CANADIAN TAX *Highlights*

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Quebec Ombudsman Lambastes Revenu Québec

The public protector (or ombudsman) is appointed by the Quebec National Assembly with the mandate to "intervene . . . whenever [s]he has reasonable cause to believe that a person or group of persons has suffered or may very likely suffer prejudice as the result of an act or omission of a public body." The public protector enjoys extensive investigatory powers, and her jurisdiction extends to Revenu Québec. The public protector regularly intervenes in audits, collection disputes, file processing, and other disputes with Revenu Québec after receiving complaints from taxpayers. The 2013-14 annual report, tabled on September 18, 2014, made headlines because of its searing indictment of a wide range of audit, collection, and customer service practices in which Revenu Québec officials "use, or in some cases, misuse, conferred powers to claim amounts that threaten the viability of businesses, without properly supporting their conclusions." This article summarizes the report's comments on Revenu Québec.

The report says that in 2013-14 the public protector received and substantiated more complaints against Revenu Québec than against any other provincial department or agency except Correctional Services. The problems fell into six categories: audit, collection, legal interpretation, routine taxpayer inquiries, the solidarity tax credit (STC), and support-payment collection.

■ **Audit.** The report sharply criticizes Revenu Québec's practice of automatically holding a business responsible if its suppliers fail to remit GST. Revenu Québec often issues, without meaningful inquiry into the circumstances, "outrageous assessments" that "jeopardize the operation and even the survival of these businesses," and it "[requires] businesses to check whether subcontractors have fulfilled their tax obligations [and thus imposes] a task that is not prescribed by law and that is practically impossible . . . to carry out."

The report documents cases in which auditors simply ignored information provided by the taxpayer and accelerated assessments in order to deny a taxpayer the opportunity to make representations. The disputed amounts then became payable, triggering the associated risks to the health of the business.

■ **Collection.** The report documents case studies of taxpayers who faced aggressive and even illegal actions by Revenu Québec collection agents. "Basic notions such as the unseizability of certain amounts were not heeded. In their haste to have payment agreements signed, agents did not take citizens' ability to pay into account." One example involved an auditor illegally seizing accident benefits from a victim's bank account several times. The public protector had to intervene to stop the auditor from pressuring the individual to repay significantly higher amounts than he was able.

■ **Legal interpretation.** The public protector intervened when Revenu Québec arbitrarily denied the remote-region recent-graduate tax credit to graduates of qualifying programs. Revenu Québec subsequently changed its administrative manual.

■ **Routine taxpayer inquiries.** The report documents a variety of complaints received from taxpayers in their interactions with Revenu Québec, including "difficulty getting explanations about files; refusal to carry out simple operations [that] would have made it possible to solve a problem; [and] excessive rigidity in applying rules." For example, the report documents a refusal to change a taxpayer's marital status in the department's systems and a refusal to advise the CRA that a GST debt had been paid.

■ **The solidarity tax credit.** The STC is comparable to the federal GST credit and is paid monthly on the basis of largely needs-based criteria. The report says that changes in taxpayer status are not always recorded promptly (or ever), and thus the STC either may not be paid or is overpaid and followed by potential aggressive collection actions for recovery of overpayment and interest. The report expresses particular concern about taxpayers whose "precarious financial situation" makes them vulnerable to these unfair procedures, often through no fault of their own.

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■ **Support-payment collection.** Revenu Québec is criticized for its chronic "negligence" in fulfilling its responsibility to collect court-ordered child-support payments. The report asks whether "Revenu Québec is less eager when it is time to collect arrears on support than when money is owed to the government."

The report notes that even after two years, Revenu Québec had not implemented two recommendations made by the public protector in her 2011-12 report:

> a) [to] modify the notices of determination issued to citizens so that they understand what the amounts refer to that make up the credit they receive.
>
> b) [to] change its work instructions so that audit officers do not charge interest to citizens who have provided all the documents needed for the study of their file beforehand and when Revenu Québec is late in issuing the notice of assessment.

Revenu Québec responded almost immediately to the 2012-13 report, but it has not yet responded to the 2013-14 report. The 2013-14 report is available in English and French at www.protecteurducitoyen.qc.ca/en/cases-and-documentation/index.html and www.protecteurducitoyen.qc.ca/dossiers-et-documentation/rapports-annuels/index.html, respectively.

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GST Input Tax Credit Allocation

In *Academy of Applied Pharmaceutical Sciences* (2014 TCC 171), the TCC concluded that the taxpayer must re-evaluate its GST/HST input tax credit (ITC) allocation percentages and not rely on an allocation percentage accepted by a CRA auditor for prior reporting periods. The recalculated percentages must be fair and reasonable. The TCC concluded that the doctrine of estoppel (regarding misrepresentation of facts by the CRA) and the doctrine of officially induced error (regarding receipt of erroneous advice by authorities) did not apply. The academy was required to repay about $30,000 in disallowed GST/HST input tax credits.

The academy was a training college with two kinds of programs: a diploma program (GST/HST-exempt) and a workshop program (GST/HST-taxable). The academy incurred (1) expenses directly allocable to each program and (2) mixed expenses that related to both programs (such as office lease costs, marketing, utilities, and administration).

In 2008, the CRA audited the taxpayer's 2007 taxation year. The auditor allowed ITCs for all GST paid on expenses that related to the earning of taxable income and denied any ITCs for GST paid on expenses that related to the earning of exempt income. The CRA auditor determined that 50 percent represented a reasonable allocation of mixed expenses to taxable activities and allowed as ITCs the related GST paid on 50 percent of mixed expenses for 2007. The problem arose because the academy mechanically applied this 50 percent allocation percentage for its mixed expenses in all subsequent years, saying that the original CRA auditor had endorsed this practice for subsequent years. However, the written advice of the auditor did not mention this supposed representation.

In 2012, the CRA audited the academy for the taxation years 2008 to 2012 inclusive. The CRA auditor on the file determined that no more than 11 percent and 14 percent of the mixed expenses were allocable to commercial activities for the relevant periods, and recommended that the academy re-evaluate its ITC allocation percentage each year. The academy appealed the ensuing assessment to the TCC.

The TCC reviewed ETA subsection 169(1) and concluded that a registrant may claim an ITC equal to the percentage of the tax payable that represents the extent to which the acquisition is for consumption, use, or supply in the course of the registrant's commercial activities. The TCC said that under ETA subsection 141.01(5), the method used to apportion input tax credits must be fair and reasonable and used consistently throughout the year.

After reviewing the jurisprudence, the TCC concluded that misrepresentations made by the CRA were not binding, and thus the doctrine of estoppel did not apply. (For this purpose, the court assumed that the original auditor had made the representation regarding subsequent periods as the taxpayer claimed.) Moreover, the court said that the doctrine of officially induced error does not apply to a tax appeal, because a tax assessment must be based on a correct application of the law.

In discussing the allocation percentage used, the TCC concluded that the use of a 50 percent allocation percentage for a prior year or years was not a rational basis for using that percentage for the subsequent years in issue. The ratio of taxable to exempt activities can vary greatly among periods. The ratio to be used should thus be re-evaluated and re-examined, and it is not fair and reasonable to arbitrarily apply to future periods an allocation percentage that was accepted by the CRA for an earlier period.

Although the decision was heard under the TCC informal procedure, the case is a reminder that a taxpayer cannot rely on a CRA auditor's representations involving the interpretation of a tax statute because those representations are not binding on the CRA.

The decision is also important to GST/HST registrants who must determine an ITC allocation percentage for

mixed expenses that are not exclusively for commercial or exempt activities: a taxpayer cannot mechanically apply an allocation percentage from an earlier period to subsequent periods. Even if an allocation percentage was accepted as fair and reasonable for an earlier period, that same percentage may not be fair and reasonable in a subsequent period, whether the percentage was determined by the taxpayer or by a CRA auditor during an audit. A taxpayer should determine a fair and reasonable method before it files its first return of the year and should consistently use that method throughout the year; at a minimum, the taxpayer should re-evaluate its allocation percentage at least annually and use that method consistently throughout the year. Special allocation rules and restrictions apply only to the many financial institutions that have both GST/HST taxable and exempt activities.

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Parol Evidence in Tax Litigation

The common-law parol evidence rule prevents the admission of extrinsic evidence to augment, subtract from, vary, or qualify a written contract. The underlying principle protects the contract and the contracting parties against the introduction of unreliable extrinsic evidence to modify the contractual terms and their interpretation.

The TCC recently considered the parol evidence rule in *Henco* (2014 TCC 192). Henco's project in Caledonia, Ontario was thwarted by First Nations protestors; Henco contested the taxability of the $15.8 million compensatory payment from the Ontario government to dispose of an interest in the property. The Crown unsuccessfully moved to exclude extrinsic evidence to interpret or contextualize the written agreement, saying that the agreement was unambiguous. The relevant extrinsic evidence included documents relating to ONSC orders, news reports, government press releases, internal government e-mail messages and an opinion letter, and internal documents from the federal Department of Indian and Northern Affairs.

The TCC's review of the law confirmed the inconsistent application of the parol evidence rule in tax litigation. In *General Motors of Canada* (2008 FCA 142), the FCA said that extrinsic evidence was admissible only if the words of the contract could be reasonably interpreted in more than one way. Other case law suggested that the parties' intentions should be determined according to the standard of a reasonable person in similar circumstances; if any ambiguity persists after an objective examination, then extrinsic evidence is admissible to cure the ambiguity. However, in *River Hills Ranch* (2013 TCC 248), the TCC relied on an ONCA judgment that concluded that the context of a written agreement is integral to the interpretive process and is not to be resorted to only after an ambiguity has been found.

In *Henco*, the TCC held that there is no bright line between evidence that establishes the factual matrix (the surrounding circumstances) underlying a contract and evidence that goes to the parties' subjective intention (and is perhaps inadmissible). The TCC said that even if evidence may demonstrate the parties' subjective intention, it is admissible if its purpose is to establish a latent ambiguity in the contract; however, that conclusion may conflict with previous cases that suggest that an ambiguity must be established before evidence of subjective intention is admissible. The TCC in *Henco* concluded that extrinsic evidence may be necessary to achieve a just tax result—because the court is not being asked to affect the contractual rights and obligations inter partes when the object is to characterize the contract for a third party—and thus it relaxed the parol evidence rule to admit extrinsic evidence.

The TCC's jurisdiction is limited to determining the correctness of a tax assessment; the court cannot grant declaratory relief or any other common-law or equitable remedy to resolve disputes between private parties. Thus, the TCC's consideration of extrinsic evidence can never be declarative of contractual rights or obligations. The TCC's task in *Henco* was to determine a payment's appropriate characterization for tax purposes. The TCC concluded that understanding the factual matrix of the agreement between the parties was essential to a determination of the tax characterization. The TCC said that the parties may choose inexact contractual wording without regard to tax implications, and thus it may be impossible to determine the correct tax treatment without extrinsic evidence.

The TCC in *Henco* said that an established body of law allows the court to look past the wording of agreements—for example, when the employee versus independent contractor issue is in dispute. With respect, the TCC may look beyond a payer-worker agreement when the working relationship's true nature does not accord with the agreement. In my view, the TCC's authority to look beyond a payer-worker agreement resembles its ability to look past a sham, and extrinsic evidence is clearly admissible if an arrangement is a sham. Furthermore, an employee-independent contractor case is concerned with characterizing a legal relationship for the purpose of social welfare legislation, and a court may be sensitive to imbalances in bargaining power in such circumstances. However, it is not clear that that approach has sufficiently wide application to allow the TCC to look past the wording of

agreements in tax cases in general; this conclusion is particularly pertinent in light of the well-established Canadian tax-law principle that form governs.

Arguably, the parol evidence rule has limited application in a dispute between a contracting party and a stranger to the contract because the third party did not engage in the bargaining, drafting, or reviewing of the contract. The usual estoppel against a party to a contract does not apply to a third party, including the Crown. In *Urichuk* (93 DTC 5120), the FCA said that the minister, who was not a party to a contract, was able to rely on any available evidence to support the payment's characterization. However, the TCC later restricted *Urichuk* to cases that involved the same subject matter of spousal support (see *On-Line Finance & Leasing Corp.*, 2010 TCC 475).

The parol evidence rule in tax litigation poses special challenges, and it involves policy considerations. In my view, the rule's application in tax cases should vary according to the circumstances. If the usual tools of contractual interpretation do not clearly establish a receipt's tax treatment, the admission of extrinsic evidence may be appropriate to resolve that ambiguity. However, the courts should be wary of extrinsic evidence that supports the interpretation of a contract to achieve an untenable or abusive tax result or retroactive tax planning. The Crown should also be limited in its ability to challenge the formal structure of an agreement or transaction using extrinsic evidence that violates the principles and values of Canadian tax law, such as form over substance, certainty, predictability, and fairness. Caution should be exercised so that extrinsic evidence cannot be used to look past an agreement's precise wording. Moreover, the parol evidence rule's application should vary with the nature of the transaction and with the policy of the relevant provisions of the Act. For example, tax provisions that relieve the taxation of child support may call for relaxed evidentiary rules to assist in the achievement of a just result by a single parent; but in a case in which a sophisticated and well-advised taxpayer has executed a written agreement, it may be appropriate to apply more rigorous evidentiary rules that prevent the use of extrinsic evidence. In addition, if sham is alleged, a relaxed rule may be appropriate.

Although a more relaxed application of the parol evidence rule was favourable, and substantially so, to the taxpayer in *Henco*, whether future exceptions to the rule yield favourable or unfavourable results to taxpayers will likely depend on the circumstances.

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2014 OECD Update: Beneficial Ownership

On July 15, 2014, the OECD approved the 2014 updated commentary to articles 10 (dividends), 11 (interest), and 12 (royalties) of its model treaty. Working Party 1 of the Committee on Fiscal Affairs modified earlier proposals to clarify the meaning of the treaty term "beneficial ownership." The update continues what appears to be the interpretation of beneficial ownership as an anti-avoidance rule—unlike the 1986 conduit report, which suggested the use of LOB treaty clauses and domestic avoidance rules. The proposed commentaries are almost the same for each of the three articles; the discussion draft focuses only on the article 10 commentary.

"Beneficial ownership" in the model treaty does not have the same meaning that it does in trust law. The phrase as used in the new commentary is essentially different from the traditional concept of beneficial ownership and focuses on the person to whom payment is ultimately made rather than on the initial recipient. Treaty relief is not available merely because income was paid directly to the resident of a state. The 2010 draft indicated that the common-law meaning of "beneficial ownership" may be relevant to the extent that it is consistent with the commentary: the update deletes this comment, which was said to be potentially confusing.

A footnote to the article 10 commentary says that if the trustees of a discretionary trust do not distribute dividends earned in a period, they may be regarded as the beneficial owners under the model treaty notwithstanding different treatment under the relevant trust law. The earlier draft commentary said that the relevant trust law may distinguish between legal and beneficial ownership; this comment is deleted as a "clarifying change." The commentary points out that "beneficial ownership" in these articles must be distinguished from "beneficial ownership" as it is used in other contexts (such as money-laundering legislation), which look to the individual who exercises ultimate control over entities and assets.

"Dividends" includes the distribution of profits decided by an annual shareholders' meeting (presumably also by a board of directors, where required), bonus shares (stock dividends), bonuses, and profits, and a liquidation or a redemption of shares and a disguised distribution of profits. The contracting state in which the payer company resides determines whether the benefits are taxed as dividends.

Interest on bank loans is often exempt under a treaty or domestic legislation. The commentary supports this approach: withholding is on gross income, and no deduction is allowed for a bank's expenses (such as interest

paid on deposits). Cross-border bank loans often provide that interest payments are net of withholding tax.

A comment from the 1986 conduit report—that a conduit company cannot be regarded as the beneficial owner if its very narrow powers render it a mere fiduciary or administrator acting on behalf of the interested parties vis-à-vis the relevant income—is clarified. The updated commentary says that an agent, a nominee, or a conduit company that acts as a fiduciary or administrator and receives the income is not its beneficial owner because the recipient's right to use and enjoy the income is constrained by a legal obligation to on-pay the receipt; the income is not its own. Arguably, a holdco is neither a fiduciary nor an administrator because the directors' duty is to the company, and, unlike trustees, the directors are not fiduciaries.

The commentary says that facts and circumstances may also create a constraining obligation to on-pay receipts. In a typical holdco, directors regularly declare dividends out of dividends received and not required for other investments. The regular declaration of dividends may create an inference even if time passes between the receipt and the on-payment. More importantly, however, it is unclear what means are at the payer's disposal to determine, at the time the dividend is paid, that the recipient is not its beneficial owner based on facts and circumstances. What form of certificate must the recipient provide? Must the directors never intend to pay dividends to their shareholders? The updated commentary clarifies that the necessary use of receipts for unrelated obligations such as pension obligations does not create a facts-and-circumstances obligation to on-pay.

In the case of interest or royalties, back-to-back loans or licences may impede the use of a multinational's treasury or finance companies that are financed with internal or external loans because the creditor requires contractual protection. It does not appear that the income must be on-paid by the intermediary in the same form that it was received (such as back-to-back income), and a holdco may be caught if it receives dividends or royalties and pays interest, or receives interest and pays dividends.

Presumably, a shareholders' agreement to which the holdco is a party and that provides for mandatory dividends is a contractual obligation to pass along receipts. In *Prévost* (2009 FCA 57), a shareholders' agreement (to which the Dutch holdco was not a party) mandated that 80 percent of dividends received must be on-paid. The taxpayer succeeded in part because the holdco was not a party to the shareholders' agreement and because a directors' resolution must declare a dividend: a dividend is not automatic and is not allowed if the company is insolvent.

Even if the dividend's recipient is its beneficial owner, the working party strongly disagrees that a beneficial owner should receive treaty relief if the provision is being abused. The update confirms that many avenues address a conduit company and, more generally, treaty-shopping situations, such as specific treaty anti-abuse provisions, general anti-abuse rules, and substance-over-form or economic-substance approaches. It appears that establishing a holdco in a favourable tax jurisdiction may attract suspicion, as in *Prévost*, if the withholding tax rate on dividends paid to the holdco is lower than it would be if the dividends were paid directly to its shareholders.

The treaty-reduced rate is available if the payer is in one contracting state, the agent or nominee is in a second contracting state, and the beneficial owner is in a third contracting state. Several commenters called for additional examples, but the working party concluded that specific examples would only tend to raise additional questions. The update eliminates the statement in the draft commentary that a state may make this result more explicit in bilateral negotiations.

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FA Dumping: PUC Offset

Finance released proposed amendments to the FA dumping rules on August 29, 2014 that were included (with changes) in the notice of ways and means motion released on October 10, 2014. The latest proposals differ from the August 16, 2013 proposals, and some changes, including those to the PUC offset rules in proposed subsection 212.3(7), apply retroactively to transactions that occur after March 28, 2012. Two significant and retroactive changes to the PUC offset rules are discussed below.

If the FA dumping rules apply, a corporation resident in Canada (CRIC) is generally deemed to pay a dividend to its non-resident parent. However, if the CRIC or a qualifying substitute corporation has a class of shares ("the cross-border class") that are owned by the non-resident parent or by a non-arm's-length non-resident corporation (together, "the relevant non-resident corporations"), currently the CRIC may elect to offset the deemed dividend by a PUC reduction to the cross-border class. Under the August 2013 proposals, this PUC offset was automatic (no election was required), and a requirement was introduced for the filing of a notification form showing the PUC of each cross-border class, the PUC of the shares of each class owned by the relevant non-resident corporations, and the PUC reduction of each class. (No form has yet been released: presumably, filing a letter

with the prescribed information suffices.) The proposals did not specify the consequences of non-filing or late-filing the form.

Under the October 2014 proposals, new subparagraph 212.3(7)(d)(ii) provides that if the CRIC does not file the form on time, it is deemed to have paid to the parent a dividend that the parent is deemed to have received from it on the day the form is due; the deemed dividend equals the total PUC reduction. Interest applies to any late or unpaid withholding tax on the deemed dividend. However, Finance proposes adding a reference to subparagraph 212.3(7)(d)(ii) in paragraph 227(8.5)(b) so that penalties under subsection 227(8) do not apply; this differs from the August 2014 proposals. If the form is filed late (after the deemed withholding tax was remitted), new proposed subsection 227(6.2) allows a taxpayer to request a refund of withholding taxes paid in respect of the deemed dividend via a written application no more than two years after the form is filed.

Taxpayers may have undertaken transactions in respect of which the PUC offset rules applied, but they may not have filed a form because, for example, they have not yet determined the PUC of each cross-border class. To avoid a deemed dividend and the resulting deemed withholding tax, a form should be filed. The form is due on or before the CRIC's filing-due date for its taxation year that includes the dividend time (generally, the time of the investment), but a transitional rule deems the form to have been timely filed if it is filed on or before the later of the CRIC's filing-due date for its taxation year that includes the day on which the proposals receive royal assent and one year after the proposals receive royal assent. (The normal due date has been extended from that set out in the August 2013 and August 2014 proposals, which required the form to be filed before the 15th day of the month following the month that includes the dividend time.) Thus, to avoid the deemed withholding tax, these taxpayers should begin to collect the relevant PUC information so that they can file the form on time.

The second important retroactive change to the PUC offset rules relates to the allocation of the PUC reduction if there is more than one cross-border class and their total PUC exceeds the deemed dividend. The allocation must result in the greatest total PUC reduction in respect of shares owned by the relevant non-resident corporations: the reduction first applies to the cross-border class owned in the greatest proportion by the relevant non-resident corporations, then to the cross-border class owned in the second greatest proportion by them, and so on.

If the relevant non-resident corporations own equal proportions in more than one cross-border class, currently the PUC reduction can be allocated to any such class or classes and still meet the requirement to maximize the impact of the PUC reduction on shares owned by the relevant non-resident corporations. In these circumstances, however, new subparagraph 212.3(7)(c)(iii) in the October 2014 proposals requires a PUC reduction for each cross-border class that is proportionate to that class's PUC. Because the proposal is retroactive, the impact of the PUC offset rules may be different from what a CRIC expected when it made the relevant FA investment. For example, the result may differ if a non-resident corporation owns all of a CRIC's common and preferred shares and the PUC reduction was expected to apply only to the common shares. This situation could be especially problematic if in the interim the CRIC undertook a transaction (such as a preferred share redemption) that relied on the shares' PUC being a certain amount: if the October 2014 proposal is retroactive, the redemption could inadvertently trigger a deemed dividend. It is hoped that Finance will consider making this change prospective only.

On a separate matter, in "TI Denies Cap D Rule" (*Canadian Tax Highlights*, February 2014), we expressed disagreement with the view in TI 2013-0496841I7 (October 21, 2013) that clause 95(2)(a)(ii)(D) did not apply to interest paid on debt because on the facts it was not issued to acquire shares. A recent TI (2014-0519801I7, September 16, 2014) reversed the CRA's former position and confirmed that clause 95(2)(a)(ii)(D) applies on the original TI's facts.

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Owner-Manager Year-End Tips

Optimal Salary-Dividend Mix

■ Determine the optimal salary-dividend mix for the owner-manager and family members to minimize overall taxes. Consider their marginal tax rates, the corporation's tax rate, provincial health and/or payroll taxes, RRSP contribution room ($138,500 of earned income in 2014 is required to maximize the 2015 RRSP contribution), CPP contributions, and other deductions and credits (such as child-care expenses and donations). If an owner-manager earns dividends (especially eligible dividends), alternative minimum tax (AMT) exposure may increase.

■ Establish the deductibility of salaries and bonuses by ensuring that they are reasonable, and that at the business's year-end they have been accrued and properly

documented as legally payable and then are paid within 179 days thereof. Remit appropriate source deductions and payroll taxes on time. It may be beneficial to pay a reasonable salary to a spouse or child who provides services to the business and is in a lower tax bracket; the reasonableness of the salary amount is generally determined in relation to the value of the services performed.

■ Consider dividend distributions in the following order: (1) eligible dividends that trigger a refundable dividend tax on hand (RDTOH) refund; (2) non-eligible dividends that trigger an RDTOH refund; (3) eligible dividends that do not trigger an RDTOH refund; and (4) non-eligible dividends that do not trigger an RDTOH refund. Depending on the provincial or territorial jurisdiction of residence, the payment of non-taxable capital dividends is the second or third preference.

■ A CCPC can designate and pay eligible dividends only to the extent that it has a positive general-rate income pool (GRIP) at the end of the year of payment. Generally, a CCPC's GRIP is the portion of its taxable income that has not benefited from any preferential corporate tax rates (that is, it excludes taxable income taxed at small business or investment income rates). A dividend must be designated as eligible when or before it is paid. A dividend paid and inadvertently designated as eligible (because the CCPC had insufficient GRIP) attracts part III.1 tax to the payer on the excess designation; in this case, consider an election to treat all or part of the excess designation as a separate non-eligible dividend.

■ An owner-manager in British Columbia should be aware that for 2014 and 2015, the BC personal tax rate on taxable income over $150,000 is 16.8 percent (expected to decline to 14.7 percent after 2015). Ensure that the owner-manager's remuneration strategy accounts for this temporary rate increase. If the owner-manager's income may otherwise exceed $150,000 in 2014 or 2015, consider the deferral of taxable bonuses and discretionary dividends until 2016, although that deferral may increase the owner-manager's AMT exposure in 2016.

■ An owner-manager in Nova Scotia should be aware that if the province tables a budget surplus in its 2015-16 fiscal year, it has committed to eliminate in 2015 the top $150,000 personal income tax bracket (taxed at 21 percent) and to reinstate the 10 percent surtax on personal provincial income tax that exceeds $10,000. Thus, in the event of a provincial budget surplus next year, an owner-manager should anticipate a potential personal tax rate decrease in 2015 and make appropriate adjustments to his strategy for the payment of salary and/or dividends.

■ An owner-manager in Ontario should ensure that his or her remuneration strategies contemplate Ontario's personal income tax increase on income over $150,000. Starting in 2014, Ontario's top rate is 13.16 percent plus Ontario surtax on taxable income that exceeds $220,000 (down from $514,090); the tax rate is 12.16 percent (up from 11.16 percent) plus surtax on taxable income that exceeds $150,000, up to $220,000. Ontario has said that it will eliminate the 13.16 percent top rate when its budget is balanced (scheduled for 2017-18). To avoid the highest income tax rate, the owner-manager may be able to maintain taxable income at $220,000 or less by deferring taxable bonuses and discretionary dividends.

■ Forgoing bonus payments and/or dividend distributions out of excess cash may create doubt about the status of a CCPC's shares as QSBC shares—because substantially all of its assets are arguably not used in an active business—and thus jeopardize the shareholder's claim to the $800,000 (indexed after 2014) lifetime capital gains exemption on their sale. The ratio of a CCPC's redundant or investment assets to total assets should be monitored.

■ Forgoing bonus payments may cause a CCPC's taxable income to exceed certain taxable income thresholds and thus render a CCPC's SR & ED investment tax credits (ITCs) non-refundable and subject to the lower ITC rate. If ITCs are non-refundable, consider other planning to create a federal corporate income tax liability that is sufficient to use the ITCs.

■ If the owner-manager does not need to extract cash, consider whether the retention of income by the corporation ultimately yields a tax saving (or cost) when the after-tax corporate income is paid out as a dividend. That retention defers tax because the corporation's tax rate is less than the individual shareholder-employee's rate. The table shows the income tax deferral associated with the retention of active business income (ABI) in a corporation that is not paid out as salary to the shareholder-employee, and the tax saving (or cost) when the corporation pays out a dividend.

Corporate Income

■ A corporation subject to the small business rate in New Brunswick, Newfoundland and Labrador, and Yukon should consider the deferral of income to 2015 by maximizing discretionary deductions (such as CCA). New Brunswick's small business rate decreases from 4.5 to 4 percent on January 1, 2015, and is expected to further decrease to 2.5 percent by 2018 (announced by New Brunswick's new government on October 8, 2014); Newfoundland and Labrador's small business rate and Yukon's non-M & P small business rate decreased from 4 percent to 3 percent on July 1, 2014, and Yukon's M & P small business rate decreased from 2.5 percent to1.5 percent on that date.

■ A corporation subject to the small business rate in Ontario is subject to the federal small business deduction clawback for taxation years ending after May 1, 2014 (prorated for straddle taxation years).

Determining the Optimal Salary-Dividend Mix (Based on a December 31, 2014 Year-End and $10,000 ABI)[a]

	Eligible for small business deduction[b]		No small business deduction[c]	
	Deferral	Saving/(cost)	Deferral	Saving/(cost)
	dollars			
Alberta	2,500	(25)	1,400	(47)
British Columbia	3,230	(56)	1,980	(142)
Manitoba	3,652	23	2,052	(303)
New Brunswick	3,134	91	1,984	(13)
Newfoundland and Labrador[d]				
General	2,893	150	1,443	(701)
M & P			2,343	(73)
Northwest Territories	3,005	394	1,855	178
Nova Scotia	3,600	240	1,900	(588)
Nunavut	2,750	99	1,550	(462)
Ontario[e]				
General	3,499	108	2,399	(87)
M & P			2,549	12
Prince Edward Island	3,187	(87)	1,637	(344)
Quebec				
General	3,301	78	2,511	(64)
M & P	3,416[f]	148[f]	2,511	(64)
Saskatchewan				
General	3,100	63	1,700	(111)
M & P	3,100	63	1,900	39
Yukon				
General	2,790	51	1,240	125[g]
M & P	2,940	153	2,490	1,176[g]

[a] The individual is assumed to be taxed at the top marginal income tax rate. Only federal, provincial, and territorial income tax; the employer portion of provincial health tax; and the employee portion of payroll tax (for Northwest Territories and Nunavut) are considered. Different results may arise in special circumstances, such as for credit unions.

[b] The federal small business threshold of $500,000 applies in all provinces and territories, except for Manitoba (a threshold of $425,000) and Nova Scotia (a threshold of $350,000).

[c] If there is no SBD, the after-tax corporate income is assumed to be paid out as an eligible dividend.

[d] For Newfoundland and Labrador, the figures assume that the dividends are paid after June 30, 2014. For earlier payments, the figures are as follows: Eligible for SBD (deferral: 2,893; saving: 241); no SBD (general—deferral: 1,443; cost: (152); M & P—deferral: 2,343; saving: 546).

[e] For Ontario, the figures assume that the individual is taxed at Ontario's personal income tax rate on income over $220,000. For income over $150,000 and up to $220,000, the figures are as follows: Eligible for SBD (deferral: 3,346; saving: 110); no SBD (general—deferral: 2,246; cost: (82); M & P—deferral: 2,396; saving: 21).

[f] For Quebec, the figures assume that the corporation's small business income is eligible for Quebec's M & P rate of 6.85% for 2014; the rate increases proportionately (straightline) to 8% as the percentage of M & P activities (based on M & P assets and labour) decreases to 25%.

[g] For Yukon, the figures assume that the top combined federal and Yukon eligible dividend tax rate is 15.93% (federal of 19.29% plus Yukon of –3.36%) and that the taxpayer's other income is sheltered by Yukon's negative eligible dividend tax rate. In the absence of other income, the top combined federal and Yukon eligible dividend tax rate is 19.29% (federal of 19.29% plus nil for Yukon).

■ A corporation subject to Quebec's new small business M & P rate should consider the deferral of its M & P income to 2016 by maximizing discretionary deductions: that rate decreased from 8 percent to 6 percent on June 5, 2014 and further decreases to 4 percent on April 1, 2015. Consider ways to increase the percentage of corporate activities attributable to M & P. The new rates apply to all ABI up to $500,000 if at least 50 percent of corporate activities are attributable to M & P (based on M & P assets and labour). The applicable rate increases straightline to 8 percent as the percentage of M & P activities decreases to 25 percent.

■ In order for a corporation to claim CCA, depreciable assets must be purchased by, and be available for use at, the corporation's year-end. The annual 50 percent straightline accelerated CCA rate applies to eligible M & P machinery and equipment acquired before 2016.

■ Specific reserves for doubtful accounts receivable or inventory obsolescence should be identified and claimed at year-end.

■ If goods were sold in 2014 and the proceeds are payable after the year-end, the income for tax may be deferred by claiming a reserve over a maximum of three years.

■ Ensure that intercompany charges are reasonable given changes in the economy and on the basis of the transactions' facts and circumstances. Consider adjustments to these charges to reduce overall taxes for the related group (for example, the charge of a reasonable markup for services provided by a related corporation).

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Pension Fund Investments

TI 2012-0453871E5, released on January 14, 2014 in French, applies a restrictive interpretation to the definition of a so-called pension real estate corporation (PREC) (subparagraph 149(1)(o.2)(ii)). An RPP can hold qualifying real estate investments in a PREC, which enjoys tax-exempt status.

A PREC is a corporation that, since the later of November 16, 1978 and the date of its incorporation, has limited its activities, investments, and borrowings to those specified in subparagraph 149(1)(o.2)(ii) and in general (A) "limited its activities to . . . acquiring, holding, maintaining, improving, leasing or managing capital property that is real property or an interest in real property" and investing in a partnership that so limits its activities and (B) "made no investments other than in real property

or an interest in real property—or immovables or a real right in immovables—or investments that a pension plan is permitted to make under the *Pension Benefits Standards Act, 1985* [the PBSA] or a similar law of a province." The interaction of the tests for allowable activities under (A) and allowable investments under (B) is subject to different interpretations, two of which are discussed below.

Separate tests. "Allowable activities" and "allowable investments" may be separate tests. Thus, a PREC may be able to perform all the activities permitted under (A) and also make any investments permitted under (B). The only limitation is that if an allowable investment rose to the level of an activity, it is likely that that activity must meet the more limited test in (A).

The PBSA permits a broad set of investments for pension plans. For example, a pension plan may invest in a limited partnership that invests in non-capital real property. Therefore, under the separate tests interpretation, arguably a PREC can also invest in such a limited partnership. Section 253.1 also provides that for the purposes of paragraph 149(1)(o.2), a corporation that is a limited partner is not considered to carry on any of the partnership's business or other activities solely because of its acquisition and holding of that partnership interest. Arguably, for the purposes of subparagraph 149(1)(o.2)(ii), the permissibility of a limited partnership investment should be tested under (B) and should not be considered an activity to be tested under (A).

This interpretation, however, arguably frustrates the purpose of (A), which clearly demonstrates that Parliament turned its mind to the use of partnerships by a PREC and sought to limit the scope of a PREC's investment in partnerships to those that restrict their activities to "acquiring, holding, maintaining, improving, leasing or managing" real property that is capital property. A less extreme version of this interpretation posits that under (B) a PREC can invest in other types of corporations. For example, under the "separate tests" interpretation, a PREC could invest in an income-tax-exempt corporation under subparagraph 149(1)(o.2)(iii), commonly referred to as a pension fund investment corporation ("investment corporation"). This approach does not appear to frustrate the purpose of the provision. Such an investment is also permissible for a pension plan under the PBSA and is thus permissible on a reading of (B) that assumes that (A) and (B) are completely separate tests. The approach also allows a mature PREC that has done well on its real estate investments to put its excess cash into other profitable non-real-estate investments at a time when no prudent real estate investments are available.

Interactive tests. Alternatively, the tests in (A) and (B) may be viewed as colouring one another: investments permitted under (B) must also satisfy the allowable activities test in (A). It is not clear what types of assets satisfy both (A) and (B) other than real property itself. On this interpretation, can a PREC invest in publicly listed stocks? In GICs? Even if an investment is necessary for an allowable activity, it is not clear how long the investment can be held before it is no longer necessary for the PREC's real estate activities.

This interpretation raises other issues. Arguably, the scheme for allowable pension fund investments for income tax purposes was designed to dovetail with the relevant pension law. Generally, the Act contains very little regulation of allowable pension plan investment and defers to the registration requirements of those funds under the PBSA or a similar law of a province. Thus, as a matter of policy, in the operation of a pension fund the choice and the manner of investment are already regulated by federal and provincial law, and the fund will enjoy tax-exempt status as long as it invests in accordance with that law. The history of subparagraph 149(1)(o.2)(ii) and CRA positions also reveal a general policy of deference to the applicable pension law.

Until recently, the CRA did not take a clear position on the interaction of the "allowable activities" and "allowable investments" tests. The TI outlines a restrictive application of the interactive test for interpreting how (A) and (B) should work together. To the specific question of whether a PREC can make a permitted investment under the PBSA that is not real estate, the CRA responded as follows:

> Whether a corporation has limited its activities to those mentioned in clause 149(1)(o.2)(ii)(A) is a question of fact which must be considered on a case by case basis.
>
> When a corporation makes investments permitted under the [PBSA] as mentioned in clause 149(1)(o.2)(ii)(B), we are of the opinion that it is possible, in limited circumstances, for a corporation to limit its activities to those mentioned in clause 149(1)(o.2)(ii)(A) even though such investments are not real estate investments. This could be the case where a corporation would make a *modest investment* which *is necessary* in furtherance of activities described in clause 149(o.2)(ii)(A). [Unofficial translation, emphasis added.]

This position, taken to its logical extreme, could raise significant concerns. For example, it could mean that the CRA is of the view that a PREC cannot invest in an investment corporation. But what if that investment is not "modest" and "necessary in furtherance" of its (A) activities? The TI leaves open the questions raised above about what investments are permissible for a PREC even if those investments do not rise to the level of activities.

Further clarification from the CRA would be helpful in determining the permissible investments for PRECs.

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Directors' Liability

ITA section 227.1 and ETA section 323 provide that corporate directors are personally liable for a corporation's failure to deduct or remit employee withholdings or remit GST. The liability is subject to (1) a two-year limitation period from the date when the individual ceases to be a director; (2) a due diligence defence for the exercise of a degree of care, diligence, and skill to prevent the failure that a reasonably prudent person would exercise in comparable circumstances; and (3) a requirement that the corporation be in dissolution, be in bankruptcy, or have a certificate registered against it (ITA subsection 227.1(2) or ETA subsection 323(2)). Section 21(1) of the CPP and section 83(2) of the Employment Insurance Act also incorporate ITA section 227.1. Several cases decided in the last six months have developed the area of a director's personal liability.

Due diligence defence prevails when an employee concealed failures. In *Roitelman* (2014 TCC 139), a director also operated the business and had experience completing the corporate payroll and GST remittances. As the business expanded, the director hired and personally trained a bookkeeper to take over those duties and other administrative tasks. The director frequently worked away from the office and did not consistently or directly supervise the bookkeeper. Between 2005 and 2008, the minister sent seven notices of assessment to the corporation regarding its failure to remit. The bookkeeper, who was responsible for opening the mail, never brought the assessments to the director's attention. In late 2007, the director discovered that several cheques to the minister that the director had signed were never sent, contrary to the bookkeeper's oral confirmation. Whenever the director discovered a failure to remit, he spoke with the bookkeeper and temporarily increased his supervision of her.

The court said that the FCA's test in *Buckingham* (2011 FCA 142) involved an objective standard and required that the directors establish that they were specifically concerned with the tax remittances and that they exercised their duty of care, diligence, and skill with a view to preventing a failure to remit. The TCC said that the director took reasonable steps to prevent a failure to remit. Those steps need not ensure future compliance: a director need only take the proactive steps that a reasonably prudent person would take in comparable circumstances. The director's measures were thwarted by the bookkeeper's deceitful actions, and the evidence did not demonstrate that he had knowledge of the failure to remit or that he had condoned the use of the remittances for other purposes.

Due diligence defence fails despite a director's salary reduction. In *Antifaiff* (2014 TCC 216), the corporation regularly filed its GST returns late and failed to remit net tax on any return. Citing *Buckingham*, the TCC rejected the director's due diligence defence and concluded that he had failed to show that he took specific actions to prevent the failure to remit. The TCC noted that the failures occurred repeatedly and that the director's salary reductions were not enough to demonstrate due diligence, especially because the reductions were not shown to be specifically directed to the payment of unremitted GST.

The importance of pleadings and changes to rule 145. In *Bekesinski* (2014 TCC 245), the director argued that he had resigned as director and thus the two-year limitation period applied. A preliminary hearing (2014 TCC 35) was held under rule 145 of the TCC rules (general procedure). The rule gives guidance on the admissibility and the introduction of expert evidence in the TCC. The court said that the report did not "contain the underlying data collected, quantitative analysis employed and the ratios calculated to support [the expert's] stated opinion, [and was thus] deficient as it does not contain a full statement of her proposed evidence in chief as mandated by Rule 145." Because adjournments would cause additional delays and costs and infringe the rule's purpose, the court excluded the expert report rather than order the release of her working files. Thus, when the onus shifted to the minister after the countering of her assumption that the individual was a director, the minister adduced no evidence and the assessment was vacated, even though the court said that the director's explanations were weak and that the backdating was not improbable.

The TCC commented on the "sloppy and inadequate [pleadings that were] detrimental to the [minister's] success" because the assumptions omitted allegations that the resignation was backdated and inauthentic, facts on which the minister's case rested. The court said that if the pleadings had been adequate, it is likely that the minister would have been successful even with the exclusion of the expert's report. The court also mentioned that proposed amendments to rule 145 govern expert witnesses and the admissibility of their evidence in the TCC and introduce specific requirements for expert-report content that mirror Federal Court Rules (SOR/98-106) 52.1 to 52.6 and 279 to 280.

De facto director liable. In *Grupp* (2014 TCC 184), the individual argued that he was not a director at the relevant time. The ITA does not define when a director ceases to hold office, so the court looked at the corporate legislation. Section 121(1) of the Ontario Business Corporations Act (OBCA) says that a director ceases to hold

office when he or she dies, resigns, is removed in accordance with OBCA section 122, or becomes disqualified; section 121(2) says that a resignation is effective at the later of the date on which a written resignation is received by the corporation and the date that the resignation specifies. However, the court (referring to *Moll*, 2008 TCC 234) said that even if a resignation is accepted, under OBCA section 115(4) and in the absence of directors, whoever manages or supervises the corporation is deemed to be a director. Because the individual remained active in the business, he was liable as a de facto director after he ceased to be a de jure director.

An unsigned resignation can be effective. *Gariepy* (2014 TCC 254) covered two appeals heard on common evidence. The two directors were the only directors for about two years, when their husbands decided to have them resign so that they could appoint themselves directors. One husband, Mr. Chriss, contacted the couple's law firm to advise it of the change of directors. Despite confusing, conflicting, and often irreconcilable testimony, the court held that sufficient evidence supported both resignations. Although the documents prepared by the law firm were unsigned, the wives expressly communicated their intention to resign immediately. The court noted that the OBCA requires only that a resignation be in writing to be effective, not that it be signed. (See also *Perricelli*, 2002 GSTC 71 (TCC); *Walsh*, 2009 TCC 557; and *Corkum*, 2005 TCC 755.)

That finding was sufficient to vacate the assessment, but the court also discussed the due diligence defence. Mrs. Chriss believed that she had resigned; she had in fact resigned; and she had no further influence over the matters, and thus it was reasonable—albeit exceptional—to take no action to prevent a remittance failure. Mrs. Gariepy went to another lawyer much later and backdated her resignation "with intention to deceive," which indicated that she did not reasonably think that she had done everything necessary to resign earlier. Thus, she did not meet the requirements of the due diligence defence.

It is noteworthy that the CRA assessed the wives as de jure directors but not the husbands as de facto directors. Even though one husband was bankrupt, "[t]he prospect of collections against one taxpayer should not justify the pursuit of another taxpayer even if they are husband and wife." The court added that the "CRA is now unable to collect the unremitted withholdings on behalf of the people of Canada from any directors of the company [in direct opposition to] the intention of the directors' liability collection provisions."

Relying on expectations alone is not sufficient. In *Maddin* (2014 TCC 277), the individual was one of three directors and, as the operator of the predecessor business, only intended to act in an advisory capacity based on his prior experience and knowledge. Nevertheless, the evidence demonstrated the director's involvement in the business and his control over the bookkeeper. Additionally, the court did not accept that the director never asked the bookkeeper about payroll remittances and concluded that the director had no reason to believe that the business had funds to pay the remittances. A director is not entitled to rely on his expectations if they are not confirmed by reasonable inquiry. On the basis of his discussions with the bookkeeper and his knowledge of prior failures to remit, it would have been reasonable and prudent for him to ask the bookkeeper directly whether the source deductions had been paid, even though the response was reasonably predictable. Failure to ask was at best caused by inaction and lack of due attention and was at worst a deliberate omission. The court also found that the due diligence defence was not available after the director became aware of the failure to remit, because at that time he focused on recouping the arrears of rent and other debts and not on remitting source deductions.

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Section 216: Net Rental Income

A recent TI (2014-0520701E5, July 22, 2014) confirms that a Canadian rental property agent may take into account allowable expenses paid by a non-resident if the non-resident has elected to have part XIII tax withheld on net rental payments (subsection 216(4)) and the prescribed undertakings were filed and CRA-approved. The CRA says that the Canadian agent must ensure that it has received all necessary information from the non-resident to properly calculate the part XIII tax remittances.

In the TI, a Canadian rental property agent remits rent to a non-resident owner of Canadian rental property. Several expenses relate to the rental property; some are paid by the agent and some by the non-resident. To allow the Canadian agent to remit withholding tax to the CRA on a net basis under subsection 216(4), the Canadian agent and the non-resident file form NR6, "Undertaking To File an Income Tax Return by a Non-Resident Receiving Rent from Real or Immovable Property or Receiving a Timber Royalty."

The TI discusses the meaning of the phrase "any amount . . . available out of the rent or royalty received for remittance" in subsection 216(4) with a view to determining whether the calculation of withholding tax by a Canadian agent is based on the non-resident's rental income net of expenses paid by the agent and by the non-resident. The CRA was also asked to confirm when

the Canadian agent must remit part XIII withholding tax and whether the agent should remit the tax when the rent is actually paid to the non-resident owner or when the rent is credited to a trust account maintained by the Canadian agent.

Generally, section 215 requires a payer or an agent to withhold and remit part XIII tax for certain amounts paid, credited, or provided to non-residents of Canada, including Canadian-source rents and royalties. A payer who fails to deduct or withhold tax under part XIII on an amount paid or credited to a non-resident person under subsection 215(6) is generally liable to pay the whole of the amount that should have been deducted or withheld. Under subsection 227(8.3), a payer must also pay interest at a prescribed rate from the day on which the amount was required to be deducted or withheld to the day on which the amount was paid to the receiver general.

Subsection 216(1) allows a non-resident person to elect to be taxed on a net basis for Canadian-source rents or timber royalties under part I rather than on a gross basis under part XIII. A non-resident person that elects under subsection 216(1) is generally required to file a Canadian income tax return within two years from the end of the tax year in which the income was received.

If a non-resident files this tax return but does not seek withholding tax relief under subsection 216(4), the Canadian-resident payer or its agent must still withhold and remit under part XIII on a gross basis. Any excess part XIII taxes that the agent remits over the ultimate part I tax liability triggers a tax refund to the non-resident. Under certain conditions, however, subsection 216(4) provides an election that allows an agent or other person to withhold or remit on a net basis (that is, net of any disbursements deductible in computing income). The non-resident must submit an undertaking, via form NR6, to file a tax return under part I within six months from the end of the relevant taxation year (subsection 216(4)).

The non-resident must file form NR6 on or before the first day of each tax year, or when the first rental payment is due. An agent must also continue to withhold and remit non-resident tax based on gross rental income until the CRA approves a valid undertaking in writing.

In the TI, the CRA clarifies that, in its view, the phrase "any amount . . . available out of the rent or royalty received for remittance to the non-resident person" refers to the amount of rent or royalty collected, less any allowable expenses paid by the agent. However, as noted in guide T4144, "Income Tax Guide for Electing Under Section 216," once the CRA has approved form NR6, the agent may withhold and remit tax based on the amount of the non-resident's net rental income. Thus, the Canadian agent can also take into account allowable expenses that are paid by the non-resident.

The CRA adds that if the non-resident directly pays allowable expenses and the Canadian agent seeks to withhold and remit on the net amounts, the agent must ensure that it has received from the non-resident all the information necessary to calculate the appropriate amount of part XIII tax.

The CRA also notes that an agent must remit the tax by the 15th day of the month following the month in which an amount is paid or credited to the agent or other person on behalf of the person entitled to the payment.

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US Expatriation Costs

The US income tax compliance burden for US citizens living outside the United States has become heavier since the implementation of FATCA. Expatriations by US citizens have also increased sharply. In 2013, a record 3,000 Americans renounced their US citizenship, an increase of more than 200 percent from 2012; in the first half of 2014, 1,577 individuals renounced US citizenship. The growing number of applications has led to waiting lists that stretch into 2015 for consulate appointments for renunciation in Toronto and Montreal. Effective September 12, 2014, the US Department of State increased the application processing fee for renunciation from $440 to $2,350, a 422 percent increase, generating estimated additional revenue of over $4.5 million for the State Department. This article summarizes the technical costs of renunciation.

Since June 17, 2008, a US exit tax has applied to a US citizen or long-term green-card holder who renounces US citizenship or US residence. The tax applies if any of three tests are met:

1. the taxpayer's net worth exceeds $2 million on the date of expatriation;
2. the taxpayer's average annual US tax liability for the five preceding years is at least $157,000 (in 2014); or
3. the taxpayer cannot certify compliance with all US tax obligations for the five preceding years.

An individual who meets any of these three tests is a so-called covered expatriate and is subject to the exit tax, which deems an FMV sale of his or her property regardless of its location on the day before he or she ceases to be a US citizen or resident. In most cases, the tax is a mark-to-market tax on the net gain above $680,000 (in 2014). Certain pension and deferred compensation arrangements are also taxed and payment is due. The taxpayer can elect to defer payment of the exit tax until the property

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is actually sold, but an interest charge applies and adequate security (usually a bond) must be provided; no deferral is available for most tax-deferred accounts.

A few limited exceptions apply if the individual meets the net worth or the income tax liability test. A dual citizen at birth is excepted from the exit tax if he or she is not a US resident for more than 10 of the preceding 15 years. In addition, a US citizen who is a child can renounce citizenship within six months of turning age 18, subject to the same restriction regarding US residence. In either case, however, the individual must be fully US tax-compliant for the preceding five years.

A substantial inheritance tax applies to certain gifts or bequests received by a US citizen or resident from a covered expatriate after renunciation. The recipient is taxed at the highest gift or estate tax rate at the time of receipt (currently, 40 percent): no exemption applies other than the $14,000 annual gift or bequest exclusion. This aspect of the exit tax rules is often overlooked even though it can have significant consequences for family members who remain US citizens.

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Treaty Looks Through Partnership to Realty

A recent TI (2013-0516151I7, April 14, 2014) says that the sale by a forco of its Canco shares is taxable in Canada if the Canco owns an interest in a Canadian partnership that holds commercial Canadian real property. The CRA says that because the shares derive their value principally from Canadian real property, article XIII(3) of the Canada-Country X treaty applies. The redacted treaty's provisions are similar to those in article XIII of the Canada-US treaty.

The lookthrough provision in article XIII(3) of the Canada-US treaty refers only to assets held directly by a Canco. The CRA now says that for treaty purposes a Canadian partnership is not a separate person from the Canadian partners, and the real property held in the partnership is included in each Canadian partner's assets according to its percentage partnership interest.

On the facts in the TI, the Canco is held by a forco. Canco owns an interest in two Canadian partnerships that each own commercial Canadian real property. The forco sells the Canco shares and realizes a capital gain. Is that capital gain taxable in Canada under the Canada-US treaty because the Canco shares derive their value principally from real property situated in Canada? With some exceptions, a capital gain from the sale of any property is taxable only in the taxpayer's country of residence—for example, under article XIII(4) of the Canada-US treaty. One exception allows Canada to tax a capital gain from real property situated in Canada and includes a capital gain from the share of a Canadian-resident corporation whose value is derived principally from real property situated in Canada (article XIII(3)(b)(ii) of the Canada-US treaty).

The CRA concluded that the Canco shares derived their value principally from the real property situated in Canada, although generally an interest in a Canadian partnership is not a real property even if the partnership's value is derived from real property.

The CRA had previously stated that the Canada-US treaty included in the corporation's real property only the assets that the corporation held directly; the current TI says that the relevant treaty referred to "gains from the alienation of shares from the corporation . . . whose assets are principally real property" (unofficial translation). For that purpose, the corporation included real property held by a partnership only if that real property was part of Canco's assets.

The CRA now says that the better position is that a partnership should not be considered distinct from its members for treaty purposes and that the partnership's assets should be considered to be the partners' assets. As a result, the real properties situated in Canada that a Canco holds through a partnership should be viewed as directly held by Canco in the same proportion as the percentage of units that the Canco holds in the partnership.

The CRA also said that the "as if" computation under subsection 96(1) of the Act, which assumes that a partnership is a person, operates for specific purposes under the Act (for example, for the calculation of the partnership income). However, the "as if" concept is based on the fact that a partnership is not a separate entity, and it has no application when one is determining whether a corporation's assets are principally real property for treaty purposes.

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