Canadian Tax Highlights

Editor: Vivien Morgan, LL.B.

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Liable Versus Payable

In *Exida.com Limited Liability Company* (2009 TCC 373), an informal procedure decision, the TCC concluded that the minister properly assessed a subsection 162(2.1) penalty of $2,500 against Exida.com for each of its 2003, 2004, and 2005 taxation years. Exida.com was a non-resident corporation carrying on business in Canada that had no unpaid tax but had failed to timely file an income tax return.

The TCC first considered the minister's alternative argument: that the penalties assessed against Exida.com could be imposed under subsection 162(7), which applies if there has been a failure to file an information return required by the Act or to comply with any obligation imposed by the Act. The rule specifically excludes other failures to file, etc. that are covered by another penalty provision in the Act (with some exceptions that were not relevant on the facts). On the question of whether another provision set out a penalty for Exida.com's failure to timely file income tax returns, the minister argued that the subsection 162(1) penalty for such a failure does not apply if the taxpayer has no unpaid tax, and thus the subsection should not be viewed as setting out a penalty. The TCC disagreed and said that even if the penalty is nil under subsection 162(1), the subsection nonetheless sets out a penalty for the failure to file a return. The clear intent of subsection 162(1)—to penalize late-filed returns only if tax is owing—is apparently frustrated if a penalty could be imposed under subsection 162(7) whenever none is imposed under subsection 162(1): "If Parliament had intended to impose a penalty regardless of whether there is unpaid tax, it is likely that the formula in subsection 162(1) would have provided for this."

The court rejected the proposition that subsection 162(7) applied; the central question was whether the subsection 162(2.1) penalty provision applied to a non-resident corporation that late-files its T2 corporate return but has no unpaid tax at the filing deadline. Subsection 162(2.1) may impose a greater penalty on a non-resident that is "liable to a penalty" under subsection 162(1). The TCC said that the meaning of that phrase must be derived from a textual, contextual, and purposive analysis, and it cited *North Shore Health Region* (2008 FCA 2):

> [Each provision] must be read in its entire context and in its grammatical and ordinary sense harmoniously with the scheme of the statute, the object of the statute, and the intention of Parliament. See, for example, *AstraZeneca* . . . [2006] 2 S.C.R. 560 [and] . . . *Canada Trustco* . . . [2005] 2 S.C.R. 601.

In *Exida.com*, the TCC said that the ordinary meaning of "liable" is quite broad. The term's primary meaning in the OED (second edition) is "[b]ound or obliged by law or equity, or in accordance with a rule or convention; answerable; legally subject or amenable to." Also noted was the broad meaning of "liable" in *National Trust Company* (98 DTC 6409 (FCA)), which said, "The ordinary meaning of the word 'liable' in a legal context is to denote the fact that a person is responsible at law." In contrast, the TCC in *Exida.com* noted the use of the phrase "a penalty was payable" in paragraph 162(2)(c), and said that that phrase was used to clarify that the more onerous penalty for a repeated failure to file a return applies only if an actual penalty was owing for a prior year. The use of different terminology—"liable"—in subsection 162(2.1) suggested to the TCC that a different meaning was contemplated.

The court also noted that subsection 162(2.1)'s coming into force coincided with the narrowing of the tax return filing requirements for non-resident corporations in paragraph 150(1)(a). This legislative history signalled that the likely objective of subsection 162(2.1) was "to put teeth into the more restrictive filing requirements for non-resident corporations in para. 150(1)(*a*)," a position substantiated by the technical notes published by Finance when the legislation was introduced. In the result, the TCC concluded that Exida.com was "liable to a penalty under subsection 162(1)"; thus, the minister correctly assessed a subsection 162(2.1) penalty against it for failure to file an income tax return in each of the taxation years in issue.

In This Issue

The decision in *Exida.com* is contrary to the informal procedure TCC case of *Goar, Allison & Associates Inc.* (2009 TCC 174), which held that a subsection 162(2.1) penalty applied only if tax was unpaid at the filing deadline. *Exida.com* may signal the minister's intention to pursue the assessment of non-resident corporations more actively.

Colin Green
Thorsteinssons LLP, Toronto

Treaty Trumps Section 116

In *Morris* (2009 FC 434), the Federal Court concluded that where a treaty exemption results in no tax owing on a 2006 disposition of taxable Canadian property (TCP) by a non-resident, the CRA has no discretion to refuse to issue a compliance certificate. The Crown has appealed to the FCA. If *Morris* is upheld, the decision may make the 2008 section 116 amendments redundant and call into question the interaction of other provisions of the Act with treaty exemptions for a non-resident from Canadian tax, such as the withholding requirements under regulation 105.

RCI Trust, settled under Barbados law, sold shares of RCI Inc., a Canco, for $145 million; their cost base was only $200. Previously, a Canadian individual, Lucien Rémilliard, had undertaken a convoluted trust and corporate transaction for estate and related tax-planning purposes. In 1995, a Cayman trust was formed: the beneficiaries were M. Rémilliard's family members. In 1997, two predecessor companies (later RCI Inc.) were incorporated federally in Canada (under the CBCA) with a $200 aggregate ACB. The companies were held by a Montreal lawyer in trust for a trust to be settled under Barbados law. On the same day in 2002 that RCI Trust was settled with the Cayman trust as sole beneficiary, the lawyer conveyed the predecessors' shares to RCI Trust for $200.

In May 2006, the RCI Trust trustees applied for a section 116 compliance certificate and claimed treaty exemption under the Canada-Barbados treaty. The purchaser appeared to be Les Investissements Historia Inc., incorporated under the CBCA, whose sole shareholder, officer, and director was M. Rémilliard. The CRA was concerned with several aspects of the transactions; its primary position, consistent with *Information Circular* 72-17R5 (March 15, 2005), was that the issuance of a compliance certificate is a matter of ministerial discretion. Unless both the CRA and the taxpayer agree that a treaty exempts the disposition, the CRA will not issue a compliance certificate. The CRA said that it is solely in the minister's discretion to issue a certificate confirming a treaty exemption, and thus it can refuse to issue a certificate until it is satisfied that the treaty applies.

The CRA raised arguments to rebut the prima facie presumption that RCI Trust was a Barbados resident, but the Federal Court concluded that it was a Barbados resident only and the gain was thus treaty-exempt. The Federal Court said that section 116 predated the treaty, and because the treaty did not deal expressly with its interaction with the requirement for a certificate, the court concluded that the treaty was paramount and that its language prevailed in decisions about residence and treaty exemption. The court also said that when no tax is owing because of a treaty exemption—an event not referred to in section 116—the CRA should not use section 116 for enforcement and collection objectives and that in the circular it had tried to extend its section 116 powers beyond its legislative mandate. The court was buttressed in its conclusion by draft amendments that indicated that section 116 did not apply to treaty-exempt property. The trustees were thus entitled to a binding ruling from the CRA as to the RCI Inc. shares' treaty-exempt status, because RCI Trust was a resident of Barbados only. The CRA also took issue with the 2002 transactions and with whether the $145 million sales price was supportable. The court did not address these issues, presumably because they were made moot by the finding that the gain was exempt.

The facts in *Morris* are not typical, and 2008 changes to section 116 may deal with the issues directly, but the decision leaves open several questions that may be of ongoing interest. Further analysis on appeal would be welcome on the issue of whether the treaty was paramount over the legislative direction in former subsection 116(4) that the minister "shall forthwith issue" a certificate if the non-resident has (1) remitted 25 percent of the sales proceeds, or (2) provided "security acceptable to the Minister." No mention is made of treaty exemption. In its result, the Federal Court's decision is consistent with an assumption that a non-resident who has made a "prima facie" case for treaty exemption should be considered to have furnished security "acceptable to the Minister."

Morris may also reverberate in the context of regulation 105 withholding requirements related to treaty-exempt services or employee remuneration. Currently, the CRA may issue a waiver of regulation 105 withholding obligations, the conditions for which are set out in *Information Circular* 75-6R2 (February 23, 2005). These conditions are so stringent that in many cases the activities do not meet the waiver conditions, but the income or profits therefrom are treaty-exempt. Arguably, *Morris* supports a conclusion that a taxpayer who is able to establish a prima facie case of treaty-exempt income or profits may not need to suffer withholding under regulation 105.

Phil Halvorson
Ernst & Young LLP, Toronto

Account Credit, No Refund

In the recent case of *FMC Technologies Company* (2009 FCA 217), the FCA reviewed and affirmed the minister's refusal to refund an overpayment of tax withheld under regulation 105 on the basis of its reading of the term "overpayment" in paragraph 164(7)(b). Ultimately, FMC was effectively taxed twice on the same income. The case illustrates that only the non-resident can apply for a refund of the tax withheld on and credited to its account. The unfairness of the result emphasizes that care must be taken to ensure that the desired legal relationships between corporate group members and third parties are clearly and correctly established, particularly when a contract involves a non-resident's provision of services in Canada.

FMC was a wholly owned Canadian subsidiary of a non-resident, FMCI. In 1997, as party to a project alliance agreement, FMCI agreed to provide services in connection with the development of an oil field in Newfoundland. Petro-Canada was a participant in and the operator of the project and the agent for the other participants. With Petro-Canada's consent, FMCI subcontracted with FMC so that FMC became responsible for providing all deliverables under the project agreement for services rendered in Canada. FMCI also assigned to FMC all its receivables related to that in-Canada work under the project agreement; FMCI retained the right to sue Petro-Canada if it failed to pay. From 1999 to 2002, FMC provided the services and invoiced Petro-Canada, which paid the invoices without withholding.

In 2004, the CRA assessed Petro-Canada under regulation 105 for failure to withhold 15 percent of the payments made to FMC. The CRA said that FMCI, not FMC, was the amounts' legal payee; thus, regulation 105 withholding applied because the amounts were paid to a non-resident for services rendered in Canada. Petro-Canada objected to the assessments, but it paid the tax when the minister confirmed them. FMC then indemnified Petro-Canada.

FMC's appeal to the TCC was quashed on the basis that FMC had no standing to challenge Petro-Canada's assessments. FMC then applied to the minister for a refund of overpaid tax under subsections 164(1) and (1.1), arguing that the amounts paid by Petro-Canada as withholding tax were paid on account of FMC's part I tax for the years in issue. The minister refused FMC's request, saying that FMCI and not FMC was the legal payee.

FMC's subsequent application to the Federal Court for judicial review of the minister's decision was rejected because the application was beyond the court's jurisdiction. The Federal Court found that the application was essentially an appeal of Petro-Canada's assessments, a matter exclusively within the TCC's jurisdiction. In obiter, the Federal Court said that the minister had correctly concluded that FMCI was the payee in law and that the minister had correctly credited Petro-Canada's tax payments to FMCI's account. Thus, FMC had no overpayments for the taxation years in issue.

FMC appealed to the FCA the Federal Court's determinations that it had no jurisdiction to entertain the application for judicial review and that FMC had no tax overpayments. The FCA dismissed the appeal without considering the issues of jurisdiction and standard of review. The FCA concluded that the term "overpayment" as defined in paragraph 164(7)(b) for the purposes of subsection 164(1) requires that the amounts paid by Petro-Canada have actually been paid on account of FMC's taxes for the years in issue. On the facts, the amounts were credited to FMCI's account, and thus FMC had no tax overpayments eligible for refund under subsection 164(1). FMC argued that the amounts ought to have been credited to its account because of the equitable assignment to it by FMCI of the contractual obligations and related amounts receivable. The FCA said that even if the assignment had that legal effect vis-à-vis FMC, FMCI, and Petro-Canada, FMC still did not have an overpayment within the meaning of paragraph 164(7)(b): that rule "does not ask how the amounts in question ought to have been credited, rather it asks how they were, in fact, credited."

Albert Baker
Deloitte & Touche LLP, Vancouver

Grant J. Russell
Heddema & Partners LLP, Vancouver

School Enrolment Declines, Costs Rise

Those responsible for providing government services know only too well that the pressure to spend more is relentless. Recent information from Statistics Canada on public school indicators shows that public school enrolment has declined every year from the school years 2002-3 to 2006-7. The national figures hide an increase in Alberta's enrolment in the latest year.

The national decline in numbers was not sufficient to reduce public spending on elementary and high schools. The number of educators—all school board employees required to have teaching certification—increased by 4.1 percent from 2000-1. Total spending rose to $49.6 billion, up 27.9 percent since the 2000-1 school year, despite the fact that general inflation rose only 14.4 percent over the same period. As a result, spending per pupil rose even more dramatically, after adjusting for inflation. The table shows that student enrolment fell by 3.5 percent over the school years 2000-1 to 2006-7, but spending increased by 27.9 percent. Thus, average spending per student

Selected Statistics on Public School Education: Percentage Change, 2000-1 to 2006-7

	Enrolment	Spending	Real spending per student
Newfoundland and Labrador	−17.6	20.2	48.0
Prince Edward Island	−7.7	25.1	38.2
Nova Scotia	−11.0	−4.9	8.5
New Brunswick	−10.3	30.0	47.5
Quebec	−2.7	24.0	31.9
Ontario	−1.9	30.5	34.4
Manitoba	−5.2	28.4	35.9
Saskatchewan	−11.6	36.1	55.2
Alberta	2.0	39.0	35.9
British Columbia	−7.3	21.8	31.1
National average	−3.5	27.9	34.3

increased from $7,696 in 2000-1 to $10,262 in the latest year for which information is available; in constant dollars, excluding the effects of inflation, average spending per student increased by 34.3 percent over the period.

The table shows the different patterns of growth experienced in each province; the national average includes results for the territories. The variation between provinces is significant, but the basic national pattern holds for each province and reveals the dilemma facing finance ministers and treasurers across the country. Pressure for improved facilities, better staffing, and modern equipment has produced increased spending despite the decline in enrolment. No one familiar with our public school system would argue that improvements could not be made. The Statistics Canada study indicates that key indicators of performance have improved over the period and, as in the economy as a whole, improved performance cannot be obtained unless additional resources are provided. Declining enrolments enabled the public school system to improve through increased spending available during a period of unprecedented prosperity.

David B. Perry
Toronto

Form T106: Interest on Late-Filing Penalty

Penalty and interest apply to a taxpayer who late-files a form T106 summary and slips ("Information Return of Non-Arm's Length Transactions with Non-Residents"). In particular, interest on the penalty begins to accrue from the day the T106 was originally due, not from the mailing date of the penalty assessment as in the case of a transfer-pricing penalty. Moreover, even if the corporate tax return for the particular taxation year is statute-barred, interest and penalties are triggered by a failure to file the T106 form. These issues are discussed in a recent internal technical interpretation (2009-0312521I7, July 3, 2009); none of the CRA's comments comes as a surprise, but the TI is a useful reminder of the implications of late-filing a T106.

The T106 summary and slips are annual information returns that report non-arm's-length transactions between a reporting person or partnership and non-residents. A reporting person is a person that is a Canadian resident at any time in the year or a non-resident that carries on a business in Canada other than as partner. The T106 filing deadline is the same as the filing deadline for the taxpayer's income tax return (or partnership information return).

The TI confirmed that late-filed T106 forms attract penalties under subsections 162(7) and (10). Subsection 162(7) imposes a penalty equal to the greater of $100 and $25 per day (to a maximum of $2,500) over the period in which the failure to file continues. Subsection 162(10) applies if a taxpayer fails to file a T106 knowingly or in circumstances amounting to gross negligence, but that penalty is reduced by the subsection 162(7) penalty. The TI also confirmed that interest charged on either penalty is payable at the prescribed rate, compounded daily, and computed from the day on or before the T106's filing deadline.

The TI said that the CRA can assess a penalty on a late-filed T106 even after the corporate income tax return for that year becomes statute-barred. The reasoning behind this conclusion rests on the fact that the only commonality between the filing requirements for a T2 return and those for an information return such as the T106 is that they share the same due date.

Paul Hickey
KPMG LLP, Toronto

Forgotten Green Card

A US green card obtained many years ago but never used can expose the holder to the recently enacted expatriation regime.

Our client recently applied for the Nexus program (which allows pre-approved travellers to use designated border crossings for easy access to the United States); the US database indicated that a green card, which the client had forgotten about, had been issued to him in 1981. In that year, the individual had applied for and been granted the green card for an intercompany transfer as part of a planned US business; an intervening real estate market crash derailed those plans. If the client, who had never filed US returns or complied with US foreign reporting, was found to have abandoned his green card, he would be treated as a US resident until that time under the recently enacted expatriation regime (resulting in a departure tax and possibly in restricted access to the United States) and subjected to penalties for failure to file a treaty-based return statement and forms 5471 and 5472. Arguably, the individual, who had always asserted Canadian residence and had never filed US returns, had either abandoned the green card shortly after it was issued or, alternatively, had not satisfied the condition precedent for the card's issuance because he had never expanded the business to the United States. He had also obtained green cards for his children, but the children had never had sufficient assets and income to attract the expatriation rules.

After much consultation with US immigration and tax counsel, the individual took the position that he no longer had the intent to reside in the United States by the time the visa was issued in 1981, even though the US immigration service had approved him for lawful permanent resident status and the Department of State issued him a green card later in 1981. The individual also never sought admission to the United States as a permanent resident. The conclusion that he lacked the requisite "resident intent" was based on considerations that included his stated lack of intent to become a US resident and on whether he retained property holdings or a domicile in the United States, whether he filed US tax returns, whether his family ties were in the United States, whether his absences from that country were relatively short, and whether his job was located outside that country. The individual had never obtained a US social security number. On the basis of an affidavit from him, a US immigration lawyer opined that the individual lacked the "resident intent" when he presented himself in 1981 to the immigration services at a US point of entry and then immediately returned to his home in Toronto with the intention of residing there permanently. He never took up US residence, notwithstanding the issuance of the green card, and he never had the status of a US lawful permanent resident. Form 8854 ("Expatriation Information Statement") was completed on the basis that he expatriated before June 17, 2008 (part A), and 1981 was indicated as the date of expatriation. We advised our client that he was exempt from having to report foreign bank accounts under the rules relating to the reporting of foreign bank and financial accounts (FBAR) on the basis that he was not a US citizen and, according to the US legal opinion, was not a green-card holder or a lawful permanent resident. In the result, the individual was allowed to surrender his green card without exposure to the expatriation provisions or to US income tax or gift tax. His children also gave up their green cards, but their net worth and annual income were below the expatriation provisions' threshold.

Jack Bernstein
Aird & Berlis LLP, Toronto

Inbound US Financing

Generally, interest on debt incurred by a USco is deductible. The debt-versus-equity debate in the related-party context is contentious: there is no bright-line test to distinguish the two either in case law or in the Code (section 385). The IRS and GlaxoSmithKline are currently locking horns in the US Tax Court over a $13.5 billion obligation, and other cases are at various stages of dispute. The Glaxo fact pattern is one example of various US tax issues that should be kept in mind when structuring inbound US financings.

In *GlaxoSmithKline Holdings (Americas) Inc. & Subsidiaries* (2009 TNT 99-14), two commonly controlled US groups were merged, purportedly in a type D reorganization with boot. The boot was a deferred payment obligation (DPO) that did not bear interest; Glaxo says that the DPO is an original issue discount (OID) obligation embedded in the merger agreement itself, not in a separate document. The DPO was prepayable without penalty at any time, and it had a seven-year term; an accounting firm conducted contemporaneous section 385 work that was ostensibly fully documented.

The IRS proposes to disallow Glaxo's OID deductions related to the DPO and recharacterize them as distributions on stock (probably dividends). The US Tax Court documents do not clearly state the IRS's grounds for the deductions' disallowance, but the IRS asserts two statements of fact, both of which are in dispute: (1) that the accounting firm did not conclude that the issuer could have obtained investment grade debt of comparable size from unrelated creditors, and (2) that the analyses completed by the accounting firm were incorrect.

The IRS litigation appears to involve a classic section 385 allegation: the DPO given in consideration was equity, not debt. The ability to obtain loans from third-party lenders indicates debt, but equity is indicated if the borrower could not have borrowed the same amount from an unrelated creditor on terms comparable to the related-creditor arrangement. (See, for example, *Litton Business Systems, Inc.*, 61 TC 367 (1973).) The nature and degree of risk assumed by the creditor must be assessed against arm's-length standards: in short, how commercially reasonable was the DPO's issuance? Some key considerations for intercompany financings into the United States are as follows.

■ **Thin capitalization.** The US operations cannot take on an excessive amount of debt.

■ **Transfer pricing.** The debt's terms and conditions should reflect arm's-length market requirements, including the rate of interest, the maturity date, and the schedule for the principal's repayment.

■ **Economic reality.** One should be able to demonstrate that the US operations could have borrowed a like amount from unrelated persons on similar terms and conditions, normally in US dollars unless a strong business case indicates otherwise. Economic reality can be demonstrated by objective proof, which includes documented offers to lend from third parties (and which also helps prove transfer-pricing and thin-cap matters), or by well-reasoned financial projections of a kind acceptable to third-party lenders.

■ **Interest deductibility.** Among other limitations, a US person's related-party interest expense is deductible only as paid (cash basis); the deduction's timing is matched with that of the US withholding tax liability. Generally, deductibility may be deferred under the earnings-stripping rules, which seek to limit base erosion by capping the annual deduction for most related-party interest expense at about 50 percent of cash-basis EBITDA.

■ **US withholding tax.** Generally, 30 percent US withholding tax applies on interest payments to non-US persons, unless reduced by domestic tax law or a treaty. Nearly all tax reductions require the lender to provide a valid form W-8BEN to the US payer before any interest is paid.

■ **Treaty-based lenders.** Generally, in order to be eligible for treaty-reduced US withholding tax, the corporation must be resident in its home country and subject to tax there on its worldwide income. A limitation-on-benefits treaty provision imposes additional requirements; a typical requirement is that the resident either be a publicly traded corporation in its home country or conduct a substantial and active trade or business there.

■ **Anti-conduit rules.** Some US tax provisions seek to prevent back-to-back loan arrangements that inappropriately reduce US tax. For example, some arrangements attempt a reduction of US withholding tax that would not be available if the original or first lender loaned the funds directly to the US borrower instead of lending them to an intermediary that on-lent to the US borrower.

■ **Group finance company.** If the US operations borrow from a group finance company (Finco), Finco generally should be engaged outside the United States in the business of lending money for profit and should not conduct any US-based trade or business activities. Finco should carry out other significant business and activities, such as factoring group receivables, in addition to lending money to the US operations. Finco must also demonstrate "dominion and control" over earnings such as the US-source interest income: Finco should invest its earnings in its own name and on its own behalf and should be under no requirement and have no present intention to distribute or lend funds to its direct or indirect shareholder.

Steve Jackson
Ernst & Young LLP, New York

Non-Resident Shareholder Benefit

A recent CRA technical interpretation (TI 2006-0196241C6, October 6, 2006) is a reminder that a shareholder benefit may be taxable in Canada, even if both the corporation and the shareholder are non-residents of Canada. The TI confirms that part XIII withholding tax applies to a benefit conferred by a non-resident corporation on a non-resident shareholder by way of its making property located in Canada available to him.

If a corporation confers a benefit on a shareholder, or on a person in contemplation of his becoming a shareholder (subject to certain exceptions), subsection 15(1) includes the amount or value of that benefit in the shareholder's income for tax purposes. The rule applies even if the corporation is not resident in Canada or does not carry on business in Canada.

A non-resident individual who does not carry on business in Canada is generally not subject to tax under part I. However, if section 15 would include an amount in a taxpayer's income if part I applied, that amount is deemed to have been paid to the non-resident taxpayer as a dividend from a Canadian-resident corporation. Because a non-resident person is subject to withholding tax on dividends deemed or actually paid or credited to him by a Canadian-resident corporation, the non-resident is liable for withholding tax of 25 percent (or a treaty-reduced rate) on the amount or value of the deemed dividend.

In the TI, a resident of the Bahamas, Mr. X, holds all the shares of a corporation resident in the Bahamas. The corporation owns an automobile located in Canada, but has no other ties with Canada. The automobile is available to Mr. X at all times, although he uses it for only a few weeks each year. The TI concludes that if Mr. X had been a Canadian resident, he would have had a taxable benefit under subsection 15(1). Because he is a non-resident, the amount of the benefit is deemed to be a dividend paid to him by a Canadian corporation. Mr. X is therefore subject to tax on the value of the benefit at a rate of 25 percent, with no reduction under a treaty because Canada does not have a tax treaty with the Bahamas.

Jim Yager
KPMG LLP, Toronto

US Estate Tax Savings

Increasingly, Canadians are purchasing real estate in the United States in order to take advantage of the current US real estate market and low interest rates. Planning is required to reduce or eliminate exposure to US estate tax for a Canadian who owns US real estate outright. Although Canadian individuals and their advisers frequently inquire about the appropriate method of acquiring US real estate, in many cases the question is asked after the purchase transaction has been completed. Fortunately, although implementing the proper structure at the outset is the best practice, planning opportunities exist even for a completed transaction.

If a Canadian citizen and resident owns US real property at his or her death, it is US-situs property and potentially subject to US estate tax on its full value at rates up to 45 percent (2009). Under the Canada-US treaty, a Canadian citizen-resident qualifies for a US estate tax exemption equal to

$$\text{US citizen's \$3.5 million estate tax exemption (in 2009)} \times \frac{\text{Value of decedent's US-situs assets}}{\text{Value of decedent's worldwide assets}}$$

In many cases, the available exemption is insufficient to prevent US estate tax exposure. This is commonly the case if a couple has significant wealth located outside the United States; however, with proper planning and structuring, a residence trust can avoid exposure.

In a typical residence trust structure for a married couple, one spouse (the grantor spouse) creates and contributes funds to a trust of which the grantor's spouse and descendants are the beneficiaries. If specific requirements and procedures are followed, the trust structure avoids the inclusion of the US-situs real property in either spouse's estate for US estate tax purposes. Moreover, a properly implemented residence trust structure also qualifies for the current 15 percent US long-term capital gain tax rate on the property's future sale and avoids the Canadian shareholder benefit rule.

It is preferable for the trust to purchase the US property at the outset; but even if the Canadian purchaser seeks advice after having purchased the US property personally, with a few additional planning steps the residence trust technique can still be effective if a subsequently established residence trust later purchases the property from the individual. To minimize the US estate tax exposure, the sale transaction must be structured with terms that are as close to arm's-length as possible. Any gain from the sale is subject to withholding tax under the FIRPTA rules. State transfer tax on the sale price may also be exigible at the time of closing. The Canadian individual must also include the gain on the sale in his income for Canadian tax purposes; the US tax is creditable against the higher Canadian tax, and the residual balance must be paid. Given the depressed US real estate market, many properties can be sold at no gain or even at a loss. The time is thus opportune for a Canadian who already owns US real estate personally to consider a sale to a residence trust in order to achieve substantial US estate tax savings.

To effect a sale transaction to a residence trust, a Canadian citizen-resident must, inter alia, (1) obtain a current fair market appraisal for the US property; (2) document the original cost and capital improvements to determine basis; (3) prepare and finalize the residence trust agreement and fund the trust; (4) retain local counsel to prepare a contract of purchase and sale whereunder the residence trust's trustee contracts with the individual to purchase the US real property; (5) apply for an IRS withholding certificate (form 8288-B) so that the FIRPTA withholding tax is based on the actual amount of the gain, rather than the 10 percent of the purchase price otherwise required; and (6) file a US non-resident income tax return (form 1040NR) by June 15 of the following year to report the property's sale.

Kevin Gluc
Hodgson Russ LLP, Buffalo

Non-Eligible Dividend Rates Update

Non-eligible dividend rates after 2009 are revised in British Columbia, Manitoba, Ontario, and Prince Edward Island (table 1). Those provinces are decreasing tax credit rates to correspond with provincial small business rate reductions, with the intention of ensuring that the combined corporate and personal tax on business income eligible for the small business deduction and earned through a CCPC approximates the tax that would be payable if an individual earned the income directly. (For changes to eligible dividend rates, see "Eligible Dividend Rates Update," *Canadian Tax Highlights*, July 2009.)

British Columbia's non-eligible dividend tax credit rate is set to decline in 2010 because its small business rate dropped from 3.5 to 2.5 percent on December 1, 2008; a further decline is anticipated in 2012 because the province's small business rate will drop to 0 percent on April 1, 2012. The decrease in Manitoba's non-eligible dividend tax credit rate in 2011 reflects the reduction in the provincial small business rate from 1 to 0 percent on December 1, 2010. Ontario's non-eligible dividend tax credit rate will decrease in 2010 in step with the decrease in its small business rate from 5.5 to 4.5 percent on July 1, 2010. Prince Edward Island will decrease its non-eligible dividend tax credit rate in both 2010 and 2011 to correspond to decreases in its small business rate from 3.2 to 2.1 percent on April 1, 2009 and to 1 percent on April 1, 2010.

These changes increase the tax rates on non-eligible dividends in British Columbia, Manitoba, Ontario, and

Table 1 Non-Eligible Dividend Tax Credit Rates (on Grossed-Up Dividends)

	2009	2010	2011	2012
		percent		
Federal	13.33	13.33	13.33	13.33
Alberta	3.50	3.50	3.50	3.50
British Columbia	4.20	3.40	3.40	3.40
Manitoba	2.50	2.50	1.75	1.75
New Brunswick	5.30	5.30	5.30	5.30
Newfoundland and Labrador	5.00	5.00	5.00	5.00
Northwest Territories	6.00	6.00	6.00	6.00
Nova Scotia	7.70	7.70	7.70	7.70
Nunavut	4.00	4.00	4.00	4.00
Ontario	5.13	4.50	4.50	4.50
Prince Edward Island	3.20	2.10	1.00	1.00
Quebec	8.00	8.00	8.00	8.00
Saskatchewan	6.00	6.00	6.00	6.00
Yukon	4.45	4.45	4.45	4.45

Table 2 Top Combined Federal, Provincial, and Territorial Marginal Tax Rates on Non-Eligible Dividends[a]

	2009	2010	2011	2012
		percent		
Federal	19.58	19.58	19.58	19.58
Alberta	27.71	27.71	27.71	27.71
British Columbia	32.71	33.71	33.71	33.71
Manitoba	38.21	38.21	39.15	39.15
New Brunswick	34.21	30.83	28.83	27.96
Newfoundland and Labrador	32.71	32.71	32.71	32.71
Northwest Territories	29.65	29.65	29.65	29.65
Nova Scotia	33.06	33.06	33.06	33.06
Nunavut	28.96	28.96	28.96	28.96
Ontario	31.34	32.57	32.57	32.57
Prince Edward Island	38.15	39.66	41.17	41.17
Quebec	36.35	36.35	36.35	36.35
Saskatchewan	30.83	30.83	30.83	30.83
Yukon	30.49	30.49	30.49	30.49

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

Table 3 Integration: $10,000 Active Business Income Subject to Tax at the Small Business Tax Rate, Dividend Versus Salary Saving/(Cost)[a]

	2009	2010	2011	2012
		dollars		
Alberta	117	117	117	117
British Columbia	191	104	104	229
Manitoba	190	195	168	168
New Brunswick	126	140	148	151
Newfoundland and Labrador	211	211	211	211
Northwest Territories	485	485	485	485
Nova Scotia	448	448	448	448
Nunavut	289	289	289	289
Ontario	476	407	441	441
Prince Edward Island	95	31	(86)	(86)
Quebec	188	188	188	188
Saskatchewan	245	245	245	245
Yukon[b]	148	148	148	148

[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; for example, CPP contributions are not considered. Different results may arise in special circumstances (such as for credit unions). [b] The figures assume that Yukon's rate on non-M & P active business income applies; the tax savings are $253 on M & P income.

Prince Edward Island; table 2 shows the top combined federal and provincial or territorial marginal tax rates on non-eligible dividends. The changes also affect the integration of personal and corporate taxes; table 3 shows the tax saving or cost when corporate income subject to the small business rate is paid out as a dividend in lieu of salary. The changes also affect the integration of personal and corporate taxes on investment income, which will be discussed in a future article.

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

Customs Duty: Related Companies

A Canadian company engaged in cross-border trade with related parties often pays fees not related to the goods' purchase—for example, for management or administrative services. The Canada Border Services Agency (CBSA) recently issued new information on its policy concerning the treatment for customs duty purposes of certain payments or fees paid by a Canadian purchaser to a related vendor after the goods are imported into Canada (D memo 13-4-13, July 8, 2009). The CBSA says that many types of these "post-importation payments or fees" and "subsequent proceeds" may have to be included in the value of the imported goods declared for duty, unless the importer provides evidence to the contrary.

According to the CBSA, subsequent proceeds that form part of the value for duty may include any payment based on the resale of the goods that cannot be related by the importer to services received, management or administration fees, contributions to research and development, contributions to worldwide marketing or promotion, overhead expenses related to the manufacture of the goods but not captured in the sales price and recovered after importation, interest on deferred payments, and other payments made after importation. Subsequent proceeds are a post-importation payment and under customs law may have to be added to the goods' value for duty. Typically, such a payment accrues directly or indirectly to the goods' foreign vendor and is related to the resale, disposal, or use of the goods in Canada. Unlike royalties, subsequent proceeds do not have to be a condition of sale of the goods.

An importer should examine its agreements with any related-party trading partner to determine whether any payment thereunder should be included in the goods' value for duty. In particular, an importer should carefully examine any management and administrative fees paid to a related company. The CBSA's tests are designed to determine whether the payment was justifiable in relation to the service provided. An importer that relies on unwritten agreements or policies to make a payment is strongly advised to commit them to writing. If agreements are not clear or are nonexistent, the CBSA may require the payments to be included in the goods' value for duty. The D-memo guidance seems to imply that a payment not related to the goods may have to be included: "the mere fact that such payments exist requires that they be added to the price paid or payable." However, section 45(1) of the Customs Act says that " 'price paid or payable,' in respect of the sale of goods for export to Canada, means the aggregate of all payments made or to be made, directly or indirectly, in respect of the goods by the purchaser to or for the benefit of the vendor."

To avoid a dispute with the CBSA over an appropriate value for duty, an importer should have a clear understanding of the meaning of "value for duty" and ensure that its customs-related procedures are documented in detail, that its related-party agreements are clear and recorded in writing, and that a payment made to a related party is posted with clear documentation substantiating its rationale. If the CBSA determines that any payment should have been but was not included in the goods' value for duty, the importer risks penalties; exercising its right of appeal can be a lengthy and costly process.

Joseph Brick
KPMG LLP, Toronto

CRA on Section 116

A non-resident must generally notify the CRA before or within 10 days of the disposition of taxable Canadian property (TCP), a life insurance policy in Canada, non-capital Canadian real property, and Canadian resource and timber resource property (section 116). Amendments to the Act effective after 2008 and ongoing CRA initiatives are designed to alleviate the associated compliance burdens. The following is a précis of a recent CRA summary of its disposition program and initiatives. (For the full text of the CRA's release, see http://www.albertacas.ca/Libraries/Public_Practice_Bulletins_2009/CRA_section_116_Sept_09-ATC.pdf.)

Within 10 days after a disposition, or at least 30 days before a proposed disposition, a non-resident vendor must pay or provide security for the resulting tax and file the relevant form and any supporting schedule: (1) form T2062 (TCP); (2) form T2062A (Canadian resource and timber resource property, non-capital Canadian real property, and depreciable TCP) and supplemental schedule form T2062ASCH1 for Canadian resource property; and (3) form T2062B (life insurance policy in Canada) to be completed by the insurer on the non-resident's behalf, along with supplemental schedule form T2062BSCH1. A purchaser that is related to the vendor must file form T2062C to claim treaty-protected property status.

The forms are not prescribed but are recommended by the CRA. If they are correctly completed and include the documents listed thereon, the forms should contain the information required by the CRA to review the request and then issue a certificate of compliance. The review is based on the facts provided; if there is a risk of non-compliance, a complete verification is done.

Failure to notify the CRA of the disposition within 10 days exposes the non-resident to a penalty of $25 per day overdue, to a minimum of $100 and a maximum of $2,500. If a certificate of compliance (form T2064 or T2068) has not been issued, or if a certificate is issued and the actual proceeds exceed the certificate limit, the purchaser may be liable for tax related to the disposition; the purchaser may withhold 25 percent (50 percent in some cases) of the proceeds net of that limit, if any.

Treaty-protected property is property whose income or gain on disposition is fully part I exempt because of a tax treaty with the vendor's country of residence. If the vendor and purchaser of treaty-protected property are related, the purchaser must remit form T2062C within 30 days of its purchase of the property; otherwise, the vendor must notify the CRA of the disposition. If the parties are not related, neither of them is required to notify the CRA. However, because protection rests on the vendor being resident in a treaty country and the Canadian property being exempt under that treaty, the purchaser should make every reasonable effort to ensure that the property is treaty-protected, including determining the vendor's country of residence for treaty purposes (part D of form T2062C). The purchaser may further reduce its potential tax liability by filing form T2062C within 30 days of the acquisition. Generally, the CRA will not assess the purchaser if it has made every reasonable effort to determine that the property is treaty-exempt and has filed form T2062C within the 30-day period. The CRA does not generally acknowledge receipt of the form, but it will advise the purchaser if it is late-filed (a deficiency that invalidates the notice).

A non-resident vendor of TCP must generally file a tax return and attach copy 2 of the certificate of compliance, unless no tax is payable for the year of disposition, no tax is outstanding for a prior year, and each Canadian property disposed of in the year is excluded property or is not property for which tax or security must be remitted or provided to obtain a certificate of compliance.

In response to comments received in recent years, the CRA has undertaken pilot projects aimed at streamlining the review process to reduce processing time.

1) The CRA recently began comprehensive risk assessment in its review of all requests: low-risk files with all required supporting documents are processed quickly and certificates are issued forthwith.
2) The CRA will soon establish a pilot regional intake centre responsible for screening all requests to ensure that supporting documents are provided, creating individual tax numbers (ITNs) where required, and assessing each file's risk. A request related to a low-risk disposition will be processed at the centre; files requiring further review will be assigned to the TSO of record. If the pilot project is successful, regional intake centres will be established in all five administrative regions.
3) CRA representatives are meeting with tax practitioners across Canada to discuss the recent amendments to the Act and the implementation of the regional intake centres. The meetings will also provide opportunities for questions and comments about and suggestions for improvement of the CRA program as a whole.
4) The CRA is updating the disposition pages of its Web site as well as *Information Circular* 72-17R5 (March 15, 2005), which deals with section 116 procedures.
5) The CRA is also exploring possible improvements to internal systems used by CRA employees in the program.

Efficiencies in issuing certificates can also be achieved by the efforts of the non-resident vendor and its representatives in three areas:

1) If the vendor is an individual, a request for the required ITN should be made before the disposition by remitting form T1261 and supporting documentation to the International TSO; an ITN is usually issued within five working days.
2) The supporting documentation required for the issuance of a certificate of compliance should be submitted at the outset; a detailed list of required information is contained in each of the T2062 forms. Information deficiencies, which occur in 40 percent of all requests, delay the process: a certificate will not be issued without the documentation. If all required documentation is not available at the time of filing, in order to avoid a penalty the form should be filed on time and with a covering letter explaining that further information will follow shortly.
3) The covering letter accompanying the form should use the term "certificate of compliance"; use of the term "clearance certificate," which refers to another CRA program, will result in misdirection of the request and its delay.

Processing the vendor's tax return also takes less time if all the proper information is provided at the time of filing. A vendor should complete all details in the information area of the return, enter its identification number, and include copy 2 of the certificate of compliance, which is used to verify payments, security, and exemptions. If, due to a change in circumstances, the actual amount reported on the return differs substantially from the amount reported on the certificate of compliance, an explanatory note and the appropriate documentation should be attached to the return.

The CRA is striving to achieve a more efficient and successful disposition program. Comments, concerns, and suggestions for improvement should be directed to Steve Gillis, manager of the Disposition Program, at steve.gillis@cra-arc.gc.ca. For inquiries regarding the disposition of TCP or section 116, interested parties should call the International TSO at 1-800-267-5177.

Vivien Morgan
Canadian Tax Foundation, Toronto

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Please write to Vivien Morgan at vmorgan@bellnet.ca

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Canadian Tax Foundation
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Telephone: 416-599-0283
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Foreign Tax News

Treaties

A protocol to the **Switzerland-UK** treaty was signed on September 7, 2009 and, inter alia, contains an arbitration clause. The IRS revised Publication 597 ("Information on the United States-Canada Income Tax Treaty"), which discusses **Canada-US** treaty provisions frequently applicable to US citizens or residents. The Association of Southeast Asian Nations signed an **ASEAN-Australia-New Zealand** free trade agreement (expected to be in force by 2010); an **ASEAN-China** investment agreement (the final pillar in their free trade area); and an **ASEAN-India** trade in goods agreement (the first pillar in their free trade area). A **Switzerland-Japan** free trade agreement entered into force on September 1, 2009. **Netherlands** Finance announced public consultations on treaty fiscal policy; comments may be sent by October 1, 2009 to Ministerie van Financiën, Directie Internationale Fiscale Zaken, Postbus 20201, 2500 EE Den Haag.

An August 31, 2009 press release from the Swiss Federal Taxation Administration (FTA) states that the IRS had filed a request for administrative assistance for about 4,450 UBS accounts. As agreed earlier between UBS and the IRS, UBS will provide all requested information to the FTA, which will process it, issue a "conclusive decree," and direct its release to the IRS. Concerned persons may examine the records and appeal the decision. A conclusive decree must be issued for 500 of the cases within 90 days and for the balance within 360 days. Forty FTA legal and tax experts and 30 staff from an outside audit company (supervised by the FTA) will process requests.

France

The 2010 Finance bill reportedly includes the introduction in 2010 of a universal carbon tax on fossil fuel consumers, including households and businesses. Further measures to combat tax evasion may include (1) up to 50 percent withholding tax on interest, dividends, and royalties paid to tax haven residents and (2) the exclusion of dividends from tax haven affiliates from the participation exemption regime.

The Treasury minister announced that a VAT audit identified 3,000 French residents with undeclared Swiss accounts, and the accounts' balances. Commentators say it is unclear how the audit accessed the account balances.

OECD

The Committee of Fiscal Affairs released a proposed revision of chapters I to III of the transfer-pricing guidelines. The status of last resort currently assigned to transactional profit methods of transfer pricing is proposed to be revoked so that the transfer-pricing method to be used is the one that is most appropriate in the circumstances. Proposed additional guidance is given for those methods, and annexes contain practical illustrations. The general guidance of comparability analysis is updated, and a new detailed guidance is proposed. Comments may be sent in Word format only by January 9, 2010 to mjeffrey.owens@oecd.org.

On September 2, 2009, the Global Forum on Transparency and Exchange of Information, which now represents almost 90 countries, committed to a global monitoring and peer review process to examine each jurisdiction's legal and administrative framework for and progress in implementing standards. Negotiation of TIEAs will be accelerated and new multilateral options explored.

International Fiscal Association

The 63d Congress in Vancouver examined the PE concept in the context of, inter alia, the supply of software by a local server.

United Nations

The 25 new appointees to the UN Committee of Experts on International Cooperation in Tax Matters will serve until June 2013. The first annual session is set for October 2009 in Geneva. Revision of the UN model treaty is a priority.

China

On July 6, 2009, the State Administration of Taxation announced that monitoring and scrutiny of related-party transactions will increase to prevent MNEs from shifting losses to China. The profit margin must be reasonable and commensurate with function and risk; a new rule will require that contemporaneous documentation be filed in all cases before June 20 of the year following a loss year.

Vivien Morgan
Canadian Tax Foundation, Toronto