My Holiday Tax Reading

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While most people who go on long holiday plane rides watch in-flight movies or sleep, I use the occasion to catch up on my tax reading. This article deals with some of it – summarizing some recent developments which may be of interest to readers.

Report on International Tax

Last month, the "Advisory Panel on Canada's System of International Taxation" released its final report**[1]**, which featured a large number of recommendations to improve Canada's international tax system.

While many readers are only vaguely aware of the Panel's deliberations**[2]**, it's a different story for international tax specialists – where every word in the report is dissected. In case you are not familiar with this group, they are a special breed of tax advisors, whose preferred habitat is in a big tower at King and Bay (or a reasonable facsimile). Apart from this, they are rarely seen (even by their families), other than getting in and out of their BMWs - or maybe in the first class lounge, en route to an IFA conference.

For months they had been stewing about what the committee would come out with. But not to worry. Generally, the report not only largely affirms business as usual**[3]**, it supports more liberal rules, even restoring a tax planning opportunity which many tax planners thought had gone the way of the Dodo Bird. Unfortunately, space constraints (and my penchant for purple prose) do not permit more than a sampling of the recommendations in the report, but here are a few. The Panel recommends "a broader exemption system for foreign active business income earned through foreign affiliates"**[4]**, so that active business income can be repatriated to Canada as a tax-free dividend irrespective of whether the income is earned in a country with which Canada has a tax treaty. The report states that a byproduct of this would be the elimination of surplus tracking, which the Panel believes generates little, if any Canadian tax revenue**[5]**. A related recommendation is that "Canada's exemption system should be extended to capital gains by Canadian shareholders on foreign affiliate shares**[6]** where the shares derive all or substantially all of their value from assets used or held principally to earn active business income".**[7]** As for the fact that it may seem inconsistent to exempt gains on the sale of foreign affiliate shares while taxing gains on the sale of Canadian company shares, "this difference can be accepted on the basis that the current rules are out of step with most other countries that have exemption systems," and would also result in a simpler tax system.**[8]**

On other fronts, the Panel believes that the proposed FIE and NRT rules should be "reconsidered" and that the government "should undertake a fresh review to coordinate the FAPI, FIE and NRT regimes".**[9]** The panel also recommends the repeal of section 18.2**[10]**, slated to come into effect for periods beginning after 2011, which restricts the deductibility of interest on borrowings by Canadian companies used to invest in foreign affiliates, i.e., for so-called "double dips". The Panel made no recommendation for further laws to restrict treaty shopping, their view being that "businesses should be able to organize their affairs to obtain access to treaty benefits".**[11]**

Whew! It must have been high fives at King and Bay when the report came out. Now the international people can stop worrying about it - and get back to worrying about their mutual funds. All kidding aside, recent months illustrate the importance of having a competitive international tax system which is free of red tape and ambiguities.

Now in Effect: the Canada-US Protocol

The protocol to amend the Canada-US income tax treaty came into effect on December 15. A number of provisions have differing effective dates. Interest paid between related parties in Canada and the US is subject to a withholding tax rate of 7% (reduced from 10%), effective January 1, 2008. If tax was withheld at 10% rate, it is possible to get a refund of the extra 3%. In calendar 2009, the rate will reduce to 4% and will be phased out starting January 1, 2010. Interest between unrelated persons would be subject to a zero rate of withholding effective January 1, 2008, but effective the same date, Canada changed its tax laws so that similar rules apply to interest payments to residents of all foreign countries. Other changes to withholding tax take effect on February 1, 2009 (e.g., the nil withholding rate for guarantee fees).

The protocol rules that limit the availability of treaty benefits to hybrid entities – particularly ULCs - are effective January 1, 2010. A 25% withholding rate will apply to cross-border dividends paid by these entities.

Before relying on the treaty, Canadians should make sure that the new "limitation on benefits" provisions now applying on the "Canadian side" do not knock out favourable withholding rates or other benefits.[12] The basic thrust of these provisions is that the benefits of the treaty apply to "qualifying persons", including natural persons, publicly-traded companies and their subsidiaries, and government bodies. Companies controlled by qualifying persons may qualify for the treaty but must meet "base erosion" rules designed to protect against siphoning income outside of the US[13]. In other cases, two other exceptions may apply: (i) an "active trade or business test" whereby the treaty may apply to income derived in Canada, provided that the US resident or a related person carries on a business which is substantial in relation to the Canadian activities; (ii) a "derivative benefits test" applying to interest, dividends or royalties, where the US company is owned by a resident of a third country which has a treaty with Canada with applicable rates at least as favourable as under the Canada-US treaty, provided that the third-country resident would be a "qualifying person" if resident in the US.[14]

Ontario Harmonization – Get Out Your Reading Glasses

Readers in Ontario who are tax advisors or corporate tax return preparers will be interested in learning more about federal and provincial harmonization. This will come online for Ontario taxpaying corporations with taxation years ending after 2008 – so the first filing deadlines will start cropping up this summer. Sometime between now and then, it will be advisable to develop a working knowledge of the new system, especially the transitional debits and credits.

Replacing the old provincial tax forms are a series of federal forms starting at schedule 500, which is used to calculate basic Ontario tax (e.g., the small business deduction and clawback, but excluding tax credits and additional taxes which are calculated on other 500 series schedules). Schedule 506 is a computation of transitional debits/credits, which arise because Ontario tax balances are replaced by federal balances. The general idea is simple: you tally up various Ontario balances, such as non-capital and net capital losses, UCC, etc., and likewise for federal balances[15]. If Ontario tax balances exceed federal balances, so that the company loses coverage, it gets an Ontario tax credit based on 14% of the difference, which is normally amortized over five years[16]. If the opposite is the case – Ontario tax balances are less than federal balances, so that the company gains coverage - there will be a transitional tax debit (i.e., extra tax) based on 14% of the difference, which is also normally amortized over five years.

While this sounds simple enough, the devil, as they say, is in the details. And a good way to get a flavour for them is to go to the CRA's website, www.cra-arc.gc.ca, and pull the form. You will see that it is eight pages long, with the first page devoted to new and unfamiliar terminology and definitions. Some of the complications arise from wind-ups and amalgamations occurring within the amortization period[17]. There is also a special adjustment to Ontario SR&ED balances, whereby federal investment tax credits may be added, as well as an election to defer transitional debits in respect of SR&ED. One possibly time-consuming requirement is to calculate the adjusted cost base of partnership interests, for both federal and provincial purposes, the rationale being to pick up differences in partnership-level balances. This, of course, could be particularly burdensome for older partnerships. The transitional credits/debits are entered on schedule 5[18] which deals with provincial tax (in the new section for Ontario), along with the results of schedule 500.[19]

Tax return preparers should make sure they have budgeted extra time to cope with these new forms. Hopefully, PD courses and additional explanatory material will be available in coming months.

Faraggi Appeal Released

Last month, the *Faraggi* case[20] – which had been dragging through the courts for so long that it pre-dates GAAR - was released by Federal Court of Appeal. The facts of the case are complex. But in a nutshell, the taxpayers were - literally – in the business of crafting capital dividends for sale to third-party corporations through an intricate series of gains and offsetting losses, with the capital dividends in between. The buyers would pay a premium on certain share subscriptions which were paid out as capital dividends to the devisers of the plan. In the case, the CRA's focus was on the devisers of the plan and their companies: it sought to recharacterize the premium paid to the companies as income from a business, and knock out the capital-dividend-account elections which had allowed the devisers to pocket the premium tax free – or so they thought.

The lower court decision was troubling to practitioners for at least two reasons: As has been observed by my MERITAS colleague, Tim Huot[21], the sham doctrine was expanded by including an additional element, namely an abuse of the provisions of the *Income Tax Act*, contrary to their object and spirit. Potentially, this opened a second line of attack which could complement GAAR. Also troubling was the attack on the "papering" of the transaction, particularly the daylight loans that were used. The judge attacked the loans on the basis that they were invalid, among other things, because there was no security or interest charged. Trouble is, temporary loans and the like are common in tax planning. Practitioners are left to wonder where this sort of thing stops — when will a loan without commercial terms be vulnerable to an attack?

The Court of Appeal by and large cleared up these concerns (but it may have opened up another – see below). The court indicated that the doctrines of sham and abuse are not the same[22] and that "subject to the invocation of the GAAR in a particular case, taxpayers are entitled to arrange their affairs in such a way as to minimize their tax burden, even if in doing so, they resort to elaborate plans that give rise to results which Parliament did not anticipate."[23] The court also indicated that it is not possible to conclude that there was a misrepresentation of the relationship of lender/borrower; and the loans in question could not be held to be shams.[24]

The Court of Appeal held that the share subscription premiums were business income: as no transaction or operation is systematically excluded from the concept of business, the question whether a given operation amounts to a business must be determined in accordance with the particular facts of each case.[25] Moreover, because the gain-making shares were acquired by the subsidiaries for the purpose of their immediate sale, this excludes the possibility that the shares could have been capital property in the hands of the subsidiaries[26]. Thus, the characterization as a capital gain was a misrepresentation and the resultant capital dividend elections were shams[27]. Accordingly, the taxpayers were grossly negligent for failing to report fully-taxable income at the corporate level as well as taxable rather than capital dividends - so that penalties also applied[28].

What I find a bit troubling is penalties being imposed as a result of reporting capital gains rather than income - and the reasoning that led to this result.[29] The court observed that capital gains status was out of the question because the acquisition of the gain-making shares by the subsidiaries and their sale had been "pre-ordained"[30] The concept that a pre-ordained sale pre-empts capital gains status could be troublesome, e.g., in respect of a series of transactions involving a pre-sale reorganization which ultimately leads to a sale of an asset.[31]

Hopefully, this will be clarified in another case. Personally, however, I am not really fussed about the issue. The real point may be that the court was not sympathetic to the appellants, so that this line of reasoning could end up being largely confined to the case. On that note, I think that *Faraggi* is also indicative that the Federal Court of Appeal – usually the court of last resort – is not particularly sympathetic to taxpayers. In a very unscientific attempt to check this out, I counted the last 50 Federal Court of Appeal decisions on my system (other than those dealing with procedural-type issues). I counted only three which went in favour of taxpayers.

[1] *Enhancing Canada's International Tax Advantage*, Advisory Panel on Canada's System of International Taxation, December 2008.

[2] The genesis of the Panel is the 2007 federal budget, which contained controversial proposals to eliminate the deductibility of interest on debt incurred by corporations to finance foreign affiliates. This was later withdrawn in favour of section 18.2, focusing on double dips.

[3] Some recommendations are taxpayer-negative, notably the proposal to lower the thin capitalization ratio in subsection 18(4) from 2 to 1 to 1.5 to 1.

[4] Paragraph 4.33 of the report.

[5] Paragraph 4.26 of the report.

[6] As well as "capital gains realized by foreign affiliates on the sale of shares of other foreign affiliates" (currently the gains themselves may be exempt, but 50% is taxable when the proceeds are repatriated to Canada as dividends).

[7] Paragraph 4.52 of the report.

[8] Paragraph 4.53 of the report.

[9] Paragraphs 4.103 and 4.104 of the report.

[10] Recommendation 4.7 of the report.

[11] Paragraph 5.68 of the report.

[12] Limitation on benefits provisions have been in effect on the "US side" since 1995.

[13] Where deductible expenses for the preceding fiscal period to persons that are not qualifying persons is equal or greater than 50% percent of gross income for that period.

[14] Otherwise, a person can be granted treaty benefits by competent authority.

[15] This is done as at the "transition time", which is the first day of the corporation's particular taxation year that includes January 1, 2009.

[16] A carryforward mechanism applies in respect of periods where the credit cannot be used.

[17] "Eligible post-2008 winding-up" and "eligible amalgamation". There may also be an adjustment for an "eligible pre-2009 winding-up", which contemplates situations where taxation years in respect of the wind-up straddle December 31, 2008. There may also be adjustments for "straddle" non-arm's length transfers.

[18] Lines 414 or 276.

[19] The Ontario section also includes various additional taxes/tax credits computed on schedules which follow 500 (e.g., the new 4.5% Ontario R&D credit: schedule 508). The total provincial tax liabilities are summarized on line 255 of schedule 5, which is entered on lines 750/760 of the T2.

[20] *2529-1915 Québec Inc., 2530-1284 Québec Inc., Robert Langlois and Ralph E. Faraggi* v. *The Queen*, 2008 FCA 398.

[21] Of BCF, Montreal. See "Sham — As Bad As It Gets", *Tax Topics* No. 1857, October 11, 2007.

[22] Paragraph 55.

[23] Paragraph 56.

[24] Paragraphs 70 and 71.

[25] Paragraph 65. It is interesting to compare this approach with the old cases involving SRTC "quick flips," which are somewhat reminiscent of the fact situation, in that the SRTC debentures were similarly acquired for immediate redemption. Notably, *Loewen* v. *The Queen* (94 DTC 6265, FCA) held that the gain on the redemption of a SRTC debenture was on capital account rather than an adventure in the nature of trade. While at first blush, this seems inconsistent, the court indicated that, for there to be an adventure in the nature of trade, it must be one which could produce a profit. A purely

notional profit, therefore, cannot serve to turn an otherwise unprofitable transaction into an adventure in the nature of trade. In *Faraggi*, for the reasons indicated, the transactions did produce a profit.

[26] Paragraph 73.

[27] Paragraphs 72, 77 and 79. As stated at paragraph 59: "the existence of a sham under Canadian law requires an element of deceit which generally manifests itself by a misrepresentation by the parties of the actual transaction taking place between them." (The classic definition of sham refers to acts done or documents executed by the parties to which are intended by them to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create.)

[28] Paragraph 85.

[29] In addition, although the relationship of the shame doctrine and deceit are well known, query whether future applications of the sham doctrine may more commonly involve the imposition of penalties, by virtue of *Faraggi*.

[30] Paragraph 74.

[31] Or even for some investors in securities, where an ultimate sale is a virtual certainty.