Canadian Tax Highlights

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Hong Kong-Chinese Mainland Treaty

On August 21, 2006, the Chinese mainland government and the Hong Kong SAR government signed a new double taxation arrangement to replace their 1998 treaty. Subject to completion of the ratification procedures by both sides before December 31, 2006, the new treaty takes effect with respect to Hong Kong taxes for a year of assessment beginning after March 31, 2007 and with respect to mainland taxes for a taxable year beginning after 2006.

The new treaty, based on the OECD model, has a broader scope than the old treaty. In addition to employment income and business profits, the new treaty addresses the taxation of passive income such as dividends, interest, royalties, and capital gains and, in keeping with the international norm, also contains an exchange-of-information article. Under certain conditions, the new treaty affords mainland-source property income received by Hong Kong investors preferential treatment in the form of reduced withholding tax rates or tax exemption—treatment that generally compares favourably with China's domestic tax law and its other tax treaties.

- Withholding tax rates for dividends received by a Hong Kong resident from investments in mainland enterprises are reduced from 20 percent to 10 percent and to 5 percent on dividends received by a Hong Kong company holding 25 percent or more of the capital of the mainland enterprise. China's domestic exemption on dividends paid by foreign investment enterprises in China to foreign investors may be repealed as part of its pending tax reform, in which case the new treaty's 5 percent rate represents a preferential rate.

- Withholding rates for interest and royalties received from the mainland by a Hong Kong resident fall to 7 percent from 20 percent (from 10 percent if received by a Hong Kong company). The 7 percent rate compares favourably with China's normal domestic 10 percent rate and the rate established in its treaties with Macao and Singapore.

- Hong Kong alone is allocated the exclusive right to tax gains realized from the transfer of shares in a mainland enterprise by a Hong Kong-resident individual or a Hong Kong company, overriding the Chinese domestic law that generally imposes a 10 percent withholding tax. If the mainland enterprise's assets are composed mainly of immovable property on the mainland, or if the transferred shareholding is 25 percent or more of all the mainland enterprise's shares, the income may be taxed in both jurisdictions, but a tax credit arrangement effectively prevents double taxation. The exemption should facilitate some cross-border restructuring and merger and acquisition activities.

- The new exchange-of-information article allows exchanges between the mainland's State Administration of Taxation and Hong Kong's Commissioner of Inland Revenue, but only of information necessary for carrying out the domestic law of both jurisdictions in respect of taxes covered by the new treaty. This limitation is intended to ensure that the provision of taxpayer information is not abused and is generally viewed favourably by the business communities in both jurisdictions. But given the two jurisdictions' different accounting and tax systems, concern exists as to how the exchange provision will be administered and enforced. It is thus important that implementation guidelines be promulgated to further clarify the provision's operation and to introduce greater transparency in the exchange process.

- Income from immovable property and transactions between associated companies are covered, and cross-border employment coverage is expanded. The old treaty provisions—such as the PE definition and the treatment of business income—are generally retained.

The new treaty is generally welcomed by the business community. It is expected to foster closer investment and trade links between the two jurisdictions and to enhance cross-border financing arrangements and the transfer of technical knowhow and patent rights. The new treaty reinforces Hong Kong's stature as an international financial centre by adding incentives for international investors to use it as a portal to the mainland market. A taxpayer that operates in both Hong Kong and the Chinese

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mainland should review its business and investment structures to evaluate whether and how it can benefit from the new treaty.

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Fairness Request Saga

The taxpayer in *Lanno* (2006 FCA 220) recently asked the FCA to force the CRA to comply with the FCA's earlier decision regarding the CRA's refusal to allow him to late-file notices of objection under the fairness provisions. The taxpayer first appealed unsuccessfully to the FC for judicial review of the CRA's refusal of relief; on further appeal, the FCA ordered the CRA to refer the taxpayer's fairness request to a different CRA decision maker. The CRA referred the request, but it was again denied. In the present case, as a procedural matter, the FCA said that the complaint that the CRA had not complied with the FCA's previous decision must be taken back to the FC where the complaint was originally filed, not the FCA.

Mr. L was one of many investors in a real estate project; in his 1993, 1994, and 1995 tax returns, he claimed related losses that the CRA disallowed in 1997 because he had no reasonable expectation of profit (REOP). Mr. L thought that the accounting firm retained to represent the investors had filed the notices of objection on his behalf, but he learned otherwise in February 2002. In December 2002, the accounting firm applied for fairness relief under subsection 152(4.2) on Mr. L's behalf to allow him to late-file the objections. The CRA denied the application in May 2003 (fairness review no. 1) because it was based solely on a successful appeal to the courts by another taxpayer. (In May 2002, the SCC in *Stewart* ([2002] 2 SCR 645) held that the REOP test should not determine whether a taxpayer's activities constitute a source of income for section 9.) On Mr. L's behalf, the accounting firm then requested a review of fairness review no. 1 (fairness review no. 2), a request denied in July 2003 because the circumstances that prevented the accounting firm's filing an objection in the first place were not beyond its control. The CRA said that it cannot assume responsibility for the errors or omissions of a taxpayer's representative.

In response to Mr. L's request for a reconsideration of fairness review no. 2 (fairness review no. 3), the CRA said in November 2003 that its decision was unchanged. Mr. L then applied to the FC for judicial review of fairness review no. 2 (fairness review no. 4); the FC's June 2004 decision dismissed the application because the CRA's refusal was not patently unreasonable. On appeal (fairness review no. 5), the FCA disagreed, saying that the standard of review for a fairness application should be a less deferential one of reasonableness, based on its decision in *Hillier* ([2001] 3 CTC 157). The FCA allowed the application for judicial review—because, inter alia, the CRA failed to take into account a relevant consideration—and ordered that the application be referred to a different CRA decision maker for reconsideration (fairness review no. 6). In March 2006, a different CRA decision maker denied fairness review no. 6.

In the current case, Mr. L applied to the FC for judicial review of fairness review no. 6 and to the FCA for an order to enforce the FCA's earlier ruling, with which he believed the CRA had not complied. The FCA agreed with the CRA that enforcement should be brought before the FC, not the FCA: there were no special circumstances to warrant an exception. Mr. L's request for fairness relief remains unresolved despite several years' worth of effort and expenditure—no doubt a frustrating experience for him.

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PST: Software Use

Conflicting provincial administrative policies may oblige a taxpayer to remit provincial sales tax to more than one province on the same licence fee for software. In each of the five retail sales tax provinces, PST is imposed on the "use" of software. Although most provinces define the term "use," the definitions are not easily adapted to software, and the tax authorities differ in their administrative interpretations.

British Columbia, Saskatchewan, and Prince Edward Island say that software is used at the location of the person that accesses the software; Ontario and Manitoba say that software's use occurs at the location of the computer or the server on which the software is stored. A problem arises if, for example, a licensee in British Columbia remotely accesses software that is physically located on a server in Ontario: on the basis of current administrative policies, the licensor must remit tax to both British Columbia and Ontario. Common sense and the general presumption against double taxation suggest that only one of the competing positions is tenable; the different provinces' legislation should mesh.

No Canadian jurisprudence is directly on point, but the SCC in *Canadian Pacific Ltd.* ((1994), 99 CCC (3d) 97) said that in interpreting the term "use," dictionary definitions are a starting point that may require refining in light of the applicable context and facts. In *Monsanto Canada Inc. v. Schmeister* ([2004] 1 SCR 902), the SCC adopted the following as a definition of "use": "[to] cause to act or serve for a purpose; bring into service, avail oneself of."

The court said that the term denotes utilization for a purpose, or with a view to production or advantage. In *Gibbs v. Grand Bend (Village)*((1995), 49 RPR (2d) 157), the Ontario Court of Appeal said that "use" signified "[t]hat enjoyment of property which consists in its employment, occupation, exercise or practice."

If software is provided by remote access, does its use occur where the software is stored (on the server), where the person who accesses and works with the software is located, or where the resulting information is received? Each event may occur in a different location. For example, a software licence often provides employees located in different provinces with the ability to access the same software simultaneously. Or the licensor may contractually retain control of the software and the right to determine its location and merely grant limited rights to access the software, but not the right to manage or control its content. It is far from clear how the courts will apply the different provincial definitions of "use" in any particular fact pattern.

The provinces are constitutionally restricted to "direct taxation within the province," which requires, according to the SCC, a sufficient nexus or connection to the province as a basis for taxing the property. The courts have addressed this nexus requirement with respect to tax on aircraft, railway cars, and trucks, but its application to sales taxes on intangibles is unclear. For example, it is uncertain whether the mere remote accessing of a software program located on a server in Ontario from a computer in British Columbia can establish sufficient nexus for British Columbia to impose tax.

Subject to a judicial or legislative resolution of the issue, the provinces could adopt a uniform administrative solution that parallels the rule generally used for the taxability of telecommunications: when two of three conditions are met—the telecommunication originates in the province or terminates there or the charge for the invoiced service relates to a transmitter ordinarily located there—the service is taxable in the province. In the meantime, taxpayers should review their tax obligations with respect to all software licences.

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Accounting for a Tax

The annual budget statement provides information on government revenue and the spending supported by that revenue. The relationship between tax rates and spending predictions reveals the government's fiscal policy, but the overall review often fails to provide the details necessary for readers to realize clearly the reason for specific changes and the pressures on spending.

Revenues and Expenses of the Air Travellers Security Charge, 2001-2 to 2007-8

	Revenues	Operating expenses	Depreciation	Annual balance
	millions of dollars			
2001-2 actual	0	40	0	−40
2002-3 actual	445	205	5	235
2003-4 actual	420	250	10	160
2004-5 forecast	390	280	30	80
2005-6 forecast	350	325	85	−60
2006-7 forecast	365	365	100	−100
2007-8 forecast	380	380	110	−110

The recent report from the Department of Finance on the operations of the Air Travellers Security Charge (http://www.fin.gc.ca/news06/06-041e.html) provides the type of detailed analysis and rationale missing from the highly aggregated budget statements. Because the charges imposed on passengers at Canadian airports are intended to cover the cost of providing security, and thus in effect are user fees, they must, over a reasonable period of time, raise enough money to finance the security system but no more. Adjustments to the rates in three consecutive budgets show that the government's intention has been honoured.

The table summarizes the information contained in the report and shows revenues from the charge since its inception in the 2001-2 fiscal year (and projections through 2007-8). As in all federal financial reporting, accrual accounting is used; thus, the early capital expenditures do not show up in the spending side, but as the system matures and that capital is used in daily operations, depreciation becomes a more significant part of the overall budget. The initial surpluses have been used to build up a fund that peaks at $435 million by March 31, 2005 and stabilizes the financial picture to at least the end of 2007-8. The Finance report reveals that the new demands for increased airport security will push operating costs higher but that most of the accumulated surplus will be drawn down to finance the increased costs without rate increases.

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Joint Committee Recommendations

The CBA-CICA Joint Committee on Taxation (JCT) recently submitted to the minister of finance proposed amendments addressing income tax technical concerns on personal taxation, business and property income, trusts and estates, partnerships, corporations, and miscellaneous issues. Six of the 25 recommendations are summarized below.

Business and Property Income

1) *Section 67.6 and provincial sales tax penalties.* If a vendor fails to collect provincial sales tax, Ontario and British Columbia impose a penalty equal to the amount of sales tax that should have been collected (the BC penalty includes related interest). Section 67.6 denies a deduction for these penalties. In contrast, provinces such as Manitoba, Saskatchewan, and Prince Edward Island deem a vendor to have collected the sales tax. The vendor must remit that deemed amount: the remitted amount is not a penalty, and the vendor should be able to claim a deduction. The JCT says that the amount payable by a vendor who has failed to collect sales tax should be deductible whether or not the province imposes the obligation by way of a deemed collection or by way of a penalty: there is no difference in substance. The penalty is simply a tax-collection mechanism; it is not a penalty as contemplated by section 67.6, and the JCT recommends its exclusion from section 67.6.

2) *Deduction of contingent interest.* An accrual-basis taxpayer contingently obliged at year-end to pay interest for that year on borrowed money used to earn eligible income cannot deduct the interest in that year (paragraph 20(1)(c) permits a deduction only for interest legally payable in the year), and it cannot deduct the interest in a subsequent taxation year when the obligation becomes absolute (the interest is not payable for that year). Arguably, once the interest is payable because the obligation becomes absolute, it is deductible in the year that it accrued; but even if the CRA allowed taxpayers to file amended tax returns, it is impractical for a taxpayer to file waivers for the affected years in order to go back and claim the interest deduction. The JCT recommends a new rule to allow taxpayers to deduct contingent interest in the year that the obligation to pay becomes absolute.

3) *Foreign currency gains and losses.* Subsection 39(2) deems non-income-account gains and losses arising from foreign currency fluctuations to be capital gains and losses from the disposition of foreign currency. The first $200 of an individual's net gain or loss realized each year is excluded. The rule appears to apply to gains and losses realized for liabilities and to foreign-currency-related gains and losses realized on the disposition of property, which are also accounted for in the general rules that determine capital gains and losses. The JCT recommends restricting the application of subsection 39(2) to liabilities and individuals' monetary assets and updating the $200 exemption to reflect inflation.

Trust and Estates

4) *Acquisition of control by a trust.* A recent CRA technical interpretation (2004-0087761E5, May 24, 2005) concludes that a change in a trustee of a trust that holds sufficient voting shares to control a corporation may result in an acquisition of control of that corporation. This alone may lead to inappropriate acquisitions of control; moreover, if the CRA adopts a similar position on the transfer of shares from an estate to a testamentary trust or from one trust to another, an inappropriate acquisition of control may be triggered if the trustees of the recipient trust are not related to the transferor executors or trustees. The JCT submits that, generally, a trustee change or a transfer of shares from an estate or trust to another trust should not trigger an acquisition of control, but certain changes of beneficiaries should. New anti-avoidance provisions may be required.

Partnerships

5) *Subsection 40(3.12) elective capital loss: tiered partnerships.* A non-trust person who is a partner may elect a deemed loss on disposing of its partnership interest up to its adjusted cost base, if the partner was deemed by subsection 40(3.1) to have a gain in a previous year because its ACB was negative. The election is not available to a partnership that is a partner of another partnership, nor to a partner of the top-tier partnership for the interest in the lower-tier partnership. The JCT recommends that subsection 40(3.12) be amended to allow these types of partners to elect.

Corporations

6) *Affiliated corporations in an amalgamation context.* When two or more corporations amalgamate, certain rules require a determination of whether the new amalco was affiliated with one or more predecessors. Subsection 251.1(2) deems the amalco to have been affiliated with a predecessor if the two companies would have been affiliated immediately before the amalgamation had the amalco existed with the same shareholders that it had immediately after the amalgamation. If a predecessor was widely held, it is not deemed to have been affiliated with the amalco. The JCT recommends that a rule (similar to subsection 251(3.2)) be added to section 251.1 affiliating an amalco with those predecessors that were affiliated with each other immediately before the amalgamation.

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FORCO AND FOREIGN-OWNED USCO REPORTING

On June 21, 2006, the IRS issued final and temporary Treasury regulations (TD 9268 REG-109512-5) clarifying information required to be reported by certain foreign corporations and foreign-owned domestic corporations. The regs update and modify regs under Code section

6038 principally and also section 6038A to reflect changes in the Taxpayer Relief Act of 1997.

A US person who owns an interest in a foreign corporation may have information-reporting obligations; a US person who controls a forco must report certain information (on form 5471, "Information Return of U.S. Persons with Respect to Certain Foreign Corporations") on or before its US federal income tax return due date. Control exists if the person owns, or is deemed to own, more than 50 percent of the total combined voting power or value of all classes of the forco's stock for an uninterrupted 30 days or more during the forco's annual accounting period. Attribution applies, including stock held by certain non-resident alien family members.

Under section 6038(a)(4), a US shareholder who owns at least 10 percent of the total combined voting power of a controlled foreign corporation (CFC) must also report certain information on form 5471. A foreign corporation whose voting power or value is held more than 50 percent by US shareholders is a CFC.

Under section 6038A, a USco that is at least 25 percent foreign-owned at any time in a taxable year must furnish information to the IRS and maintain certain records and provide information about related-party transactions on form 5472 ("Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business").

Form 5471 includes a balance sheet, a description of the various classes of stock or interests outstanding, and a list of shareholders of record or partners owning at least 5 percent in value of any class of stock or interest outstanding, and their names, addresses, and number of shares held. The US person must also report information relating to transactions between the foreign business entity and certain related parties. The previous section 6038 regs require summaries that show the total amount of the corporation's related-party transactions involving sales or purchases of stock in trade and certain intangibles; purchases of tangible property; compensation paid for the rendering of certain technical or scientific services; rents or royalties, interest, or dividends paid or received; amounts loaned or borrowed; and premiums received for insurance or reinsurance. The new temporary regs now also require the reporting of any related-party sales of tangible property and of premiums paid to related parties for insurance or reinsurance.

The new final regs also update the penalty dollar amounts for failure to furnish required information. A $10,000 penalty applies to any taxpayer who fails to file form 5471 on or before the taxpayer's US-income tax return due date, including extensions; continued failure to file for more than 90 days after the IRS mails a notice of failure to file attracts an additional $10,000 penalty for each 30-day period or fraction thereof. The aggregate penalty cannot exceed $50,000 for a specific accounting period. In addition to the monetary penalty, failure to file results in a 10 percent reduction (plus an additional 5 percent reduction for any three months of continued failure after the 90-day period expires) in creditable foreign taxes (deemed) paid during the taxable year. The reduction is offset by any monetary penalty imposed.

If the taxpayer can prove reasonable cause in a written statement submitted to the IRS, the taxpayer is not deemed to have failed to file form 5471—either by its due date or after the expiration of the 90-day post-notice period—and the due date is generally extended and the penalties waived (section 6038). The new temporary regs seek to clarify confusion over proof of reasonable cause and the subsequent due date of form 5471. In an example provided, a taxpayer fails to file form 5471 by the April 15, 2008 due date for its 2007 return; the taxpayer receives a notice from the IRS on June 1. On August 1, 2008, the taxpayer submits a statement asserting reasonable cause. After discussions with the taxpayer, the IRS finds that the taxpayer had reasonable cause and establishes a September 15, 2008 due date for form 5471 and thus a start date for the 90-day period. The taxpayer must file form 5471 within 90 days (by December 14, 2008) in order to avoid penalties. The initial penalties for failure to file by the return due date are, however, waived due to the showing of reasonable cause.

The only new reg related to information reporting by a foreign-owned domestic corporation requires a foreign corporation that uses accrual accounting to report transactions between the corporation and a related party on an accrual basis.

These information-reporting requirements may affect many US shareholders of Canadian corporations. A Canco's US shareholder may need to file form 5471 even though the Canco is not a CFC, because different attribution rules apply for the purposes of determining control under section 6038. In addition, many Canadians who own shares of a US corporation should be aware of the form 5472 filing requirement.

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GST: Financial Services

The Excise Tax Act definitions of exempt "financial services" are among some of the most convoluted in the GST regime. A recent case, *Banque Canadienne Impériale de Commerce* (2006 TCC 336), illustrates the basic concepts and the difficulties facing financial institutions and tax practitioners in determining whether near-financial services are GST-exempt.

In the course of its business, the CIBC makes loans, grants credit, and issues credit cards. When borrowers default, the CIBC attempts to recover the money owing; after several attempts, the matter is turned over to one of several external collection agencies. The collection agencies are given authority to settle a claim at a lower amount—within limits set out in directives from the bank—and may extend the time for repayment. The agencies are paid a fee plus GST for successful collections. The CIBC attempted to recover, as a rebate for tax paid in error, over $2 million of GST paid to various collection agencies. (The CIBC is involved in exempt banking activities and thus cannot fully recover those amounts by way of input tax credit.) The minister disallowed the rebate and assessed the bank for the amount, saying that the debt-collection services were not exempt as financial services under the ETA.

The TCC described the mechanics of determining the existence of a qualifying financial service. (1) Determine whether the service is within those listed in paragraphs (a) to (m) of the subsection 123(1) definition of "financial service." (2) If it is, determine whether the service is excluded by any of paragraphs (n) to (t). Paragraph (t) refers to a prescribed service, described in the Financial Services Regulations; regulation 4(2)(b) includes "any administrative service . . . other than solely the making of the payment or the taking of the receipt." (3) If the service is an administrative service, and thus potentially excluded from the definition of "financial services" and taxable, determine whether the service falls within one of numerous exceptions to administrative services. In this case, the relevant exception was "other than solely the making of the payment or the taking of the receipt." The CIBC argued that the collection agencies' services were financial services under paragraphs (a), (d), (f), and (l) of the definition in subsection 123(1) and were excepted from prescribed administrative services, because they were "solely the making of the payment or the taking of the receipt."

The TCC concluded that the collection services did not initially fall within the listed services in the definition of "financial service" and thus were taxable. The TCC said that although the elements of the collection agencies' services and the broad definition of "financial service" may overlap to some extent, the supply was predominantly the provision of a debt-collection service.

However, in the event that it was mistaken, the TCC said that the service was an excluded administrative service. Although the collection agencies were empowered to settle accounts, reduce payment amounts, and extend payment arrangements, they still provided administrative services only; any decision made in the process of fulfilling their collection duties was ancillary to the collection services. Furthermore, the services were not excepted from administrative services: they were not "solely the making of the payment or the taking of the receipt." The French version of the subsection uses the term "recouvrement," which means "collection" in English; but the TCC, referring to *Medovarski* (2005 SCC 51), concluded that the shared meaning between the English and French versions is established by the English word "receipt," a term narrower than "recouvrement" or "collection." Thus, the activity excepted from the definition of administrative services is the "making of the payment or the taking of the receipt" of money and not the actual collection of money.

The CIBC also referred to the TCC's *Royal Bank of Canada* decision (2005 TCC 802) that a branch service—the arranging for the distribution of mutual funds—was an exempt financial service and not an administrative service, even though the supply had a customer service element. However, the TCC in the *CIBC* case noted that there was no evidence that the collection agencies had a non-administrative function; they had "no voice in how CIBC ran its business."

The *CIBC* case lays out the mechanics of determining whether a GST-exempt financial service exists. It is sometimes forgotten that an exempt financial service must first fall within the definitions in paragraphs (a) through (m); if it does not, debating the exclusions and exceptions is moot. More importantly, the case is one of a handful that sheds light on the meaning of administrative services. On the whole, *CIBC* appears to set a high threshold for arguing that services are exempt financial services. Interestingly, legislation released in draft before the *CIBC* decision will soon retroactively specifically exclude debt-collection services from the definition of "financial service" (SC 2006, c. 4, s. 136). The CIBC pursued its case in the TCC apparently in part to gain a favourable finding before the legislation's enactment.

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Insurance's Protean Nature

Flexible benefit plans that grant employees credits to purchase taxable or non-taxable benefits are not mentioned in the Act, nor is the health and welfare trust, a funding vehicle for benefit plans. What little tax legislation governs non-pension employee benefit plans sets out only descriptive, not prescriptive, rules. The regulation of these plans is almost the exclusive province of the CRA.

A private health services plan (PHSP) is defined as a contract of insurance in respect of hospital expenses or medical expenses, a medical care insurance plan, or a hospital care insurance plan. The CRA requires that a PHSP must be either an insurance contract with a licensed insurer or a plan that exhibits the essential attributes of insurance—namely, an undertaking by one person to indemnify another from loss in respect of an uncertain event.

A health services spending account (HSSA), a type of PHSP recognized by the CRA, grants employees credits to defray medical expenses. An HSSA must exhibit the attributes of insurance, which according to the CRA means that unused credits or unreimbursed expenses (but not both) can be carried forward but not for more than one year: allowing some employees to carry forward credits and others to carry forward expenses violates insurance principles, as do cash refunds of unused credits.

Under a cost-plus arrangement, an insurance company or other third party (including a trust) pays the permitted medical expenses and is reimbursed by the employer, who pays an administrative fee for the service. In effect, a cost-plus arrangement is a type of administrative-services-only (ASO) arrangement. The elements of insurance necessary to constitute a PHSP must be found not in the ASO payment mechanism, but in the attributes of the plan under which the benefits are provided.

A recent technical interpretation (TI 2006-0188061M4, July 14, 2006) discusses a cost-plus medical plan for sole proprietors and their families. The CRA says that if the proprietor has no employees there can be no insurance, and the plan fails to qualify as a PHSP: looking through the third-party provider, the CRA says that the proprietor is the payer and is not indemnifying another person. However, even if the proprietor participates in the plan, as long as an employee (even a family member) also participates under the plan, the plan qualifies as a PHSP if the other insurance elements are present. To benefit from the deduction under section 20.01 for contributions to PHSPs, sole proprietors and partners without employees must actually purchase insurance from licensed insurers.

The CRA requirements for insurance can vary according to the nature of the benefit plan. Sickness or accident, disability, and income maintenance insurance plans are known as wage loss replacement plans (WLRPs); employer contributions are not considered a taxable benefit. If a WLRP is not insured by a licensed insurer, it must be based on insurance principles, which includes the requirement that the plan be funded. An unfunded contingency reserve is not acceptable to the CRA. Asked at the 2006 annual meeting of the Conference for Advanced Life Underwriting why insurance principles required funding of WLRPs but not of PHSPs, the CRA said that "distinguishing whether self-funded arrangements contain the requisite element of insurance presents a difficult challenge for the CRA" (see document no. 2006-0174121C6, May 9, 2006). The CRA is attempting to distinguish WLRPs from salary continuances. Without giving additional reasons, the CRA declared that it was not prepared to recognize unfunded WLRPs.

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Ontario Dividend Tax Changes

In response to federal draft legislation that creates a new tax regime for eligible dividends, Ontario announced on August 3, 2006, that its dividend tax credit on eligible dividends will increase over five years, subject to enactment of the federal legislation. (See "New Dividend Tax Regime," *Canadian Tax Highlights*, August 2006.) Ontario is the third province (after Quebec and Manitoba) to follow the federal lead. (See "Reduced Tax on Dividends," *Canadian Tax Highlights*, June 2006.) The combined federal and Ontario changes cause the top federal-Ontario personal tax rate on eligible dividends to decline from 31.34 to 22.38 percent—an 8.96 percentage point reduction—from 2005 to 2010. (See table 1.) Both the federal and the Ontario rules for non-eligible dividends are unchanged; Ontario's dividend tax credit therefor remains 5.13 percent, and the top federal-Ontario personal tax rate remains 31.34 percent.

Ontario adopts the federal definition of "taxable income" for personal income tax purposes, so that the 45 percent federal dividend gross-up on eligible dividends automatically applies for Ontario tax purposes. Ontario further parallels federal rules by enhancing its dividend tax credit on eligible dividends, but the federal increase is fully effective in 2006, and Ontario's is phased in from 2006 to 2010. Ontario explains that its changes are intended to "better reflect existing corporate tax rates": presumably, Ontario's phase-in reflects the phase-in of federal general and M & P corporate income tax rate reductions. The announcement also says that when Ontario's dividend tax credit on eligible dividends is fully phased in, it will completely offset for Ontario top-marginal-tax-rate individuals the province's 12 percent corporate income tax rate for M & P, farming, fishing, logging, and mining income. Table 1 outlines the changes.

Table 1 Proposed Treatment of Eligible Dividends

	Dividend tax credit %		Top rate %	
	No surtax	With 56% surtax[a]	Ontario	Federal + Ontario
Before 2006[b]	5.13	8.00	11.76	31.34
2006	6.50	10.14	10.54	25.09
2007	6.70	10.45	10.09	24.64
2008	7.00	10.92	9.41	23.96
2009	7.40	11.54	8.51	23.06
2010	7.70	12.01	7.83	22.38

[a] Rates apply to all taxable Canadian dividends.

[b] In 2006, when Ontario taxes payable after non-refundable tax credits (including the dividend tax credit) exceed $5,065, the surtax is 56%; when they are between $4,016 and $5,065, the surtax is 20%.

Table 2 Combined Corporate and Personal Tax Cost of Eligible Dividends, 2005-10

	M & P income	Non-M & P income
	dollars	
2005	5,477	5,614
2006	5,065	5,215
2007	5,035	5,186
2008	4,867	5,019
2009	4,768	4,922
2010	4,644	4,799

Note: No small business deductions; December 31 year-end; $10,000 active business income.

The federal legislation permits a CCPC to elect to be treated as a non-CCPC for the purposes of the new dividend regime and the small business deduction; Ontario announced that the election applies for Ontario purposes. Ontario-resident shareholder-managers of Ontario CCPCs should re-evaluate their strategy for receiving salary versus dividends after 2005. The lower tax cost on dividends paid out of income subject to the general or M & P corporate rate may increase a shareholder-manager's preference to receive distributions of that income as dividends, but salary may reduce his or her alternative minimum tax exposure. Table 2 compares the decline in the combined corporate and personal tax cost on dividends paid out of $10,000 M & P or non-M & P income. Table 3 shows the income tax deferral if the income is earned and retained in the corporation and not paid out as salary to the shareholder; it also compares the tax saving (cost) of that strategy (and an ultimate payout of the after-tax corporate income as an eligible dividend to the shareholder) with a payment of pre-tax income as salary. Table 3 shows that in 2010, a shareholder-manager who distributes income subject to the M & P rate as dividends can both defer and save tax; in all other cases, the tax on dividends exceeds the tax on salary. However, the decreasing tax cost, coupled with the increasing tax deferral, makes retention in the corporation more attractive in each subsequent year. Of course, tax can be deferred only as long as the shareholder-manager does not require the funds.

Table 3 Dividends Versus Salary, 2005-10

	Dividend from M & P Income		Dividend from Non-M & P Income	
	Deferral	Saving (cost)	Deferral	Saving (cost)
	dollars			
2005	1,331	(734)	1,131	(871)
2006	1,331	(322)	1,131	(472)
2007	1,331	(292)	1,131	(443)
2008	1,493	(124)	1,293	(276)
2009	1,543	(25)	1,343	(179)
2010	1,643	99	1,443	(56)

Note: No small business deduction; December 31 year-end; $10,000 active business income. The table assumes that the Ontario-resident individual is taxed at the top marginal income tax rate. Different results may arise in special circumstances (for example, for resource companies). A cost (in parentheses) indicates that the tax on dividends exceeds the tax on salary.

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Canadians and US Real Estate

Many Canadians invest in, speculate in, and develop US real estate; the tax consequences depend on the acquisition vehicle.

■ **Individual.** A Canadian-resident individual who owns US real estate directly is exposed to the associated commercial risks and to US estate tax on death. If the property earns income, US and Canadian returns must be filed. The calculation of income differs: the US tax is creditable against Canadian tax, and the final cost is the higher of the two. An individual carrying on a US trade or business is not subject to US branch profits tax; the US net election is available if no business exists. FIRPTA applies on the property's disposition. The mortgage can be increased up to an appreciated value without automatically triggering a gain or an income inclusion in either country; interest on funds reinvested in another income-producing investment is deductible in Canada.

■ **Trust.** A Canadian discretionary trust that is recognized for US purposes and owns US real estate is not subject to US branch tax or to thin capitalization or earnings-stripping rules. If no US trade or business exists, the trust may elect to pay US tax on net rental income. Canadian tax applies at the top personal marginal tax rate in the province where the trust resides (about 46.4 percent in Ontario, 39 percent in Alberta): the trustee's residence is determinative. US tax paid is creditable on the Canadian return. A trust partner in a US partnership may suffer 35 percent US withholding. A beneficiary is not subject to US estate tax on death if his or her interest ceases on death.

A trust with a US trustee and Canadian beneficiaries is US-resident but is deemed resident in Canada: the treaty contains no tie-breaker clause for trusts. The trust is taxable at US marginal rates applicable to a trust, and the tax is creditable in Canada; no US withholding applies if the US trust is a partner in a US partnership. A US discretionary trust beneficiary may be exposed to US estate tax; the trust must avoid US grantor trust status.

The trust's maximum tax rate is the top Canadian tax rate, which compares favourably with the total tax on distributions to a Canadian shareholder from a Canco or

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a USco or a tandem Canadian parent and US subsidiary: combined taxes on the latter may reach 55.84 percent for passive property.

■ **Canco.** A Canco that directly owns US real estate files US and Canadian income tax returns and may credit the US tax in Canada. If Canco carries on a US trade or business or has effectively connected income, it suffers US corporate tax and 5 percent US branch profits tax on net income over Cdn$500,000. A US branch that pays interest to a Canadian lender suffers 10 percent US withholding. If there is no US trade or business, Canco pays 30 percent US withholding on its US-source income unless it makes a net election. Thin capitalization rules may prohibit the deduction of interest paid to shareholders. US interest allocation rules are based on a fungible allocation; a US sub may simplify the structure, avoid US branch profits tax, and coordinate the allocation issues for US federal and state tax purposes. No US estate tax applies on the death of Canco's shareholder.

A Canco's rental income from its US companies is taxable as a specified investment business if it has fewer than six full-time employees; refundable dividend tax on hand is refunded on the payment of sufficient dividends, reducing the effective Canadian corporate tax rate to about 16 percent. Otherwise, Canco pays tax at about 36 percent. (The small business deduction does not apply to income not earned in Canada.)

Canco is subject to US and Canadian tax on gains on the property's sale; the treaty confirms the United States' right to impose FIRPTA. Canada allows a credit for US tax; one-half of the gain is added to Canco's capital dividend account and 26⅔ percent of the taxable capital gain is added to refundable dividend tax on hand. A $1 refund is available for every $3 of taxable dividends paid to Canco's shareholders. The acquisition of US replacement property may be tax-deferred under the US like-kind exchange rules; no Canadian rollover applies for US-situs property.

Limited liability company (LLC). An LLC is not a popular vehicle for Canadian ownership of US real property, because it is not subject to tax and is not a treaty resident. The LLC is Canadian-resident if its central management and control is in Canada. The LLC is a flowthrough entity for US tax purposes and a foreign affiliate for Canadian tax purposes, a difference that may create a mismatch if it carries on an active business: no Canadian foreign tax credit exists for income that is deemed to flow through for US tax purposes and is not taxed in Canada unless it is distributed in the same year. If a US sub of a Canadian holdco holds an LLC that carries on an active business, only US returns are filed.

An individual LLC shareholder must pay US tax on its undistributed income; no credit is available in Canada, because it is a deemed foreign affiliate. If the LLC earns FAPI, a problem may also arise in applying a tax credit, because the LLC has not paid any US tax. On death, the individual suffers US estate tax on the shares' value.

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Foreign Tax News

United States

The IRS and the CRA announced (IR-2006-121, August 3, 2006) significant progress in their pursuit of an abusive cross-border tax scheme involving hundreds of taxpayers and tens of millions of dollars in deductions and unreported income from retirement account withdrawals by US and Canadian individuals. The Washington-based Joint International Tax Shelter Information Centre, which tracks international schemes and shelters, originated the project. The centre, established in 2004, is staffed by delegates from the founding countries (Australia, Canada, the United Kingdom, and the United States).

Proposed IRS regs (IRB 2006-36 REG-124152-06, August 3, 2006) provide guidance on the allocation of foreign taxes paid or accrued after 2006. Foreign law is generally deemed to impose legal liability for income tax on the person required to account for the income (or the owner of the non-income tax base) for foreign tax purposes, even if someone else is solely obliged to pay it. A reverse hybrid's foreign tax liability is based on the ratio of the owner's taxable income attributable to its share of the hybrid's income. If a hybrid that is a partnership for US tax purposes is taxable as an entity under foreign law, the foreign tax is deemed to be the hybrid's legal liability even if its owners are secondarily obliged to pay. Comments are requested on the legal liability rule's application to hybrid instruments and payments disregarded for US tax purposes.

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