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Dealing with CRA: The Audit

by Michel H. Bourque

There is no feeling like the feeling you get when the Canada Revenue Agency ("CRA") writes to announce an audit of your tax filings. Anger and anxiety are not uncommon first reactions. How you deal with the audit can potentially exacerbate those feelings. There are numerous tips that can make the audit process go smoothly—and some traps that inevitably will make it painful.

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Keep in mind that in carrying out an audit, CRA is merely performing its statutory obligations under the various tax statutes it administers on behalf of the federal or provincial governments. CRA's role is to ensure that taxpayers have filed the proper returns and accurately calculated their taxes and, where necessary, to take enforcement measures to collect those taxes. CRA auditors do not receive incentive-based compensation nor are they promoted on the basis of how much they collect from taxpayers.

1. Designate a taxpayer representative to deal with CRA. No matter the size of the taxpayer's organization, there generally is one person who has responsibility for tax compliance and audits. If there is none or more than one, designate a person who is familiar with the organization's tax filings to deal exclusively with CRA. Advise the CRA auditor that his or her only contact person is the designated person. The designated person should be responsible for dealing with all of the auditor's queries and for gathering any requested information from others in the business.

2. Get them in, get them out. If you want to increase your chances for a successful audit, plan for it as you would any other business activity (that you want to see be successful). Prior to the audit commencement date, find out from the auditor what years or periods are in issue, and if there are any particular issues that are being examined. On the audit commencement date, make sure that the CRA auditor has a comfortable place to work and have all the relevant books and records at his or her ready. The quicker the auditor can get through your files, the quicker he or she will leave.

3. Make sure everybody in the office knows that CRA is in the building. Water-cooler talk is damaging even if it is inadvertent. Always alert your employees of the CRA auditor's presence and to be discrete.

4. Be nice – a happy auditor may overlook certain deficiencies. It is common for auditors to advise taxpayers that their past compliance on certain issues was not necessarily accurate, but may "let it go" provided that the amounts are not material and the taxpayer agrees to adjust its compliance. Of course, this generally does not occur when the taxpayer has been openly hostile with the CRA auditor.

5. What documents to I have to show the auditor? Tax legislation generally provides CRA with broad powers to administer and enforce tax statutes. CRA is entitled to inspect, audit or examine the books and records of the taxpayer. "Books and records" generally refers to any records (including those on electronic media) that contain information that may enable the auditor to verify tax compliance. CRA is not entitled to information that is covered by the solicitor and client privilege, including legal opinions, correspondence to and from legal advisors and other similar documentation. A common misconception is that lawyers' accounts are privileged – they are not. As a result, make sure that your lawyers do not disclose information in their time entries that could lead the CRA auditor to discover unidentified tax issues. Although there is no specific privilege attaching to working papers, risk analysis memos and the like, you may wish to resist providing any of these unless specifically

asked. The time during which taxpayers are required to keep books and records varies under various statutes. To avoid running afoul of those requirements, one should keep books and records for at least 10 years after the end of the taxation year to which they relate.

6. How far back can CRA look? The period during which CRA is entitled to re-assess is generally 3 years for individuals and Canadian-controlled private corporations and 4 years for everybody else. CRA may also re-assess beyond the limitation period, in the case, for example, of transactions the taxpayer has carried out with persons who are not resident in Canada. It is important to note, in any case, that the limitation period runs from the date of the initial tax assessment. For example, most individuals will have filed their income tax return for 2006 by April 30, 2007 and will receive a Notice of Assessment by May 31, 2007. In that case, the limitation period will run for 3 years (in the case of individuals) from the date of the Notice of Assessment.

In the case of loss years, where no tax is payable, CRA does not issue a Notice of Assessment and the limitation period never commences. In these cases, it is good practice to request that the CRA issue a Notice of Loss Determination. At a minimum, the issuance of a Notice of Loss Determination will cause the limitation period to start.

7. Should I give a waiver? It is also not uncommon for CRA to request taxpayers to ask for a waiver if the limitation period is approaching. Whether it is a good idea to provide a waiver is largely dependent on the facts of each case. Where the CRA is "fishing" and has not identified any specific issues, the usual and appropriate response is to refuse. However, if there is an issue that you and CRA have identified and potentially can work out a mutually-satisfactory solution, then it is generally a good idea to provide the waiver. Waivers extend the limitation period indefinitely, so it is important to revoke the waiver once you and CRA have completed your dealings. The waiver revocation is only effective 6 months after filing it with CRA.

(In the next edition of *Tax Matters*, look for a continuation of the series *Dealing with CRA*, with a discussion of CRA's Collection Tools).



ARTC Reassessment Risk

by Denise D. McMullen

It has recently come to our attention that Alberta Finance (Tax and Revenue Administration) is proposing to deny Alberta Royalty Tax Credits (“ARTC”) claimed in prior years on crown royalties paid by otherwise qualifying farmees who have earned an interest in the farm-out lands of “restricted corporations” or “restricted partnerships” by drilling and completing test wells and paying non-convertible gross overriding royalties. Thus although the ARTC program has been discontinued, it may still impact Alberta corporations.

The ARTC program was intended to assist smaller players in oil and gas to (effectively) reduce a portion of their crown royalties and thereby reduce the risk to which they were exposed as a result of drilling and producing Alberta wells. It was not the intention of the architects of the program that larger producers (“restricted” corporations and partnerships) have the benefit of ARTC, and the applicable legislation contains rules, referred to as the “restricted resource property rules”, which ensure that such producers cannot obtain such benefit by indirect means. However, there appears to be no reason why an ordinary commercial arrangement whereby a smaller exploration and development corporation farms-in and drills test wells at its own cost and risk on leases issued to restricted corporations, should offend the intent of the program simply because that smaller corporation paid for the right to drill with a non-convertible gross overriding royalty.

In order for a right or interest in a well drilled after 1986 to be a “restricted resource property” for purposes of paragraph 26(h)(ii) of the *Corporate Tax Act* (Alberta) (the “ACTA”) the right or interest must be

“any right or interest of any nature whatsoever or howsoever described or part thereof in any production from a petroleum or natural gas well in Alberta *that was disposed of after its finished drilling date* (emphasis added) and after April 7, 1986 by a restricted corporation.”

It must be noted that paragraph 26(h)(ii) of the ACTA does not refer to a disposition of an *interest* in production from a well or an interest in a crown lease on which a well is drilled. Rather, it refers to a disposition of a well itself. The thrust of the language is that restricted resource property is an interest of any sort in a well in circumstances where the well has been disposed of by a restricted corporation. This is entirely consistent with the aims and limitations of the ARTC program. ARTC could be claimed with regard to royalties paid by a party as a result of that party’s interest in a producing well. However, if the claiming party was not an intended beneficiary of the program, because it was either too large a producer or because it had obtained the well from too large a producer (where the purchase price could be assumed to have been supported in part by the purchaser’s access to ARTC), the benefit of the ARTC program would be denied.

In many circumstances, test wells will have been drilled under Article 3 of the 1997 CAPL Farm-out and Royalty Procedure (or equivalent language) which specifies that the farmee will drill each test well to the contract depth and complete, cap and abandon that well, *all at the farmee’s sole cost, risk and expense*.¹ As a result of undertaking the foregoing, the farmee will have earned interests in the farmor’s lands, *effective as of the drilling rig release date for the test well*.² The farmor retains its gross overriding royalty out of the interest earned by the farmee *in the royalty lands*,³ not in the wells drilled. Finally, Article 7 sets out the procedure for the farmor to

take over wells abandoned by the farmee. That procedure is contingent on the farmee assigning the wells.⁴ So it seems clear that test wells are the farmee's own property unless and until assigned to a third party. In fact, unless farm-ins were farm-ins on previously completed wells, the wells were not the farmor's wells to transfer to the farmee at any time. This being the case, wells drilled by farmees should not be restricted property for ARTC purposes, since the definition in paragraph 26(h)(ii) of the ACTA requires the disposition of a well.

In the fall of 1989, Elaine G. Ramsay, then Director, Interpretation and Appeals Division, Alberta Tax Administration, was asked the following question at a Canadian Petroleum Tax Society "round table":

If a below limit entity farms-in to undeveloped acreage of an above-limit entity, subject to a standard farm-in agreement that provides for the passage of title in the property at the conclusion of drilling, is the below the limit entity entitled to Alberta royalty tax credit on its Alberta crown royalty in respect of the property?

She gave the following answer:

From a policy perspective, it was not intended that standard farm-in arrangements would be caught under the restricted resource property rules (emphasis added). Technically they may be—at two points, in fact. One is the point described in the question at which a below limit entity earns a working interest from an above-limit entity after completing a well. The second, is where, after payout, a below limit farmor exercises its option to convert an overriding royalty into a working interest held to that point by an above-limit farmee.

The matter of farm-ins and the restricted resource property rules is under study in corporate tax administration. Our objectives are to determine whether standard farm-in arrangements can be technically accepted from the restricted resource property rules under existing legislation with perhaps more liberal interpretation and, if not, what the reasonable corrective action is. We are conferring with industry representatives on this, we hope to have something substantive this summer.

In the meantime, **in keeping with the policy intent** (emphasis added), we are not applying the restricted resource property rules to standard farm-in arrangements.

In 1990, subsection 26(1.94) of the ACTA was enacted, apparently in response to the round table question. Subsection 26(1.94) confirms that an arrangement whereby a farmee earns an interest in a farmor's lands will not give rise to a disposition for purposes of Subsection 26(h)—and will therefore not give rise to a restricted property – provided the farmor either retains a working interest or retains an interest convertible into a working interest.

Several things can be taken from the foregoing:

1. There was no intention that a standard farm-in be caught by the restricted property rules. Thus, we find it curious that the department's position now is that all farm-ins are caught unless described in subsection 26(1.94).
2. The department believed that, technically, standard farm-ins might or might not be caught by subsection 26(h). We believe that farm-ins such as the ones entered into under the 1997 CAPL procedure (or equivalent) with respect to test wells were in fact not caught.
3. The language in subsection 26(1.94) was intended to be "corrective" in the event the language of subsection 26(h) inadvertently applied to standard farm-in arrangements. It was not intended that the corrective language be applied to force otherwise standard commercial arrangements, which do not involve in any substantive way the transfer of a well, into the restricted property rules.

The question of what constitutes a "standard farm-in" for tax purposes is far from clear. That said, the CAPL procedure by its wide-spread use, creates two types of commercially standard farm-in—one in which the farmor has a carried interest in the well or wells drilled on its leases that converts after "payout" into an interest in the production

therefrom, and one in which the farmor has a non-convertible interest in the production from the well or wells from the outset.⁵ The first alternative is apparently contemplated by subsection 26(1.94). The second alternative is not so described—but in our view need not be since unless the farm-in is on a well completed by it, the farmor under the second alternative has no interest in the well itself at any time.

It appears that industry has never, until now, been given any reason to believe that its

agreements to drill wells for non-convertible overriding royalties resulted in dispositions of those wells to it by the farmors in question. Given that the farmee had full risk, cost and ownership of those wells (in the eyes of all parties including the EUB) unless and until it assigned them, it is not surprising that it expected none.

It is only reasonable that non-restricted corporations be entitled to ARTC with respect to test wells drilled under farm-in arrangements in accordance with:

1. the original intent of the ARTC program;
2. the technical provisions of the ACTA; and
3. the department's long standing assessment practices.

Footnotes

¹Article 3.01A

²Article 3.03

³Article 5.01A

⁴Article 7.01(c)

⁵Alternate 1 and 2 described in Article 5.01

What's New in Tax Law A Look at Recent Cases

by Heather R. Digregario and Josh A. Almario

DUE DILIGENCE IN TAX LAW— HOW MUCH ADVICE DO YOU NEED?

Royal Bank v. R (2007 FCA 72)

The due diligence defence arises most often in tax law when a taxpayer is assessed a penalty. Often the penalty will be waived if the taxpayer can show that it has used due diligence in determining its tax filing position. If the taxpayer has taken all reasonable steps to determine the correct interpretation of the law, then it is less likely to be penalized with a statutory penalty once it is revealed that the taxpayer's interpretation was incorrect.

When the Tax Court released the decision in *Royal Bank*, 2005 TCC 802, in 2005, comments from the court raised questions as to what extent a taxpayer must go to establish the defence of due diligence. The taxpayer had taken the position that certain mutual fund services were not "financial services" within the meaning of the *Excise Tax Act* (Canada), relying on the advice of its in-house tax department. It had not attempted to obtain a ruling from the Canada Revenue Agency, or an independent opinion, to confirm such treatment.

Ultimately, the Court decided that the taxpayer had been incorrect in its position and the taxpayer then asserted the defence of due diligence, in an attempt to avoid a penalty. The Tax Court, in denying the taxpayer's claim of

due diligence, specifically noted the lack of a tax ruling or an independent opinion. The taxpayer appealed this finding, arguing that the Tax Court judge had altered the nature of the due diligence defence by setting the standard too high.

The Court of Appeal has now clarified the issue. A taxpayer is not required to show that it obtained a ruling, or an independent opinion, in order to prove that it has conducted due diligence. However, taking such steps may be evidence that will assist in establishing the defence of due diligence. The defence will be assessed against all of the facts of each particular taxpayer's case. A court will also consider the merit of a ruling or independent opinion, the extent of the ambiguity in the legislation and the overall reasonableness of the taxpayer who asserts due diligence.

TAX AVOIDANCE AND PARTNERSHIPS

XCO Investments Ltd. v. R. (2007 FCA 53)

Penn West Petroleum Ltd. v. R. (2007 TCC 190)

Most people think of the general anti-avoidance rule (the "GAAR") when they think of tax avoidance. But the GAAR is only one of many anti-avoidance rules in the Income Tax Act. The Act is also replete with specific anti-avoidance provisions. In particular, there is a rule which allows the Minister to reassess partners in circumstances where they have agreed to split the partnership's income in such a way as to reduce tax (the "Partnership Avoidance Rule").

The allocation of partnership income, and resulting tax liability, is ordinarily based on each partner's interest in the partnership (i.e. if two partners each own a 50% interest in the partnership, then income will be split 50/50). The two recent cases of *Xco* and *Penn West* are both cases where the partners of a Partnership agreed to allocate income disproportionately to their ownership interests. In both cases, the Tax Court applied the Partnership Avoidance Rule, and reallocated the partnership income.

In *Xco*, the taxpayers had arranged to bring a third-party (the "New Partner"), who had accrued significant losses, into their partnership immediately before the partnership disposed of some real estate. The partnership allocated the majority of the proceeds of the real estate to the New Partner, and because of its accrued losses, the New Partner was able to shelter those proceeds from tax. The New Partner left the partnership shortly thereafter.

In *Penn West*, the taxpayers were involved in a commercial dispute with a third-party (the "New Partner") concerning the values of a right of first refusal (the "ROFR") on certain property (the "ROFR Property") that the partnership had purchased. To settle the matter between the parties, the New Partner joined the taxpayer partnership. Shortly thereafter, the New Partner left the partnership by redeeming its partnership units, in exchange for the ROFR Property. A pre-existing clause in the partnership caused all of the partnership's proceeds of disposition to be allocated to the New Partner. Even though the Court accepted that the pre-existing clause was standard in the industry, and was negotiated between arm's length parties, it still held that its primary purpose was to reduce tax. As opposed to *Xco*, there was no evidence that the New Partner could shelter the proceeds from tax.

The *Xco* and *Penn West* cases demonstrate the Tax Court's unwillingness to allow partners to agree to allocate income in a disproportionate manner. The decision in *Xco* is not surprising, since *Xco* essentially involved a partnership using the losses of a third party, and it is clear that there is a policy against arm's length loss trading in Canada. The decision in *Penn West*, however, has taken the Partnership Avoidance Rule to a new level, essentially holding that arm's length parties cannot agree to allocate partnership income disproportionately if it results in even one of the partners having a reduction in tax.

The *Penn West* decision will have a significant impact on partnerships in Western Canada, and in particular resource partnerships, where it is standard practice for partnership agreements to contain a clause allocating the proceeds of property as was done in *Penn West*. In essence, it has been common for partnership agreements to provide that the economic consequences of the property

(i.e. the proceeds of disposition) follow the property, when a partner removes it from the partnership. The decision of the Tax Court will essentially invalidate many of these agreements. Instead, a strict, proportionate allocation of partnership income will be required, even where the agreement was negotiated between arm's length parties with a commercial purpose.

In the end, it should be noted that the decisions in both *Xco* and *Penn West* were fact-specific, and that partnerships with a different set of circumstances will not necessarily have the same result. However, it is now clear that any partnership that is considering a disproportionate allocation of income, for any purpose whatever, should take caution.

Employee Stock Option Payouts on Takeovers & Mergers

by Heather DiGregorio

INTRODUCTION

With the pace of takeovers and mergers in the oil patch in the last few years, and the amount of money that is often paid out to stock option holders, the question of whether a company can deduct employee stock option payouts has become an increasingly important issue.

The Canada Revenue Agency (the "CRA") appears to have been taking the position that such payments are not deductible, where a merger or a takeover is on the horizon, much to the surprise of many companies and their tax advisors. The surprise stems from the fact that the CRA has had an administrative position, dating back to at least 1991, setting out when such payments are deductible. It is only recently that the CRA has modified its position, and begun denying the deductions of such payments. Moreover, a recent decision from the Tax Court of Canada suggests that the CRA may not be successful in many such reassessments.

THE ISSUES

In what circumstances is the CRA targeting Stock Option Payouts? What do you need to be aware of when determining whether you can deduct these payments? And what steps can a company take to protect its position?

DISCUSSION

a. Background

The taxation of stock option benefits is generally governed by the provisions in section 7 of the Tax Act. This section of the Tax Act dictates what the value of a 'stock option benefit' is, and when an employee must

include such benefit in calculating its taxable income. This section also specifically prohibits an employer from deducting the amount of such 'stock option benefit' from its income. However, the CRA's position has long been that the restriction on the employer only applies where the employee actually exercises his or her option, and the employer issues a share.

Thus if an employer simply pays an amount in cash to the employee in exchange for the cancellation of the option, instead of going through the formalities of exercising the option and issuing the share; the amount paid is generally deductible to the employer. This type of payment will be referred to as a "stock option payout" in this article, and it is these stock option payouts that are the cause for concern.

The CRA has begun reassessing companies that have made stock option payouts in contemplation of a merger or a takeover. Specifically, the payments that have been targeted by the CRA are those where the 'target' company in a merger or takeover (i.e. the company that does not survive the merger), pays out its employee optionholders prior to the actual merger. It has been a very common practice for target companies to include provisions in their stock option plans providing for an automatic payout in the case of a merger.

b. Rationale of CRA

The CRA's position is essentially that stock option payouts will generally be deductible up until the point in time that a merger or takeover is anticipated. At that point in time, a stock option payout becomes a capital payment, and is thus denied under paragraph 18(1)(b) of the Tax Act. The position is rooted in a couple of cases, the *Canada Forgings Ltd. v. The Queen*¹ ("*Canada Forgings*") and the *Kaiser Petroleum Ltd.*

v. Canada² (“Kaiser”) cases. The *Canada Forgings* case was a case where one corporation (Aco) wished to purchase a target corporation (Bco). However, it did not want Bco’s optionholders to have a claim on its share capital after the acquisition. Bco’s option plan did not provide for a stock option payout to Bco’s optionholders. Aco, therefore, made an offer to pay Bco’s optionholders in exchange for the cancellation of their options. The Court found that Aco could not deduct such payment, since it was expenditure on account of capital.

The difference between *Canada Forgings* and the recent cases that the CRA has been assessing is that in *Canada Forgings*, it was *not* the target company who paid out its optionholders. Instead it was the purchaser company that made such payment. Since the purchaser was, indeed, making a payment to shape the capital structure of a company, and thus a capital asset that it was acquiring, this decision makes a good deal of sense.

In the *Kaiser* case, however, the Court of Appeal took it one step further and found that even when a target corporation paid out its optionholders, such payment was on account of capital, and was not deductible. In *Kaiser*, a target corporation had issued stock options, but its option plan did not provide for stock option payouts. Once the takeover loomed, the target company specifically amended its option plan and paid out its optionholders. The CRA is essentially relying on this case to support the denial of all stock option payouts that occur in contemplation of a merger. This position, however, is flawed in several respects, and many criticisms have been levelled at it by esteemed scholars and authors. Additionally, a recent decision from the Tax Court of Canada distinguished the *Kaiser* case, and may indicate that the *Kaiser* decision will be restricted to its particular facts.

c. Critique of CRA position

The first criticism of *Kaiser* stems from the fact that the Court ignored a very long line of jurisprudence that has consistently held that the income vs. capital question should be decided by looking at the purpose of an expense. Decades of case law have established the principle that one must examine the purpose of an expense, when determining whether it is deductible as a current expense, or whether it is on account of capital. In *Kaiser*, even though the Court agreed that the purpose of stock option payouts in general is to compensate employees, such purpose is completely dominated in the circumstances of a takeover. Thus, the stock option payout became a capital payment.

Secondly, in *Kaiser*, the Court deviated from another line of case law that has held that takeover expenses which are legitimately incurred by a target company, are generally deductible as current expenses. This includes expenses related to shareholdings of the corporation, which would seem to have a similar capital nature to stock option payouts. The *Kaiser* case, therefore, stands out from its peers in several respects.

Both the *Canada Forgings* and the *Kaiser* cases were decided before 1991. The CRA’s position with respect to stock option payouts dates back to at least 1991. Curiously, however, the CRA never mentioned

either of these cases, or the possibility that they might be applied in the context of a stock option payout, until 2000. In 2000, a taxpayer wrote the CRA and asked them how they could reconcile their position that stock option payouts were deductible, with the decisions in these two cases. The CRA responded that the *Kaiser* case was specific to its own facts, and absent those specific facts, it would not be applicable:

In our view the result in *Kaiser* follows from the facts in that particular case and is not inconsistent with our position that the payment by an employer of cash rather than shares pursuant to the terms of a stock option plan will, in the absence of evidence to the contrary (e.g. the fact situation in *Kaiser*) be a deductible expense to the employer. (Ruling 2000-0048355)

This emphatic response from the CRA provided quite a bit of reassurance for taxpayers and the use of the words “payment by an employer of cash rather than shares pursuant to the terms of a stock option plan... will be a deductible expense to the employer” were particularly comforting. Many advisors took this to heart, and took it quite literally. Recall that in *Kaiser*, the stock option plan had to be amended in order to create a cash-out right.

Thus, advisors concluded that so long as a stock option plan already contained a cash-out right, then they would not have the “fact situation in *Kaiser*”.

However, the CRA is no longer sticking to such a narrow interpretation of the *Kaiser* case. It is specifically relying on both *Canada Forgings* and *Kaiser* to target stock option payouts that have been made in recent years.

For companies that are currently facing a reassessment of this nature, therefore, there are many steps that can be taken to mount the best possible defence.

NOT THE FINAL SAY

The CRA’s position, however, is not absolute, and may not reflect the law. The recent case of *Shoppers Drug Mart v. R.*³ (“*Shoppers*”) held that a payment made from a wholly-owned subsidiary corporation to reimburse its parent corporation’s stock option payouts was deductible by the subsidiary. In that case, employees of the subsidiary actually held stock options in the parent company. The Chief Justice of the Tax Court held that payments made to employees for the surrender of their options is a deductible expense as it is employee compensation that is a cost of doing business. The Chief Justice further held that such payments do not become capital expense just because they are made in the course of a corporate reorganization. Importantly, the Court distinguished the *Kaiser* decision.

If the *Shoppers* case is not overturned on appeal, then it may be the first signal that corporations are justified in deducting stock option payouts on mergers and reorganization. For companies that are currently facing a reassessment of this nature, therefore, there are many steps that can be taken to mount the best possible defence.

Footnotes

¹ 83 DTC 5110 (F.C.T.D.)

² 90 DTC 6603 (F.C.A.)

³ [2007] T.C.J. No. 482



Changes to the Canada-U.S. Income Tax Treaty Affecting Withholding Taxes

by Jeffrey A. Fortin and
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On September 21, 2007, Canadian Finance Minister Jim Flaherty and U.S. Treasury Secretary, Henry M. Paulson signed the Fifth Protocol (the “Protocol”) to the Canada-U.S. Tax Treaty (the “Treaty”). The protocol is expected to bring significant changes to cross border investment.

ELIMINATION OF WITHHOLDING TAX ON INTEREST

A key component of the Protocol is the elimination of withholding tax on interest. This will affect any resident of Canada or the United States who pays interest to a person in the other country. Currently, if interest is paid across the Canada-U.S. border, the tax treaty generally allows the payer’s home country to tax that interest. Requiring the payer to withhold and remit a portion of the interest payment collects the tax. With the addition of the Protocol, the source country will not be able to tax cross-border interest. This change is expected to reduce the cost of borrowing as well as make cross-border investment more efficient. The withholding tax on interest paid to arm’s length parties will be eliminated effective at the beginning of the year in which the Protocol comes into force. Practically speaking, the Canadian withholding tax on interest between arm’s length parties will generally be eliminated effective January 1, 2008 following the Department of Finance’s November 13, 2007 Notice of Ways and Means Motion introducing changes to the withholding tax regime on interest. (See subsequent article by Michael J. Flatters) For interest paid to non-arm’s length lenders, the elimination of the withholding tax will be phased in over 3 years. During the first calendar year that ends after the Protocol comes into force, the rate will be 7%; during the second calendar year the rate will be 4% and after that the withholding tax will be eliminated.

DENIAL OF TREATY BENEFITS FOR UNLIMITED LIABILITY CORPORATIONS

Entities that are treated as corporations under the law of one country, but are treated as partnerships or “flow through entities” in the other country, will also be affected by the implementation of the Protocol. Currently, there is no specific accommodation for these hybrid entities. In order to benefit from the

existing tax treaty that entity must be resident in either the United States or Canada. If an entity is a flow through entity in its home country then it is not taxable there and its investors are taxed directly as the entity earns income. But if the other country sees the entity as a corporation, that other country will apply the residence test for taxability to the entity itself and the entity will subsequently fail. The new rule outlines that income that the residents of one country earn through a hybrid entity will, in certain cases, be treated by the source country as having been earned by a resident in the residence country. This rule applies, for example, when a US limited liability company (“LLC”) earns Canadian source income. On the other hand, a corollary rule provides that if a hybrid entity’s income is not taxed directly in the hands of its investors, it will be treated as not having been earned by a resident. This rule applies, for example, to an Alberta unlimited liability corporation (“ULC”) with US shareholders.

Specifically, the Protocol addresses U.S. residents that use LLCs to invest in Canada. LLCs are treated as corporations from a Canadian standpoint but, by default, are considered to be flow-through entities for U.S. tax purposes. Generally, the Protocol allows, in Article IV(6) of the Treaty, income, profit or gain earned by an entity to be ‘derived by’ a resident of Canada or the United States if, under the tax laws of the country in which the owner is resident:

- the owner derived the income, profit or gain through an entity;
- the entity receiving the funds is “fiscally transparent” under the laws of the home country; and
- the treatment of the income, profit or gain is the same as its treatment would be if the income, profit or gain had been derived directly by the owner.

U.S. resident investors in LLCs will, therefore, no longer be denied the treaty benefit of a reduction from or an exemption from Canadian tax otherwise available on Canadian source income derived by them through LLCs.

However, this change intended to provide relief to owners of LLCs also comes with an anti-avoidance provision aimed at US owners of certain hybrid entities such as

Nova Scotia, Alberta or British Columbia ULCs which, by default, are treated as pass-through entities for U.S. tax purposes. The Protocol contains a rule that appears to deny the benefit of the Treaty to holders of interests in ULCs. Specifically, amounts received by U.S. taxpayers from ULCs would be ineligible for the reduced rates of withholding under the Treaty. U.S. taxpayers have primarily used ULCs as operating companies because U.S. investors can claim a foreign tax credit on their individual U.S. tax return for Canadian taxes paid by the ULCs. Since ULCs are not treated as corporations under US tax law, they were also used to avoid the myriad of corporate anti-deferral rules in the Internal Revenue Code, most notably, Subpart F and the passive foreign investment company (“PFIC”) rules. Many U.S. taxpayers use ULCs as the operating entity in Canada for

Dividends paid by the ULC to its parent company will also be subject to the 25% withholding tax under the new Protocol.

state tax, start-up loss and foreign tax credit planning purposes. Although a ULC is a taxable Canadian corporation for Canadian tax purposes, it is treated as a Canadian branch of the parent corporation for U.S. tax purposes. Under Article IV(7)(b) of the Treaty, payments made by a ULC to its parent that are subject to withholding tax will not be considered paid to a resident of the U.S. This subjects the payments to the full Canadian statutory rate of withholding tax – 25%. In the case of dividends, this would also be true notwithstanding that the income of the ULC is included in the income of the U.S. parent as branch income and has already been fully taxed in Canada. It is arguable as to whether the denial of treaty benefits to dividends paid by an operating ULC is appropriate, but the Protocol appears to apply to such dividends. It appears that this provision was intended to eliminate certain cross border “double dip” financing structures. Unfortunately, it has gone way beyond closing this limited loophole and has levied the high rate of tax in situations in which ULCs were most commonly used, where there was no tax avoidance on either side of the border, or collectively for that matter.

In a typical hybrid entity financing structure a parent company makes a loan to a subsidiary ULC, which also holds an interest in a Canadian partnership. For Canadian tax purposes, interest paid on the loan offsets income that is allocated to the ULC by the partnership. For U.S. tax purposes, the interest income on the loan to the ULC is disregarded and income of the partnership is taxed as a dividend, but only upon an actual distribution by the partnership. Accordingly, any income inclusion is deferred for U.S. tax purposes. Under Article IV(7)(b), interest payments made by the ULC will be subject to the 25% withholding tax because the parent company does not recognize the interest income for U.S. purposes.

Dividends paid by the ULC to its parent company will also be subject to the 25% withholding tax under the new Protocol. This would also be the case notwithstanding the fact that the distribution from the partnership to the ULC would be taxable to the parent company as a dividend. If the ULC is used to hold shares of other Canadian and foreign subsidiaries, any dividends paid to the ULC will be viewed as dividend income to the parent company for U.S. tax purposes. Following a strict reading of the Protocol, it appears that the subsequent dividend distribution by the ULC of the dividend will be subject to the 25% withholding tax rate.

Article IV(7)(b) appears to only apply to payments from a resident of the source country, such as a Canadian ULC. Accordingly, it may still be possible to establish a hybrid entity in a foreign jurisdiction to avoid the application of Article IV(7)(b). In addition, paragraph 7 does not generally affect structures that use hybrid instruments as opposed to hybrid entities. Article IV(7)(b) also only appears to apply to US resident recipients of the income payments. Accordingly it may be possible to insert a 3rd country disregarded entity between the US shareholder and the ULC so as to shift the treaty analysis to the Canada-3rd country treaty.

The Protocol will become effective on the later of the date that the countries exchange notifications of ratification and January 1, 2008. The Treaty changes that are applicable to withholding taxes will generally apply to amounts paid on or after the first day of the second month after the Protocol comes into force.

Income Tax Changes

Withholding Tax on Canadian Resident Debtor's Debt

by Michael J. Flatters

A Notice of Ways and Means Motion ("NOWMM") was introduced on November 13, 2007 to implement certain measures previously announced by the Minister of Finance. The NOWMM departs from the previously announced timetable for some of these amendments. Although it is not quite like the scene from that cinematic classic "The Jerk" where Steve Martin runs around exclaiming "... the new phone books are here, the new phone books are here", the release of the NOWMM has created a certain level of excitement among tax practitioners!

The NOWMM includes significant amendments to the provisions of the Income Tax Act (the "Act") dealing with withholding tax on interest payments. [Note, the recently announced Canada-US Tax treaty amendments are distinct and must be adopted by separate enactment of Parliament.] The tax policy behind the existing provisions of the Act dealing with exemptions from withholding tax for interest on certain long term debt was premised on the view that Canada is a comparatively capital poor country. Therefore, it was long considered necessary to remove any limitations (e.g. withholding tax that lender insist be covered by borrower gross-up or indemnity payments) on the flow of long term debt capital into the country. As a result, under the existing legislation there were exemptions from withholding tax on certain corporate debt issued to arm's length non-resident persons where no more than 25% of the principal was due within 5 years from the issue of the debt (sometimes known as the "5-25 rule"). It seems that for reasons of competitiveness and many other possible explanations, these incentives were not considered to be sufficient or were too tight. Hence the NOWMM brings more relief from withholding tax on interest paid or payable to non-resident persons under the Act.

If the NOWMM is passed in its current form, the amendments can be summarized as follows:

1. Effective January 1, 2008 the requirement that the debtor must be a corporation in order to enjoy certain exemptions from withholding tax will no longer be relevant. Any debtor may qualify under the new exemptions from withholding tax on interest.
2. Effective January 1, 2008 interest (other than something defined as "participating interest"¹) payable by anyone resident in Canada to a non-resident person will be exempt from withholding tax if the non resident payee deals at arm's length with the Canadian resident debtor.
3. Effective January 1, 2008 if the non-resident payee does not deal at arm's length with the Canadian resident debtor then the interest payable by anyone resident in Canada will only be exempt from withholding tax if the interest is something defined as "fully exempt interest"² and is not "participating interest".
4. Effective from March 19, 2007 to December 31, 2007 the existing 5-25 rule will be amended so that the interest will be exempt from withholding tax if under the terms of the obligation or any agreement relating thereto more than 25% of the principal is due within 5 years from the issue of the debt if such obligation is conditional upon a change to the Act or to any treaty that has the effect of relieving the non-resident payee from tax in respect of the interest. This is the amendment addressed by a September 4, 2007 Department of Finance Comfort Letter. It permits parties to build quicker retirement obligations into their current agreements than the 5-25 rule would otherwise have allowed, as long as the enforceability of the quicker retirement obligation is conditional upon an amendment to the Act or a treaty to relieve the non-resident payee from withholding tax.
5. Effective January 1, 2008 interest payable by anyone resident in Canada to a non-resident person on "participating interest" will be subject to withholding tax, regardless of whether the non-resident payee deals at arm's length with the Canadian resident debtor.

As with most matters of taxation, the foregoing serves only as a summary of the amendments. Readers are cautioned to consult with someone knowledgeable in this field when considering the impact of the amendments upon their particular circumstances.

Footnotes

¹ "Participating Interest" is defined generally to mean interest (other than certain types of "fully exempt interest") that is contingent or dependent on use or production from property in Canada, or that is computed by reference to revenue, profit, cash flow, commodity price or any other similar criteria or by reference to dividends payable on shares of the debtor.

² "Fully exempt interest" is generally defined to pick up interest on most of the kinds of debt that are presently described in existing 212(1)(b)(i) - (xiii) of the Act and are thus currently exempt from withholding tax. These debts include government (or government controlled entity) issued or guaranteed debt, debt secured by foreign property and debt issued pursuant to certain securities lending arrangements.



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