**QUEBEC CORPORATE LAW: VOTING SHARES**

Quebec’s new Business Corporations Act (QBCA) provides that upon the redemption or cancellation of all issued voting shares of a corporation, all issued non-voting shares acquire voting rights. That rule was behind a plan to establish a substantial interest in order to avoid part VI.1 tax: a technical interpretation (2013-0511101 E 5, December 18, 2013) examines the relevant tax and corporate law in the context of a subsection 164(6)-driven preferred share redemption on the death of Mr. X.

In the TI, a QBCA corporation had three share classes issued and outstanding: non-voting class A and B shares and voting class C shares. Mr. X held the class B (preferred freeze) non-voting shares, and the other two classes were held by an inter vivos trust. The share structure was the result of an estate freeze. Mr. X’s class B shares were taxable preferred shares that did not qualify under subsection 191(4). The executors of the estate of Mr. X were the same individuals as the trustees of the inter vivos trust.

After the class C voting shares were redeemed, the class B shares held by the estate became voting shares because of the QBCA rule, and thus the estate controlled the corporation. As a result, the estate was related to the corporation and had a substantial interest therein.

The CRA was asked whether the plan offended the specific part VI.1 anti-avoidance rules (paragraphs 191(3)(a) and (b)) and whether an acquisition of control occurred when the estate became the controlling shareholder. The taxpayer also wanted to know whether the change in voting rights triggered a disposition of the class A and B shares.

The CRA indicated that paragraph 191(3)(a) did not apply because there was no acquisition of a substantial interest in the corporation: the voting rights were latent in the class A and B shares, and thus nothing was actually acquired. Furthermore, paragraph 191(3)(b) does not appear to apply to the estate because it did not acquire a share in the corporation.

Concerning the acquisition of control, the trustees of the inter vivos trust and the executors of the estate were the same individuals. Did the shifting of votes from the trust to the estate trigger an acquisition of control? The CRA said that there was no acquisition of control: the persons who controlled the corporation before the redemption (the executors) were the same persons who controlled it after the redemption (the trustees).

The CRA also said that there was no disposition of the class A and B shares when they became voting shares, because the voting rights crystallized by virtue of the operation of corporate law. The latent voting rights were always present in the class A and B shares, and there was thus no change in rights that gave rise to a disposition. This position was consistent with the view that there was no acquisition for subsection 191(3) purposes.

In addition, the TI seemed to conclude that GAAR did not apply to this series of transactions, but the CRA did not express a firm determination. In the TI’s factual context, the taxpayer was trying to avoid part VI.1 tax, and the underlying policy of that part was not to catch an estate freeze. According to the CRA, part VI.1 tax was intended to apply to situations in which a taxpayer used preferred shares instead of debt. On the TI’s facts, the taxpayer was not attempting to use preferred shares in place of debt financing, but nonetheless might have been caught by part VI.1. The TI concluded that although there was clearly a tax benefit and an avoidance transaction, good arguments could be made that the purpose of part VI.1 was not abused and thus GAAR should not apply.

The TI’s facts show that opportunities for flexibility may arise through the use of a corporation incorporated in Quebec or a jurisdiction in which latent votes in non-voting shares coalesce when all the voting shares are redeemed. On the facts, the estate was able to achieve a change in voting rights and become the corporation's
controlling entity without a disposition or acquisition of any preferred shares. The CRA’s comments on GAAR are consistent with the position that part VI.1 was intended to apply to certain types of preferred share financing and not to post mortem planning.

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Transfer Pricing: Different from Arm’s Length

In Marzen Artistic Aluminum Ltd. (2014 TCC 194), the TCC largely dismissed an appeal from transfer-pricing adjustments made under paragraphs 247(2)(a) and (c). The court also upheld a penalty under subsection 247(3) and relied on the deeming provision in subsection 247(4) to hold that the taxpayer had not made reasonable efforts to determine and use arm’s-length prices. Although the provisions were enacted in 1997, this is the first time that the deeming provisions and the penalty have been applied by the TCC.

Marzen, a Canco incorporated in 1970, engaged in the design, manufacture, and sale of aluminum and vinyl window products in British Columbia. Marzen was not at arm’s length with Starline Windows Inc. (SWI), which was incorporated in Washington state. In 1998, SWI opened a sales office and storage facility and engaged a staff of about 20 employees to provide sales, administrative, accounting, storage, and delivery services in its business of selling in the United States window products that it had purchased from Marzen. Starline International Inc. (SII) was wholly owned by Marzen and was incorporated in Barbados in 1998.

Acting on expert advice on how to structure its affairs in a tax-efficient manner, on July 1, 1999 Marzen entered into a marketing and sales services agreement (MSSA) with SII, which undertook to provide marketing services to Marzen in the United States. In 2000, the MSSA was amended: Marzen agreed to pay SII a one-time bonus of about 20 employees to provide sales, administrative, accounting, storage, and delivery services in its business of selling in the United States window products that it had purchased from Marzen. Starline International Inc. (SII) was wholly owned by Marzen and was incorporated in Barbados in 1998.

Acting on expert advice on how to structure its affairs in a tax-efficient manner, on July 1, 1999 Marzen entered into a marketing and sales services agreement (MSSA) with SII, which undertook to provide marketing services to Marzen in the United States. In 2000, the MSSA was amended: Marzen agreed to pay SII a one-time bonus of 10 percent on confirmed contracts in the California market if SII achieved at least US $10 million in net sales between August 1, 2000 and December 31, 2001. Marzen’s owner had met with Mr. C, who was established in Barbados; he became SII’s managing director, and advised Marzen’s owner that SII should abandon the residential US market for the condominium market in California.

SII and SWI also entered into a personnel secondment agreement (PSA) on July 1, 1999: SWI agreed to second its personnel to SII to perform marketing services for Marzen. Before then, SWI had performed for Marzen essentially the same tasks that SII agreed to perform under the MSSA. SII also agreed to pay SWI monthly fees under an administrative and support services agreement (ASSA) for providing SII with secretarial and administrative support services.

Marzen paid SII approximately Cdn$13 million in 2000 and 2001 under the MSSA; SII paid SWI Cdn$4.9 million for the secondment of its sales and administrative staff under the PSA. Under the post-July 1, 1999 arrangements and as a result of the marketing fees paid under the MSSA by Marzen to SII, virtually all profits realized by the controlled group of Marzen, SWI, and SII were realized by SII in Barbados.

In assessing the 2000 and 2001 taxation years, the minister assumed that the amounts that SII paid to SWI under the PSA and ASSA were arm’s-length amounts. The court found that SII was an empty shell with no personnel, no assets, no intangibles, and no intellectual property. The court also concluded that there was only one reasonable explanation for Marzen’s agreeing to pay SII under the MSSA: to report the fees as SII’s profits and then return them to Marzen as exempt surplus dividends. Thus, the court concluded that Marzen had failed to “demolish” the minister’s assumption that an arm’s-length party would not have paid to SII the marketing fees that Marzen paid in its 2000 and 2001 taxation years for the services that SII provided to Marzen.

Nevertheless, the court concluded that “some on-going direction” and "some strategic advice" (emphasis in original) were provided to SWI by Mr. C as managing director of SII on its behalf. The court accepted that a US$32,500 fee in 2000 and 2001 paid by SII to Mr. C at arm’s length for those services was a reliable internal comparable, and it said that the pricing adjustments under paragraph 247(2)(c) should be reduced by US$32,500 in each year.

The TCC declined to give any weight to Marzen’s expert report because it wrongly identified the transaction under review (it treated SWI and SII as one entity) and it was based on assumptions that were not found to be facts. For reasons that are not apparent from the judgment, the minister’s principal expert’s report was not admitted into evidence. However, the TCC did rely on the conclusions in the minister’s expert’s rebuttal report and commented on its “careful and thorough analysis of the weaknesses [that the minister’s expert] had identified” in Marzen’s expert’s report.

In upholding the subsection 247(3) penalty assessed for the 2001 taxation year, the TCC said that the response to the minister’s request for contemporaneous documentation did not fulfill the requirements of subparagraphs 247(4)(a)(v) and (vi).
The CRA’s Duty of Care to a Taxpayer

Taxpayers have a long history of unsuccessfully suing the CRA for the alleged negligence of its auditors. The recent decision in Leroux (2014 BCSC 720) does not change that trend, but for the first time in Canadian common-law history, CRA officers were found to owe a duty of care to a taxpayer under audit. The decision also contains interesting comments on the standard of care owed by an auditor and on the causation test applicable to an auditor’s negligence, but in this article I discuss only the BCSC’s findings on the CRA’s duty of care. The taxpayer has appealed the BCSC’s decision—which said that the taxpayer failed to demonstrate that the auditor’s negligence caused the alleged damages—and the Crown has cross-appealed the award of costs.

Mr. Leroux alleged that the CRA was negligent in auditing and reassessing his 1993, 1994, and 1995 taxation years. The reassessments totalled more than $600,000 in tax, interest, and penalties, but they were ultimately settled for less than $50,000. In the interim, after Mr. Leroux was unable to obtain the financing necessary to carry on his business, he was forced to sell the property on which he lived and operated an RV park. He alleged that he was unable to obtain financing as a direct result of the CRA’s collection efforts.

Mr. Leroux brought an action in negligence against the CRA for damages that included the loss of his home and business. The agency initially moved to strike his notice of claim on the basis that it owed him no duty of care, but both the chambers judge and the FCA concluded that a full trial was necessary to determine the point (Leroux, 2010 BCSC 865; aff’d 2012 BCCA 63).

The BCSC applied the standard two-part test to establish a duty of care. First, it determined that the CRA owed a prima facie duty of care, having regard to the reasonable foreseeability of harm to the plaintiff and the degree of proximity between the plaintiff and the defendant. Second, the court determined that residual policy considerations did not negate the duty of care.

The CRA wisely conceded that it was reasonably foreseeable that Mr. Leroux could be harmed by the actions of its auditors and appeals officers. However, the CRA argued that its duty is to the public at large and that its interests are thus inherently opposed to those of a taxpayer under audit; consequently, the required proximity could not be established. The CRA also argued that the establishment of a duty of care to particular taxpayers would encourage a flood of litigation against the agency. Moreover, the CRA argued that the jurisprudence had already established that no duty of care existed, and it cited a series of cases, including Canus (2005 NSSC 283), 783783 Alberta Ltd. (2010 ABCA 226), Leighton (2012 BCSC 961), and Foote (2011 BCSC 1062).

Mr. Leroux relied primarily on Hill v. Hamilton-Wentworth Regional Police Services Board (2007 SCC 41), in which a wrongfully accused plaintiff successfully sued a police department for negligence in the course of the investigation that led to charges against him. The court in Hill rejected arguments similar to the CRA’s arguments in Leroux and concluded that the finding of a duty of care would only improve the quality of police work. Mr. Leroux also pointed to the fact that a taxpayer was effectively at the mercy of the CRA, which would be unaccountable for its actions if it owed no duty of care to a taxpayer.

The court in Leroux found that the relationship between the CRA and a taxpayer under audit was similar to the relationship between the police and a suspect under investigation. Although prior jurisprudence had found that the CRA owed no duty of care to a taxpayer under audit, the BCSC concluded, perhaps in order to balance the competing authorities, that the CRA sometimes—but not always—owes a prima facie duty of care to a taxpayer under audit:

An audit may not necessarily place a taxpayer in a close and direct relationship with the auditors. In the vast majority of cases, the required degree of proximity may well not exist. There may not be the extended and personal relationship between the auditors and the taxpayer, the close and direct nexus between the pivotal discretionary decisions taken by the auditors and the harm alleged, or the foreseeably huge and devastating effects of these discretionary decisions on the taxpayer, obvious to the auditors at the time they made them.

The CRA and its auditors were found to owe the taxpayer a prima facie duty of care because the audit was focused and intensive, took place over many years, and involved discretionary decisions and huge penalties. The term “discretionary decisions” seems to have been used in reference to the exercise of judgment involved in determining, for instance, whether capital or income treatment was appropriate.

The court concluded that no residual policy considerations negated that duty of care and, echoing Hill, found that there was no conflict between an auditor’s duty to the public and his or her duty to a taxpayer under audit. Both the public and a taxpayer under audit benefit from the auditor taking reasonable care. In reaching this conclusion, the BCSC noted that the CRA would otherwise be unaccountable to any independent body except through appeals to the TCC. The BCSC also concluded that a flood of litigation was unlikely to occur, given the difficulty of overcoming the Crown’s practically limitless resources.
Although the court concluded that the CRA owed a duty of care to the taxpayer and that it had breached that duty in its assessment of penalties, the taxpayer was unable to demonstrate that the assessment of penalties had caused any of his losses, and therefore he was unable to recover damages.

The court’s holding that a duty was owed to the taxpayer in Leroux is a welcome extension of the law, but the conclusion that a taxpayer is not always owed a duty of care is troubling. In particular, it is surprising that the court suggested that a duty of care might not have been owed if the audit had been shorter or less thorough, or if the issues had been less complex. Future jurisprudence will clarify whether there are circumstances in which an auditor does not have a duty to exercise reasonable care.

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**Undisclosed Agency Questioned**

Undisclosed agency is a well-accepted common-law principle. An undisclosed agency exists if an agent enters into a contract with a third party on behalf of a principal but does not reveal to the third party either the identity of the principal or the fact that the agent is acting on behalf of any principal. However, in 2253787 Ontario Inc. (2014 TCC 121), the TCC seemed to take a dim view of undisclosed agency, nearly analogizing it to a sham transaction that was intended to deceive and thus should not be upheld by the courts. The decision is surprising, but it is a reminder that a taxpayer’s representative may need to provide legal submissions on non-tax matters to the court.

Two private corporations (the taxpayers) were incorporated for the sole purpose of purchasing Apple iPhones in Canada and reselling them to grey-market wholesalers in other regions such as Hong Kong, where the products were not yet officially available. The taxpayers used friends, relatives, and contractors to buy one or two iPhones a day; they reimbursed each buyer for the purchase of the iPhone, including HST, and paid a fee in return for proof of payment and the iPhone. The taxpayers couriered the iPhone overseas and resold it in a foreign market. The taxpayers, which were GST/HST registrants, claimed ITCs on the iPhones purchased in Canada.

The CRA disallowed ITCs on the iPhone purchases, saying primarily that the taxpayers were not the recipients of the supply of the iPhones and that there was no agency relationship between the taxpayers and the buyers. The taxpayers appealed to the TCC on the basis that an agency relationship had existed and that they satisfied the evidentiary requirements of ETA subsection 169(4).

The TCC seemed to rely on Royal Securities Corporation Ltd. v. Montreal Trust ([1967] 1 OR 137 (HC)), which established a three-part test to determine whether an agency relationship exists: (1) consent from both parties, (2) authority from the principal to allow the agent to affect the principal’s rights and obligations as if it had entered the contract itself, and (3) its control over the agent’s actions. The TCC found that the first and third requirements were met, but not the second requirement.

The TCC noted that it was a term of a contract with Apple (the retail store purchase policies and sale and refund policy) that only an end user may purchase a product and that resale and export were prohibited. Thus, the TCC concluded that the taxpayers could not have created or maintained a legal relationship with Apple directly because they intended to export and resell the product. An agent cannot have a legal capacity that exceeds that of the principal, and the TCC concluded that the buyers therefore could not have been the taxpayers’ agents.

The TCC also said that the documentary evidence provided by the taxpayers to support their ITC claims and meet the requirements of subsection 169(4) was unsatisfactory: many of the buyers’ names were fictitious, unreliable, or missing, and fewer than half of the transactions met the minimum standards necessary for a person to legally make an ITC claim.

We have serious concerns about the TCC’s analysis of the purported agent-principal relationship. A minor point is that ETA subsection 177(1), which the TCC mentioned several times, is irrelevant to a person’s claiming of ITCs as agent; it applies only if the principal made a supply through an agent (that is, to Apple making a supply through an agent), a point that was not in issue.

The TCC’s apparent conflation of the capacity to enter into a contract with the intention to breach a contract is a more significant matter of concern. The TCC correctly cited the FCA’s decision in 1524994 Ontario Limited (2007 FCA 74, at paragraph 18) as authority for the legal concept that a principal cannot appoint an agent to enter into a contract that the principal lacks the legal capacity to enter into. The FCA cited Haggstrom et al. v. Dey and Westminster Credit Union ((1965), 54 DLR (2d) 29 (BCCA)), in which the BCCA found that Mr. Dey could not have been the credit union’s agent when preparing conveyancing documents because conveyance was ultra vires the credit union under the Credit Union Act. However, in 2253787 Ontario, the TCC implied that the taxpayers lacked capacity to contract directly with Apple to purchase the iPhones because they intended to breach terms of the contract by exporting and reselling the iPhones; if that proposition were true, it would undermine the concept of efficient breach. A corporation’s capacity to enter into legal relationships is found in its constating document, and is not
affected or limited by any contractual terms to which it may agree. The contractual terms of Apple's sales, including prohibitions on export, did not affect the taxpayers' capacity to contract, even if from the outset they intended to breach the contractual terms by exporting and reselling the iPhones. Apple may have a claim for breach of contract, but in our view the taxpayers had the capacity to contract with—to purchase from—Apple directly.

It is also a matter of concern that the TCC seemed to take a dim view of the fact that the agency relationship was undisclosed to Apple at the time of sale: “[N]o agency existed given the required necessity of concealment to the initial seller, with whom, without such a concealment, a legal relationship could not have been created or maintained affecting the rights and obligations of the purported principal.” The court’s conclusion seems to ignore the widely accepted legal concept of an undisclosed agent, and it implies that the non-disclosure of an agency relationship to a third party is inappropriate even though the common law recognizes the legitimacy of an undisclosed agent. The SCC has said that generally in contracts with third parties, the undisclosed principal “has the same rights and liabilities under the contract whether he or she was disclosed to the third party and despite the fact that his or her name did not appear on the face of the contract” (Friedmann Equity Developments Inc. v. Final Note Ltd., 2000 SCC 34).

Without having had the benefit of reviewing the full trial record, we wonder whether the TCC’s decision reflected the positions advanced by the parties' counsel. Every court relies on each party to present the relevant legislation, the positions advanced by the parties’ counsel. Every court has an opportunity to revisit these important legal issues.

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TFSA: US Tax Classification

The TFSA allows savings deposits to earn tax-free investment income (subsection 146.2(1) of the ITA), but causes problems for the estimated 1 million US persons in Canada who must report TFSA income on their US tax returns and pay any related tax. There is no official IRS guidance on the TFSA as there is on the RRSP, and the IRS has not responded to requests for clarification on proper reporting procedures for TFSA; some advisers report that the IRS will not issue a private letter ruling on the matter.

A TFSA is generally assumed—incorrectly—to be a foreign trust for US tax purposes that requires the filing of a form 3520 (“Annual Return To Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts”) and a form 3520-A (“Annual Information Return of Foreign Trust with a U.S. Owner”). Arguably, a TFSA is not an entity separate from its owner for US federal tax purposes, and no additional reporting is necessary. Even if a TFSA is a separate entity, it should be treated as a disregarded entity for US tax purposes and a form 8858 should be filed.

Not an RRSP. The conventional wisdom that a TFSA is a foreign trust is based on an analogy to the IRS's tax treatment of an RRSP. Without the substantiation of legal concepts, in Notice 2003-75 the IRS classified an RRSP as a foreign trust. The IRS’s position on RRSPs and RRIFs does not automatically apply to a TFSA, which is created under different statutory and contractual arrangements. A TFSA functions more like a normal bank account, and less like a trust, than an RRSP does. Withdrawals from and contributions to a TFSA are almost instantaneous in comparison with the financial institution's involvement in RRSP transactions. In contrast to a TFSA, tax is withheld on RRSP withdrawals, and receipts are issued by the financial institution for most RRSP transactions.

Not a separate entity. The Code’s entity classification regime under regulations 301.7701-1 to -4 applies only to entities that are separate from their owners. Certain contractual arrangements under which the participants carry on a trade, business, financial operation, or venture and divide the resulting profits give rise to an entity for US federal tax purposes. A TFSA is a contractual arrangement between two parties, but the TFSA holder does not divide the TFSA returns (profits) with the sponsoring financial institution.

The IRS has issued rulings on whether an entity is separate from its owners. Rev. rul. 2004-86 says: “Generally, when participants in a venture form a state law entity and avail themselves of the benefits of that entity for a valid business purpose, such as investment or profit, and not for tax avoidance, the entity will be recognized for federal tax purposes.” A TFSA does not have a business purpose: its only purpose is to minimize Canadian tax.

In ASA Investerings Partnership (201 F. 3d 505), the DC Circuit said that “the absence of a non-tax business purpose is fatal” to the classification of an entity for US federal tax purposes.

Rev. rul. 2004-86 also identifies characteristics that make a Delaware statutory trust (DST) an entity separate from its owners, characteristics that are not all shared by a TFSA: (1) In contrast to the DST, it is unclear whether
under local (Canadian) law a TFSA is recognized as separate from its owners. (2) Creditors of the DST owners may not assert claims directly against the property held by the entity: a TFSA’s property is not protected from claims by the owner’s creditors. (3) Unlike a TFSA, a DST can sue or be sued and is subject to attachment and execution as if it were a corporation; only the TFSA’s sponsoring financial institution or its holder can be sued. (4) The DST’s beneficial owners have the same limitation of liability as corporate shareholders, a limited liability that does not inure to a TFSA holder. (5) The DST can merge or consolidate with or into other entities. Property can be transferred from one TFSA to another, but it is unclear whether a TFSA can be merged or consolidated with another TFSA; moreover, a TFSA cannot be merged with a non-TFSA.

If it is a separate entity, then it is not a trust. If an entity is separate from its owner, it is subject to the entity classification regime unless it is specifically classified in the Code or regulations; the TFSA is not. A TFSA also does not meet the definition of a trust for US tax purposes. A foreign trust is defined in Code section 7701(a)(31)(B) as any trust that is not domestic. A trust is defined in regulation 301.7701-4(a) as an arrangement in which the trustee “take[s] title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts.” A bank does not take title to property deposited into a TFSA. A statutory precondition to the establishment of a TFSA (ITA paragraph 146.2(2)(e)) is that at the customer’s direction the financial institution “shall transfer all or any part of the property held in connection with the arrangement (or an amount equal to its value) to another TFSA of the holder,” a right that assumes that the customer retains title to the property.

Moreover, Rev. rul. 2013-14 said that a Mexican land trust arrangement was not a trust under regulation 301.7701-4(a) because the beneficiary retains control over the property and is obliged to pay any related taxes. The same is true of the TFSA, and it is thus not a trust; even if the financial institution takes title to the property, the TFSA holder retains control over the property and is obliged to pay any related (US) taxes.

Possibly a disregarded entity. Classification of a TFSA involves further steps. (1) A non-trust’s classification is determined by reference to the number of members: if it has two or more members, it is a partnership or a corporation; otherwise, it is an association that is taxable as a corporation or is a disregarded entity. The term “member” is not defined, but it generally means “owner.” A TFSA has one member; jointly held TFSA s are not allowed. Thus, a TFSA is a corporation or a disregarded entity for US tax purposes. (2) If an entity meets any of seven definitions of “corporation,” it is automatically treated as a corporation; a TFSA meets none of these definitions. (3) A TFSA, which is organized under Canadian law, is a foreign entity because it is not domestic. (4) If an entity does not meet one of the set definitions of a corporation, it is an eligible entity, and the owner may elect that it be classified as a corporation or a disregarded entity for US tax purposes. (5) In the absence of an election, the default classification of a foreign eligible entity that has one member is that of an association if that member has limited liability, and the entity is disregarded if that member does not have limited liability (that is, the member is personally liable for any of the entity’s debts even if he or she is indemnified therefor). Because a TFSA owner is not insulated from any personal liability generated by assets held in the TFSA that lead to a cause of action, a TFSA by default is classified as a foreign disregarded entity for US tax purposes. A US person who has an interest in a foreign disregarded entity must file form 8858 every year.

In summary, the precise classification of a TFSA is not certain, but a TFSA is not a foreign trust because it is not an entity separate from its owner; thus, the entity classification rules do not apply and no special reporting of the TFSA is required. Even if the entity classification rules apply, the default classification of a TFSA is that of a disregarded entity for US tax purposes, and a form 8858 must be filed annually.

It is hoped that the IRS will clarify the issue once and for all. In the interim, the safest option for a US citizen in Canada may be to file form 8858 annually. Alternatively, a taxpayer may write to the IRS, describe the nature of a TFSA, and request reporting guidance. Although the IRS has not yet replied to any such requests, this disclosure is simpler than a full form 8858 and may make the taxpayer compliant with his or her obligations.

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**BEPS and Tax Executives**

Under its base erosion and profit shifting (BEPS) initiative, which has the support of the G20, the OECD has developed 15 action steps aimed at the transparent allocation of the taxable profits of multinational entities. The objective is to provide “comprehensive, balanced and effective strategies for countries concerned with base erosion and profit shifting.” The OECD says that the BEPS initiative’s essential elements include the arm’s-length principle and the elimination of double taxation and inappropriate double non-taxation, “whether [the latter] arises from aggressive strategies put in place by taxpayers or from tax policies introduced by national governments.” The OECD has already
issued several draft reports covering certain areas, and it intends to finalize all reports by December 2015. Individual countries are responsible for amending their law and their tax treaties accordingly.

It is too early to assess the exact scope and nature of changes that will result from the OECD’s BEPS recommendations, but recent public statements by some countries—in particular, the United States—make it clear that the desired consensus has not yet been reached. But changes are clearly coming. For many taxpayers, change has already arrived: in a number of countries, unilateral legislative changes have been proposed or enacted to address base erosion, and tax authorities have assessed with a view to many issues that BEPS is intended to address. It is critical for each taxpayer to approach this shift strategically, by undertaking a timely analysis of the impact of these developments and by weighing the alternatives and communicating their consequences within its organization.

Are multinational entities prepared for the shifting landscape? A recent global survey of more than 550 tax executives conducted by Deloitte LLP revealed that 93 percent of respondents agreed that their country has experienced increased media and political interest in tax. Overall, 74 percent of respondents agreed that their organization is concerned about the increased media, political, and activist group interest in tax, and 60 percent have received questions from their senior executives and/or board of directors about that increased interest. In the context of international tax planning, 73 percent of respondents said that reputational risks are a concern. The distribution of responses was generally consistent among countries and continents surveyed. Despite these concerns, however, only 58 percent of executives indicated that their organizations have assessed the potential impact in their country from BEPS-related initiatives and from administrative and legislative initiatives that were made unilaterally by their own country. Somewhat surprisingly, only 48 percent of respondents have developed additional policies and procedures in response to the increased scrutiny and anticipated changes.

More than 90 percent of respondents expect BEPS initiatives to foster increasingly robust international tax audits that focus on the level of substantive business operations in international tax structures. Nearly 90 percent of respondents anticipate a substantially increased income tax compliance burden due to enhanced reporting requirements arising from BEPS recommendations.

Overall, about 50 percent of respondents expect (1) significant unilateral domestic legislative changes that are not coordinated with other countries’ changes and that are intended to protect the country’s tax base, and (2) significant domestic legislative and treaty changes flowing from the BEPS initiative. Although these concerns vary substantially from jurisdiction to jurisdiction, generally 80 percent of respondents expect that the BEPS initiative will generate important legislative and treaty changes in many countries.

Respondents diverged by country as to whether tax authorities were becoming increasingly aggressive—about 85 percent of respondents in Canada, Scandinavia, and France, but only 27 percent in the Netherlands, 36 percent in the United Kingdom, and 60 percent in the United States—about 63 percent overall. About 69 percent overall believe that tax strategies are under greater scrutiny than they were a year ago.

Some perspectives vary between countries, but respondents’ concerns about the implementation of the BEPS initiative generally include the potential for double taxation if countries do not align their taxation regimes and instead take unilateral action; increased administration and compliance costs; increased tax audits in many locations; and greater international tax uncertainty.

Respondents most commonly noted the following main challenges for tax authorities faced with the cooperative implementation of the OECD’s BEPS recommendations:
- different objectives and agendas among the countries; the desire of each country to preserve its tax base; different skill levels between countries to implement a complex tax regime; and the disagreement of the United States with the BEPS process conclusions if US interests are challenged.

Final BEPS recommendations will call on tax administrations to design the best domestic approach that reconciles both international and national interests, such as the need to raise capital and stimulate growth, jobs, and productivity on an individual country basis. In turn, tax executives must create efficient business and tax strategies in an uncertain and evolving regulatory environment and in a social context that involves reputational concerns. Companies should closely monitor BEPS developments and regularly re-evaluate existing international structures as tax law and administrative changes are proposed.

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EFT Reporting to the CRA

As part of the fight against international tax avoidance, tax authorities around the world have expanded their ability to collect and share information on a taxpayer’s offshore assets and investments. Measures to obtain greater taxpayer transparency assume various forms, including increased obligations on financial entities to report information concerning a client’s offshore activities; FATCA is the most well-known example. The CRA has also expanded its requirement to collect information on a Canadian
taxpayer’s offshore activities, including recent proposals that certain Canadian financial entities report certain electronic fund transfers (EFTs) to and from Canada, proposals that piggyback on financial entities’ existing reporting obligations under the Proceeds of Crime (Money Laundering) and Terrorist Financing Act (PCMLTF Act). This newly enhanced tax reporting aligns with the global trend, but it is unclear how much the reporting will reveal about Canadians’ offshore assets. EFT reporting is scheduled to begin after 2014.

The reporting of EFTs was first announced in the 2013 federal budget to discourage taxpayers from moving funds out of Canada to offshore accounts in order to evade tax. Draft legislation added part XV.1 (sections 244.1 to 244.6). Under proposed section 244.2, a reporting entity must file a prescribed information return if on a client’s behalf it sends (or receives from) outside Canada an EFT of at least $10,000 in a single transaction. Part XV.1 is technically separate from the PCMLTF Act, and the existing EFT reporting obligations are not intended to be duplicated: a reporting entity apparently continues to file a single EFT report, and that report is shared by FINTRAC (Financial Transactions and Reports Analysis Centre) and the CRA. Reporting entities generally include Canadian regulated financial institutions such as banks, trust companies, loan companies, and credit unions, and include Canadian casinos and money services businesses that service Canadians.

In general, an entity carries on a money services business if it provides any of the services of foreign exchange dealing, fund transfers, and the issue or redemption of negotiable instruments such as money orders or travellers’ cheques. An EFT made by a reporting entity within Canada is excluded from reporting unless the entity instructed the intermediary reporting entities to make the EFT to a final offshore recipient. In determining whether the $10,000 threshold is met, proposed section 244.4 requires that multiple EFTs be treated as a single EFT if they are requested by the same client (other than an exempt person), made within 24 hours, and aggregate to at least $10,000. Reporting on an EFT must be made on an information return filed electronically no later than five working days after the transfer day. A reporting entity must also maintain relevant records for at least five years from the transfer day. A reporting entity that fails to comply with these part XV.1 reporting requirements is subject to the ITA general penalty provisions. Proposed ETA amendments permit the use of information collected under part XV.1 for the purposes of administering the GST/HST. Other ITA proposals permit information sharing between the CRA and FINTRAC.

Proposed part XV.1 expands on the existing requirement to report information about EFTs (and other money transactions) to FINTRAC under the PCMLTF Act and the existing mechanisms thereunder that require FINTRAC to share that information with the CRA. The PCMLTF Act is anti-crime legislation that requires certain financial institutions and other entities to provide information on EFTs and other money transactions to FINTRAC for analysis by it in order to detect, prevent, and deter money laundering and terrorist financing. The EFT reporting requirements under the PCMLTF Act apply to the same reporting entities and cover the same transactions and reportable information covered under proposed part XV.1 of the ITA. The PCMLTF Act authorizes FINTRAC to disclose information to other law enforcement agencies within and outside Canada, including the CRA if evidence of tax evasion is uncovered in the course of FINTRAC’s analysis. However, disclosure under the PCMLTF Act is subject to privacy law restrictions that generally limit what can be disclosed and when, and an application to a court may be necessary in order to access more detailed information. If the CRA seeks access to the information, it must have reasonable grounds to suspect that the information is relevant both to a money-laundering or terrorist-financing offence and to a tax offence. If those conditions are met, FINTRAC can disclose to the CRA only designated information, which is limited to basic information that identifies the relevant transactions (such as the parties and the dollar amounts involved). Access to additional information is available only by court order. Proposed part XV.1 and related amendments attempt to avoid these restrictions by authorizing the provision of the information directly to the CRA for tax purposes.

The general rationale for enabling the CRA and other tax authorities to collect more information on the offshore activities of their respective taxpayers is understandable: the collection of the information is a tool to deter international tax avoidance. Proposed part XV.1 is intended to further that objective by allowing the CRA greater access to a pool of existing information on one aspect of Canadians’ offshore activities. It is unclear, however, whether and to what extent information on EFTs can assist in the stated objective of deterring and detecting offshore assets. A report that targets an EFT solely on the basis of a dollar threshold is unlikely to distinguish between avoidance and other transactions. In comparison, FATCA—although it is draconian—requires a foreign financial institution to report directly on offshore assets and investments that are held by a US taxpayer. If some of the published commentary on the PCMLTF Act is indicative, the part VI.1 broad-based reporting requirements may, at best, result in the collection of a large pool of data that does not provide any useful intelligence without additional analysis: the bulk of the information may involve innocent transactions entered into in the ordinary course. Moreover,
only limited resources are available to perform the required analysis. At worst, indiscriminate information collection may result in a taxpayer being targeted for CRA scrutiny for no reason other than the size or frequency of fund transfers. Thus, part XV.1 may provide the CRA with unrestricted access to more personal information without necessarily providing more insight into hidden offshore assets—a result that may demonstrate the limitations that any country (including Canada) faces when it tries to obtain information about its taxpayers’ offshore assets through unilateral domestic reporting obligations.

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IRS GUIDANCE: OFFSHORE VOLUNTARY DISCLOSURES

On June 18, 2014, the IRS announced a number of significant changes to the 2012 IRS streamlined filing compliance procedures and the offshore voluntary disclosure program (OVDP). In 2009, the IRS introduced the first OVDP. Since then, the IRS has made several changes to the process and has introduced other programs to encourage US taxpayers to come forward by providing additional flexibility in some of the programs’ key aspects. There is welcome relief for many US citizens living in Canada who have failed to file US tax returns and report foreign accounts, but some changes—such as the new non-residence requirement—may have the opposite effect.

Streamlined procedure expanded. The streamlined program now includes a much broader group of US taxpayers. Notably, the $1,500 tax threshold for eligibility has been eliminated, and thus more US taxpayers living in Canada may qualify for the program if they meet other conditions.

The IRS has also eliminated the risk assessment analysis and the questionnaire that a US taxpayer must complete in order to enter the streamlined program. A US taxpayer must still file three years of past US federal tax returns and six years of past foreign bank account reports (FBARs). The full amount of the related tax and interest due must be remitted with the returns.

Under the new guidance, in order to be eligible for the streamlined procedures applicable to offshore disclosures, a US taxpayer must meet an applicable non-residence requirement (for joint return filers, both spouses must meet the applicable non-residence requirement) and have failed to report the income from a foreign financial asset and pay tax as required by US law. The taxpayer may have also failed to file an FBAR (FinCEN form 114, previously form TD F 90-22.1) regarding a foreign account. Those failures to file must have resulted from non-wilful conduct.

An individual US citizen will meet the applicable non-residence requirement if, in any one or more of the most recent three years for which the US tax return due date (or for which an extended due date properly applied) has passed, the individual did not have a US abode and he or she was physically outside the United States for at least 360 full days. Therefore, a US-citizen snowbird who has consistently wintered in a warmer US climate may not qualify as a non-resident under the new guidelines. Also, a US citizen who resides in Canada close to the border may have travelled to the United States frequently and thus may not qualify as a non-resident.

A US taxpayer who has made a submission under the 2012 streamlined filing compliance procedures before July 2014, but who has not already been notified of a high-risk or low-risk determination, will not receive correspondence related to his or her risk determination. The returns filed will be processed without regard to that risk assessment.

OVDP modifications. The IRS also revised the terms of the OVDP in order to cover (1) a US taxpayer whose failure to comply with the reporting requirements is considered wilful and (2) a taxpayer who does not qualify for the streamlined program. The changes to the OVDP will also focus on a US taxpayer who seeks certainty and relief from criminal prosecution.

A US taxpayer who wants to participate in the OVDP in the future must provide more information than before, including the submission of all relevant account statements when he or she applies to the program. The OVDP carries a 27.5 percent penalty, which continues to apply in many cases; however, in some cases of voluntary disclosure filed after August 2, 2014, a US taxpayer faces a 50 percent penalty on the maximum value of unreported assets.

These changes arise partly from feedback received by the IRS from many tax practitioners and the US national taxpayer advocate. The IRS discovered that for many US taxpayers, the existing program penalties were too harsh. Some US taxpayers did not really need the protection from criminal prosecution offered by the OVDP, but they did not fit within the confines of the streamlined program’s relatively narrow criteria.

The IRS has warned US taxpayers, however, that anyone who continues to wilfully and aggressively evade US tax laws by hiding money in foreign accounts must pay a higher price for that non-compliance. Although the IRS is tightening the OVDP components, it still believes that the OVDP is preferable to the alternative: the IRS warns US taxpayers that if the IRS initiates action against a taxpayer, he or she faces higher penalties and possibly criminal prosecution and jail time.

The IRS has also warned US taxpayers that it continues its efforts to track down any remaining US citizens who
are concealing assets in foreign accounts. Canada just signed a Canada-US intergovernmental agreement (IGA) to implement the new reporting requirements under the Foreign Account Tax Compliance Act (FATCA). Canadian financial institutions will soon begin to disclose information about their US customers. Elimination of the $1,500 tax threshold for eligibility and the risk assessment analysis is a step in the right direction. However, the addition of the non-residence requirement to the streamlined procedure may be problematic for many Canadians who travel frequently to the United States. A US citizen who lives in Canada should consult a US tax adviser regarding his or her compliance options.

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LIMITED PARTNERSHIP LOSS IN A TRUST

An internal technical interpretation (TI 2013-050884117, February 12, 2014) confirmed the CRA’s longstanding position that a business loss allocated to a trust that is a limited partner is a business loss and not a property loss for tax purposes. Thus, a taxpayer that is the sole beneficiary of the trust cannot access the business tax losses that the limited partnership allocates to the trust.

Generally, the revisionary trust rule in subsection 75(2) provides that income derived from certain trust property is attributed to a person resident in Canada if the trust received the property from the person (the settlor) and the property can revert to the person (or pass to other persons determined by that person). If a person is a specified member of a partnership (which generally includes limited partners and passive partners, as defined in subsection 248(1)), subsection 96(1.8) deems that person’s share of the partnership income or loss for a fiscal period in which the person was a partner to be income or loss from property for the purposes of sections 74.1 and 74.3 and subsection 56(4.1).

In the TI, the CRA was asked to consider a situation where the taxpayer (Canco) is the sole limited partner of a partnership established under Quebec law. Canco 2 is the general partner.

Canco settles the trust and is its sole beneficiary. After establishing the trust, Canco transfers cash and all of its partnership units to the trust. Thus, the trust becomes a limited partner of the partnership (subsection 96(2.4)) and a specified member of the partnership (subsection 248(1)).

Canco then contributes additional cash to the trust so that the trust can further capitalize the partnership, and the trust consequently acquires additional partnership units. In subsequent years, the partnership has business activities and allocates business losses and capital gains to the trust.

The CRA was asked whether the partnership’s business losses maintain their nature as business losses when they are allocated to the trust. The partnership’s business losses become property losses. The taxpayer also asked whether the reversionary trust rule attributed the partnership’s business losses—initially allocated to the trust—to Canco (the trust’s settlor).

The CRA said that under section 96, a partnership’s income or loss is calculated at the partnership level. Although a partnership is not a person, it is treated as a person when its income is calculated under section 96. The CRA also confirmed that a partnership’s income or loss retains its character in the partner’s hands, so that income from a source that is business or property remains so sourced.

In considering whether the partnership’s loss is from business or property when it is allocated to a trust, the CRA referred to Robinson et al. (98 DTC 6065 (FCA)). In that case, the court concluded that a limited partner of a partnership that was established under Manitoba law was considered to carry on a business if the partnership carried on a business. This supporting principle also applies under Quebec law, and thus the CRA indicated that any business loss from the partnership retains its character as a business loss in the hands of the trust (the limited partner).

However, the CRA said that subsection 75(2) does not attribute to Canco the partnership’s business losses that were allocated to the trust. That position is supported by jurisprudence and by Interpretation Bulletin IT-369R, “Attribution of Trust Income to Settlor.” Furthermore, the Act does not allow a trust’s business loss to be allocated to the beneficiary. Without the operation of subsection 75(2), a trust cannot allocate capital losses or non-capital losses for the benefit of its beneficiaries.

The CRA also referred to Interpretation Bulletin IT-511R, “Interspousal and Certain Other Transfers and Loans of Property,” and stated that although partnership income is usually income from a business, subsection 96(1.8) provides an exception for the purposes of certain attribution rules under sections 74.1 and 74.3 and subsection 56(4.1). If it is a Canco that transfers property to the trust, subsection 96(1.8) does not apply: that rule applies only to a transfer by an individual. The CRA added that the law’s intention was not to include income or gains attributed under subsection 75(2) in the operation of subsection 96(1.8), because the former rule is not mentioned in subsection 96(1.8).
The CRA also commented on the relevance of the definitions of “investment expense,” “investment income,” and “cumulative net investment loss” in subsection 110.6(1) for the capital gains exemption in determining whether the partnership’s business losses allocated to the trust are property losses to the trust. The CRA noted that these definitions are relevant only in calculating a person’s net cumulative investment loss.

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PROVINCIAL INCOME ALLOCATION: NON-RESIDENT EMPLOYEES

In a technical interpretation (TI 2013-05068017, March 11, 2014), the CRA concluded that amounts paid to a non-resident employee of a foreign permanent establishment (PE) of a Canadian corporation are included in salaries and wages for interprovincial allocation purposes. However, the CRA also noted that salaries and wages for those purposes are not reduced by related employee expenses. The CRA made its comments in response to questions about the meaning of the phrase “salary or wages” in subsection 248(1) for the purposes of allocating taxable income to the provinces under the regulations.

Under regulation 402(3), if a corporation has a PE in more than one province, it must allocate its taxable income for the year between those provinces. Taxable income is generally allocated to a province as one-half of the aggregate of (1) the proportion of the corporation’s gross revenue for the year that is attributed to the PE in the province relative to overall gross revenue and (2) the proportion of the corporation’s salaries and wages paid to the PE’s employees relative to the aggregate amounts.

For most purposes of the Act, the term “salary or wages” is defined in subsection 248(1) as a taxpayer’s income from an office or employment computed under subdivision A of division B of part I. This income is defined to include all fees received for services that were not rendered during the taxpayer’s business, which is also defined in subsection 248(1). These rules also allow an employee to take various deductions in calculating his or her income from an office or employment.

Generally, a non-resident’s taxable income earned in Canada is the amount that would be his or her income under section 3 if the taxpayer had only certain sources of income, including income earned from an office or employment performed in Canada (subsection 115(1)). (Section 3 is the basic rule for computing income for a taxation year under part I, which also includes sections 5 to 7.) In Oceanspan Carriers Limited (87 DTC 5102), the FCA clarified that a non-resident that does not have income from Canadian sources is not included within the meaning of the term “taxpayer.”

In the TI, the CRA considered whether employee expenses reduce salaries and wages for interprovincial allocation purposes, and stated that the definition of the term “salary or wages” in subsection 248(1) generally applies for the purposes of regulation 402(3). However, the CRA said that regulation 402(3) contemplates only the salaries and wages that the corporation paid to its employees in the year, thus precluding consideration of the deductions available to the employee under section 8.

In addition, the CRA said that the rules in part I generally apply to a non-resident for amounts attributed to services in Canada, because only his or her income from employment in Canada is subject to taxation under that part. The CRA noted that “salary or wages” is not limited to those amounts earned by Canadian-resident individuals: the definition simply provides that “salary or wages” is the amount computed under the rules, which includes an amount paid by a Canadian corporation to a non-resident employee who earns income from employment in Canada.

The CRA further said that the FCA’s comments in Oceanspan do not extend to salaries and wages in part IV of the regulations. The CRA concluded that the definitions of the terms “salary or wages” and “taxpayer” in the context of these regulations and the principles of allocating income to the provinces include the non-residents’ employment income regardless of whether they were liable for tax. The CRA noted that the definition of “salary or wages” in subsection 248(1) simply states how those amounts should be calculated, not that the amounts in question must also be taxable in Canada.

In addition, the CRA noted that the regulations address situations in which the salaries and wages of an employee of a PE outside Canada are not included in the salaries-and-wages calculation or are deemed to be nil. The CRA said that those provisions would be redundant if the salaries and wages of a non-resident who was attached to a Canco’s foreign PEs were already generally excluded from the calculation.

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CRA’S LIAISON OFFICER INITIATIVE

The liaison officer initiative (LOI) is part of the CRA’s three-point plan to support small and medium-sized business tax compliance. (For more information on the three-point plan, see “Small Business Compliance,” Canadian Tax Highlights, May 2014, and “Registration of Tax Preparers Program,” Canadian Tax Highlights, June 2014.) The LOI
will provide in-person information to a small or medium-sized business at key points in its business cycle to help it complete its tax filings correctly the first time. The CRA’s goal is to provide proactive support to a taxpayer before costly and time-consuming audits become necessary. The LOI is not part of the audit program and, according to the CRA’s website, “is not about identifying high-risk non-compliers and assessing past tax filings.” LOI pilot projects were launched in Toronto and Montreal in March 2014; additional pilots are planned for the Atlantic, Prairie, and Pacific regions throughout the 2014-15 fiscal year. A pilot consists of (1) small business support visits, (2) a books and records review, and (3) compliance support arrangements.

Small business support visits. Businesses that have been selected to participate in the LOI may receive an invitation for a meeting with a liaison officer. When a business accepts the invitation, a liaison officer will visit the business to provide income tax support and guidance. The officer will address tax-related questions and concerns, provide general information on tax obligations, and advise the taxpayer about unintentional or recurring errors that are common in the taxpayer’s industry or business sector.

Books and records review. Among small businesses, poor record keeping is a common contributor to tax non-compliance. If a taxpayer agrees to participate in the LOI, a liaison officer will review the taxpayer’s books and records to provide advice and guidance on their accuracy and completeness in order to avoid potential problems before tax filings.

Compliance support arrangements (CSAs). After a site visit and/or a books and records review, a liaison officer may ask the taxpayer to sign a CSA to acknowledge that he understands the nature of his and the CRA’s tax responsibilities and the information that he has received. The signing of a CSA is intended to reinforce the opportunity for learning and awareness via a written reminder of what was discussed. A taxpayer may be asked to sign (1) a general CSA, which identifies unintentional or recurring income tax errors that are common in the taxpayer’s business sector, or (2) a tailored CSA, which asks that the taxpayer, before he files his tax return, commit to the correction of any errors noted in the review of his books and records. Both general and tailored CSAs outline the CRA’s and the taxpayer’s key responsibilities and the industry benchmarks that the taxpayer can use to compare his performance with that of the sector in general. The CSA is voluntary and is not binding in a court.

Selection of a business for the LOI pilot project. A business is randomly selected from an industry sector chosen to participate in the LOI pilot project. The choice of industry sectors is based on three criteria: (1) the sector is not the focus of significant audit treatments or special projects; (2) the sector has a population base sufficiently large to enable the CRA to conduct statistically valid research and to accurately measure the impact of the LOI treatments; and (3) the sector has historically experienced low to moderate rates of change to tax returns that were audited.

A selected business will be offered various services, including (1) general information that identifies unintentional or recurring errors made in the industry sector and recommendations of ways to fix them, and (2) an invitation from a liaison officer to make an appointment for a small business support visit, to have a books and records review conducted, and/or to enter into a general or a tailored CSA. Although a business is encouraged to participate in the LOI, the acceptance of these services is voluntary. If a business participates in the LOI and the CRA finds errors, the business can still make a voluntary disclosure under the voluntary disclosure program. A voluntary disclosure can be made if the start of an audit or criminal investigation (enforcement action) has not been noted in the CRA file on the business. The LOI is not considered an enforcement action.

Industry campaign approach and industry benchmarks. Another new initiative, the industry campaign approach, was launched by the CRA to complement the LOI, with the intent of encouraging voluntary tax compliance in various industry sectors. The CRA will work with industry associations to provide businesses with sector-specific tax information to help them comply with their tax obligations. The CRA will also consult with industry associations to develop the industry benchmarks for use in the LOI and to ensure that they are sector-appropriate. Industry benchmarks are established on the basis of the information that businesses report on their financial statements and tax returns; a business can use the benchmarks to see how it compares with the sector in general. If the need occurs, a business may want to contact a tax adviser to discuss why it does not fall within the industry benchmarks. A future article will discuss the industry campaign approach.

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CROSS-BORDER ESTATE-PLANNING TRAPS

When structuring an estate plan, a tax adviser should ask his or her clients whether the participants are Canadian residents only, or whether any family member is a US citizen. This article reviews some Canadian and US tax considerations when US-resident or US-citizen children
are involved in the reorganization of a Canco, in an estate freeze, or in a windup of a Canadian trust.

**Canco reorganization.** Assume that a client wants to freeze a family Canco with real estate and other investments. The Canco’s common shares are owned directly by all adult family members, who want to transfer their shares to a new holdco in exchange for fixed-value preference shares. (Aside from the passive foreign investment company [PFIC] rules discussed below, it is preferable to freeze into an unlimited liability corporation [ULC], which is treated as a disregarded entity or partnership for US tax purposes.) However, the client’s daughter has lived in the United States for the past five years and is thus domiciled there. The Canco is likely to be a PFIC (defined below) for US tax purposes. The section 85 rollover by the US-resident daughter may not qualify for tax-free treatment as a non-recognition transaction (Code section 351); and even if the daughter was not part of the reorganization, the PFIC regime may apply and subject her to punitive tax consequences if she sells her shares or receives a distribution from the PFIC. The daughter can make a qualified electing fund (QEF) election for US tax purposes to avoid many adverse PFIC consequences, but she is then taxed annually on the PFIC’s accrued net income without credit for any non-US corporate tax paid by the company. Thus, the daughter is subject to US tax annually even in the absence of cash distributions, and the company must undertake significant US tax accounting to provide her with the certification necessary for a QEF election.

Generally, a PFIC is a non-US corporation that meets an income test or an asset test. The income test is met if at least 75 percent of corporate gross income in the taxation year is passive (generally dividends, interests, rents, royalties, and disposition gains from passive assets). Rental income from an active trade or business is not passive for the purposes of these rules, although strict tests must be met. The asset test is met if at least 25 percent of the average value of corporate assets held in the taxable year produced or were held for the production of passive income. Included in these tests are the income and assets of the corporation’s parent and of each subsidiary entity in which the corporation owns an interest of 25 percent (or greater).

**Freeze of Canadian parent.** Assume that the Canadian-resident parents (non-US citizens) contemplate an estate freeze when one or more of the freeze’s beneficiaries are US residents. Is the holdco a PFIC or a controlled foreign corporation (CFC) for US tax purposes? If the US-resident beneficiaries receive common shares on the estate freeze directly or through a non-foreign grantor trust, US reporting is required; significant penalties are imposed for non-compliance, and the PFIC or CFC rules apply. US beneficiaries of a trust that owns a PFIC or a CFC interest are subject to detailed reporting requirements. Under the CFC regime, a US resident may also need to include his or her share of passive income in his or her US tax return as a non-qualified dividend. The adverse PFIC regime may apply, although special US tax rules govern overlapping CFC and PFIC rules if both apply otherwise.

If the Canadian-resident parents are not US persons (they are neither US citizens nor green-card holders and spend so few days in the United States annually that they are not deemed US tax residents), the estate freeze may be structured by using a foreign grantor trust. (PFIC and other negative tax rules may apply if a trust is a foreign non-grantor trust for US tax purposes.) A foreign grantor trust’s US beneficiary is not subject to US income tax on the trust’s income or distributions because the foreign grantor is the income’s deemed owner. A foreign grantor trust thus avoids the adverse US tax consequences to the US beneficiaries of a foreign trust, a PFIC, and a CFC. The drafter must navigate the rules to qualify the trust as a foreign grantor trust for US tax purposes and simultaneously avoid the Canadian attribution rules and render the trust revocable for US tax purposes. A foreign grantor trust also avoids US estate tax for US beneficiaries on the trust corpus if those beneficiaries die before receiving any trust assets. Although the foreign grantor trust still serves an important estate tax-minimization function, its US income tax benefits are lost when the trust grantor dies; and without proper planning there may be adverse income tax consequences to the US beneficiaries under the throwback regime if they subsequently receive distributions.

Moreover, if the parent implementing the freeze is a Canadian resident and also a US citizen, a Canadian estate freeze may give rise to US gift tax.

**Windup of a trust.** On a trust’s 21st anniversary, there is a deemed disposition of its assets. One solution is to distribute the trust assets before the anniversary, but tax is payable if assets are distributed to a non-resident beneficiary. If trust assets are distributed to a Canadian-resident child who subsequently gifts them to non-resident siblings, the distribution to the Canadian resident is tax-deferred, but the gift to the siblings triggers the realization of any gains on the assets. A direct trust distribution to the non-residents also triggers a realization of any gain on the assets. If the assets are shares of a Canco that holds passive assets and non-resident beneficiaries are US residents, there may be ongoing US reporting, and the PFIC rules or CFC rules may apply. The US residents may also have other US tax problems that flow from their trust interest and the company’s PFIC or CFC status.

If the trust terms permit, each non-resident beneficiary child may assign his or her trust interest to a holdco (which should be a ULC if a US resident is involved). The
assignment is tax deferred upon an ITA section 85 election. A section 116 certificate of compliance may be required if the trust interest is taxable Canadian property. The trustees of the existing trust, who must be duly notified of the assignment, then encroach on the capital and distribute that child’s share of the assets to his or her ULC. There may still be US tax on accumulations in the trust if the company meets the PFIC or CFC test; an analysis is required to determine whether the business is active. Alternatively, a freeze can be implemented before the distribution is made from the existing trust, and the frozen shares can then be distributed to the child’s ULC. A new Canadian trust structured to qualify as a foreign grantor trust can be established for each child and his or her issue; each then subscribes for the future growth in value. The trust must qualify as a foreign grantor trust for US tax purposes and yet not be subject to the Canadian attribution rules.

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