CANADIAN TAX Highlights

Editor: Vivien Morgan, LL.B.

Volume 17, Number 7, July 2009

Trust Residence Questioned

It has been generally accepted in Canada that a trust resides where the trustees who control the trust reside. Recently, however, the CRA began to question the residence of trusts situate for tax-planning reasons in Alberta, which has the lowest tax rates in Canada. The CRA challenge is premised on the trust being resident in another jurisdiction, where it is managed and controlled. The fate of the CRA challenge will affect not only trusts used in interprovincial tax planning but also international trusts with Canadian beneficiaries.

Interprovincial tax planning involves shifting income from one province to a province with a lower tax rate. For example, the tax rates in Ontario may exceed by up to 7 percentage points the Alberta 4 percent rate, depending on whether the income is ordinary income, dividends, or capital gains. On May 15, 2008, at the Toronto Centre CRA & Professionals Group breakfast seminar, the CRA announced that its Aggressive Tax Planning Division had hired 35 additional audit officers and that one Tax Service Office per region is to be dedicated as a provincial anti-avoidance centre of expertise.

Quebec is the only province that has enacted specific avoidance rules to curtail the use of trusts in interprovincial planning and prevent the taxation of trust income in another provincial jurisdiction. (Ontario relies on GAAR.) Since 2002, a Quebec-resident beneficiary of a non-Quebec Canadian-resident trust must include in his Quebec return any income earned by the trust and taxed in its hands via an election under subsection 104(13.1) or (13.2) of the Income Tax Act (sections 671.5 to 671.10 of the Quebec Taxation Act). The beneficiary must also report on his return's form T1-663-V information such as the trust's name, the trustee's name and address, the date on which the taxpayer became a beneficiary, changes in trustee, and amounts payable in the year and for which the trustee elected federally.

In March 2009, each of several prominent Alberta trustees received a questionnaire from the CRA's Aggressive Tax Planning Division in Calgary indicating its intention to review the specific trust's residence. The CRA posed the following questions and requests for information to the trustees.

1) How, by whom, when, and why was the trustee appointed? What is the trustee's relationship to the trust? Copies are requested of the trustee agreement and/or contracts the trustee entered into.
2) What are the trustee's qualifications, expertise, and experience?
3) Does the trustee receive a fee for his services? What is the fee's amount and how is it determined and paid? Copies are requested of all billings/invoices issued to the trust with regard to the fees during the periods under review.
4) A list of the trustee's duties and responsibilities is requested.
5) Does the trustee have control over the trust's investment portfolio and any other trust assets?
6) What signing and/or contracting authority does the trustee have? Does the trustee have the power to contract and deal with the trust advisers such as accountants and lawyers?
7) Is the trustee responsible for the management of any business or property owned by the trust and, if so, how is that done?
8) Is the trustee responsible for banking and financing arrangements, for the trust and, if so, how is that done?
9) Is the trustee responsible for preparing the trust's accounts and reporting to the beneficiary and, if so, how is that done? Copies are requested of all correspondence, memoranda, faxes, e-mails, handwritten notes, minutes, and/or records of meetings and conversations, etc. with respect to communications between the trustee, the settlor, and the beneficiary during the periods under review.
10) How, where, and by whom are decisions made in relation to the trust property? Are the decisions documented, and who signs off on them? Copies are requested of all correspondence, memoranda, e-mails, handwritten notes, minutes, and/or records

In This Issue

Trust Residence Questioned	1
CRA Tweaks Employee Benefits	2
Netherlands' Attraction Increases	3
Federal Cash Distributed Through the Income Tax System	3
CRA Competent Authority Requests	4
Retroactive RST Amendments	5
US Budget Proposals	6
Ontario HST Refined	7
Eligible Dividend Rates Update	8
GST Policy on Grants and Subsidies	9
IRS VDP Guidance re Offshore Income	9
IRS Pre-Filing Agreements	10
Foreign Tax News	11

of meetings and conversations, etc. with respect to all decisions made by the trustee in relation to the trust property during the periods under review.

11) By whom and where was the decision made to distribute income from the trust to the beneficiary and to elect to have the income taxed in the trust during the periods under review? Copies are requested of all correspondence, memoranda, e-mails, handwritten notes, minutes and/or records of meetings and conversations, etc. with respect to these decisions.

Jack Bernstein
Aird & Berlis LLP, Toronto

CRA Tweaks Employee Benefits

Income Tax Technical News (ITTN) no. 40 contains administrative policy changes on taxable employment benefits, including non-cash gifts and awards, overtime meals and allowances, and employer-provided motor vehicles. The CRA says that a 2007 review of taxable benefits and their related administrative costs underlies the changes.

Non-cash gifts and awards. Under the current CRA gifts and awards policy, an employer can provide a non-taxable employee benefit of up to two non-cash gifts that cost it $500 or less in all and up to two non-cash awards with the same total cost. Effective for 2010, any number of non-cash gifts and awards to an arm's-length employee are non-taxable up to an aggregate value of $500 annually; excess value is taxable. A separate non-cash long service or anniversary award with a maximum $500 value is also non-taxable. Non-arm's-length employees and persons related to them are not eligible under the gift and award policy. Items of an immaterial or nominal value (such as coffee, tea, T-shirts with employer logos, mugs, plaques, and trophies) are not taxable benefits to employees. The CRA's administrative policy on the nature of qualifying gifts and awards remains the same; for example, performance-related rewards such as sales targets and near-cash awards such as gift certificates do not qualify and must be included in the employee's income.

Overtime meals and allowances. Previously, the CRA said that certain overtime meals or reasonable allowances therefor were non-taxable when the employee worked three or more hours of overtime right after scheduled work hours and the overtime was infrequent and occasional (fewer than three times a week). Effective for 2009, the CRA says that no taxable benefit arises if the value of a meal or meal allowance is reasonable (up to $17); the employee works two or more hours of overtime right before or right after the scheduled work hours; and the overtime is infrequent and occasional, which generally means fewer than three times a week, but occasionally may be more often to meet workload demands such as major repairs or periodic financial reporting. If the overtime occurs frequently, the overtime meal allowance is taxed as additional remuneration.

Employer-provided motor vehicles. Travel between home and work in a motor vehicle provided by an employer is generally considered to be personal use of the vehicle and an employment benefit. The current employment benefit (generally, 52 cents for each of the first 5,000 kilometres driven and 46 cents for each additional kilometre) is reduced to the operating benefit rate (24 cents per kilometre for 2009) if the motor vehicle is specifically designed or suited for the employer's business or trade and is essential for the performance of the employee's duties, the motor vehicle is not defined as an automobile under subsection 248(1), the vehicle has not been used for personal use other than commuting between home and work, and there are genuine business reasons for requiring the employee to take the motor vehicle home at night. The CRA says that the use of the vehicle is not personal if the employee proceeds directly from home to a point of call (such as the scene of an emergency) or returns home from that point of call.

Loyalty programs. Many employees collect loyalty points from third parties (such as frequent flyer points) on their personal credit cards when travelling on employer-reimbursed business trips or when incurring other business-related expenses. Effective after 2008, employees need no longer include these employment benefits in their income if the points are not converted to cash, the plan or arrangement is not indicative of an alternative form of remuneration, or the plan or arrangement is not for tax-avoidance purposes. However, if the employer controls the points (for example, if they are earned on a company credit card), the employer must still report in the employee's T4 the FMV of benefits received when the points are redeemed.

Municipality or metropolitan area. After 2008, the CRA will allow the exclusion from income of an allowance paid for travel within the municipality or metropolitan area and primarily for the employer's benefit.

Surface transit passes for family members of transit employees. After 2009, free or discounted surface transit passes are non-taxable only when provided to a transit employee for his or her exclusive use: such passes provided to an employee's family members are a taxable benefit to the employee.

Jim Yager
KPMG LLP, Toronto

Netherlands' Attraction Increases

The traditional view of the Netherlands as an attractive financing and holding jurisdiction continues in many respects, but its current interest taxation and deduction rules and the 2007 changes to its participation exemption regime have limited the jurisdiction's relative usefulness. On June 15, 2009, Dutch Finance issued a discussion paper proposing amendments to enhance the Netherlands' allure as an intermediary financing and holding jurisdiction. The discussion paper is formatted as a white paper rather than a draft bill, but its contents are likely to form the basis for draft legislation. If enacted, the measures enter into force after 2009 at the earliest.

Interest box regime. Interest income is generally subject to a 25.5 percent tax rate; interest expense deductibility reaps the benefit of that rate but is subject to certain specific restrictions and thin capitalization rules. The discussion paper proposes a mandatory interest box regime in which interest income and interest expense are netted and subject to taxation or deduction at an effective 5 percent rate. A similar, but discretionary, 2006 proposal met with European Commission challenges on the basis that it was state aid under EU law; making the rule mandatory apparently addressed the concern adequately, because on July 8, 2009, the commission approved the proposal. The proposal applies to all intragroup interest income and expense and pre-empts the thin capitalization rules. The mandatory nature of the new regime may be disadvantageous for Dutch companies that have a net intragroup interest expense (not net interest income). Income from hybrid loans—currently equity for Dutch tax purposes if certain conditions are met (and therefore eligible for the participation exemption)—is also subject to tax in the interest box. The proposals will generally allow the Netherlands to be used to leverage operations in other jurisdictions at a reduced tax cost, but they may in some cases be disadvantageous.

Interest expense. Changes are proposed to the deductibility of interest expense. Dutch law has both specific anti-base erosion rules and thin capitalization rules, but it may still be possible to deduct interest expense incurred to finance certain qualifying participations even though the related income is eligible for the participation exemption. The discussion paper proposes to address the mismatch between non-taxable participation income and related interest expense; existing thin capitalization rules are eliminated, and the specific anti-base erosion rules are expanded using either additional targeted anti-base erosion rules or German- or US-style general earnings-stripping rules. Existing structures should be carefully reviewed when the final rules are enacted to determine their impact on what is now deductible or non-deductible interest expense.

Participation exemption regime. Currently, a Dutchco's dividends received and capital gains realized that relate to qualifying participations are fully exempt from Dutch tax if either the subject-to-tax test or the asset test is satisfied. Under the subject-to-tax test, the participation's annual profits—recalculated under Dutch standards—must be subject to an effective tax rate of at least 10 percent. In practice, minor deviations in the taxable base or nominal rate may result in a failure to meet the test. Under the asset test, 50 percent or more of the aggregate assets of the participation and its subsidiaries must qualify as good assets, which excludes assets such as group receivables and IP licensed to group companies even though the income therefrom is subject to a high rate of tax.

The practical application of both the subject-to-tax test and the asset test, introduced in 2007, has sometimes resulted in unintended, unreasonable, and unforeseen consequences. To further improve the Netherlands as a holding jurisdiction, the discussion paper proposes to broaden the application of the participation exemption regime, principally by making it conditional on the participation not being held as a portfolio investment. Simplified subject-to-tax and asset tests are maintained as safe harbour tests. The proposed subject-to-tax test no longer requires recalculation of a participation's profit under Dutch standards but merely requires that a nominal 10 percent tax rate be achieved. Under the simplified asset test, an asset is a good asset if the income generated by the assets of the participation and its subsidiaries is subject to a minimum 10 percent tax rate.

Albert Baker and Tanvi Vithlani
Deloitte & Touche LLP, Vancouver

Federal Cash Distributed Through the Income Tax System

The federal government estimated in its January 2009 budget that personal income tax collections would amount to $117 billion in the fiscal year 2008-9. Information on the CRA Web site indicates that during the period July 1, 2008 to June 30, 2009, payouts under the three major income-assistance programs administered by the CRA totalled $15.3 billion, about 13 percent of collections.

The GST credit, introduced in 1991, is administered by the CRA using information provided in annual income tax returns. The basic amount—currently $248 for adults

Payment Programs Administered by the CRA, 2006-7 to 2008-9

	2008-9	2007-8	2006-7
		millions of dollars	
GST credit	3,192	3,169	3,103
Child tax credit	9,514	9,519	9,581
Universal child-care benefit	2,557	2,496	2,394
Total	15,263	15,183	15,078

and $130 for children—is reduced by 5 percent of net income over $32,312. The benefits are paid by cheque or direct deposit quarterly. As shown in the table, payments totalled $3.2 billion in the latest year. Because the payments are based on information in the tax return filed by April 30, the CRA recalculates entitlements and shows payments on a July-to-June basis. Information on the distribution by income or family type is not available on either the benefits Web site or the taxation statistics Web site.

The child tax benefit is also administered by the CRA, is based on tax returns, and is shown on a July-to-June basis. The basic program currently provides for $1,340 per child, reduced by a portion of family net income over $40,726. Additional support is available for larger families, low-income families, and those with special needs. In the immediately past benefit year, the CRA paid out child tax credits exceeding $9.5 billion. Although the program is administered by the CRA, information on the incidence of the benefit is not available on a basis comparable to the information in the agency's income tax statistics.

Unlike the two programs discussed above, cash received under the universal child-care benefit is taxable as ordinary income, but it does not reduce the benefit under the child tax credit. Payments are $1,200 per year for each child under 6 years of age. In the year ending June 30, 2009, federal payouts under the program totalled $2.6 billion.

These programs are easily identified and quantified. Most provinces run parallel programs of assistance for families, and some also provide refundable credits for sales or property taxes, all based on the annual income tax return. The figures shown in the table are sufficient to indicate that changes in the income tax system can have an impact on major federal and provincial assistance programs and their recipients.

David B. Perry
Toronto

CRA Competent Authority Requests

Under article XXIX A (the LOB article) of the Canada-US treaty's fifth protocol, a US resident that meets one of three objective tests or, alternatively, that receives a determination is entitled to treaty benefits. On May 22, 2009, the CRA released long-awaited guidelines outlining its policies and procedures for making determination requests to the competent authority.

The objective tests require that the US resident (1) be a qualifying person (paragraph 2); (2) engage in an active trade or business (paragraph 3); or (3) enjoy derivative benefits through its qualifying-person shareholders (paragraph 4). If none of these tests is met, the US resident can request a grant of treaty benefits by the Canadian competent authority (paragraph 6). The competent authority must determine—on the basis of all factors, including the person's history, structure, ownership, and operations—whether its creation and existence did not have as a principal purpose the obtaining of otherwise unavailable treaty benefits, or whether it would not be appropriate to deny the person treaty benefits in light of the LOB's purpose. Treaty benefits flow automatically if either determination is made.

The May 2009 guidelines contain the following key points.

■ Either a taxpayer's conclusion that treaty benefits are not available or the benefits' denial by the CRA rulings directorate is sufficient to trigger the right to initiate a request. A request can be made at any time after either occurrence.

■ The competent authority is expected to complete its review and issue its decision in a determination letter within six months of a completed request's receipt. Treaty benefits may be granted retroactively. They expire at the earlier of three years from the date of the determination letter and the date immediately before a material change of facts or circumstances. When benefits are expected to expire or do expire, the taxpayer can request new or extended treaty benefits.

■ Within 60 days of a material change—including changes related to treaty residence, ownership structure, business activities, or business restructuring—the taxpayer must notify both the competent authority and all persons relying on the determination letter. It is not clear whether failure to report a material change nullifies treaty benefits.

■ The guidelines state that the Canadian competent authority has the right to consult with or provide information to the US competent authority or "other tax administration," but they do not clarify why information sharing extends beyond the US competent authority.

■ The CRA's grant of treaty benefits is binding on it, but it retains the right to subsequently deny treaty benefits under paragraph 7 of the LOB article for a perceived treaty abuse. Because the CRA must have been reasonably satisfied that no treaty abuse was present prior to the granting of treaty benefits, it is assumed that the denial of benefits would occur in only the most exceptional circumstances.

■ There is no prescribed form for making a request, but for each year under review a request must contain specific and detailed information outlined in the guidelines' appendix, such as the following:

1) Organizational information: a description of the taxpayer's current ownership structure up to its ultimate owners and historical ownership, focusing especially on persons resident in non-treaty countries; the taxpayer's control of or connection with related or unrelated persons from which income covered under the request was or can be expected to be received by the taxpayer; and a description of the taxpayer's business and the business relationship of the taxpayer and all relevant persons.
2) Financial statements of the taxpayer and related persons that paid or will pay income covered by the request.
3) A general description of the taxpayer's tax liability in its home country and copies of tax rulings or tax concessions that provide information or opinions related to the taxpayer's tax liability, operations, or business structure.
4) An analysis of why the taxpayer does not otherwise qualify for treaty benefits and of why treaty benefits should be granted, including meeting one of the conditions in paragraph 6 of the LOB article.

The CRA recently issued for public comment by September 30, 2009 its forms for completion by non-residents that qualify and seek to apply for treaty benefits for Canadian-source income and gains: form NR301 (individuals, corporations, and trusts); form NR302 (partnerships with non-resident partners); and form NR303 (hybrid entities such as LLCs). All three forms cover amounts subject to part XIII tax. (Forms NR302 and NR303 also cover business profits and capital gains.) To determine the blended tax rate for a partnership or a hybrid entity, information required includes the applicable tax rate and the allocation of a particular item of Canadian-source income or gain to the partners or the hybrid's owners. The statement accompanying the forms' release indicates that "the forms provide important guidance and assistance in terms of the CRA's expectations of payers," but the nature of those expectations remains unclear.

Both the competent authority request guidelines and the withholding tax forms are silent on the CRA's view of the payer's compliance obligation under the Act to withhold and remit. What level of reliance can be placed on a determination letter or the forms? What level of due diligence, if any, must the payer perform? With respect to the forms, one hopes that other publications such as the updated *Information Circular* 76-12R6 will provide further insight.

Paul L. Barnicke and Melanie Huynh
PricewaterhouseCoopers LLP, Toronto

Retroactive RST Amendments

Since 2005, Procter & Gamble has been embroiled in litigation over the application of Ontario retail sales tax (RST) to some of its rented pallets. The litigation may offer guidance to taxpayers and practitioners who wish to pursue refunds denied under established administrative policy.

P & G manufactured, distributed, and marketed various consumer products, which it generally packaged in boxes that were then stacked on flat wooden pallets. The stacked pallet was wrapped in a plastic stretch wrap, and P & G sold the palletized product units to high-volume retailers. P & G had rented the pallets, which were later retrieved from the retailers by the lessor and put back into circulation with P & G. P & G initially paid RST on the rental payments, but around 2003 it reversed its position, saying that RST did not apply, and filed a refund claim for the RST paid in error. The refund claim was denied. P & G filed a notice of objection and applied under rule 14.05(3)(d) to the Ontario Superior Court of Justice for an interpretation of section 7(1)(41) of the Retail Sales Tax Act; the minister moved to strike the application, which he said was effectively a disguised request for actual determination of the tax (court file nos. 08-7717-00CL, 08-7718-00CL).

The applications judge said that the transfer of the pallets from P & G to the retailers was not a sale and that P & G was not a reseller of pallets; however, the pallets were RST-exempt under section 7(1)(41) as returnable containers. The Ontario Court of Appeal upheld the decision, and the minister later abandoned its leave application to the SCC in favour of retroactive amendments to the definition of "returnable container" to capture such fact patterns and subject them to RST. P & G continued to pursue its statutory right of appeal (under section 25) in the Superior Court, to which the minister brought a rule 21 motion (*Procter & Gamble Inc. v. Ontario (Finance)*, 2009 CanLII 9475 (Ont. SCJ)) for a determination of whether the retroactive amendments applied to P & G's action.

P & G argued that the language of the retroactive amendments indicated an intent to affect rights in general, not a specific intent to affect P & G's previously adjudicated rights. P & G also argued that it had settled expectations created by the adjudication. The motions judge cited the SCC's decision in *British Columbia v. Imperial Tobacco Canada Ltd*. ([2005] 2 SCR 473), and confirmed that "a retroactive amendment is assumed to be prospective in nature unless there is clear language to the contrary." However, the amendments were made retroactive to May 7, 1997—the day from which P & G's claim dated—and thus the legislature had decided to encompass P & G's claim. The Ontario budget that announced the change also referred to a recent court interpretation as the impetus. On the settled expectations point, the motions judge pointed out that the minister's policy for the preceding 20 years was consistently contrary to P & G's position, pre-empting a settled expectation on P & G's part. Furthermore, the Ontario Court of Appeal decision had "almost invited" the minister to rectify the results of its decision via a legislative amendment.

In complex tax cases involving disputes of facts and issues, rule 14 applications appear to be of limited practical assistance. The Crown can be expected to fight the application tooth and nail, and even a successful application does not eliminate the need for a full-blown action to unlock the tax refund. The delay inherent in P & G's successful rule 14 application may only have given the Ontario government the opportunity to enact the retroactive legislation that forestalled P & G's action for an actual refund.

Procter & Gamble also illustrates the continuing predilection of tax authorities to remedy what they perceive to be an inappropriate judicial decision by enacting retroactive amendments. Retroactive amendments are a very real prospect when a taxpayer attempts to upset what the government authority views as a clearly expressed administrative position. Unfortunately, the tax litigator must prepare the client for the possibility that winning a battle may not win the war.

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

US Budget Proposals

US congressional and 2010 budgetary efforts to limit the use of tax havens mark a significant change in tax policy from the last several decades. In May 2009, the Treasury released its long-awaited *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals* (the Green Book) (http://www.treas.gov/offices/tax-policy/library/grnbk09.pdf), which shows that the international tax proposals will raise an estimated US$210 billion over 10 years. In the coming months, lawmakers seeking health reform and other initiatives will have an eye on the revenue associated with these proposals. International tax proposals that may be relevant to Canadian multinationals include those set out below.

1) The administration proposes to repeal all 80-20 company provisions. An 80-20 USco can pay interest and occasional dividends free of US withholding tax. At least 80 percent of the USco's gross income during a three-year testing period must be derived from foreign-source trade or business income.
2) A number of other measures that may affect the Canadian investor's US business include codifying the economic substance doctrine; repealing the LIFO and lower-of-cost-and-market methods of inventory accounting; making permanent the research and experimentation (R & E) tax credit; expanding the net operating loss carryback rules; extending the limitation period to six years for certain reportable cross-border payments to certain foreign entities (such as those that USco reports on form 5472); and eliminating many oil and gas company preferences (such as percentage depletion and expensing of intangible drilling costs).
3) Significant proposals that affect a USco's foreign assets, including foreign subsidiaries, are particularly relevant to a Canadian investor with a so-called sandwich structure (its US sub owns one or more controlled foreign corporations).
   a) A USco does not generally pay current US federal tax on its foreign subsidiaries' undistributed profits (except certain US-source, passive, or tainted business income). The administration considers that the deduction of interest (and other) expenses against those undistributed profits is a tax advantage of eschewing domestic for overseas investment. A proposal defers and carries forward expense deductions associated with foreign investments (except R & E expenses) until US tax is paid on the foreign income.
   b) Foreign tax credit proposals target tax-planning structures that claim credits for foreign taxes paid on income not subjected to US tax. A USco earns a deemed-paid foreign tax credit upon receipt of a dividend (and some other payments) from some foreign subsidiaries, representing underlying foreign tax paid and preventing double tax on the foreign income. The proposal determines the deemed-paid credit on a consolidated basis, not entity by entity, by pooling all foreign subsidiaries' foreign taxes and earnings and profits. The deemed-paid credit can be claimed only on the repatriation of the consolidated earnings and profits. A US taxpayer can credit certain foreign taxes that it has paid and was liable to pay under foreign law. The administration considers that hybrid arrangements allow the inappropriate separation of creditable foreign taxes from the associated foreign income and, without providing any details, proposes a preventive matching rule.

c) A shareholder that exchanges stock in a target corporation for boot (non-share property) during a reorganization must recognize a gain equal to the lesser of the gain realized in the exchange and the boot (the boot-within-gain limitation). Part of the gain may be taxed as a dividend up to the exchanging shareholder's share of the target's undistributed earnings; the remainder is a gain from the exchange of property. The Green Book indicates that the boot-within-gain limitation "is inconsistent with the principle that previously untaxed earnings of a foreign subsidiary should be subject to U.S. tax upon repatriation" because it permits US shareholders to repatriate those earnings with minimal US tax consequences if there is little or no built-in gain in the target's stock. The administration proposes to repeal the boot-within-gain limitation in any reorganization by a non-US acquiring corporation in which the exchange is treated as a dividend under Code section 356(a)(2).

The impact of the Green Book proposals on US multinationals has received significant attention in the US tax community. Canadian-owned groups should also carefully review the proposals to determine how they may be affected (such as their current financing or holding structures), assess the opportunities and/or pitfalls, and perhaps even consider involvement in the legislative process.

Steve Jackson and Katherine Loda
Ernst & Young LLP, New York

Ontario HST Refined

The 2009 Ontario budget announced the harmonization of Ontario sales tax with the GST and provided a broad outline of the tax's operation. A June 18, 2009 announcement proposed an important change to the treatment of new homes under the Ontario harmonized sales tax (HST)—relief for the construction and sale of new residential rental buildings, and transitional rules clarifying the tax's application to sales of new residential property during the changeover to the new system.

Under the budget proposal, new houses were eligible for a partial rebate of the provincial portion of the HST, reducing the effective provincial tax rate to 2 percent for houses valued at $400,000 or less. The rebate phased out for new houses priced above $400,000 up to $500,000, after which the full 8 percent provincial tax applied. Industry spokespersons have claimed that the HST threatened a serious blow to homebuilders that would reverberate throughout the sector. Furthermore, the rebate clawback could permanently distort the way houses are sold in Ontario, resulting in builders selling stripped-down houses without appliances, finished basements, or landscaping. A separate contract with a buyer to supply those features as add-ons could reap the builder a potentially significant tax saving.

The Ontario government apparently heeded these concerns. The newly announced revised rebate continues to reduce the effective rate to 2 percent for houses valued at $400,000 or less, resulting in a maximum tax saving of $24,000, but that saving is extended to higher-priced houses. Thus, there is no clawback for houses priced at over $400,000, a major improvement in the HST's operation in this sector. The June 2009 announcement also proposed a similar rebate for new residential rental properties that was conspicuously absent in the budget documents, a change that mirrors the GST rebate for such buildings and is welcome news for rental property developers and purchasers.

The June 2009 announcement's proposed transitional rules for the residential construction industry are essential for the successful implementation of the tax in this sector, given the long lead times between when the sale agreements are entered into and when the properties are occupied. Under the transitional rules, the provincial portion of the HST does not apply to sales of new homes if (1) a written agreement is entered into before June 19, 2009 (the tax is grandfathered); (2) ownership or possession under the agreement is transferred before July 2010; or (3) GST is self-assessed before July 2010 (for new rental housing). Such homes will continue to bear RST on building materials purchased before July 2010.

If a new home is grandfathered and the property is completed after June 2010, the builder must pay a transitional tax in an amount dependent on the level of completion on July 1, 2010. The broad intention of this transitional tax is to ensure that if no tax applies on the sale of a new home that was partly constructed after June 2010 (and that entitles the builder to claim input tax credits), the builder must bear unrecoverable tax roughly equal to that under the RST regime. The government has also proposed a transitional rebate for new houses and condos that are subject to the new HST but have borne RST on building materials, based on the extent of construction completed as of July 1, 2010. The rebate avoids the imposition of both RST and HST on the same house. The sales agreement must clearly document whether the provincial portion of the tax is added to the price.

The elimination of the new housing rebate clawback and the extension of the rebate to rental housing units are positive steps that will improve the operation of the HST in this vital sector. As the veil begins to lift on the new sales tax system, Ontario businesses should turn their full attention to the details of the tax's implementation and application to ensure a smooth transition.

Audrey Diamant and Brian Wurts
PricewaterhouseCoopers LLP, Toronto

Eligible Dividend Rates Update

Federal eligible dividend changes (see table 1) will increase personal taxes in all provinces and territories from 2010 to 2012. Generally, the intention is to make roughly equal the combined corporate and personal tax on business income earned through a corporation and the tax paid by an individual who earned the income directly. Table 2 shows provincial and territorial dividend tax credit rates for eligible dividends, and table 3 shows the top combined marginal tax rates on eligible dividends. Table 4 shows the tax saving or cost if the corporation pays its income out as an after-tax dividend in lieu of pre-tax salary.

Table 1 Eligible Dividends

	2009	2010	2011	2012
	percent			
Dividend gross-up	45.00	44.00	41.00	38.00
Federal dividend tax credit (on grossed-up dividend)	18.9655	17.9739	16.4354	15.0198
Top federal rate*	14.55	15.88	17.72	19.29

* Assumes top federal marginal income tax rate remains 29%.

Table 2 Eligible Dividend Tax Credit Rates (on Grossed-Up Dividends)

	2009	2010	2011	2012
	percent			
Alberta	10.00	10.00	10.00	10.00
British Columbia	11.00	10.83	10.31	9.76
Manitoba.	11.00	11.00	11.00	11.00
New Brunswick.	12.00	11.81	11.24	10.65
Newfoundland and Labrador.	9.75	9.60	9.14	8.65
Northwest Territories	11.50	11.32	10.78	10.20
Nova Scotia	8.85	8.71	8.29	7.85
Nunavut	6.20	6.11	5.82	5.51
Ontario	7.40	6.40	6.40	6.40
Prince Edward Island.	10.50	10.34	9.84	9.32
Quebec.	11.90	11.90	11.90	11.90
Saskatchewan	11.00	11.00	11.00	11.00
Yukon	11.00	10.83	10.31	9.76

Table 3 Top Combined Federal, Provincial, and Territorial Marginal Tax Rates on Eligible Dividends*

	2009	2010	2011	2012
	percent			
Alberta	14.55	15.88	17.72	19.29
British Columbia	19.92	21.45	23.91	26.11
Manitoba.	23.83	25.09	26.74	28.12
New Brunswick.	21.80	19.46*	19.77	21.16
Newfoundland and Labrador.	22.89	24.37	26.68	28.75
Northwest Territories	18.25	19.81	22.33	24.61
Nova Scotia	28.35	29.80	32.00	33.94
Nunavut	22.24	23.64	25.72	27.56
Ontario	23.06	26.57	28.19	29.54
Prince Edward Island.	24.44	25.95	28.36	30.50
Quebec.	29.69	30.68	31.85	32.81
Saskatchewan	20.35	21.64	23.36	24.81
Yukon	17.23	18.80	21.34	23.64

* Assumes that the top combined federal, provincial, and territorial marginal income tax rates remain at their 2009 levels, except for New Brunswick, where the top provincial marginal income tax rate declines to 14.3% in 2010, 12.7% in 2011, and 12% in 2012.

In the absence of legislative changes, the provincial and territorial eligible dividend tax credit rates will decrease (except in Manitoba and Quebec) after 2009 because in all jurisdictions (except for Manitoba and Quebec) those rates are linked to the federal dividend gross-up for eligible dividends, which will decrease after 2009. Alberta, Ontario, and Saskatchewan revised their legislation. Alberta's Bill 40, Alberta Personal Income Tax Amendment Act, 2009 (royal assent June 4, 2009), maintains the rate at 10 percent. Ontario's Bill 114, Budget Measures and Interim Appropriation Act, 2008 (royal assent November 27, 2008), sets the post-2009 rate at 7.7 percent, but the 2009 Ontario budget decreased the rate to 6.4 percent because the corporate tax rate is reduced commencing July 1, 2010. Saskatchewan's Bill 87, the Income Tax Amendment Act, 2009 (royal assent May 14, 2009), maintains the rate at 11 percent.

When the federal eligible dividend tax regime was implemented in 2006, all provinces and territories except Newfoundland and Labrador and Nova Scotia modified their dividend tax credit rates to better achieve integration. Newfoundland and Labrador's 2009 budget more closely aligns the dividends' tax treatment with the other provinces' by increasing its dividend tax credit rate on eligible dividends from 6.65 to 9.75 percent in 2009; without

Table 4 Integration: $10,000 ABI Subject to Tax at the General/M&P Corporate Income Tax Rate, Dividend Versus Salary Saving/(Cost)[a]

	2009	2010	2011	2012
		dollars		
Alberta	(33)	(43)	(52)	(47)
British Columbia	(24)	(14)	(37)	(88)
Manitoba	(30)	(5)	(10)	(1)
New Brunswick	(43)	8	26	93[b]
Newfoundland and Labrador	(274)/420	(298)/382	(346)/314	(382)/259
Northwest Territories	187	158	97	46
Nova Scotia	(518)	(542)	(585)	(617)
Nunavut	(384)	(405)	(439)	(462)
Ontario	(102)/52	(190)/(43)	(104)/21	(61)[b]/27
Prince Edward Island	(352)	(376)	(427)	(467)
Quebec	(109)	(108)	(88)	(55)
Saskatchewan	(104)/55	(115)/42	(120)/33	(111)/39
Yukon	(297)/737	(319)/696	(372)/611	(415)/540

[a] Assumes that the individual is taxed at the top marginal income tax rate. Levies other than federal, provincial, and territorial income tax, the employer portion of provincial health tax, and the employee portion of Northwest Territories and Nunavut payroll taxes are not considered (such as CPP contributions). Different results may arise in special circumstances (such as for credit unions). [b] General corporate income tax rates further decrease in New Brunswick on July 1, 2012 and in Ontario on July 1, 2012 and July 1, 2013; thus, a lower tax cost or increased tax savings arise in 2013 and 2013 and 2014, respectively.

further amendments, the eligible dividend tax credit rate falls after 2009 to the table 2 rates.

Louis J. Provenzano and Donald E. Carson
PricewaterhouseCooopers LLP, Toronto

GST Policy on Grants and Subsidies

The recent TCC decision in *City of Calgary* (2009 TCC 272) strengthens the burgeoning case law that supports the use of fundamental contractual and statutory principles to determine the GST treatment of grants and subsidies, and eschews the policy guidelines in *GST/HST Technical Information Bulletin B-067*. The impact of the decision will undoubtedly be considered by commodity tax practitioners in other government funding contexts. The Crown has appealed to the FCA.

The city of Calgary and the province of Alberta entered into a series of agreements whereunder the province funded most of the capital costs of various public transit facilities and rolling stock that the city purchased or constructed. The TCC said that the payments by the province were consideration for a taxable supply of a service made by the city to the province—acquiring, constructing, and making public transportation facilities available to the citizens of Calgary—even though the city owned the assets and ultimately used them to make exempt supplies of municipal transit services to the public. The city was thus entitled to claim input tax credits for full recovery of GST paid on the transit assets' input costs. Key to the decision was the fact that the province ultimately controlled which transit assets were purchased or constructed and that the province held the underlying constitutional responsibility for providing municipal transit services to its citizens and had delegated it to the city in several statutes. Various tests, such as the "purchase purpose" versus the "public purpose" set out in the technical information bulletin, played no role in the decision.

The decision was also noteworthy in its finding that the business or endeavour conducted by the city in providing services to the province was separate and distinct from the city's business of providing municipal transit services. This distinction allowed the input tax credit allocation rules (section 141.01 of the Excise Tax Act) to apply to deem all GST paid on the city's purchases under its agreements with the province to have been paid solely in the course of that particular commercial activity. Thus, the court said that the all-or-nothing allocation rules for capital personal property in section 199 did not have to be considered, although it went on to say that if section 199 applied, the city's purchases were primarily for use in making its taxable supply to the province and not in making its exempt supply of municipal transit services.

Peter Mitchell
Felesky Flynn LLP, Calgary

IRS VDP Guidance re Offshore Income

The IRS previously announced a voluntary disclosure program (VDP) to give taxpayers an opportunity to disclose unreported offshore accounts and assets. (See "US Focus on Offshore Activity," *Canadian Tax Highlights*, April 2009.) Certain foreign bank and financial accounts generally must be reported by a US person (and others) by June 30 of each year on a form TD F 90-22.1 (FBAR). The program remains in place until September 23, 2009. Recognizing that a taxpayer may be reluctant to take advantage of the VDP without more detailed guidance on the program's administration and the potential civil and criminal penalties, on May 6, 2009 the IRS released 30 frequently asked questions (FAQs) providing more program details, which it recently revised.

The first of the May 6 FAQs highlighted the need to resolve cases in an organized, coordinated manner and to make exposure to civil penalties more predictable. A specific example detailed the VDP's penalty framework faced by a taxpayer who deposited US$1,000,000 in an offshore account and earned thereon US$300,000 of unreported income over the six-year lookback period; under the VDP, the taxpayer must pay US$386,000 in tax and penalties, plus interest. In contrast, if the taxpayer did not come forward voluntarily, the IRS could impose US$2,306,000 in accuracy-related and FBAR penalties, and the taxpayer might also face interest expense and possibly criminal prosecution.

The IRS disclosed in the May 6, 2009 FAQs that it will not recommend criminal prosecution to Justice if a taxpayer truthfully, timely, and completely complies with all the VDP rules. However, the VDP does not apply if the IRS has already initiated a civil examination of the taxpayer, regardless of whether it relates to undisclosed foreign accounts or undisclosed foreign entities.

With the FBAR filing deadline fast approaching, on June 24, 2009 the IRS revised the May 6 FAQs and posted to its Web site 21 new FAQs explaining in further detail the nature of a settlement offer for taxpayers who voluntarily and timely disclose unreported offshore income. The FAQs also provide more details of the mechanics of the six-year lookback, the 20 percent penalty, and the options for those who are non-compliant with FBAR reporting responsibilities. A taxpayer may have reported and paid taxes on all 2008 taxable income but have insufficient time to gather necessary information to fulfill an FBAR filing obligation of which he only recently learned; the IRS will allow the taxpayer to file his FBAR by September 23, 2009 with an explanation detailing the reason for the late filing and will impose no penalty for failure to file by June 30, 2009.

The June 24 revised FAQs also clarify that interest on the accuracy-related and delinquency penalties runs from the due date of the relevant return; interest on all other penalties runs from the date of the penalty's assessment. If several individuals have signature authority over a trust account, each of them must fulfill his FBAR filing responsibility, but only one 20 percent offshore penalty applies for voluntary disclosures relating to the one account.

The new FAQs iterate the IRS's warning against an attempt to cure past reporting failures of unreported offshore income by way of a "quiet disclosure"—merely filing amended returns and paying the tax and interest without otherwise informing the IRS. The original FAQs acknowledged that the IRS was aware of this practice and strongly encouraged those taxpayers to come forward under the voluntary disclosure offer: failure to do so carries the risk of examination and criminal prosecution for all applicable years. New FAQs 49 and 50 elaborate further. The IRS says that taxpayers and their advisers, when deciding whether to quietly disclose or take advantage of the VDP, should consider the nature of the error they are trying to correct. A taxpayer with undisclosed foreign accounts or entities who makes a voluntary disclosure will become compliant, avoid substantial civil penalties, and generally eliminate the risk of criminal prosecution. Moreover, the total cost of resolving all offshore tax issues can be calculated with reasonable certainty. That being said, the IRS recognizes that in limited cases—such as that of a taxpayer who reported all income but failed to file the FBAR or who only failed to file information returns—it may be appropriate to simply file amended returns with the applicable service centre.

A US citizen residing in Canada who failed to file US tax returns and who previously might have quietly disclosed by filing tax returns for the prior six-year period should engage in serious discussion with his tax adviser to outline an appropriate course of action in light of the VDP. The VDP was developed initially to deal with US citizens and residents who failed to report income earned on foreign bank accounts, but the broad language in the recent IRS announcements suggests that the VDP applies whenever an individual has unreported income and there are "offshore issues." Unfortunately, in this context, Canada is offshore.

Leslie R. Kellogg
Hodgson Russ LLP, Buffalo

IRS Pre-Filing Agreements

The IRS recently made permanent its pre-filing agreement (PFA) program, which is designed for a taxpayer who wishes to work voluntarily and cooperatively with the IRS to arrive at mutually agreeable tax-reporting positions on significant issues that arise in a taxable year. The PFA program requires a binding agreement of up to five years between the taxpayer and the IRS on transactions or events completed but not yet reported on a tax return. The IRS examines only the specific issues identified by the taxpayer, not all of the taxpayer's activities for the taxable year. The taxpayer's prize is certainty about the specific tax matters addressed.

A PFA may assist with the many unanswered questions related to the recently ratified fifth protocol to the Canada-US treaty, especially its new PE rules, which may apply to any Canadian business that performs services or conducts activities in the United States. A PFA may provide a taxpayer with certainty on its PE tax-reporting position under the new rules; previously, the IRS refused to rule on PE issues, which can pose complex interpretation and application issues even in a plain-vanilla fact pattern.

The editor of *Canadian Tax Highlights* welcomes submissions of ideas or of written material that has not been published or submitted elsewhere.
Please write to Vivien Morgan at vmorgan@interlog.com

Published monthly
Canadian Tax Foundation
595 Bay Street, Suite 1200
Toronto, Canada M5G 2N5
Telephone: 416-599-0283
Facsimile: 416-599-9283
Internet: http://www.ctf.ca
ISSN 1496-4422 (Online)

For example, the fifth protocol deems a Canadian enterprise to have a US PE when it conducts a certain level of activities related to a project that is the "same or connected"; but when a project is "connected" is often unclear. The PE rules also exclude certain preparatory or auxiliary services, but little guidance exists to analyze specific activities. The general lack of precedent for the protocol's PE rules makes more difficult an analysis that is rarely straightforward in any event because it is fact-dependent.

A PFA may provide certainty on a wide range of US tax issues, such as whether a taxpayer engages in a trade or business in the United States and whether it rises to the level of a PE under the treaty. A PFA may also resolve the quantum of the PE's profits subject to US federal income tax. A PFA may eliminate the risk of a lengthy and expensive IRS audit on a PE issue, alleviate pressure from financial statement auditors, and remove the risk of penalties and interest on unpaid US tax arising from an incorrect filing position. A PFA may favourably affect any related financial statement reserves and may resolve issues more efficiently and favourably than the often contentious post-filing examination. However, after examining the facts and circumstances and weighing the likelihood and magnitude of exposure to US tax on both the PE issue and other matters, a taxpayer's advisers may conclude that it is preferable to restructure US activities to avoid PE exposure altogether.

The PFA program provides a suitable means of resolving any US tax issue that involves a methodology to determine the quantum of an item of income or a deduction or that requires either a determination of facts or the application of well-established legal principles to known facts. A PFA is also useful to determine the treatment of intercompany transactions, such as whether an advance is a debt that requires interest payments and whether the recipient is eligible for treaty benefits.

Angela Yu and Shirley Lee
KPMG LLP, Vancouver

Foreign Tax News

Treaties

On April 28, 2009, the 2007 **Canada-Netherlands** agreement on mutual assistance in customs matters, not yet in force, was extended to Aruba and the Netherlands Antilles. On June 29, 2009, a **Canada-Greece** treaty was signed, providing for withholding tax of 5 and 15 percent on dividends to affiliated companies and all others, respectively, and 10 percent on interest and royalties, effective for withholding tax on the January 1 following the treaty's entry into force, and for other taxes for taxation years beginning on or after that date. An **Austria-Luxembourg** protocol to the October 1962 treaty was signed on July 7, 2009, providing for exchange of information in accordance with the OECD model treaty effective January 1 of the year in which the protocol enters into force. On the signing on July 7, 2009 of a **Luxembourg-Norway** treaty protocol, Luxembourg substantially met the required number of exchange-of-information agreements to meet OECD standards. Negotiations for **Peru-Korea (Rep.)** and **Peru-Japan** free trade agreements were held June 29-July 3 and July 6-10, 2009, respectively. In June 2009, negotiations for an **Austria-Switzerland** protocol were conducted to bring the 1974 treaty's administrative assistance up to the OECD model treaty article 26 standard. On June 18, 2009, a **US-Switzerland** treaty protocol was initialled; the Swiss federal council agreed to extend administrative assistance in its treaties to the standard in OECD model article 26. A **Gibraltar-Ireland** exchange-of-information agreement on tax matters was signed on June 24, 2009.

Russia

Invited to open membership negotiations in 2007, Russia submitted an initial memorandum to enter the OECD. The memorandum details its policy standards and practices vis-à-vis the OECD's.

Sweden

APAs are proposed effective after 2009 in respect of cross-border transactions. The proposed APAs cover transactions of significant volume and for a term of up to five years. Applications must be filed in Swedish or English.

Iraq

A proposal to increase the tax rate on foreign oil companies' profits from 15 to 35 percent requires parliamentary approval to become law.

Vivien Morgan
Canadian Tax Foundation, Toronto