Canadian Tax Highlights

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Resident Trust and No Trust

In two recently reported TCC cases, Canadian taxpayers attempted unsuccessfully to use a Barbadian trust to avoid Canadian tax on the sale of a Canco. *Garron Family Trust* (2009 TCC 450) extended to trusts the corporate residence test of central management and control and concluded that the trusts were residents of Canada, not Barbados. *Antle* (2009 TCC 465) concluded that the spousal trust had not been properly constituted. We understand that *Garron* will be appealed, as will *Antle* if it has enough support as a test case.

Garron Family Trust. In an estate-freeze type of transaction, an opco's common shares were converted in 1998 to fixed-value preference shares with a total redemption price of $50 million. New commons were issued for nominal consideration to two new Canadian holdcos, each owned by a separate trust formed in Barbados. Mr. Garron's friend, who was resident in St. Vincent, settled the two trusts; another friend who was also resident there acted as a protector who could remove the trustee at any time. A captive trust company owned by a Big Four accounting firm was the trustee of both trusts. In 2000, the shares of both holdcos were sold out of the trusts and a capital gain of over $450 million was realized. The trusts filed section 116 certificates and remitted as tax 25 percent of the gain; they filed Canadian tax returns claiming a refund of that tax on the ground that the Canada-Barbados treaty exempted the capital gains from Canadian tax because the trusts were Barbadian residents. (Barbados does not tax capital gains.)

In the Tax Court, Woods J rejected the test used in the landmark decision of *Thibodeau* (78 DTC 6376 (FCTD)): that a trust is resident in the jurisdiction where the trustees reside and exercise their discretion. The court in *Garron* instead applied the central management and control test established for determining a corporation's residence. The TCC concluded that the FCTD in *Thibodeau* looked to the trustees' residence because it was appropriate on the facts. The facts also supported the underlying assumption that a trustee, unlike a corporate director, owes the beneficiaries a fiduciary obligation. However, the TCC also said that it was difficult to apply the *Thibodeau* logic in all cases because trustees do not always comply with their fiduciary responsibilities, and it noted that the FCA in *Robson Leather* (77 DTC 5106) also rejected the idea that the courts should presume that trustees will comply with their fiduciary obligations.

In determining that the trusts were resident in Canada, the TCC said that the trustee had no demonstrated expertise in managing trust assets and there was no evidence that it took an active role in the trusts' management, although the trustee had significant expertise in accounting and tax matters. There was little evidence that the trustee had any involvement in the trusts' affairs beyond the execution of agreements and in administrative, accounting, and tax matters. On the contrary, it was more likely than not that the trustee "had agreed from the outset that it would defer to the recommendations" of the Canadian-resident beneficiaries (the opco's principals) with respect to the holdco shares' purchase and sale, the investment of cash proceeds from the shares' sale, distributions to trust beneficiaries, and appropriate steps to minimize their tax burden.

Garron departs significantly from the established wisdom regarding a trust's residence and may affect that determination for many international and domestic trusts subject to Canadian tax law. *Interpretation Bulletin* IT-447 ("Residence of a Trust or Estate," May 30, 1980) advocates a central management and control test to establish a trust's residence, a test that the CRA has been using to challenge the residence of some trusts that are undeniably Canadian residents but purport to be resident in Alberta specifically. It is interesting that the court in *Garron* chose to embrace the corporate test for residence because, it said, in determining residence for a trust or corporation the relevant function at the core of each case is the management of property, which the trustee in that case failed to perform. A different conclusion might have been reached in *Garron* if the trustee had been more involved in the investment of the sale proceeds. For now, tax planners should ensure that a trust is centrally managed and controlled in the jurisdiction where the trustees reside.

Antle. In the *Antle* case, as in *Garron*, the taxpayer was attempting to avoid Canadian tax on a Canco's sale by using a Barbados trust. Mr. Antle, relying on a subsection 73(1) spousal rollover, gifted shares of a Canco to a

In This Issue

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spousal trust whose trustee resided in Barbados. The trust immediately sold the shares at FMV for a note to the wife and claimed the Canada-Barbados treaty's capital gains exemption. The wife sold the shares with their stepped-up cost base to a third party, realized no gain, and used the funds to pay her note held by the trust; the trust distributed the funds to the wife and then dissolved. The CRA said that the trust was a sham or had not been properly constituted, the spousal rollover rules had not been met or subsection 69(11) denied the rollover, and GAAR applied.

In the Tax Court, Miller J disposed of the matter on the grounds that the trust was never properly constituted. The taxpayer carried out a tax plan that was a tax product—the "capital property step-up"—marketed jointly by the Barbados trustee and an accounting firm, whose professional fees were partly contingent on the plan's success. A valid trust must satisfy three certainties: of intention (generally, the settlor must intend to gift); of subject matter (the identity of the trust property); and of objects (the identity of the beneficiaries). The TCC concluded that there was no certainty of intention: "[The taxpayer] never intended to lose control of the shares or the money resulting from their sale." Mr. Antle never intended to settle the trust with the shares; they were to be sold immediately and the proceeds distributed. Mr. Antle retained some interest in the shares and recovered the part of the proceeds paid to another former opco shareholder to smooth the sale of the shares out of the trust; thus, the second certainty was not achieved. Moreover, there were many uncertainties and irregularities in the sequencing of the documents' execution, to the point that the court concluded that the shares were never transferred to the trustee and thus the trust was never effectively constituted and had never existed. (The court said that the endorsement in blank of the share certificate without delivery was not a valid transfer—an arguable proposition, because share certificates merely evidence the shares.) In conclusion, the court said that the decision

> emphasizes how important it is, in implementing strategies with no purpose other than avoidance of tax, that meticulous and scrupulous regard be had to timing and execution. Backdating of documents, fuzzy intentions, lack of transfer documents, lack of discretion, lack of commercial purpose, delivery of signed documents distributing capital from the trust before its purported settlement, all frankly miss the mark—by a long shot. They leave an impression of elaborate window dressing. In short, if you are going to play the avoidance game, it is not enough to have brilliant strategy, you must have brilliant execution.

In obiter, the court also concluded that GAAR applied, allowing Canada to tax the Canadian principals: "The strategy is so contrary to the object, spirit, purpose, policy, call it what you will, of Canada's taxation laws with respect to capital gains, specifically as they relate to the marital unit, as well as to the very essence of international conventions that it could become a classic law school model of what GAAR was intended to capture." In further obiter, the court said that on the basis of the SCC decision in *Crown Forest* ([1995] 2 SCR 802), the trust was not taxable on its worldwide income under paragraph 94(1)(c) and therefore fell outside the ambit of what constitutes a Canadian resident for treaty purposes.

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PST Planning: No GAAR

A number of tax cases have said that taxpayers can freely structure their transactions to achieve tax benefits, but the federal GAAR hurdle must be overcome if income tax or GST benefits are achieved and the CRA avers that the planning structures are abusive and inconsistent with the legislation's object and spirit. In the provincial sales tax (PST) context, however, most retail sales taxing systems do not have a GAAR. The British Columbia Supreme Court in *Terasen Gas Inc.* (2009 BCSC 1030) appears to have confirmed that legitimate tax-planning transactions are effective for PST purposes.

At a cost of $64 million, Terasen constructed a natural gas pipeline from equipment including pipe, compressors, and related material. To minimize the PST exigible on the equipment's purchase, Terasen structured the transaction using a trust (a subsidiary was the beneficiary) and a resale and leaseback. Terasen initially purchased the equipment from third-party suppliers for resale to the trust, which acquired the equipment solely for the purpose of a leaseback to Terasen. After the leaseback, Terasen installed the pipe, burying it in land owned by third parties.

The structure was devised because the Social Service Tax Act (SSTA) imposed PST only on a purchaser who acquired tangible personal property (TPP) for its own use. The definition of "use"—which excluded a resale—in combination with other special definitions led the court to conclude that each of the initial purchase and resale by Terasen escaped PST, and the leaseback to it was taxable only as each lease payment was made. However, the court said that once the equipment was buried in the ground, it became a fixture and was thus no longer TPP; consequently, the lease payments were thereafter not subject to PST. As a result, Terasen paid only a small amount of PST on the lease payments. After an audit, Terasen was assessed for, among other things, PST on the service costs of installing the pipe. Terasen's appeal to the minister of small business and revenue was allowed in part, and Terasen appealed that decision to the BC Supreme Court.

The main issue before the court was whether the lease agreement between the trust and Terasen was in substance a sale and not a lease; a sale would attract PST. The minister argued that tax planning was not illegal, but (quoting *Stubart Investments* ([1984] 1 SCR 536)) said that Terasen's plan was "unrecognizable in the eyes of the taxation program adopted by the legislature." The minister also said that the true nature of the transaction should be determined by considering the initial purchase, the resale, and the leaseback, not individually but as parts of a whole transaction. Terasen's position was that all the transactions were legitimate and resulted in beneficial tax effects under various SSTA rules, and that the sale and leaseback method was a legally acceptable activity.

The court cited cases that confirmed that a taxpayer's bona fide legal relationships should be respected unless they violated a provision of the legislation or they were a sham, and concluded that the lease agreement—although motivated by a desire to minimize PST—was still in substance a lease. Furthermore, the legal structure of the transaction was in accord with the parties' intentions and conduct, and the court should respect the legal structure adopted by the parties.

Terasen is welcome confirmation that a taxpayer can structure its affairs legitimately to reduce its PST liability. However, the judgment may not withstand the test of time, even for the limited period in which PSTs are in place. The court unfortunately failed to address, for example, the doctrine in *Cairns Construction* ([1960] SCR 619) (and other rules in the SSTA) that should have operated to make either the lessee or the lessor liable for PST on the equipment's fair value just before it became a fixture. Like the contractor who hammers a nail into the roof of a house and is liable, as the nail's last user, for PST on its fair value, perhaps either the owner or the lessee of the equipment should have borne tax on its change in use from TPP to real property.

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Corporate Taxation Statistics

The CRA has released the second edition of its electronic version of *Corporation Income Tax Statistics* (http://www.cra-arc.gc.ca/gncy/stts/gb05/pst/t2/menu-eng.html). The 1,557,033 corporations reported income of $307 billion before the elimination of exempt and duplicated income in 2005, the latest year for which data are available.

The CRA's Web site tables indicate that 1,463,681 of the corporate filers were classified as small corporations eligible for the full small business deduction. Only 93,352, or 6.0 percent of the total, were considered large corporations. However, the small corporations contributed only 19.2 percent of total federal tax in 2005; in the other four years shown in the publication, the ratio ranged close to 16 percent.

Net Federal Tax as a Percentage of Income, Tax Years 2001 to 2005

	Small companies	Large companies	All companies
2001	12.0	23.9	20.6
2002	11.6	24.3	20.6
2003	11.4	24.2	20.6
2004	11.5	21.7	18.9
2005	11.9	21.2	18.4

The table shows how rate reductions have lowered the effective rate of tax on taxable corporate income. In the tax years 2001 to 2003, total federal tax as a percentage of taxable income for all corporations stayed steady at 20.6 percent. In 2004, that ratio dropped to 18.9 percent and in 2005 to 18.4 percent. Because the rate reductions were concentrated on the higher corporate rate, the effective rate for small businesses remained relatively constant. The effective rate for large companies dropped from approximately 24 percent in the first three years to 21.7 percent in 2004 and 21.2 percent in 2005.

The electronic version of *Corporation Income Tax Statistics* contains far less detail than the previous printed version. Notably, the new version is missing a reconciliation of book profit and taxable income. The effective tax load is a function of both rates and base. Without a detailed analysis of the tax base's construction, which the printed reconciliation tables contained, the true effect of the corporate tax system remains impenetrable to the serious student of taxation. The book profit as reported in Statistics Canada's national income and expenditure accounts does not easily reveal the same degree of detail.

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Freeze Share Valuation

The CRA resolved some uncertainty surrounding the valuation of voting non-participating shares in an estate freeze in a round table session at the Foundation's BC tax conference held on September 21-22, 2009.

Income Tax Technical News no. 38, September 22, 2008 (ITTN 38) states that the CRA "does not have an established position on valuing different types of property" and "it is not the intention of the CRA to write a policy or state a formal position regarding this issue. . . . [I]t is the opinion of the CRA that a hypothetical purchaser would be willing to pay some amount for the voting control of a company. It is difficult to ascertain what a pure voting right would be worth. However, the answer to this question will depend on the facts and circumstances of each case." The Vancouver Tax Services Office (TSO) is assessing a premium on private company voting non-participating preference shares acquired on an estate freeze and held by a taxpayer at death (see "Premium for Voting Control on Estate Freeze," *Canadian Tax Highlights*, June 2008). The CRA was asked to comment on the following questions.

- "Is there a difference between the CRA's opinion and a CRA policy on this item?"
- "Many estate freezes rely on . . . assumptions about hypothetical purchasers and share values [such as] the assumption that 'freeze shares' hold all the value of a corporation at the time of a freeze. Is the CRA proposing to recommend that a premium be placed on new common shares issued after a freeze?"
- "Assuming that the CRA 'control premium' opinion is a relatively new assessing position, what steps will the CRA take to ensure that a tax premium is not assessed against estate plans that relied on the assumption that voting non-participating preference shares do not have a premium in value?" (The CRA was asked whether it would support rectification applications or the prospective application of the policy to reduce the legal and accounting costs of existing plans that rely on the assumption that there is no control premium.)

In its response, the CRA referred to ITTN 38 and reiterated that it does not have an established position on valuing different types of property, including shares, because valuation is fact-dependent. The CRA also referred to *Information Circular* 89-3, "Policy Statement on Business Equity Valuations," which outlines valuation principles and policies that the CRA considers and follows when it evaluates securities and intangible property of closely held corporations for income tax purposes. In determining the FMV of a class of shares, the CRA said that it first determines the corporate FMV as a whole (en bloc) and then allocates that value to each share class in isolation and according to the rights and restrictions; voting control is a right that may have significant value. The CRA takes the position that non-participating controlling shares have some value and may therefore bear a premium. However, in the context of an estate freeze that involves a CCPC and in which the freezor retains controlling non-participating preference shares to protect his or her economic interest in the corporation, the CRA generally will "not take into account any premium that could be attributable to such shares for the purposes of subsection 70(5)," the deemed disposition at FMV at the freezor's death.

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LRIP Eliminated: Non-Resident Shareholders

A recent technical interpretation (2009-0308511E5, March 16, 2009) comments on the computation of a non-CCPC's low-rate income pool (LRIP) when an eligible dividend is paid to its shareholders, some of whom are non-residents. On the facts given in the TI, the dividend payable to non-residents exceeds the LRIP balance. The TI concludes that the portion of a dividend that was designated as an eligible dividend but is payable to non-resident shareholders is in fact a non-eligible dividend that reduces the corporation's LRIP when the dividend becomes payable.

If the dividend is legally payable before it is paid, the logical result of the comments in the TI is an automatic reduction of the LRIP balance before the dividend distribution by the amount of the non-eligible portion of the dividend. The timing of the LRIP balance reduction is crucial, because a public company and other non-CCPCs can designate dividends as eligible only if they do not have an LRIP balance at the time the dividend is paid. The amount of the otherwise eligible dividend paid to non-residents must at least equal the LRIP balance.

An "eligible dividend" is a taxable dividend received by a Canadian resident, paid by a Canadian-resident corporation, and designated by the corporation as eligible. A corporation must designate the whole amount of a dividend it pays. A public company and any other non-CCPC can designate eligible dividends only if they do not have an LRIP at the time the dividend is paid. Generally, an LRIP exists if the non-CCPC receives non-eligible dividends (for example, from a CCPC) that are deductible under section 112; an LRIP also exists if a CCPC elects to be treated as a non-CCPC and earns investment income subject to refundable tax treatment. In determining an LRIP balance at the time a particular dividend is paid by a non-CCPC, an LRIP is reduced, inter alia, by the total taxable dividends (but not, for example, eligible dividends) that became payable in the taxation year that the particular dividend was paid but before its actual payment. The TI responds to these questions: Does the portion of a taxable eligible dividend paid by a non-CCPC to non-resident shareholders constitute a non-eligible dividend? If so, when does that non-eligible dividend reduce the LRIP?

On the TI's facts, a non-CCPC declares a taxable dividend on its shares held by Canadian residents and non-residents and designates the whole dividend as an eligible dividend. Before the dividend is paid—and presumably before it became payable—the non-CCPC has a positive LRIP balance that is less than the portion of the whole dividend payable to the non-resident shareholders. The CRA confirmed that if a non-CCPC designates a whole taxable dividend as an eligible dividend and then pays the dividend, only the portion received by Canadian residents is an eligible dividend; the portion received by non-residents is a non-eligible dividend.

The CRA also confirmed that as long as the dividend is legally payable before it is paid, the non-eligible portion of the dividend that is payable by the non-CCPC to the non-resident shareholders reduces the LRIP balance when the dividend becomes payable and thus is included in variable G of the LRIP definition at the time of the dividend's payment. On the facts given in the TI and on the assumption that the dividend was payable before it was paid, the LRIP balance is nil at the time the dividend is paid.

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Business Continuity: Subsection 98(5)

A recent technical interpretation (document 2008-0275151E5, July 9, 2009) comments on the requirement in subsection 98(5) that a partnership business continue to be carried on by a sole proprietor to secure a rollover of property out of the partnership.

When a partnership ceases to exist and, within three months, one partner continues to carry on alone the partnership business and to use the partnership property in the course of that business, subsection 98(5) generally provides that the sole proprietor's cost of the partnership property is the partnership's cost amount. The sole proprietor's deemed proceeds of his partnership interest are the greater of (1) its ACB and (2) the total of the cost amount of the property received from the partnership and any other proceeds received by him.

The TI includes two examples constructed for the purpose of discussing elements of subsection 98(5)'s requirements: (1) when the partnership business is considered to be carried on "alone" by the former partner, and (2) whether a corporation's shares held by a partnership can ever be viewed as "used in the course of business." In each case, the CRA's administrative position offers welcome clarification of the uncertainty created by the rule's precise wording.

■ The first example assumes a tiered partnership whose top-tier partnership owns only an interest in the lower-tier partnership. The CRA says that the sole proprietor meets the "business continuity" test when the top-tier partnership ceases to exist and the proprietor earns income in respect of his newly acquired interest in the lower-tier partnership, even though the proprietor is not the only partner in the lower-tier partnership and does not carry on its business alone or own all of its partnership interests. The proprietor satisfies the test because he carries on alone the business that the top-tier partnership formerly carried on—namely, the activities of the lower-tier partnership (thus indirectly using the assets of that partnership) as a member of that partnership. This view is consistent with advance ruling no. 9633813 (1997), which states that the CRA views partners as carrying on a partnership's business and suggests that the asset-use test in a tiered partnership is satisfied. (Section 253.1, which deems a limited partner not to carry on the limited partnership business, does not apply for the purposes of subsection 98(5).)

■ The second example assumes that a partnership's only activity is its ownership of an opco's shares. Subsection 98(5) applies only to partnership property used in the partnership's business; any non-business partnership assets presumably do not benefit from a tax-deferred transfer to the sole proprietor. The CRA says that subsection 98(5) applies as long as the proprietor earns income in respect of the newly acquired opco shares, on the assumption that the partnership was a valid partnership even though the opco's shares were its sole asset.

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Owner-Manager Year-End Tips, Part 1

It is time for owner-managers to focus on year-end planning and determine their optimal salary-dividend mix.

■ Determine the optimal salary-dividend mix that minimizes overall taxes for the owner-manager and family members. Consider the owner-manager's marginal tax rate, the corporation's tax rate, provincial health and/or payroll taxes, RRSP contribution room, CPP contributions, and other deductions and credits such as those for child-care expenses and charitable donations.

■ To be deductible, salaries and bonuses must be accrued before the business's year-end and paid within 179 days thereof. It may be beneficial to pay a reasonable salary to a spouse or child who provides services to the business and is in a lower tax bracket.

■ An owner-manager may set up an employee profit-sharing plan or retirement compensation arrangement as an alternative to paying a bonus, or an individual pension plan to enhance retirement income.

■ Consider dividend distributions in the following order: (1) eligible dividends that trigger a refundable dividend tax on hand (RDTOH) refund, (2) non-eligible dividends that trigger an RDTOH refund, (3) eligible dividends that do not trigger an RDTOH refund, and (4) non-eligible dividends that do not trigger an RDTOH refund. Depending

Determining the Optimal Salary-Dividend Mix (December 31, 2009 Year-End and $10,000 ABI)

	Eligible for small business deduction		No small business deduction, no M & P deduction		No small business deduction, M & P deduction	
	Deferral	Saving	Deferral	Saving/(cost)	Deferral	Saving/(cost)
			dollars			
Alberta	2,500	117	1,000	(33)	1,000	(33)
British Columbia	3,020	191	1,370	(24)	1,370	(24)
Manitoba	3,552	190	1,602	(30)	1,602	(30)
New Brunswick	3,000	126	1,450	(43)	1,450	(43)
Newfoundland and Labrador	2,959	211	1,259	(274)	2,159	420
Northwest Territories	3,005	485	1,455	187	1,455	187
Nova Scotia	3,225	448	1,325	(518)	1,325	(518)
Nunavut	2,750	289	1,150	(384)	1,150	(384)
Ontario	3,093	476	1,443	(102)	1,643	52
Prince Edward Island	3,400	95	1,237	(352)	1,237	(352)
Quebec	3,133	188	1,943	(109)	1,943	(109)
Saskatchewan	2,850	245	1,300	(104)	1,500	55
Yukon	2,740	148	840	(297)	2,090	737

Note: It is assumed that the individual is taxed at the top marginal income tax rate. Only federal and provincial income tax, the employer portion of provincial health tax, and the employee portion of payroll tax (for Northwest Territories and Nunavut) are considered. The SBD figures for Yukon assume that the rate on non-M & P ABI applies; if the M & P ABI rate applies, the tax deferral and tax savings are $2,890 and $253, respectively.

on the jurisdiction of residence, however, payment of non-taxable capital dividends is the second or third preference.

■ In all provinces, ensure that owner-manager remuneration strategies consider increases in personal taxes on eligible dividends from 2010 to 2012. A corporation in any jurisdiction (except New Brunswick) may wish to accelerate to 2009 the distribution of discretionary eligible dividends in order to take advantage of that year's lower eligible dividend tax rates. Be aware that eligible dividends may increase an owner-manager's alternative minimum tax exposure, and that acceleration of dividend payments also accelerates the payment of income taxes. (For changes to eligible dividend tax rates, see "Eligible Dividend Rates Update," *Canadian Tax Highlights*, July 2009.)

■ A corporation in British Columbia, Ontario, or Prince Edward Island may wish to accelerate to 2009 the distribution of discretionary non-eligible dividends in order to take advantage of that year's lower non-eligible dividend tax rates. (For changes to non-eligible dividend tax rates, see "Non-Eligible Dividend Rates Update," *Canadian Tax Highlights*, September 2009.)

■ A corporation in New Brunswick may wish to defer to 2010 and later years the payment of salary and/or discretionary eligible and non-eligible dividends in order to benefit from that province's staggered decreases in personal tax rates from 2010 to 2012.

■ Forgoing bonus payments and/or dividend distributions out of excess cash may cast doubt on whether substantially all of a CCPC's assets are used in an active business. Thus, the CCPC's shares' status as QSBC shares may be jeopardized, along with the shareholder's ability to claim the $750,000 lifetime capital gains exemption on the shares' sale.

■ Forgoing bonus payments may result in a CCPC's generating SR & ED investment tax credits (ITCs) that are non-refundable and calculated at the lower ITC rate. If the CCPC does have non-refundable ITCs, ensure that the level of bonus payments leaves sufficient income to attract enough federal corporate income tax to absorb the non-refundable ITCs.

■ If the owner-manager does not need to extract cash, consider retaining income at the corporate level. In uncertain economic times, cash damming improves the corporation's cash flow and allows the corporation to report income and pay corporate tax that it can recover if potential business losses materialize. If income is retained for later offset with a loss carryback, it is preferable to offset income that was taxed at the general rate.

■ Tax is deferred if the corporation retains income when its tax rate is lower than the individual shareholder-employee's rate. The table shows the income tax deferral if active business income is retained in a corporation and not paid out as salary to the shareholder-employee, and the tax saving (or cost) realized when the after-tax corporate income is paid out as a dividend.

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NY Sales Tax Nexus Expands

New York recently enacted two laws expanding the nexus for its sales and use tax. The changes reflect a trend among US states to apply more aggressive theories of "attributional" and "affiliate" nexus to establish a physical link with out-of-state sellers and oblige them to collect state taxes. The trend may surprise many Canadian companies that sell in the United States, such as Canadian manufacturers that sell on the Internet or through commission agents in the United States.

One new law adds affiliate nexus rules to the definition of a company that must collect sales taxes, effective June 1, 2009. A seller that has no physical presence in the state but has an affiliate with a New York presence and certain defined connections with the seller must collect sales tax from its New York customers. "Affiliation" is defined as more than a 5 percent ownership link between the in-state party and the out-of-state seller, but there must be a further connection before the in-state party's presence can be attributed to its out-of-state affiliate. Currently, that further connection is satisfied if a New York affiliate solicits for an out-of-state seller: the new law adds other connections that may create nexus for the seller, such as sharing the same trademark or name with the in-state affiliate. The new law also expands the types of activities that are considered to be solicitation—and that create attributional nexus—to include activities such as customer referral, acceptance of returns, handling distribution, and performing repair services. If the ownership link exceeds 50 percent and the New York affiliate engages in any of these activities, nexus is presumed to be created for the out-of-state seller. If the ownership link is between 5 and 50 percent, exclusive, the state evaluates the connections and degree of control to determine whether nexus with the out-of-state seller exists.

New York's second new law—the "Amazon law," after the bookseller—obliges an Internet retailer to collect New York sales taxes from its New York customers. If a New York resident provides a click-through link to a retailer's Web site, a rebuttable presumption arises that the resident is soliciting on the retailer's behalf, thus creating a physical presence in the state for the retailer. Certain thresholds apply, but once the presumption arises, the state's requirements for its successful rebuttal are very difficult to meet. Amazon.com and Overstock.com sought judicial confirmation that this law was unconstitutional under the commerce, due process, and equal protection clauses, but their application was dismissed in January 2009. Since then, nearly a dozen other states have proposed or enacted similar rules.

The expansion of nexus to include a corporation that uses a state as a market only, without any local employees or assets, is a very attractive route for cash-strapped state governments to launch more aggressive tax-collection efforts. A Canadian or other foreign entity should not count on avoiding scrutiny, because state tax authorities are beating the bushes for any revenue source to help reduce their deficits. In particular, a Canadian manufacturer that sells through affiliated or third-party commission agents in the United States should consider whether its current operating structure creates potential tax exposure under new state initiatives. An Internet seller or a company that provides digital services (such as Web site maintenance, online information databases, e-fax, and services that facilitate audio or video streaming) to other Internet users should be aware that tax laws are evolving to catch up with new ways of doing business. A regular review of ever-changing tax laws is essential to avoid unpleasant surprises.

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Offshore Funds' Interest: ECI?

A recent IRS internal memo says that interest earned by a foreign corporation from loans to US borrowers can be taxed under the Code as effectively connected trade or business income (ECI) if the foreign corporation retains a US agent to provide loan origination services.

The memo transaction involved a foreign corporation (Forco) organized in a non-treaty country. All of Forco's shares were held by non-US persons. Forco loaned to US persons within the United States, but it had no office or employees there. Forco retained and paid arm's-length fees to a US corporation (USco) under a service agreement to perform all activities relating to loan origination, including solicitation, negotiation, and credit analysis. USco had no authority to conclude contracts on Forco's behalf; Forco's employees outside the United States had final approval of any loan and signed the loan documents. USco performed its services from its US-situs office and conducted those services on a considerable, continuous, and regular basis. No information was provided on the relationship between Forco and USco. The memo addressed whether the interest that Forco earned from those loans was taxable under the Code as ECI. (Interest that was not ECI would be portfolio interest.)

Generally, a non-bank Forco can earn US-source interest on arm's-length loans without US tax. Offshore funds rely on this portfolio interest exemption to earn US-source interest free of US tax; but if the interest is ECI, US tax applies as if a US domestic corporation had earned it. Income is ECI if (1) Forco carries on a trade or business in the United States and (2) the income is effectively connected with that US trade or business. There is little guidance on when Forco's lending activity rises to the level of a US trade or business: the memo provides little clarification and stresses that an examination of the issue is not within the memo's purview, although the facts largely assume that a US trade or business exists. The memo clarifies that the Code safe harbours—which exclude trading in securities in the United States through an independent agent or on one's own account from being a US trade or business—do not apply to a lending activity, which does not involve "trading."

The memo's main focus is the ECI issue. If Forco lends to US borrowers as part of the active conduct of a "banking, financing or similar business," under the regulations Forco is considered to earn interest that is ECI if the underlying securities are attributable to the US office through which the business is carried on and those securities were acquired as a result of making loans to the public. A security is attributable to a US office only if it actively and materially participates in soliciting, negotiating, or performing other activities required to arrange its acquisition. Previously, many practitioners thought that for interest to be considered ECI, the US office that earned the interest must belong to the lending Forco, and they generally did not contemplate that the US office might belong to an independent agent or have no authority to contract. The memo clearly rejects this position: to satisfy the regulatory requirement that the lending activity be attributable to a US office, the office may belong to Forco's dependent or independent agent and need not belong to Forco itself. Thus, on the memo's particular facts, Forco's interest was considered ECI vis-à-vis its US trade or business.

The memo does not directly affect Canadian-resident lenders because the Canada-US treaty's requirement of a PE exempts ECI of a Canco from US tax in circumstances similar to those set out and assumed in the memo. The memo's intended targets appear to be loans made through offshore funds or corporations resident in non-treaty jurisdictions. The memo encourages IRS field offices to review other strategies that structure US-inbound loans purporting to avoid ECI characterization. The memo appears to reflect both a more aggressive IRS approach to reduce US tax base erosion through existing law and a concern that the present regime for taxing interest earned by nonresidents may be lacking because today's capital markets contain a significant non-bank lender population.

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Inversion Regs: Private Placements

The IRS has announced that it will issue new regulations governing foreign inversions, further limiting the ability of a foreign corporation to acquire a USco without triggering unfavourable US tax results (Notice 2009-78, 2009-40 IRB 452). Congress first enacted the corporate inversion regime in 2004 to address the expatriation of USco s in circumstances that appeared to lack a legitimate business purpose. Since then, the IRS has gradually tightened the rules through a series of temporary regulations. The latest regulatory change addresses third-party investments in foreign acquisitions of a USco.

A corporate inversion occurs when (1) a foreign acquiring corporation (forco) acquires substantially all of a USco's properties; (2) the post-acquisition "expanded affiliated group," which includes the forco, does not have substantial business activities in the foreign country where the forco was organized; and (3) after the acquisition, at least 60 percent of the forco's stock (determined by vote or value) is owned by the USco's former shareholders. Similar rules apply if the forco acquires substantially all the properties constituting a US partnership's trade or business. Certain forco stock is disregarded in determining how much is owned by the former USco shareholders: (1) forco stock held by members of the expanded affiliated group, which includes the USco, and (2) forco stock sold in a public offering related to the acquisition.

Sixty percent stock ownership is the minimum level that invokes the inversion rules. Once that level is attained, an inversion's tax consequences depend on whether the former USco shareholders' ownership in the forco reaches 80 percent or more. If the former USco shareholders own between 60 and 80 percent of the forco acquiror's shares, the forco's status as a foreign corporation is respected, but certain corporate-level "toll charges" that may apply cannot be offset by tax attributes such as net operating losses or foreign tax credits. If the former USco shareholders own 80 percent or more of the forco's stock after the acquisition, the forco is treated as a US domestic entity for all US tax purposes: it is subject to US income tax on its worldwide income and its stock is considered to be a US-situs asset subject to US estate tax—an important consideration for any non-US shareholder.

Until the latest regulations were announced, the USco shareholders could minimize their forco share ownership for the purposes of the 80 percent ownership test by bringing in an outside investor. For example, the USco shareholders could transfer all of their USco stock to a newly formed forco in exchange for less than 80 percent

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of the new forco's stock. In a related transaction, the investor transferred cash to the new forco in exchange for more than 20 percent of its stock; because these forco shares were not "sold in a public offering" to the investor, they were counted for the purposes of determining whether the former USco shareholders owned at least 80 percent of the forco. The former USco shareholders owned less than 80 percent of the forco shares, and thus the forco's status as a foreign entity was respected for US tax purposes.

The new regulations are intended to curb this private placement practice, which the IRS believes manipulated the inversion rules by using a third-party investor. Under the new regulations, applicable to acquisitions completed after September 16, 2009, forco stock issued in exchange for "nonqualified property" in a transaction related to the acquisition—whether or not the stock is publicly traded—is not taken into account for the purposes of applying the ownership test. With certain exceptions, the term "nonqualified property" is defined as (1) cash or cash equivalents, (2) marketable securities, and (3) any other property acquired in a transaction whose principal purpose is avoidance of the inversion rules. Marketable securities generally do not include stock (or a partnership interest) issued by a member of the post-acquisition expanded affiliated group, which includes the forco.

The following example illustrates the new regulations' effect. Individual A wholly owns USco. Forco X, a newly formed corporation, acquires all of USco's stock in exchange for Forco X stock only. In a transaction related to the USco stock acquisition, a Canadian partnership transfers marketable securities to Forco X solely in exchange for Forco X stock. Under the new regulations, Forco X stock issued to the Canadian partnership is not taken into account in determining the amount of stock owned by the former USco shareholders. The former USco shareholder is treated as owning 100 percent of Forco X's stock after the acquisition, and Forco X is treated as a US domestic entity for US tax purposes.

The new regulations thus expand the type of forco stock that is disregarded for the purposes of applying the ownership test to encompass stock issued under a private placement. Combined with the June 2009 temporary regulations' removal of the "substantial business activities" safe harbour (TD 9453, 2009-28 IRB 114), the new regulations will have a chilling effect on the acquisition of a USco by a forco.

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FOREIGN TAX NEWS

Canada's Tax Treaties

Negotiations on the **Canada-Netherlands** treaty commenced the week of October 5, 2009 in Ottawa. Interested persons may submit comments to Finance, particularly regarding difficulties encountered under the Netherlands tax system. Write to Department of Finance, 17th Floor, East Tower, 140 O'Connor Street, Ottawa K1A 0G5. For further information contact Sophie Chatel, Tax Legislation Division, (613) 995-3586.

France

The president's office confirmed that French banks undertook to close branches and subsidiaries in OECD grey-listed jurisdictions. BNP Paribas previously decided to close its operations in Bahamas and Panama.

OECD

The Council of Europe announced that before the G20 meeting in March 2010 it expects to revise the Convention on Mutual Administrative Assistance in Tax Matters to reflect closer international cooperation related to the exchange of information in the context of bank secrecy legislation. The treaty will be opened to non-OECD members to facilitate a worldwide effort to combat tax evasion.

Many countries worldwide are negotiating and signing exchange-of-information agreements. Aruba, Austria, Belgium, and the Netherlands Antilles are among those that have substantially met the internationally agreed-upon standard for exchange-of-information agreements. Austria also curbed its bank secrecy rules for non-citizens.

Annual statistics will be publicly available on the OECD Web site to show the mutual agreement procedure (MAP) caseloads of members and of non-members that provide such information. The OECD's MAP work intends to improve the timeliness of MAP case completion and the transparency of the process.

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