CANADIAN TAX Highlights

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Auditor General: Legislative Process Too Slow

The *2009 Fall Report of the Auditor General of Canada* comments on the slow pace of the federal tax legislative process, the comfort letter process, and the CRA's issuance of advance tax rulings and technical interpretations. The 26-page discussion in chapter 3 of the report, released on November 3, 2009, includes several recommendations that both Finance and the CRA improve their processes for tax legislation or related interpretive guidance.

Taxpayers will be pleased to note that the AG makes a specific example of old Bill C-10, which died on the order paper on September 7, 2008 with the last election call. The bill contained more than 155 clauses of technical amendments, including the foreign investment entity (FIE) and non-resident trust (NRT) rules, which still have not been reintroduced. Some of these technical amendments date back to December 20, 2002. Both the CRA and Finance agreed with the AG's recommendations and with the use of old Bill C-10 as an example.

In addition to the 155 outstanding technical amendments in old Bill C-10, the AG estimates that at least 250 other technical amendments identified by Finance have not yet been drafted or released for comment. No income tax technical bill has been passed since 2001, although the government concluded that an annual technical bill was desirable.

The AG also notes that between 1996 and 2008, Finance issued 297 comfort letters, and the recipients and other taxpayers may be assessed on that basis. To date, only 46 of the issues dealt with in the letters have become law. Because no legislation has been developed or released for most comfort letters issued after 2002, as many as 250 of the identified legislative deficiencies that require technical amendments arise from comfort letters alone.

The AG also comments on communication between the CRA and Finance. The AG says that the current list of income tax legislative issues identified by the CRA's Compliance Programs Branch includes approximately 150 items. The 2008 list of issues submitted to Finance for possible inclusion in a technical bill contains 108 items, up from 54 in 2005.

The AG further notes that technical issues are not systematically tracked and monitored within the CRA, nor is there any "systematic review of their impact on compliance or on the tax base." The report highlights the example of the use of tax losses by unaffiliated corporations, which the CRA identified to Finance as an area in need of legislative amendments.

> The *Income Tax Act* contains many provisions that are designed to ensure that a corporation's tax losses cannot be used by unaffiliated corporations unless certain conditions are met.
>
> In recent years, some transactions have been designed to get around these rules, described as "tech-wreck" restructurings. The name arose from the use of losses originating in the technology sector.
>
> The [CRA]'s Legislative Policy Directorate wrote to [Finance] on 1 February 2001, following up on a request from the Income Tax Rulings Directorate about inappropriate use of losses . . . [and again] on 8 March 2004 regarding more recent inappropriate corporate reorganizations involving losses.
>
> A meeting was held in August 2005 on the trading of non-capital losses and other losses. Staff from the [CRA] and [Finance] attended.
>
> The [CRA]'s Legislative Policy Directorate wrote to [Finance] again in 2007 on the same issues involving loss trading and informed [Finance] of another scheme that it believed was resulting in tax revenue losses. The [CRA] again asked [Finance] to recommend legislative amendments.
>
> To date, the issue remains unresolved.
>
> The [CRA] has stated in Income Tax Technical News #34 that it will apply the [GAAR] to such transactions. Any resulting litigation will likely take several years before the uncertainty is resolved.

To improve legislative maintenance, the AG recommends that Finance take the following steps:

- Implement "an integrated and consistent process for recording, tracking, and prioritizing all technical issues for possible legislative amendment."

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■ "[D]evelop and implement a plan to address the current backlog of necessary technical amendments."

■ "[R]egularly develop and release draft technical amendments, including those that arise from comfort letters, so that taxpayers and tax practitioners know what changes will be made and can provide input."

The AG also recommends that the CRA take the following steps:

■ "[C]reate an electronic database to help validate, analyze, and prioritize identified technical issues that should be referred to [Finance] and to track how they are addressed."

■ "[D]evelop more concrete plans to meet its own target times for issuing advance tax rulings, given the significance of the rulings to the proposed business transactions."

■ "[I]mprove the information it provides to users about specific paragraphs in Income Tax Interpretation Bulletins that are no longer accurate." (Interestingly, the CRA indicates in its response to the AG that it may "cancel its inventory" of IT bulletins, given the other mediums available for this kind of information; the CRA will evaluate this option in 2010.)

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Challenging a Director's Derivative Liability

A director can be derivatively assessed under the Income Tax Act (and the Excise Tax Act) if the corporation fails to remit taxes. The CRA says that generally a director cannot defend against derivative liability by contesting the underlying assessment if the corporation failed to do so. In *Barry* (2009 TCC 508), the TCC confirmed that the FCA decision in *Gaucher* (2000 DTC 6678) extends to a director's derivative liability, allowing him or her to attack the original corporate assessment. *Gaucher* dealt with spousal liability under an ITA section 160 assessment; case law has been mixed on whether *Gaucher* applies to a director's derivative assessment.

In *Gaucher*, the appellant's former husband transferred a residence to her at less than FMV and entered bankruptcy after the TCC confirmed an assessment against him for $350,000. The CRA assessed the wife under subsection 160(1) as jointly and severally liable for the primary assessment against her husband because of the transfer at less than FMV. The wife alleged that the primary assessment was statute-barred, a defence the husband had not raised; the TCC said that a secondary taxpayer cannot interfere with the court's earlier confirmation of the primary assessment. The FCA disagreed: "It is a basic rule of natural justice that, barring a statutory provision to the contrary, a person who is not party to the litigation cannot be bound by a judgment between other parties." The wife may have been a witness at but was not party to the proceedings between the minister and the former husband, which did not purport to impose a liability on her. A derivative assessment is a special mechanism that allows the minister to seek payment from a secondary taxpayer for tax assessed against a primary taxpayer. "That second person must have a full right of defence to challenge the assessment made against her, including an attack on the primary assessment on which the second person's assessment is based," a right that does not affect the primary assessment against the primary taxpayer vis-à-vis the minister.

In *Barry*, the secondary taxpayer, Mr. B, was a director of two corporations that were assessed for unpaid source deductions, interest, and penalties. Mr. B was derivatively assessed for those amounts under ITA section 227.1. Before the hearing of his assessment, he applied for an order compelling the CRA to answer questions at examination for discovery. Was Mr. B entitled to challenge the correctness of the underlying assessments? He argued that in its primary assessment the CRA had included on one company's payroll a significant number of employees of its subsidiaries, of which Mr. B was not a director. The Crown objected to the line of questioning on the basis of "relevance," because Mr. B could not attack the underlying corporate assessment—which the corporation had not challenged—and it also submitted that *Gaucher* did not apply because of fundamental differences between section 160 and section 227.1. The Crown argued that section 227.1 was specific to business corporation law—directors are controlling minds of a corporation who can challenge the corporation's debt and are accountable for unremitted source deductions because they have knowledge of the corporation's financial position. The Crown also said that a director can raise a due diligence defence, which is not available in other third-party assessments, and that the nature of the underlying debt in section 227.1 and section 160 was different.

Ultimately, the TCC disagreed. It held that derivative assessments under both sections 160 and 227.1 are issued under the same legislation and a taxpayer can defend against an assessment irrespective of its cause or origin. The court agreed with *Gaucher* that to bind a taxpayer (including a director) to an assessment issued to another taxpayer violates natural justice. The court said that a corporation may decide not to object to its assessment for a variety of reasons, and directors who are derivatively assessed may be prejudiced if they cannot attack the primary assessment. For example, an individual director may not have been able to cause the company to object to and appeal the assessment, or the books and records may have previously been in disarray. The court in *Barry* agreed with the TCC in *Scavuzzo* (2005 TCC 772) that the principle in *Gaucher* should not be diluted by requiring the court to inquire into whether the primary assessment had been challenged and whether the secondary taxpayer could have influenced a challenge.

Barry is an extremely significant decision by the TCC's chief justice. The Crown is appealing to the FCA, but in our view it is unlikely to succeed. In the interim year or so, the law will be somewhat unsettled; nevertheless, it seems prudent for practitioners in directors' liability cases to advise clients to begin to probe the correctness of the underlying corporate assessment, particularly if it was not challenged.

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CRA Audits Domestic Trusts

At the CRA's Kitchener-Waterloo seminar held on November 25, 2009, the CRA announced that some Tax Services Offices (TSOs)—in Mississauga, Hamilton, Kitchener, London, and Windsor—are undertaking a special project to audit domestic inter vivos trusts. There is a strong likelihood that the initiative will spread to other TSOs.

Typically, a domestic inter vivos trust owns shares or partnership interests and facilitates income splitting with a settlor's lower-income spouse and children. The CRA is apparently concerned that many trusts have paid distributions to beneficiaries with promissory notes, some of which may be unenforceable under the Ontario Limitations Act, and that trustees (usually one or both parents) have taken cash out of a trust for their own use. In such cases, the CRA may challenge the trust's deduction for the distribution, or it may assess a benefit to the parents. Other concerns include the absence of proper accounting records or trustees' minutes and the inability to locate the original settlement property (often a silver coin) used to establish the trust. The CRA also intends to ensure compliance with the 21-year rule.

In anticipation of the CRA initiative, it is a good time to contact clients who have established inter vivos family trusts in order to conduct a review that will determine the compliance level and ensure that records are in order.

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Provincial Tax Comparisons

In Canada, those looking for the lowest tax bill should be equipped with extreme cold-weather gear. As the table illustrates, one measure of the tax burden shows that Nunavut and the Northwest Territories have tax loads significantly lower than those in the rest of the country.

Statistics Canada's recently released *Provincial and Territorial Economic Accounts* provides details on the financial operations of all levels of government in Canada, including taxes collected. Because the data are cast in terms unique to economic analysis, the numbers may not agree with those provided in public accounts and budget documents.

The accounting problems pale in comparison with the hazards involved in comparing tax burdens. The incidence of a particular tax may vary significantly between jurisdictions. Taxes that fall on the factors of production have a quite different economic effect from those that affect consumer spending. There is no one unequivocal measure, but the best approximation is the ratio of total tax collected to gross domestic product (GDP).

The table shows that in the calendar year 2007, the latest for which detailed information is available for the 10 provinces, Quebec achieved the highest GDP ratio (39.0 percent) and Newfoundland and Labrador achieved the lowest (20.0 percent). Across the nation as a whole, taxes were equivalent to 33.2 percent of GDP. Total taxes in the ratio's numerator include collections of contributions to the Canada and Quebec pension plans.

Taxes as a Percentage of GDP, 2007

	Federal	Provincial	Local	All levels
Newfoundland and Labrador	8.6	8.4	1.0	20.0
Prince Edward Island	16.9	15.0	1.2	36.8
Nova Scotia	14.4	13.4	2.9	33.8
New Brunswick	13.5	13.1	1.8	31.9
Quebec	14.6	18.0	3.4	39.0
Ontario	16.1	12.7	3.8	35.6
Manitoba	12.9	12.8	2.6	31.5
Saskatchewan	12.9	10.7	3.2	28.1
Alberta	14.1	6.9	1.8	25.0
British Columbia	15.5	11.5	2.0	32.1
Yukon	11.8	6.0	1.6	23.1
Northwest Territories	9.5	6.5	0.9	19.1
Nunavut	9.9	3.4	0.6	16.2
Total	14.9	12.5	3.0	33.2

Federal taxes ranged from a low of 8.6 percent of GDP in Newfoundland and Labrador to a high of 16.1 percent in Ontario. Alberta's provincial taxes were the lowest (the equivalent of 6.9 percent) and Quebec's the highest (18.0 percent), but in Quebec the federal income tax is abated to compensate for the federal grant system that operates in other provinces. Local taxes averaged 3.0 percent of GDP, and ranged from a low of less than 1.0 percent in the Northwest Territories and Nunavut to a high of 3.8 percent in Ontario.

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Payments from ULCs

During the round table session at the Canadian Tax Foundation's 2009 annual conference (November 22-24, 2009), the CRA expressed its view on techniques available to address unintended results from the application of article IV(7)(b) of the Canada-US tax treaty to dividend payments from ULCs. The next day, the CRA released TI 2009-0318491I7 (dated November 13, 2009) on the concept of "same US tax treatment" for the purposes of articles IV(6) and (7). According to the TI, an amount of Canadian-source income or gain earned by a US person must have the same US tax treatment under the required comparable scenarios in respect of three factors: (1) the amount's character, (2) its timing of recognition or inclusion, and (3) its quantum.

Article IV(7)(b) applies to amounts of income that Canada considers to have been received by the US person. The CRA acknowledged that when this provision applies to a payment subject to part XIII tax, such as interest, the US person may have been taxed on an accrual basis. In that case, the amount is not subject to US tax on receipt regardless of the fiscal transparency of the Canadian payer for US purposes. However, the CRA does not accept this accrual income recognition method as a basis for arguing that the amount of income has not been received by the US person.

The timing of the recognition of an amount is considered to be the same if it is included in the same tax year under the scenarios being compared. This condition is considered met if an amount is derived by a US person through an entity treated as a partnership for US purposes; although they both have different tax years, the income is recognized by the US person in its tax year that ends after the relevant partnership tax year.

In determining whether the quantum of an amount is the same under article IV(7)(b), currency differences are ignored. Quantum is based on the US person's gross amount of the income item, ignoring deductions or tax credits available in computing the US person's standalone or consolidated US tax results. Thus, geographic sourcing of an amount is not relevant if it only affects the US foreign tax credit position, because the CRA does not view the availability of the credit to be relevant in determining how an amount is treated as an item of income.

In examples from the TI (listed below) involving hybrid ULCs, the CRA concludes that technically article IV(7)(b) does not apply; GAAR may negate otherwise available treaty benefits.

ULC as partnership. USco and its wholly owned US Sub together own 90 and 10 percent, respectively, in ULC, which carries on an active business in Canada and owes interest-bearing debt to USco. For US purposes, ULC is treated as a partnership, USco earns interest on the debt, and each of USco and US Sub is allocated its share of the interest expense incurred by ULC. If ULC were regarded as a corporation, USco would still be considered to earn interest on the debt, but no interest expense would be allocated. Article IV(7)(b) does not apply because the analysis is done without regard to the corresponding partnership expense allocation and the US foreign tax credit potentially available.

Grandparent loan. The facts are similar to those in the example above, except that US Sub owns 100 percent of ULC. For US purposes, the debt is considered owed by US Sub to USco, and US Sub's interest expense is available to offset USco's interest income on the consolidated tax return. If ULC were a regarded entity, the interest expense would be considered incurred by ULC and there would be no offsetting interest expense for the consolidated group. Article IV(7)(b) does not apply here because under both scenarios the treatment of USco's interest on the debt is the same, notwithstanding the ULC's US fiscal transparency.

Third-party royalty. USco owns 100 percent of a Canadian-resident ULC, which makes licence payments to a third-party US person (IPco). The licence fees are subject to part XIII tax. For US purposes, IPco receives the licence fees from USco, as opposed to receiving them from ULC if it were a regarded entity. The only difference in the treatment of IPco's income is the geographic source of the royalties; thus, the reduced treaty rate is available to IPco. (This position should also confirm that interest paid to a third-party Canadian lender in a tower structure is not denied treaty benefits.)

Sale of ULC shares. USco sells its shares in ULC to a third party at a gain subject to tax under section 115. For US purposes, USco is considered to have sold the assets of ULC (as opposed to a sale of the ULC shares if ULC were a regarded entity), resulting in potential differences in the character and quantum of income or gain derived by USco. The CRA stated that article IV(7)(b) does not deny treaty exemption of USco's gain, because the gain is not derived from proceeds received from ULC. However, the CRA noted that article IV(7)(b) may apply if the shares were sold to another ULC wholly owned by USco and section 212.1 applies, or if ULC redeems, acquires, or cancels its shares from USco.

At the round table, it was suggested that in order to deal with dividends paid from a disregarded ULC to its USco parent, the ULC could increase its PUC to trigger a deemed dividend subject to withholding tax and then make a distribution as a reduction of PUC. The CRA said that article IV(7)(b) does not apply if the US tax treatment of the PUC increase would also be disregarded if the ULC was not transparent. Alternatively, a Luxco that is disregarded for US purposes may be inserted between ULC and USco to take advantage of the Canada-Luxembourg treaty rate, provided that Luxco is the dividends' beneficial owner in light of *Prévost Car* (2008 TCC 231; aff'd. 2009 FCA 57). In both cases, the CRA said that GAAR may apply, depending on the facts, but it will normally not apply if the ULC carries on active operations in Canada and the dividends are paid out of the Canadian earnings.

The TI is helpful in providing a technical explanation of the analysis of "same treatment" under the protocol. However, if the ULC is not an Opco, it is unclear from the comments in the TI and at the round table whether the CRA would accept the structure or find it abusive and try to deny treaty benefits.

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Taber Solids: De Facto Control

In the recent case of *Taber Solids Control (1998) Ltd.* (2009 TCC 527), two companies owned separately by a husband and wife were found to be associated and thus required to share a small business deduction. The husband's actual and potential influence over decisions by the board of his wife's company gave him de facto control over her company.

Before 1998, Mr. and Mrs. T each owned 50 percent of Canco 1 and Canco 2. Canco 1's business was renting out valuable specialized equipment, including the service and repair of that equipment. Canco 1 and Canco 2 were reorganized in 1998 to separate the businesses for liability protection: in the result, Canco 1 owned the equipment and rented it to Canco 2, which in turn rented the equipment to third parties and serviced and repaired it. After the reorganization, Mrs. T owned 100 percent of Canco 1, and Mr. T and the family trust owned 100 percent of Canco 2. Because Mr. T had extensive experience in the operations of the business and Mrs. T did not, Mr. T was central to Canco 1's equipment acquisition and disposition decisions.

Canco 1 and Canco 2 filed their tax returns on the basis that they were not associated and thus did not share the small business deduction. The CRA disagreed on both issues and reassessed each company for its 2000 and 2001 taxation years.

The CRA argued that Canco 1 and Canco 2 were deemed associated under the anti-avoidance rule in subsection 256(2.1), which generally deems two corporations to be associated if it can reasonably be considered that one of the main reasons for their separate existence was to reduce tax otherwise payable. The TCC was satisfied that the reorganization was undertaken for the legitimate business purpose of creditor proofing, and that it would have taken place regardless of the tax benefit of doubling the small business deduction. Subsection 256(2.1) did not trigger association just because the allocation of Canco 1's and Canco 2's shares after the reorganization may have been motivated by potential tax benefits.

The CRA also argued that Canco 1 and Canco 2 were associated under the de facto control rules in paragraphs 256(1)(a) and (b), which are applicable if one corporation directly or indirectly controlled the other or if both are controlled by the same person or group of persons. In determining whether Canco 1 was controlled by either Mr. T or Canco 2, the TCC considered subsection 256(5.1), under which de facto control generally exists where the controller at any time has any direct or indirect influence that, if exercised, would result in control in fact of the corporation. The TCC also considered *Silicon Graphics* (2002 FCA 260), *Transport M.L. Couture* (2004 FCA 23), and other jurisprudence on the determination of de facto control.

The TCC in *Taber Solids* found that Canco 1 and Canco 2 were associated and thus must share the small business deduction, because (1) Mr. T had actual influence over the major operational decision that Canco 2 was to be Canco 1's only customer; (2) Mr. T had actual influence over Canco 1's board decisions regarding the disposition of the specialized equipment; and (3) Canco 2 had potential influence, based on Canco 1's complete economic dependence on Canco 2, to control decisions regarding acquisitions of equipment, notwithstanding the reality that Mr. T and Mrs. T jointly made those decisions.

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Dividend Rates and Investment Income Update

Eligible and non-eligible dividend tax rates are revised to help achieve better integration of corporate and personal taxes on active business income. (For changes to eligible and non-eligible dividend tax rates, see "Eligible Dividend Rates Update," *Canadian Tax Highlights*, July 2009, and "Non-Eligible Dividend Rates Update," *Canadian Tax Highlights*, September 2009.) However, these changes also affect the integration of corporate and personal taxes on investment income. Tables 1, 2, and 3 show the income tax deferral or prepayment if portfolio dividends, capital gains, or interest is earned and retained in a corporation rather than earned directly by an individual. The tables also show the tax cost or saving if the after-tax corporate income is paid out as a dividend to the individual shareholder, compared with the income being earned directly by the individual.

Table 1 $10,000 Investment Income, Portfolio Dividends Initial Deferral or (Prepayment) with Holdco[a]

	2009	2010	2011	2012
	dollars			
Alberta	(1,878)	(1,745)	(1,561)	(1,404)
British Columbia	(1,341)	(1,188)	(942)	(722)
Manitoba	(950)	(824)	(659)	(521)
New Brunswick[b]	(1,153)	(1,387)	(1,356)	(1,217)
Newfoundland and Labrador	(1,044)	(896)	(665)	(458)
Northwest Territories	(1,508)	(1,352)	(1,100)	(872)
Nova Scotia	(498)	(353)	(133)	61
Nunavut	(1,109)	(969)	(761)	(577)
Ontario	(1,027)	(676)	(514)	(379)
Prince Edward Island	(889)	(738)	(497)	(283)
Quebec	(364)	(265)	(148)	(52)
Saskatchewan	(1,298)	(1,169)	(997)	(852)
Yukon	(1,610)	(1,453)	(1,199)	(969)

[a] The tables assume that (1) the individual is taxed at the 2009 top marginal income tax rate, except for New Brunswick, where the top provincial rate decreases in stages from 2010 to 2012; (2) the portfolio dividends are designated eligible dividends; (3) the capital gains deduction for qualifying small business corporation shares or qualified farm and fishing property is not available; and (4) a full refund of the refundable tax is generated on payment of the taxable dividend ($10,000 in the case of portfolio dividends, $4,000 for capital gains, and $8,000 for interest).

[b] The top combined federal/New Brunswick personal income tax rate declines after 2009 because of gradual decreases in the provincial top rate from 2010 to 2012, increasing the income tax prepayment in 2010 to 2012; however, the increase in the income tax prepayment is partly offset by decreases in the province's eligible DTC rates after 2009 (affecting table 1) and lower corporate tax rates from 2009 to 2012 (affecting tables 2 and 3).

Table 2 $10,000 Investment Income, Capital Gains Initial Deferral or (Prepayment) with Holdco / Overall Saving or (Cost) with Holdco[a]

	2009	2010	2011	2012
	dollars			
Alberta	(283)/(58)	(283)/(58)	(283)/(58)	(283)/(58)
British Columbia	(98)/(73)	(73)/(88)	(48)/(63)	(48)/(63)
Manitoba	(38)/(233)	(13)/(208)	(13)/(246)	(13)/(246)
New Brunswick[b]	(58)/(93)	(143)/(43)	(173)/7	(133)/82
Newfoundland and Labrador	(208)/(183)	(208)/(183)	(208)/(183)	(208)/(183)
Northwest Territories	(155)/(8)	(155)/(8)	(155)/(8)	(155)/(8)
Nova Scotia	(120)/(109)	(120)/(109)	(120)/(109)	(120)/(109)
Nunavut	(308)/(133)	(308)/(133)	(308)/(133)	(308)/(133)
Ontario	(113)/(34)	(63)/(33)	(1)/29	24/54
Prince Edward Island	(164)/(357)	(164)/(417)	(164)/(478)	(164)/(478)
Quebec	83/(38)	83/(38)	83/(38)	83/(38)
Saskatchewan	(133)/(33)	(133)/(33)	(133)/(33)	(133)/(33)
Yukon	(363)/(250)	(363)/(250)	(363)/(250)	(363)/(250)

[a] See note a to table 1.

[b] See note b to table 1.

Table 1 shows that for all jurisdictions except New Brunswick, the income tax prepayment on portfolio dividends paid to a corporation decreases after 2009 because of decreases to the federal eligible dividend gross-up factor and dividend tax credit (DTC) rate; the gross-up factor also affects most provincial and territorial eligible DTC rates. In Nova Scotia in 2012, the prepayment changes to a deferral. Alberta and Saskatchewan amended their legislation so that they could maintain their eligible DTC rates at their 2009 levels and not be affected by the federal changes. In New Brunswick, the effect of the federal changes is offset by declining provincial personal tax rates from 2010 to 2012, but the prepayment effect falls after 2009 if the province's eligible DTC rates are reduced to reflect the province's corporate tax rate reductions in 2009 to 2012. The prepayment effect in Newfoundland and Labrador increased after 2008 because its eligible DTC rate increased in 2009. Prepayment in Ontario is reduced after 2009 because of a 2010 decline in its eligible DTC rate. In all cases of portfolio dividends earned through a corporation, there is no tax cost or saving when they are subsequently paid out to the individual shareholder, compared with portfolio dividends earned directly.

Tables 2 and 3 deal with the integration of capital gains and interest, respectively. For British Columbia, the tax

Table 3 $10,000 Investment Income, Interest Initial Deferral or (Prepayment) with Holdco / Overall Saving or (Cost) with Holdco[a]

	2009	2010	2011	2012
	dollars			
Alberta	(567)/(117)	(567)/(117)	(567)/(117)	(567)/(117)
British Columbia	(197)/(147)	(147)/(177)	(97)/(127)	(97)/(127)
Manitoba	(76)/(466)	(27)/(417)	(27)/(492)	(27)/(492)
New Brunswick[b]	(116)/(186)	(286)/(86)	(346)/14	(266)/164
Newfoundland and Labrador	(417)/(367)	(417)/(367)	(417)/(367)	(417)/(367)
Northwest Territories	(312)/(17)	(312)/(17)	(312)/(17)	(312)/(17)
Nova Scotia	(242)/(220)	(242)/(220)	(242)/(220)	(242)/(220)
Nunavut	(617)/(267)	(617)/(267)	(617)/(267)	(617)/(267)
Ontario	(226)/(66)	(125)/(64)	nil/61	49/110
Prince Edward Island	(330)/(715)	(330)/(836)	(330)/(957)	(330)/(957)
Quebec	165/(76)	165/(76)	165/(76)	165/(76)
Saskatchewan	(267)/(67)	(267)/(67)	(267)/(67)	(267)/(67)
Yukon	(727)/(499)	(727)/(499)	(727)/(499)	(727)/(499)

[a] See note a to table 1.

[b] See note b to table 1.

cost of earning capital gains or interest in a corporation increases in 2010 because the province's non-eligible DTC rate decreases; however, lower corporate tax rates in British Columbia (2010 and 2011) partly offset the effect of the non-eligible DTC reduction and subsequently reduce both the tax cost and income tax prepayment. The tax cost in British Columbia may increase further after 2011 if its non-eligible DTC rate decreases to account for a drop in the province's small business rate to 0 percent on April 1, 2012. In Manitoba, both the prepayment and the tax cost decrease in 2010 because of lower corporate tax rates, but the tax cost increases after 2010 because the province's non-eligible DTC rate decreases in 2011. In New Brunswick, the prepayment increases in 2010 to 2012 because of personal tax rate reductions; the effect is partly or fully offset by the province's lower corporate tax rates (2009 to 2012), which also reduce the tax cost in 2010 and transform it into a tax saving thereafter. In Ontario, the prepayment and tax cost decrease after 2009 because of declining corporate tax rates (2010 to 2013); but for 2010, the decrease in tax cost is partly offset by a decrease in the province's non-eligible DTC rate. Ontario's prepayment and tax cost change to a deferral after 2011 and tax saving after 2010, respectively. For Prince Edward Island, the tax cost increases in 2010 and 2011 as a result of decreases to the province's non-eligible DTC rates.

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Post-Deadline Voluntary Disclosure

IRS Commissioner Douglas Shulman announced on November 17, 2009 that about 14,700 taxpayers participated in the IRS voluntary disclosure program (VDP). The October 15 deadline has passed, but the IRS still encourages taxpayers to disclose foreign accounts. Outcomes for those who disclose after the deadline are unclear.

The *Internal Revenue Manual* contains the regular procedure for voluntary disclosures: communication must be truthful, timely, and complete, and the taxpayer must demonstrate a willingness to cooperate with the IRS and make a good faith effort to pay the tax, interest, and penalties. A voluntary disclosure at this time is no guarantee against criminal prosecution, which is more likely to occur if the IRS discovers the non-compliance.

It is not clear whether the previous VDP terms still apply. A taxpayer coming forward now should expect to incur more penalties: it is unclear whether reasonable-cause arguments may be raised. Post-VDP penalties are potentially significant, including (1) civil fraud penalties as high as 75 percent of unpaid tax; (2) failure-to-file and failure-to-pay penalties; (3) penalties for failure to file information returns such as forms 5471, 3520, and 8865; and (4) penalties for failure to file the foreign bank account report (FBAR) as high as 50 percent of the account balance. More importantly, a taxpayer who makes a disclosure post-VDP may face criminal prosecution.

Unlike most countries, the United States taxes its citizens on worldwide income regardless of residence; a US citizen who has lived abroad for years may not be aware that he or she must still file a US tax return and may not know of the several information returns required to disclose certain foreign investments. Penalties for failure to file those information returns are harsh.

The IRS is likely to continue its international enforcement efforts. On November 24, 2009, Switzerland announced that it intends to disclose information on 500 UBS clients to the United States pursuant to an August 2009 agreement with the US Justice Department. Congress has proposed legislation to force foreign financial institutions, foreign trusts, and foreign corporations to disclose information about, respectively, US account holders, grantors, and owners. Consequently, it may only be a matter of time before the IRS receives information about US owners of offshore assets and accounts. Tax practitioners advising Canadian-resident US citizens should be aware of US filing obligations and of the voluntary disclosure procedure.

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Solicitor-Client Privilege and Transparency

A recent Canadian Bar Association memorandum ("Laptop Searches at the Border: What the Revised U.S. Guidelines Say") reflects the increased stresses on solicitor-client privilege created by the perceived need for heightened security and transparency. The memo recommends that lawyers not store confidential information on computers when entering the United States: if the Department of Homeland Security exercises its right to review the contents of any computer, solicitor-client privilege may be undermined. Legislation regarding money laundering and FINTRAC may also erode privilege. This article focuses on the retention of solicitor-client privilege in the context of Canadian tax practice. Audits have increased for domestic and international transactions and for transfer pricing, and the CRA has a number of powers under the Act to obtain documents and records.

Solicitor-client privilege is a substantive right under Canadian law. In *Descôteaux et al. v. Mierzwinski* ([1982] 1 SCR 860, at 872-73), the SCC adopted the following definition of the solicitor-client communication rule of privilege: "Where legal advice of any kind is sought from a professional legal adviser in his capacity as such, the communications relating to that purpose, made in confidence by the client, are at his instance permanently protected from disclosure by himself or by the legal adviser, except the protection be waived." A client seeking advice must be able to speak freely to his lawyer and be secure in the knowledge that what he says will not be divulged without his consent: the privilege is the client's, not the lawyer's.

In the context of a tax dispute, *Telus Communications Inc.* (2004 FCA 380) stated that for privilege to attach to a document, the document must be a communication between a solicitor and client and entail the seeking or giving of legal advice, and the parties must intend that it be confidential. Litigation privilege applies to communications between any of the lawyer, the client, and third parties in the course of existing or contemplated litigation, which in the tax context may occur when the CRA challenges a position taken in a tax return. Common interest privilege extends the privilege to persons other than the client who share an interest in a matter and, together with the client, jointly consult a solicitor.

There is no privilege with respect to documents prepared by accountants, auditors, or consultants. However, if a lawyer retains an accountant to assist a client in connection with a tax matter, communications from the accountant may be privileged. Similarly, if privilege is desired for the work provided by valuators or actuaries, the lawyer should retain them. Privilege may be maintained if the accountant meets to outline a problem with a lawyer acting on the client's behalf, or if the accountant reviews a privileged communication with a lawyer in order to prepare the financial statements.

Some precautions can be taken to maintain privilege for documents required for tax matters:

1) Generally, do not retain draft documents (such as memoranda, agreements, tax-planning documents, associated notes, and correspondence) that are not required for the determination of taxes. For example, estimated values and allocations of purchase price may change from the initial draft agreement to the final agreement, and those initial documents may be extraneous.

2) All communications between a lawyer and client that may be of a sensitive nature should be marked "privileged and confidential."

3) Ensure that privileged documents are not given to third parties.

4) If third parties such as accountants or actuaries are to be retained in connection with tax matters to provide tax or other advice, they should be retained by the lawyer.

5) Avoid inadvertent waiver of privilege. Ideally, all privileged documents should be maintained in a separate file.

6) Avoid detailing controversial issues on work in progress; if the client requests a WIP memo, be sure to provide it in a separate memorandum that is marked "privileged."

7) The number of privileged documents should be kept to a minimum in order to avoid inadvertent disclosure.

8) Avoid putting privileged or sensitive documents in minute books, which are included in the type of books that the CRA has the right to review.

9) Be careful when providing advice in e-mails and in controlling the direct (and indirect) recipients thereof. Provide sensitive advice over the phone or in person.

10) When an auditor requests privileged documents such as a legal opinion for the purpose of an audit opinion, the auditor and the client should agree in writing that the information is being released pursuant to a statutory obligation. The agreement should acknowledge that the documents

are subject to solicitor-client privilege that the client wishes to maintain and has not waived. The auditor should agree in writing that it is not permitted to disclose such information to third parties without the client's written consent. Once the audit is completed, the documentation should be returned to the client or verified to have been destroyed.

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HST Input Tax Credit Restrictions

The curtain slowly rises on harmonization as Ontario releases more information, including the who and what of HST temporary ITC restrictions. A technical document released on November 16, 2009 (*Ontario's Tax Plan for Jobs and Growth*) confirms that ITCs are restricted for the provincial portion of the HST (OVAT) for the first five years after HST is implemented, and then phased in with a 25 percent ITC in year 6 and an additional 25 percentage points per year thereafter.

The restrictions apply to a so-called large business—a registrant that is one of certain financial institutions (FIs) or one that makes taxable supplies in Canada in excess of $10 million. Enumerated FIs encompass banks, trust companies, credit unions, investment plans, and insurers and their segregated funds, and persons related thereto. Special rules will be developed for selected listed financial institutions. The $10 million threshold is based on the previous fiscal year's associated group, and includes zero-rated supplies, supplies made outside Canada through a Canadian PE, and deemed supplies made for nil consideration under some related-party elections. Exempt supplies, supplies of financial services and capital real property, and otherwise non-taxable supplies of goodwill are excluded. Special rules still under consideration determine the impact of various reorganizations. The temporary ITC restrictions do not apply to public service bodies.

Unless a large business acquires the restricted items for resale or resupply, it cannot claim ITCs for the OVAT exigible on energy (unless the energy was purchased by a farm or used to produce goods for sale); telecommunications services (other than Internet access fees or charges for toll-free numbers); automobiles and other road vehicles weighing less than 3,000 kilograms and parts, fuel, and some services therefor; and food, beverages, and entertainment expenses.

The restrictions for energy purchases cover electricity, gas, steam, and combustibles, except motive fuels used to power a propulsion engine. Excluded is "energy used as an integral part of a process of producing tangible personal property for sale, or for the design or production of equipment used in the production of tangible personal property." Energy used for heating, lighting, or ventilating the production site is generally restricted (presumably unless the nature of the product renders temperature control essential to its manufacturing process).

Restricted telecommunication services include long distance, voice mail, and conference calls, but exclude Internet access, toll-free numbers, and Web site hosting. It remains to be seen how these terms will be defined and whether ancillary but related services are restricted. Restrictions apply to road vehicles registered for use on public highways and to parts and service not provided in routine maintenance and acquired in the first 12 months after the vehicle's acquisition (presumably to prevent the sale of stripped-down vehicles and then a separate sale of non-restricted parts). Meal and entertainment expenses subject to 50 percent income tax deductibility are also restricted.

The issues and definitions raised in the technical document are reminiscent of the interpretation and administration of similar Quebec sales tax (QST) rules developed over many years. A review of QST bulletins on the matter may be a useful guide. Ontario also anticipates the release of an information notice with additional details.

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Foreign Tax News

Isle of Man

The Treasury began consultation on the taxation of investment products, particularly insurance bonds and rollup funds, with a view to eliminating the current uncertainty of tax treatment created by the lack of rules for the former and highly complex rules for the latter.

Treaties

A **Bahamas-China** tax information exchange agreement was signed December 1, 2009.

Netherlands Antilles

Netherlands Finance published a new tax legislation proposal for Bonaire, St. Eustatius, and Saba (BES), including a general expenditure tax resembling a VAT. The Netherlands Antilles, a federation of islands each with its own government, proposes to disband in October 2010 to form autonomous territories (Curaçao and Sint Maarten) and three Dutch communes (BES).

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OECD

On November 25, 2009, the OECD Committee on Fiscal Affairs released a discussion draft related to telecommunication transaction issues in treaties, including the PE impact of satellites, roaming agreements, and undersea cables and pipelines; payments for the use of the radio frequency spectrum are not considered royalties. Also on that day, the committee released a discussion draft on the application of treaties to state-owned entities, including sovereign wealth funds, and on treaty interaction with the doctrine of sovereign immunity. Interested parties should send comments electronically in Word format before January 31, 2010 to jeffrey.owens@oecd.org.

On November 24, 2009, the committee released revised draft article 7 (business profits) of the OECD model treaty. The paragraph 3 proposal has been completely revised and is intended to ensure the prevention of double taxation. New related commentaries are included in the discussion draft. Interested parties should send comments electronically in Word format before January 21, 2010 to jeffrey.owens@oecd.org.

Australia

A Treasury report discusses human decision making in the tax context and considers compensating changes. For example, the report says that people do not attempt to arrive at rational optimal solutions and avoid complexity, and yet the current tax system seems to reward complexity. A general failure to file returns even for a refund could be counterbalanced by sending taxpayers provisionally completed tax returns that could then be accepted or rejected.

New Zealand

Proposed changes to the binding rulings system deal with the Commissioner of Inland Revenue's ability to rule only on the facts provided; to rule when a substantially similar case is in ligation; to rule with respect to a tax other than that specified in the ruling request; to allow partial rulings, such as for some taxes; to allow a product's promoter to apply for a ruling; and to issue notices of rulings and withdrawals in the IR's publications and not the government's gazette.

United Kingdom

The final bills (Corporation Tax and Taxation (International and Other Provisions)) were introduced under the tax law rewrite project. The rewrite was intended to make the text more accessible without significant substantive changes; minor changes improve legislation or codify practice.

United States

The IRS released an industry directive regarding US filing and withholding obligations for taxpayers engaged in exploration for and exploitation of natural resources on the US outer continental shelf in the Gulf of Mexico. A foreign contractor providing services on the shelf is generally considered to perform services in the United States and to derive US-source income and is taxable on income from a US trade or business.

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