CANADIAN TAX Highlights

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TIME TO REFREEZE?

The economic downturn negatively affected the valuation of many businesses, including Canadian manufacturers exporting to the United States, Canadian steel manufacturers, parts suppliers for automotive manufacturers, restaurateurs, hoteliers, retailers, mining companies, and construction companies. Because the earnings multiples used in valuations have fallen, it is wise to revisit an estate freeze done at the top of the market; the company may now be worth less than the redemption price of the outstanding freeze shares.

Freeze shares are redeemable and retractable preference shares issued at the time of an estate freeze. The freeze shares' redemption price equals the FMV of the assets or common shares exchanged for the freeze shares. A refreeze may be advisable if the business's current value is underwater relative to that redemption price but it is hoped that the business will recover. Assume that a business frozen at $15 million is today worth $8 million, making worthless the common shares issued to a trust for the benefit of the children. Any recovery in value from $8 million to $15 million accrues to the benefit of the holder of the freeze shares, whose redemption amount is still fixed. A refreeze reorganizes the share capital so that the original freeze shares are exchanged for a class of preference shares with a redemption price equal to the assets' current FMV (in this example, $8 million) either by exchanging the freeze shares for a new class of preference shares under subsection 86(1) or rolling them over under subsection 85(1) to a holdco for the new preference shares. When the company's FMV recovers, any increase accrues to the common shareholders' benefit, ultimately saving the tax otherwise potentially payable on capital gains on the later of the death of the preference shareholder and the death of his or her spouse.

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Numerous technical interpretations opine favourably on refreezes. The CRA confirms that no benefit arises to the freezor or to the children on a refreeze if the decrease in the preferred shares' FMV did not result from a stripping of corporate assets (see TI 9607635, May 28, 1997; TI 9229905, June 3, 1997; and TI 2000-0029115, November 17, 2000). The CRA takes a similar position if the freeze was to benefit employees (1997 APFF round table question 2.5, freezes following a drop in value).

When share value increased following a freeze, the CRA approved a refreeze and said that GAAR did not apply because it was motivated by the fact that sufficient wealth had accrued to the children's benefit. The refreeze allowed future growth to accrue for the benefit of a new trust that included the parents as discretionary beneficiaries. The plan proposed that capital (including shares) distributed by the new trust would enable the parents to make charitable donations (Ruling 2000-0050983). At the 1997 APFF round table (question 2.6, unfreezing following an increase in value), the CRA confirmed that no shareholder benefit occurred under subsection 15(1) and no diversion of income occurred under subsection 56(2) in a refreeze in the parents' favour.

In TI 9229905, a proposed refreeze converted existing freeze shares into a new class with a lower redemption amount, either by way of a share-for-share exchange (section 86) or a rollover (subsection 85(1)) to a new holdco whose common shares were not owned by the transferor. The TI confirmed that no benefit was conferred on the common or the preferred shareholder; furthermore, no benefit arose if, before the refreeze, the common shares were sold at FMV (presumably nominal) to either the preferred shareholder or the freeze corporation.

In TI 9234925 (January 18, 1993), the CRA confirmed that if the company is worth less than the redemption price of the freeze shares, the FMV of the freeze shares on death reflects the holdco's FMV rather than the freeze shares' redemption price.

If a Canadian trust received common shares on an estate freeze, often a refreeze is entered into just before the deemed FMV disposition of trust assets on its 21st anniversary. The parents may be reluctant to have the children acquire the voting common shares at the anniversary date. The trust may exchange the common shares for frozen shares as a tax-deferred transfer (section 86). The trust and the parent who owns the original freeze shares may then enter into a shareholders' agreement restricting the shares' transfer and their redemption or purchase for cancellation without the consent of all of the shareholders or the majority of holders of the voting shares (typically, the parents). The frozen shares may then be rolled out of the trust to

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the children (subsection 107(2)) and new common shares issued to the existing trust or to a new trust for children that benefits from a fresh 21-year period.

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Non-Resident Withholding Tax

The TCC recently found in favour of the taxpayer in *Stora Enso Beteiligungen Gmbh* (2009 TCC 282) regarding non-resident withholding tax for services performed in Canada. The reimbursement of a foreign corporation by a Canco in the same corporate group for services provided to the Canco by an unrelated forco did not trigger withholding tax.

A German company related to a Canadian-resident corporation engaged a Swedish company to provide advice on Canco's operations in late 1998. Germanco paid Swedishco's invoices for $1.54 million but did not withhold and remit tax to the CRA. Canco reimbursed Germanco the full $1.54 million in 1999, also without withholding tax.

The CRA advised Canco in an audit that it must withhold tax on the Swedishco invoices under regulation 105. Canco remitted $231,000 (15 percent of $1.54 million) to the CRA, but then the CRA reassessed Germanco for failing to withhold the same 15 percent on the $1.54 million it had paid to Swedishco for services rendered in Canada, along with penalties and interest. The CRA did not receive withholding on the withholding amount, the so-called gross-up of the withholding obligation.

The TCC noted that Swedishco was the only non-resident service provider. Though Germanco arranged the contract with Swedishco and paid its invoices, the value of Germanco's services was relatively small. Canco effectively paid the invoiced amounts because it reimbursed Germanco and remitted withholding tax to the CRA.

The TCC noted that cascading withholding tax obligations are permitted by paragraph 153(1)(g) and regulation 105. Assume, for example, that a Canadian resident contracts a non-resident (NR 1) for services to be rendered in Canada that are partially subcontracted to a second non-resident (NR 2). The Canadian is subject to withholding tax on its payments to NR 1, which may be liable for withholding tax on its payments to NR 2. As a result, the withholding obligations are multiplied even though NR 1 is paying NR 2 out of its net payments from the Canadian resident. The cascading tax effect is temporary because the withholding tax is not a final tax: each of NR 1 and NR 2 is entitled to a credit for the withholding tax when it files its Canadian corporate tax return for services rendered in Canada.

The TCC contrasted the scenario of multiple service providers that may suffer cascading withholding obligations with the facts under consideration, which involved multiple payments to two separate non-residents for the services of a single non-resident service provider, Swedishco. In the corporate chain of payments, Canco did not pay Germanco for services rendered in Canada by Germanco, but simply reimbursed Germanco for its payments to Swedishco. This transaction differs markedly from that of a non-resident service provider that subcontracts all or a portion of the services. Citing *Weyerhaeuser* (2007 TCC 65), the TCC concluded that the CRA cannot impose multiple withholding tax obligations for the same payment for the same services provided by a single service provider: there was a "lack of logic" to the CRA's position that Germanco should withhold a further 15 percent.

The TCC noted that Swedishco's invoice did not account for actual out-of-pocket expenses, and included an out-of-pocket expenses surcharge of $140,000 (about 10 percent of the agreed fees). In *Weyerhaeuser*, the invoices excluded reimbursements and out-of-pocket expenses from the withholding tax, but on the facts in issue withholding should apply to an out-of-pocket surcharge that was not substantiated by actual outlays. Moreover, the taxpayer was liable to pay withholding tax of some $40,000 on the withholding gross-up amount.

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GAAR: Surplus Stripping

As part of a surplus-stripping strategy, the taxpayer in *Collins & Aikman* (2009 TCC 299) entered into a series of transactions that created $167 million of paid-up capital (PUC) without investing new money into the corporation. The TCC concluded that GAAR did not apply to the series of transactions: the minister's GAAR assessment was an attempt to fill a perceived gap in the legislation. The finding is consistent with other recent TCC decisions that have held that no overall scheme in the Act prohibits surplus stripping.

The taxpayer (Parent) was a US-resident corporation that through a non-Canadian-resident Holdco held all the shares of a Canadian-resident corporation (Opco) that carried on a substantial car-part manufacturing operation. Parent undertook a reorganization. In essence, Parent incorporated a new Canadian-resident holding company (Newco) and transferred on a taxable basis its Holdco shares to Newco in exchange for Newco's sole common share. Because Parent was not resident in Canada and the Holdco shares were not taxable Canadian property, Parent's gain on the transfer was not subject to Canadian tax. However, as a result of the transfer, the PUC of Parent's one Newco share equalled the FMV of the Holdco shares ($167 million). After the transfer, Holdco became a Canadian resident, and $104 million of Opco's surplus was ultimately distributed to Parent free of Canadian tax as a reduction of Newco's newly created PUC.

The minister said that the reorganization resulted in a misuse of subsection 84(4) because the taxpayer artificially increased the Newco share's PUC. Subsection 84(4) deems a distribution of capital to a shareholder in excess of the share's PUC to be a dividend. In the CRA's view, GAAR applied to the reorganization: the PUC created by the reorganization did not exist, and the return of capital should have triggered a dividend. The CRA thus assessed Parent for Canadian non-resident withholding tax.

Both the CRA and the taxpayer agreed that the taxpayer realized a tax benefit within the meaning of subsection 245(2) and that the transactions were avoidance transactions within the meaning of subsection 245(3). The sole issue was whether the series of transactions constituted a misuse or abuse of the Act within the meaning of subsection 245(4). The TCC disagreed with the minister's suggestion that pursuant to an unstated scheme of the Act, all corporate distributions are taxable unless a specific exception applies, and subsection 84(4) must be read in the context of this unstated scheme. Consistent with the decisions in *Evans* (2005 TCC 684), *Copthorne* (2007 DTC 1230 (TCC)), and *McMullen* (2007 DTC 286 (TCC)), the TCC found that no overall scheme of the Act prevents surplus stripping.

The court noted that the reorganization was effective because Holdco and Parent were not residents for the purposes of the Act, and thus Parent could dispose of its Holdco shares without the imposition of Canadian tax. Ultimately, the court concluded that the transactions did not frustrate, defeat, or circumvent any specific policy or provision. Interestingly, the court did not allude to the fact that but for the reorganization, the distributions of Canadian-source earnings from Opco to Holdco (and ultimately to Parent) would have attracted Canadian withholding tax.

The court said that the reorganization did not involve "the degree of artificiality, boldness, vacuity or audacity to rise to the level of being a loophole or gimmick in common parlance, nor abusive tax avoidance using the language of the *Act* and the GAAR." Moreover, "the Minister has tried to use the GAAR to fill in what he perceives to be a possible gap left by Parliament; that would be an inappropriate use of the GAAR."

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The Parliamentary Budget Officer

Policy wonks have a new tool to monitor the fiscal progress of the government of the day. The reports of the Parliamentary Budget Officer (PBO) are available on the Internet (http://www2.parl.gc.ca/Sites/PBO-DPB) and offer an alternative view of the economy and federal revenues and expenditures. Comparisons with official budget figures are invited.

The details of the PBO's projections often provide insight into the dilemmas facing budget makers. For example, the 2009 federal budget contained forecasts of employment insurance premium revenue to 2013-14. These forecasts had to assume no change in tax rates, because any such changes would imply future changes in policy that were not manifest in the budget itself. The PBO forecasts, however, build in rate increases to cover expected deficits in the program, subject to legislation that limits rate increases.

The July 2009 PBO report benefits from the data available in the six months since the federal budget. Six months can be critical in forecasting, but can also be misleading. Trend lines are not smooth curves; they consist of a series of ups and downs, deviations from an often invisible direction. When a forecast is made, one must distinguish between the main trend and the deviations, between a real change and a blip. A comparison of forecasts, if done

Budgetary Revenues, 2009-10 and 2013-14

	2009 federal budget	PBO July estimate	Percentage difference
	billions of dollars		
2009-10			
Personal income tax	110.3	110.0	−0.3
Corporate income tax	26.4	23.7	−3.0
GST	25.8	26.7	3.4
Employment insurance premiums	16.8	16.8	0.0
Total revenues	224.9	223.4	−0.7
2013-14			
Personal income tax	146.0	141.7	−3.0
Corporate income tax	39.5	29.7	−33.0
GST	33.0	31.9	−3.4
Employment insurance premiums	20.4	26.3	22.4
Total revenues	294.3	280.7	−4.8

properly, will show which changes have lasted and which will disappear in a short time.

The table compares the budget forecasts for the main revenue sources with those forecast by the PBO for both the current fiscal year and for 2013-14. In 2009-10, the two are within $2 billion; but by 2013-14, the budget forecast seems to be $13.6 billion too optimistic—about 4.8 percent high. As noted, the budget forecast was constrained by the need to ignore possible policy actions that were factored into the PBO forecast. The art beyond the projection of numbers lies in recognizing their significance and adjusting policy to meet broader economic and social objectives.

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Harmonization Dominoes

On July 23, 2009, British Columbia announced that it intends to harmonize its provincial sales tax (PST) with the GST effective July 1, 2010. The combined BC harmonized sales tax (HST), payable at a 12 percent rate, will apply to the same goods and services as the GST, with limited exceptions.

The BC HST is patterned on the Ontario HST, which is also slated for implementation on July 1, 2010. Both the BC and the Ontario HST offer point-of-sale rebates for the provincial portion of the tax paid on books, children's-sized clothing and footwear, car seats and boosters, diapers, and feminine hygiene products. Unique to the BC HST is a point-of-sale rebate for the provincial portion of the tax paid on gasoline, diesel fuel, marine diesel fuel, and aviation fuel, including biofuel components for motor vehicles, boats, and aircraft.

Like Ontario, British Columbia will restrict the recovery of input tax credits (ITCs) for the provincial portion of the HST paid on certain purchases by large businesses in the province (those with annual taxable sales in excess of $10 million) and financial institutions: recovery is restricted completely during the five years after implementation, followed by a three-year phase-in. British Columbia's list of restricted purchases mirrors that of Ontario's: energy (except where purchased by farmers or used to produce goods for sale); telecommunications services other than Internet access and toll-free numbers; road vehicles weighing less than 3,000 kilograms (and parts and certain services); and food, beverages, and entertainment. ITCs are not restricted for items purchased for resale, including resale inventory purchased by an auto dealership and electricity purchased by a utility for redistribution.

Other commonalities between the BC HST and the Ontario HST include a rebate for the provincial portion of the tax for owner-occupied or rented new housing, and a rebate for charities, qualifying not-for-profit organizations, and municipalities to ensure that they do not pay any additional tax under the proposed new system.

The separate hotel room tax will be eliminated on the BC HST's implementation. However, motor fuel tax, carbon taxes, and tobacco taxes will continue to apply and form part of the purchase price upon which the BC HST is imposed.

The key legislative underpinnings of the harmonization changes, including the transitional and place-of-supply rules, have yet to be released. One can only speculate about whether the remaining PST provinces will join in rather than risk falling behind competitively, and make July 1, 2010 a PST independence day.

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Registered Disability Savings Plans

To help taxpayers save for the long-term financial security of persons with disabilities, the federal government has introduced the registered disability savings plan (RDSP), the Canada disability savings grant, and the Canada disability savings bond.

An individual who is eligible to claim the federal disability tax credit, or his or her parent or other legal representative, can establish an RDSP for the eligible individual; only one RDSP can be established for that person (the RDSP beneficiary). The RDSP beneficiary must be a Canadian resident when the plan is established and when it receives contributions. Anyone can make a contribution to an RDSP until the end of the year in which the RDSP beneficiary turns 59, up to a $200,000 lifetime maximum per beneficiary, with no annual limit. The government will supplement the RDSP with grants and bonds: merely setting up the plan can trigger bond payments, but RDSP contributions must be made to generate grant payments (see the accompanying table). The government grants and bonds do not affect the $200,000 lifetime contribution limit.

The key tax features of the RDSP are as follows: (1) a contribution to an RDSP is not deductible and cannot be returned to a contributor; (2) contributions are distributed tax-free to the RDSP beneficiary; (3) investment income earned in an RDSP accrues tax-free; and (4) investment income, grants, and bonds are taxable to the RDSP beneficiary on distribution to him or her. The types of investments that can be held inside an RDSP generally mirror those that can be held by an RRSP. The individual who establishes an RDSP (the RDSP holder) is subject to a significant

Canada RDSP Grants and Bonds: Criteria for Eligibility

	Grants		Bonds	
Net family income*	≤$77,664	>$77,664	≤$21,816	$21,816-$38,832
Matching rates on RDSP contributions	300% on first $500, 200% on next $1,000	100% on first $1,000	No contributions required	No contributions required
Annual maximum qualifying RDSP contribution	$1,500	$1,000	No contributions required	No contributions required
Annual grant/bond maximum incentive	$3,500	$1,000	$1,000	Up to $1,000
Lifetime limit for grant/bond	$70,000	$70,000	$20,000	$20,000

* Amounts shown are for 2009, to be indexed.

penalty tax if RDSP funds are invested in non-qualifying investments. Any income earned from those investments is also taxable in the RDSP as ordinary income, including full taxation of both capital dividends and capital gains net of capital losses.

Planning can optimize the tax deferral on investment income earned from contributions to an RDSP and maximize the lifetime grant paid to an RDSP. For example, a one-time contribution of the $200,000 lifetime limit to a plan results in only one grant of either $3,500 or $1,000, depending on net family income, far less than the $70,000 maximum grant possible. Furthermore, the timing of RDSP contributions should take into account that grants are higher when net family income is $77,664 (indexed for inflation) or less. The grants may be optimized if contributions are made after the year in which the beneficiary turns 18; at that time the relevant net family income is that of the beneficiary and of his or her spouse or common-law partner. Eligibility for grants and bonds for a particular year is determined by the net family income for the second year preceding; for example, 2007 net family income determines eligibility for 2009. Grants and bonds can be earned up to December 31 of the year in which the beneficiary turns 49.

Disability assistance payments are payments from an RDSP to the beneficiary and are made up of contributions, grants, bonds, and investment income. The portion of the disability assistance payment not derived from contributions is taxable to the beneficiary. The RDSP must begin to make annual disability assistance payments by the end of the year in which the beneficiary turns 60. A maximum annual limit is determined by the beneficiary's life expectancy and the FMV of the plan property. Disability assistance payments can generally be made at any time. However, because the purpose of the RDSP is to encourage long-term savings for persons with disabilities, grants and bonds must be repaid to the government if they were received in the 10 years preceding a disability assistance payment. Assume, for example, that an RDSP beneficiary wants to withdraw $11,000 from his or her RDSP. The RDSP has assets valued at $70,000, including $20,000 of grants and bonds of which $13,000 was received within 10 years of the planned withdrawal. If the $11,000 is withdrawn, all $13,000 of grants and bonds must be repaid to the government.

If the RDSP beneficiary ceases to be eligible for the disability tax credit or dies, funds remaining in the plan (net of certain grant and bond repayment requirements) must be paid to the RDSP beneficiary or to the beneficiary's estate. The distribution net of contributions is included in the beneficiary's or the estate's taxable income.

RDSP payments are not taken into account for the purpose of calculating income-tested benefits delivered through the federal income tax system, nor do they affect old age security or employment insurance benefits. Further, most provinces and territories exclude RDSP assets and income when determining eligibility for provincial or territorial disability benefits; Quebec, New Brunswick, and Prince Edward Island have partial exemptions, and Nunavut has not announced its position.

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US Renewable Energy Incentives

The US federal government's policy for promoting the development and operation of renewable and alternative energy projects has materialized in new US tax laws. The Energy Improvement and Extension Act of 2008 (the 2008 Energy Act) extended and amended many tax incentives originally introduced under the Energy Policy Act of 2005 (the 2005 Energy Act). The American Recovery and Reinvestment Act of 2009 (the Stimulus Act) further expanded and extended the array of available tax incentives: (1) production tax credits; (2) investment tax credits; (3) for the first time, direct cash grants to the owners of certain renewable energy assets; and (4) accelerated tax depreciation of renewable energy assets. Permitting eligible taxpayers to apply for a cash grant in lieu of taking a tax credit reflects the effects of the economic downturn on businesses' ability to use certain tax credits. The legislation also permits a taxpayer to elect alternative credits, thereby providing flexibility for obtaining tax incentives.

Production tax credits and investment tax credits are two of the primary incentives for the production, development, and investment in renewable energy projects. A production tax credit (PTC) is an income tax credit for the production of electricity generated from qualified energy resources and sold to unrelated persons (a PTC) is provided in Code section 45 (originally enacted as part of the 2005 Energy Act and extended and modified in the 2008 Energy Act and the Stimulus Act). Qualified energy resources include wind, closed-loop biomass, open-loop biomass, geothermal energy, solar energy, small irrigation power, municipal solid waste, qualified hydropower production, and marine and hydrokinetic renewable energy. For 2009, the credit is 2.1 cents per kilowatt hour or 1.1 cents per kilowatt hour, depending on the source of production. The credit is adjusted for inflation; it is reduced for grants, tax-exempt bonds, and similar items; and it is allowed during the 10-year period from the date on which the facility was originally placed in service.

The Stimulus Act also extended and liberalized existing energy incentives. Specifically, renewable generation facilities eligible for the PTC may instead elect an upfront section 48 qualifying advanced energy project credit (an ITC) (a component of the section 38 investment credit). That ITC for any taxable year equals 30 percent of that year's qualified investment with respect to any qualifying advanced energy project of the taxpayer. Only that part of the basis of eligible property used in a qualified advanced energy project that was constructed, reconstructed, or erected (or acquired and placed in service) after 2008 and before 2017 is eligible for a section 48 ITC. A project must apply for and receive Treasury certification as a qualifying advanced energy project. Congress has authorized the Treasury to allocate up to an aggregate of $2.3 billion in ITCs for all taxpayers.

A taxpayer can now elect to treat a qualified facility as a qualified investment credit facility and take the ITC in lieu of the PTC. IRS Notice 2009-52 (2009-52 IRB 1094) prescribes the election procedure. The election, which is irrevocable, is available for facilities placed in service after 2008. The election provides a significant benefit for investors in wind facilities because under current business practice wind facilities, like solar facilities, may be leased or subject to a sale and leaseback, and under the ITC rules the developer of the facility can still benefit from the ITC.

The cash grant program in lieu of the ITC monetizes it for eligible taxpayers. The Stimulus Act allows taxpayers who are eligible for an ITC (including ITCs elected in lieu of PTCs) to receive instead an equivalent financial grant from the Treasury if the property is (1) placed in service in 2009 or 2010 or (2) placed in service before the credit termination date (January 1, 2013 for wind projects) and the property's construction began in 2009 or 2010. The Treasury must pay the grant within 60 days of the later of the date of application therefor and the facility's placed-in-service date. A grant is subject to the ITC recapture rules. A grant does not constitute taxable income, and the property's basis must be reduced by 50 percent of the grant. On July 9, 2009, the Treasury issued procedures for applying for payments and clarification of the eligibility requirements under the grant program.

The 2008 Energy Act provided additional energy-related benefits, such as a special deduction for energy-efficient commercial buildings and a 50 percent first-year bonus depreciation allowance for qualified reuse and recycling property. The Stimulus Act extends bonus depreciation for capital expenditures incurred in 2009; removes the dollar caps from the small-wind ITC; repeals subsidized energy financing limitations on the ITC; provides a 30 percent ITC for investment in property used in a qualified advanced energy manufacturing project; provides funding for workforce training for renewable energy and energy-efficiency careers as specified in the Green Jobs Act of 2007; and creates a loan guarantee program at the Department of Energy for commercial and innovative technologies, generation projects, and transmission and manufacturing facilities.

Many states also offer tax incentives for renewable energy projects and other green projects. The differences in incentives from state to state, as well as differences in non-tax considerations such as geography and business climate, make it important to analyze the full range of opportunities before locating a renewable energy project in the United States.

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Purposive Interpretation

Strict construction of tax legislation was replaced some time ago by the modern approach to statutory construction, under which, according to Driedger, *Construction of Statutes* (2d ed.), "the words of an Act are to be read in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act, and the intention of Parliament." The SCC in *Canada Trustco* (2005 SCC 54) called this approach a "textual, contextual and purposive analysis." In contrast, the pendulum seems to swing dangerously in the other direction in *Cascades Inc*. (2009 CAF 135): the FCA effectively uses purposive interpretation in order to close a perceived gap in the Act.

In *Cascades*, the corporate taxpayer sold at a loss one subsidiary's shares to a new subsidiary for its shares and then merged the two subsidiaries. The taxpayer said that the stop-loss rule in subsection 40(3.4) did not apply because the threshold condition in paragraph 40(3.3)(c) was not met: at the end of the 61-day period straddling the transfer, neither the transferor nor an affiliate owned the substituted property. Moreover, the taxpayer said that subsection 40(3.5) did not change that result. The TCC agreed (2007 TCC 730), but the decision was reversed on appeal to the FCA. GAAR was not in issue.

The focus of the case was the proper interpretation of paragraph 40(3.5)(c). The preamble to subsection 40(3.5) reads, "For the purposes of subsections (3.3) and (3.4)" and "Les présomptions suivantes s'appliquent dans le cadre des paragraphes (3.3) et (3.4)" in the French text. The opening words of paragraph (c) state that "where subsections (3.3) and (3.4) *apply* to the disposition by a transferor of a share of the capital stock of a corporation, and after the disposition the corporation is merged with one or more corporations" and deems the merged corporation to own the share while it is affiliated with the transferor. The French text reads "lorsque les paragraphes (3.3) et (3.4) *s'appliquent* à la disposition par un cédant d'une action du capital-actions d'une société" and proceeds to describe the merger and deemed share ownership. (Emphasis added in both cases.) The taxpayer said that the word "apply" ("s'appliquent") with reference to the disposition of shares meant that all the conditions of subsections (3.3) and (3.4) must be met before paragraph 40(3.5)(c) could operate in the case of a share disposition. The Crown said that the word "apply" ("s'appliquent") denoted the scope and not the operation of subsections (3.3) and (3.4); the FCA agreed and concluded that paragraph (c) operated to assist in determining whether the stop-loss rule in subsections (3.3) and (3.4) was triggered.

The FCA said that if the legislature had intended the meaning proposed by the taxpayer, it would have phrased the opening words of paragraph (c) to refer to situations in which subsections (3.3) and (3.4) apply "and . . . there is" a disposition of a share, etc. Furthermore, the preamble to subsection (3.5) declares that all of its paragraphs apply for the purposes of subsections (3.3) and (3.4); the opening words of paragraph (c) merely provide supplementary precision and indicate that it applies "specifically for the purposes of those subsections where there is" a disposition of shares and a merger. The TCC had agreed with the taxpayer that subsections (3.3) and (3.4) must operate before paragraph 40(3.5)(c) is triggered, and thus the taxpayer could claim its loss because the merger was within the 61-day period; the effect of paragraph (c) was to resurrect an otherwise denied loss for a taxpayer if the merger occurred after the 61-day period. The FCA disagreed with the TCC's conclusion and adopted the Crown's suggested meaning of "apply"—namely, "pertain," "relate," "concern," or "deal with" (*Oxford Compact Thesaurus*) and "applicable à," "concerner," or "viser" (*Le Nouveau Petit Robert*). The FCA also said that in considering the overall spirit of the Act and the transactions in issue, it should be remembered that subsections (3.3), (3.4), and (3.5) establish a stop-loss rule.

Arguably, the FCA used an unduly broad meaning of "apply" and ignored the word's proper context in order to accommodate the perceived spirit and purpose of the Act and the stop-loss provisions in particular. The term "apply" is not defined in the Act, where it and its variants appear over 400 times. The word has different ordinary meanings depending on the context, such as to apply varnish on wood or to apply for a job. Arguably, an analysis of the context in both the Act and the broader field of law, leads to a conclusion—recognized, for example, in *Merriam-Webster's Collegiate Dictionary*—that when used in a legal provision, the word "apply" means "to put into operation or effect." However, the FCA seems to have eschewed this contextual analysis and adopted the meanings of the term suggested by the Crown.

In *Cascades*, the FCA effectively used purposive interpretation to construe paragraph 40(3.5)(c) and thus improperly assumed a legislative role. The court's approach is not consistent with the imperatives of "consistency, predictability and fairness" set out by the SCC in *Canada Trustco.* Moreover, the FCA's decision is contrary to the principle that the FCA itself pointed out in its recent decision in *Landrus* (2009 FCA 113): tax losses are generally allowed unless denied by a specific provision of the Act.

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Mother Ship in FA's Partnership

Taxpayers commonly operate non-Canadian active business through corporations, but sometimes other business organizations such as partnerships and trusts are used for commercial reasons. Thus, as a general policy, the tax treatment of foreign active business income should be consistent regardless of the form of business organization. On June 4, 2009, Finance issued to a taxpayer an as yet unpublished comfort letter stating that it is prepared to recommend certain changes to subparagraph 95(2)(a)(i) involving foreign partnerships held by FAs. The amendment is expected to apply to an FA's taxation years that begin after the announcement date of the related draft legislation's release, or to taxation years of a taxpayer's FAs ending after 2007 if so elected by the taxpayer in respect of all of its FAs.

Many changes have been made to the FA rules over the years to ensure that there is no difference in tax treatment when a partnership, not an FA, is used to carry out some aspect of a foreign active business. Subparagraph 95(2)(a)(i) was amended in 1995 to permit an FA's income earned through a partnership to be treated as active business income, but the provision may not operate if a taxpayer carries on the main active business (the mother ship) in a partnership.

If two conditions are met, subparagraph 95(2)(a)(i) recharacterizes as active business income an FA's property income that would otherwise be FAPI: (1) the income must be derived by the FA from activities reasonably considered to be directly related to the active business activities carried on by another FA, and (2) the income would be included in that other FA's active business income if earned by it. The rule is designed to accommodate business activities that might otherwise be carried out as a single active business, but for commercial reasons are carried out in two or more separate legal entities. Assume that Canco operates a foreign real estate business through a wholly owned subsidiary (FA 1) that has more than five employees and is considered to carry on an active business of developing real estate for sale; to avoid exposing FA 1's assets to risks associated with one particular property, Canco's other wholly owned subsidiary (FA 2) is used solely to develop it. FA 2's activities are performed by FA 1 employees. FA 2's income from the sale of its property is deemed active because its related development and sale activities are directly linked to FA 1's business activities (the mother-ship business) and if FA 1 had earned the income, it would have been included in FA 1's active business income.

If FA 2's property is held in a partnership of which it is a member, and the mother-ship business is carried on by FA 1, subparagraph 95(2)(a)(i) correctly recharacterizes FA 2's income allocated from the partnership: the income is derived from activities linked to the activities carried out by FA 1 and would be its active business income if earned by it. However, issues arise if the mother-ship business is held in a partnership. Assume that the mother-ship business is carried out by a limited partnership of which FA 1 is a limited member and another FA (FA 3) is a general member; all the business activities are performed by partnership employees. If the partnership is ignored, it is unclear whether its activities satisfy the first requirement in subparagraph 95(2)(a)(i) with respect to FA 2's income: that they can be considered to be carried on by FA 3 in its capacity as a general member. This concern arises partly because of subclause 95(2)(a)(ii)(B)(II), which deals with interest paid to a Finco by a partnership held by another FA; presumably the rule's drafters concluded that the partnership could not be ignored, and thus the payment is tested as if it were paid by the partnership, not the partners.

Finance's recent comfort letter acknowledges that subparagraph 95(2)(a)(i) should be updated to accommodate foreign partnerships. Finance is prepared to recommend amendments to the rule to allow the property income of a foreign partnership of which an FA is a member to be recharacterized as active business income, in circumstances similar to the recharacterization currently available to an FA that earned such income directly. Although it is not specifically stated in the comfort letter, the reference to applying subparagraph 95(2)(a)(i) to income or loss of a foreign partnership was made in the context of a situation in which the mother-ship business is held in a foreign partnership and the FA earns the income directly or through a partnership interest.

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TFSA Estate Freeze Plan

A recent CRA internal technical interpretation (TI 2009-0320311I7, May 27, 2009) confirms that if, as part of a freeze, a company issues its common shares to a key employee's tax-free savings account (TFSA), the CRA considers the shares' FMV increase to be an advantage that is a taxable benefit to the employee.

An advantage extended to a TFSA holder or a person related thereto is taxable under section 207.05 beginning in 2009. "Advantage" is generally defined as a benefit that is an increase in the FMV of the TFSA's property that is attributable, directly or indirectly, to a transaction that would not occur in the open market between parties dealing at arm's length and that is primarily undertaken to achieve a part I tax exemption under paragraph 207.01(1)(b). Generally, a TFSA is exempt from part I tax (paragraph 146.2(b)). If a TFSA advantage exists, either the TFSA holder or its issuer is generally liable for tax equal to the benefit's FMV.

On the facts in the TI, the CRA was asked whether there was an advantage as defined in subsection 207.01(1). Mr. X, Opco's sole shareholder, freezes the company's shares. As part of the freeze, the TFSA of a key employee not related to Mr. X subscribes to 5 percent of the newly issued Opco common shares; Mr. X owns the remaining 95 percent plus all of the freeze shares. The key employee's remuneration is not reduced as a result of the 5 percent share issue and continues to increase according to the consumer price index.

According to the CRA, the shares subscribed by the TFSA were issued by Opco because of the employment relationship that exists between it and the key employee; the

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share issue would not have occurred in an open market with arm's-length parties, and one of the main objectives of issuing the shares appears to be to allow the TFSA holder to benefit from the part I tax exemption. As a result, the CRA concluded that any increase in the TFSA's FMV that is directly or indirectly attributable to the share issue can reasonably be considered to be an advantage under subsection 207.01(1). However, the CRA did not provide any guidance on how to calculate the value of that advantage.

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Foreign Tax News

Treaties

The **Bahamas** commenced negotiations for TIEAs with several countries, including Canada, China, the United Kingdom, and several European countries; a TIEA is already in place with the United States. A new legislative framework will support the TIEA network and allow cooperation with regard to tax offences. **Panama**'s National Commission for the Defence of International Financial Services recommended that tax treaty negotiations begin with Spain and the United States. The **Canada-Peru** free trade agreement entered into force on August 1, 2009. **Belgium** signed protocols containing an exchange-of-information provision reflecting the OECD treaty article 26 standard with Australia, Denmark, France, Luxembourg, Monaco, San Marino, Seychelles, Singapore, and the United Kingdom. (The UK protocol, inter alia, includes changes to withholding rates.)

Status of Canada's Tax Treaties

In force (85)

Algeria
Argentina
Armenia
Australia
Austria
Azerbaijan
Bangladesh
Barbados
Belgium
Brazil
Bulgaria
Cameroon
Chile
China (PRC)*
Croatia
Cyprus
Czech Republic
Denmark
Dominican Republic
Ecuador
Egypt
Estonia
Finland
France
Gabon
Germany
Guyana
Hungary
Iceland
India
Indonesia
Ireland
Israel
Italy
Ivory Coast
Jamaica
Japan
Jordan
Kazakhstan
Kenya
Korea
Kuwait
Kyrgyzstan
Latvia
Lithuania
Luxembourg
Malta
Mexico
Moldova
Mongolia
Morocco
Netherlands
New Zealand
Nigeria
Norway
Oman
Pakistan
Papua New Guinea
Peru
Philippines
Poland
Portugal
Romania
Russia
Senegal
Singapore
Slovak Republic
Slovenia
South Africa
Spain
Sri Lanka
Sweden
Switzerland
Thailand
Trinidad and Tobago
Tunisia
Ukraine
United Arab Emirates
United Kingdom
United States
Uzbekistan
Venezuela
Vietnam
Zambia
Zimbabwe

* This treaty does not apply to Hong Kong.

Signed but not yet in force (5)

Colombia
Greece
Italy
Lebanon
Turkey

Under negotiation or renegotiation (12)

Barbados
Bolivia
Costa Rica
Cuba
Egypt
Madagascar
Malaysia
Namibia
Poland
Serbia and Montenegro
Singapore
Spain

Chile

A bill was approved by the Chamber of Deputies of the National Congress to deal with access to bank information by the tax administration authorities.

New Zealand

A newly released paper suggests improvements to the binding rulings system, including replacing the prohibition on questions of fact with a limited list of factual matters for which a ruling would not be available; introducing a more flexible waiver of fees; and allowing the promoters of publicly marketed schemes to request rulings.

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