federal	19.50	19.00	11.00	11.00	11.00
Alberta	29.50	29.00	14.00[b]	14.00	14.00 or 15.73[c]
British Columbia	31.00	30.00	14.91	13.50	22.00
Manitoba	33.00	31.50	13.00	12.00	23.50
New Brunswick	32.50	31.50	16.00	16.00	16.00
Newfoundland and Labrador	33.50 (24.50)	33.00 (24.00)	16.00	16.00	16.00
Northwest Territories	31.00	30.50	15.00	15.00	15.00
Nova Scotia	35.50	35.00	16.00	16.00	27.00
Nunavut	31.50	31.00	15.00	15.00	15.00
Ontario	33.50 (31.50)	33.00 (31.00)	16.50[d]	16.50	16.50
Prince Edward Island	35.50	35.00	14.47	13.37	13.37
Quebec	30.90[e]	30.90	19.00	19.00	19.83
Saskatchewan	32.00 (29.50)	31.00 (29.00)	15.50[f]	15.50	15.50
Yukon	34.50 (22.00)	34.00 (21.50)	15.00 (13.50)	15.00 (13.50)	26.00 (13.50)

[a] In 2008, CCPC ABI between $400,000 and $500,000 is the same as the general (and M & P) rate, except in Alberta, Ontario, and Saskatchewan. [b] Between $400,000 and $500,000, the Alberta rates are 22.50% (up to $430,000); 24.24% (up to $460,000); and 29.50% (up to $500,000). [c] The lower Alberta rate applies to a CCPC's ABI between $400,000 and $460,000. [d] Between $400,000 and $500,000, the Ontario rate is 25.00%. [e] The 2008 Quebec rate does not apply to financial institutions (other than insurers) and oil-refining companies. [f] Between $400,000 and $500,000, the Saskatchewan rates are 24.00% (up to $450,000) and 28.23% or 26.73% (up to $500,000, the lower rate for M & P income).

Table 2 CCPC Small Business Taxable Income Threshold

	From	To	Effective date (after January 1, 2008)
	dollars		
Federal	400,000	500,000	January 1, 2009
Alberta	430,000	460,000	April 1, 2008
	460,000	500,000	April 1, 2009
British Columbia	400,000	500,000	January 1, 2010
Manitoba	400,000	400,000	Unchanged
New Brunswick	400,000	500,000	January 1, 2009
Newfoundland and Labrador	400,000	500,000	January 1, 2009
Northwest Territories	400,000	500,000	January 1, 2009
Nova Scotia	400,000	400,000	Unchanged
Nunavut	400,000	500,000	January 1, 2009
Ontario	500,000	500,000	Unchanged
Prince Edward Island	400,000	500,000	January 1, 2009
Quebec	400,000	500,000	March 20, 2009
Saskatchewan	450,000	500,000	July 1, 2008
Yukon	400,000	400,000	Unchanged

increase was no longer effective once Alberta's CCPC limit ceased to exceed the federal CCPC limit. Changes to small business thresholds are outlined in table 2.

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Financial Service Exemption

For persons who facilitate the exchange, transfer, and issuance of financial instruments, the recent FCA decision in *Canadian Medical Protective Association* (2009 FCA 115) is an important reminder that the financial services exemption in part VII of schedule V to the Excise Tax Act is potentially broad and expansive. Legislative amendments may be launched to reverse the finding, but the court held that discretionary investment management services are an exempt supply of the financial service of arranging for the transfer of financial instruments. The FCA concluded that the meaning of the phrase "arranging for" includes "cause to occur," "give instructions," "make preparations for," and "plan," words and phrases that are "as wide and as elastic as one wishes them to be."

The court said that an investment management service was an exempt financial service, not a taxable advisory service, even though research and analysis was the dominant character of the activities undertaken by the investment managers in providing their service. The court focused on the "end result" of the service, which was to "cause . . . a transfer" of financial instruments to occur through undertaking research and analysis and then instructing brokers to effect the relevant trade on behalf of the account holder.

The decision does not apply to investment management services provided to pension plans, mutual funds, investment corporations, or any other person whose principal activity is the investing of funds; services rendered to these particular persons are expressly excluded. High net worth individuals, insurance companies, public sector bodies, and any business or organization that does not otherwise recover 100 percent of its GST may benefit from the *CMPA* decision if their investments are held in an account (including a pooled or separate account) that is not held by a separate legal entity, including a trust. Rebate claims for tax paid in error must be made within two years from the date that GST was paid on the services. Given Finance's history of retroactive ETA amendments, investment managers may continue to charge GST pending an announcement from the CRA or Finance. If no retroactive legislative change is made, then investment managers may have erroneously claimed input tax credits to recover GST paid on certain expenses, because they cannot claim ITCs on any portion of an expense that relates to an exempt supply of a financial service.

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EU Treaty Case Dismissed

Recently a Canco (F Limited) unsuccessfully challenged its liability for Netherlands dividend withholding tax in Netherlands courts, on the basis that the Netherlands tax law was incompatible with article 56 of the EC treaty. The central issue is far from resolved as a matter of EU law.

F Limited paid almost €400,000 in Netherlands withholding tax on dividends paid to it by its Dutch subsidiary in 2005. Its claim for recovery of the tax was based on the guarantee of free movement of capital between EU member states and third countries (non-member countries) in article 56(1) of the EC treaty. If withholding tax imposes a second layer of tax on corporate profits distributed to a non-resident when a resident would be exempt or taxed at a lower rate on the dividends, then the withholding tax is incompatible with EU law because it restricts the free movement of capital, as well as the right of establishment, between EU member states (see *Amurta*, C-379/05, and *Denkavit*, C-170/05; and see "EC Dividend Taxation and Third Countries," *Canadian Tax Highlights*, January

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2008). Under Netherlands law, a dividend is exempt if paid to a parent company resident in the Netherlands or another EU country, but it is subject to 5 percent withholding tax when paid to a Canadian parent.

The formation of a wholly owned subsidiary by a nonresident parent corporation obviously constitutes a movement of capital, but it also constitutes establishment as defined by the EC treaty. The Netherlands lower court held (on October 2, 2008, published March 27, 2009, LJN BH1516, AWB 07/5334) that because F Limited was able to exercise definite influence over the Netherlands subsidiary and determine its activities, the case was governed not by free movement of capital but by establishment. The EC treaty does not prohibit restrictions on establishment between EU countries and third countries, and thus withholding taxes were not incompatible with the treaty.

The lower court followed a decision of the Hoge Raad (Netherlands Supreme Court), which said that rights to free movement of capital with respect to third countries are not applicable in cases to which the right of establishment applied. However, in late November 2008, the High Court of England and Wales ruled in *Test Claimants in the FII Group Litigation* ([2008] EWHC 2893) that the right to free movement of capital is relevant in third-country cases even if the relationship between parent and subsidiary also falls under the right-of-establishment rubric. Statements on the issue by the European Court of Justice have been somewhat ambiguous, and thus it is not clear which of the English and Netherlands courts is correct. The English case has been referred (for the second time) to the ECJ, but not on this particular point. Unfortunately, the Netherlands court in F Limited's case did not refer the question to the ECJ for a final resolution.

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