TAX PERSPECTIVES

A PUBLICATION OF THE TAX SPECIALIST GROUP (TSG)

www.taxspecialistgroup.ca

Introduction

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This latest edition of Tax Perspectives contains a wide range of articles. It begins with a quick summary of the tax changes we have seen in 2006, and what may be expected in the March, 2007 Federal Budget. Then, Thomas Lee, of Hong Kong, looks at tax reform in China.

Robert Rinninsland, of the Ruchelman law firm, New York, outlines his thoughts on U.S. tax developments in 2007. Manu Kakkar, of Kakkar and Associates, a new member of TSG, outlines the rules that apply to breaking up a corporation and dividing its assets among its shareholders. As he points out, it is much easier to transfer assets into a corporation than to get them out again afterwards.

Darrel Pearson addresses customs duty and ways to save it. Lastly, Howard Wasserman outlines certain tax developments in his In Brief column.

TSG continues to grow and expand. The group held its 7th National Conference in Edmonton in early February, attended by 30 tax specialists from across Canada and internationally. TSG members practise independently, but have access to the expertise of other members in the group in specialized areas. This ranges from international tax planning to customs duty, from GST matters to tax litigation, as well as specialized Canadian income tax areas such as butterfly reorganizations, R&D tax credit claims, and sophisticated estate planning techniques.

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Minority Governments And Tax Changes

by Michael Cadesky, FCA, TEP

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If there was any concern that a minority government would not be able to press forward with an agenda for reform and new initiatives, this has certainly been dispelled in the tax area. In 2006, we saw more changes in the ten months during which the Conservatives were in power, than in the past ten years.

Most significant are the changes to the taxation of dividends. In keeping with their election promise, there will be a two-tier tax system for Canadian dividends. Those paid by Canadian public companies, and Canadian private companies where the income has been subject to the high rate of corporate tax, will be subject to a reduced personal tax rate. Look for a new T5 design for 2006.

We saw a 1% drop in the GST rate from July 1, 2006, and the elimination of taxable capital gains for certain donations of public company stock.

We have also seen a host of tax credits for all manner of things, including university textbooks, municipal transit passes, fees for children's fitness programs, and others. While these credits are obviously beneficial to those who are eligible, it will make the 2006 personal income tax filing season a particularly intense one for accountants.

We have also witnessed the beginning of the end of income trusts. This surprise move last October unfortunately adds Mr. Flaherty to the long list of Finance Ministers who have found themselves unable to keep an election promise. Income trusts will be denied the tax advantages that made them so popular, with existing income trusts being given a four-year grace period.

Seniors will now be able to income split their pensions, an interesting idea possibly paving the way for more changes to come.

Lastly, legislation to amend the tax treatment of non-resident trusts and foreign investment entities was

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China – Tax Reform On The Way?

Thomas Lee

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For the past two decades, China has had a two-tier corporate tax system – one for corporations owned by China residents (domestic enterprise) and another for corporations owned by foreigners (foreign–owned enterprise). A Chinese foreign joint venture will be taxed as a domestic enterprise if the foreign capital represents less than 25% of the total capital of the joint venture.

In China, foreign–owned enterprises are given tax holidays, incentives, and a reduced corporate tax rate, while domestic enterprises are not.

Unlike the Canadian tax system, which overtly discriminates in favour of corporations controlled by Canadian residents, the China system does the reverse. Foreign-owned enterprises are given tax holidays, incentives, and a reduced corporate tax rate, while domestic enterprises are not.

Tax Incentives

The tax incentives for foreign-owned enterprises fall into three categories. The first is a reduced corporate tax rate. The normal rate in China is 33% (30% being the national rate and 3%, the local rate). Depending on where the entity is located, and the type of activity, the corporate tax rate may be reduced to 15% or 24%. The second type of exemption is a tax holiday, the most typical of which is a two-year exemption commencing with the entity's first profitable year after netting off all losses brought forward. There are several other additional incentives, but the most common is a refund of corporate taxes, if profits are re-invested in China activities.

The corporate tax system raises very little tax revenue. Through use of these incentives, and creative transfer pricing arrangements, very little corporate tax is actually paid by foreign-owned enterprises. One particular issue which has been noted is that corporations will sometimes wind up their activities once the tax holiday has expired, only to reappear as another business in another location, with a new tax exemption.

Possible Reforms

The China economy has been carefully planned by the Central Government so that growth can be controlled and incentives for foreign investment can be targeted. China has been extremely successful in attracting foreign investment. Tax incentives are an important part of this process. This probably explains the reluctance of the Central Government to carry out tax reforms up until now, even though the need for change has been long identified.

Legislation is now to be considered by the Central Government to unify the corporate income tax systems, with a standard rate for foreign and domestic enterprise being set at 25%. Most exemptions will be scrapped. Future preferential tax treatments will be given to encourage industries such as high-tech and environmental industries. It is possible that the legislation could be passed as early as this Spring, and could take effect by 2008. It is likely that foreign companies will be given a grace period where the existing system can be applied, possibly for as long as five years.

It is anticipated that foreign companies with an interest in China may speed up their plans to create a Chinese enterprise, in order to benefit from the existing system, prior to reforms.

China is a difficult place for foreigners to do business. Aside from fundamental differences in language and culture, there are difficulties in adjusting to its legal and financial environment. People who are unprepared for this will inevitably experience culture shock, frustration, and possibly the ultimate failure of their endeavour. It takes time to set up a Chinese business and, now more than ever, professional advice is essential.

ITSG At Your Service

The International Tax Specialist Group (ITSG) is a first cousin to the Tax Specialist Group (TSG), with overlapping membership, and common founders.

As the name implies, ITSG is an international group, focusing on international matters. Through ITSG, TSG member firms in Canada may access specialized tax expertise in the U.S., the Caribbean, Europe and Asia. Like TSG, ITSG holds an international conference each year for its members, which, in 2007, will be held in Toronto. Between 40 and 50 senior tax specialists from around the world are expected to attend.

Further information on ITSG can be obtained from the ITSG website at *itsgnetwork.com.*

The U.S. Tax Outlook-2007

Robert G. Rinninsland

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The U.S. tax law in 2007 will continue to focus on priorities that have emanated from recent legislative and administrative developments. While high profile tax cases and related rationales always represent an integral part of U.S. tax law development, the I.R.S. and Treasury intend to use their new found enforcement tools to address perceived tax abuses, particularly in cross border transactions. The U.S. Treasury and the I.R.S. have been recognized as key interested parties and stakeholders in corporate governance legislation (Sarbanes-Oxley) and governmental regulatory bodies (Securities and Exchange Commission, Public Company Accounting Oversight Board). In this regard, compliance with U.S. Accounting Pronouncement FIN 48, Uncertain Tax Positions, for financial reporting purposes, will have significant collateral effects for the I.R.S.

In addition, the 2007 U.S. tax outlook must consider the impact on legislative tax policy from Democratic control of both the House of Representatives and the Senate. With this in mind, the outlook is as follows:

Cross Border Transactions

There will be additional scrutiny of cross border transactions, focusing on transfer pricing and specific taxpayer/ transaction concerns.

Transfer pricing will focus on the use and transfer of intangible property and the performance of services. In Notice 2006-34, the I.R.S. requested information regarding cross border licensing agreements in order to issue guidance regarding the classification of income from such transactions. Depending on facts and circumstances, the I.R.S. would consider such income *(i)* a two-way licence; *(ii)* a reciprocal agreement not to sue for IP infringement; or (iii) sale or exchange of property. The income categorization would drive other U.S. tax consequences such as sourcing, trade or business determinations, etc. Regulations regarding R&D cost sharing arrangements will be considered further. The revised Cost Sharing Regulations proposed in August 2005 were meant to address U.S. Treasury's concern that intangible property was being exported by U.S. companies without due consideration. U.S. practitioners' comments on the regulations raised objections to their complexity and underlying commercial assumptions. Treasury hopes to respond to these comments in 2007.

In the inter-company services area, taxpayers have been given the option of applying new temporary and proposed service regulations as supplemented by I.R.S. Announcement 2006-50 and I.R.S. Notice 2007-3. The new regulations provide for passing certain general and administrative expenses at cost under the "Service Cost Method" (SCM). The SCM rules were due to take full effect on January 1, 2007, but this date has been extended to after 2007.

The I.R.S. will also continue to aggressively pursue enforcement to disallow and reverse U.S. tax benefits related to so-called "listed transactions." The term "listed transaction" refers to a specific set of facts that has been identified by the I.R.S. in administrative pronouncements as an abuse of U.S. tax law, the tax benefits of which will not be recognized by the I.R.S. The listed transactions identified, for example, would include those where a tax basis in a pass-through tax entity is artificially increased before a sale, where financial products are used to generate tax deductions without sufficient economic risk, and where foreign tax credits are unduly accelerated or transferred between taxpayers. See Notice 2004-67 for the most recent inventory of "listed transactions." In this regard, settlement initiatives have been instituted by the I.R.S. audit branch to encourage taxpayers who have engaged in such listed transactions to settle their outstanding tax liabilities. Examples of this initiative by the I.R.S. that will set the tone in this area for 2007 are:

- Announcement 2006-100 regarding updating procedures for dealing with listed transaction cases where the I.R.S. has been unable to reach a conclusion with the taxpayer. These procedures are designed to fully develop the facts and arguments as quickly as possible before the case is docketed for litigation.
- The issuance of proposed, temporary and final regulations under the JOBS Act of 2004 regardingthe obligation of tax advisors to maintain lists of clients who entered into listed transactions and to file a "Material Advisor Disclosure Statement" with respect to these clients.

2006 Legislation Affecting 2007 & the 2007 Legislative Outlook

The *Tax Relief and Health Care Act of 2006* extended through 2007 several individual tax incentives and benefits that were to expire at the end of 2006. The more notable provisions include the option to deduct state sales and use tax or state income tax on personal tax returns; the availability of the tax credit for research expenditures; and the deduction of qualified environmental remediation costs.

The legislative outlook for 2007 will be heavily influenced by the Democratic Party agenda. Targeted tax relief for "middle class" Americans (education tax incentives, working class family tax

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Breaking Up Is <u>*So*</u> Hard To Do

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Kakkar and Associates Limited

The biggest complaint I hear from clients (as well as my family!) about income tax is that it does not make any sense. In the client's view, a fairly straightforward business concept becomes convoluted by income tax laws created by divergent tax policy objectives. However, one area of income tax practice where the policy objectives are in line with societal norms is divisive reorganizations, or, in plain English, corporate divorce.

When people get married, events leading up to the wedding day seem to be a blur and everything is going at a mile a minute. However, when the same people get a divorce, the process may very well be slow, grinding and in some cases, an amicable resolution is just unworkable.

It is usually easy to transfer assets into a corporation. However, when one or more businesses or a particular group of assets within a corporation are to be transferred out, the complications begin.

The reason why a divisive (or break-up) reorganization is complicated is simple: there is a direct rollover to transfer an asset into a taxable Canadian corporation. There is no direct rollover, however, to transfer the same asset out of the same corporation back to the shareholder. As a result, the "corporate break-up" must rely on a complicated series of steps to transfer the asset from one corporation to another without tax.

One key provision that the divisive reorganization relies on is the tax-free inter-corporate dividend. However, where the corporation receives a dividend in the context of a divisive reorganization, it may be deemed a capital gain. If so, the reorganization will not be tax-free.

Two Kinds of Butterfly

Tax practitioners often refer to a divisive reorganization as a "butterfly." The reason for this nickname is because the corporate chart of the steps looks like the wing (or wings- depending on the complexity of the reorganization) of a butterfly. There are two kinds of butterflies: a related party butterfly and an unrelated party butterfly. A related party butterfly, simply put, involves a divestiture of assets within a related group of persons. It is prudent to mention that siblings and by extension, corporations owned by siblings, are deemed to be unrelated for the butterfly rules.

The final result of any butterfly transaction is to put the assets into corporations owned by each shareholder.

A related party butterfly is easier to implement than its unrelated party counterpart. The reason is that the unrelated party butterfly has severe restrictions on the transactions that can be done prior to, during, and after the reorganization.

The most important of these restrictions is the "pro-rata test." In an unrelated party butterfly, each shareholder corporation must receive a proportionate share of each type of asset of the corporation, i.e., cash and near cash; business assets; and investment assets. The determination of where a particular asset falls in the classification system is not always clear.

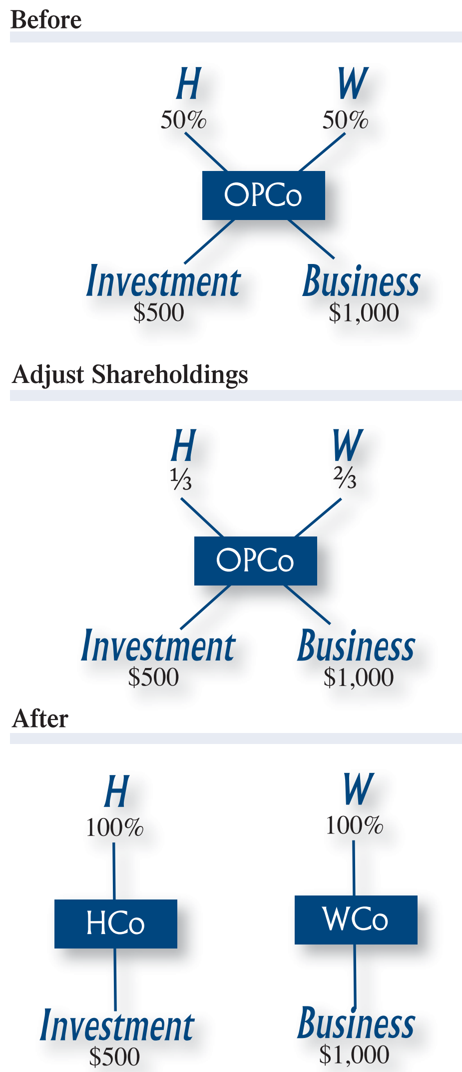
The inability to comply with the pro-rata test is the biggest reason why the unrelated party butterfly cannot be done. The related party butterfly does not have to comply with the pro-rata test.

Related Butterfly Example

Husband (H) and wife (W) each own 50% of the common shares of a corporation, Opco. Opco owns a business worth $1,000 and an investment portfolio worth $500. W runs the business and H manages the investments. H and W wish to divorce and as part of this, to divide and separate Opco's assets.

To achieve the desired result, W would first buy 16⅔% of Opco from H, bringing her ownership to 66⅔%. This is so the assets can be divided according to fair market value.

Related Butterfly



After the reorganization, H and W each have their own separate corporations, HCo and WCo, with the investments ($500) and business ($1,000), respectively.

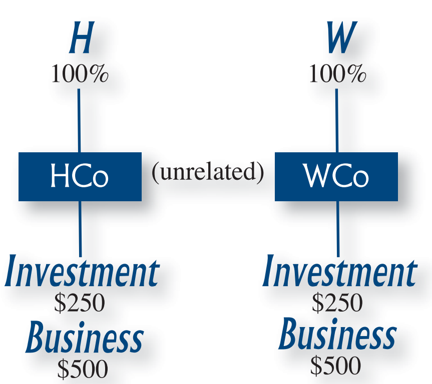
Unrelated Butterfly

Now, suppose H and W were divorced at the time of the reorganization or were unrelated parties, or brother and sister. Then an unrelated party butterfly would have to be undertaken. This would require that HCo and WCo each receive $500 of the business assets and $250 of the investments. These amounts represent each of H's and W's pro-rata share of the underlying corporate assets.

This corporate split-up might be unacceptable because W wants all of the business assets and H wants all of the investments. Unfortunately, it is not acceptable to rearrange the shareholdings before or after the butterfly (as was done above when W bought 16⅔% of Opco from H.) Lastly, this type of butterfly cannot be carried out to facilitate an arm's length sale. For example, if W's motivation for the butterfly was to sell the business, the butterfly would not work.

Unrelated Butterfly

After



Still, there are many instances where an unrelated party butterfly will work, especially in separating real estate assets.

Conclusion

The related and unrelated party butterflies are powerful tools in corporate restructuring and divestitures as well as estate planning. The tax authorities closely monitor these rules with an unusual combination of legislation and administrative practice. A skilled tax advisor needs to be consulted in order to navigate the many pitfalls of this area.

Customs Duty – Some Tax Saving Ideas

Darrel Pearson

Gottlieb & Pearson

Those engaged in international trade view customs duties as a form of "import tax." Unlike other taxes, they represent a deductible expense in the calculation of income earned by the business entity importing goods into Canada. Savings of customs duties fall directly to the bottom line.

Just as in the case of income taxation, there is a considerable amount of strategizing available to importers that, if implemented, can reduce their liabilities for import tax. These strategies relate to tariff classification, origin, and the value for duty of the imported goods. In addition, import tax may be relieved by the use of special programs that either remit, or permit drawback of, the customs duties and, in some cases, goods and services tax (GST). (GST is payable upon importation on the value-for-duty plus the duty payable.)

Tariff Classification

All goods imported into Canada must be classified under a unique tariff number from one of thousands of classification numbers contained in the Customs Tariff. Each unique tariff number stipulates the rate of customs duties payable on goods there described.

Tariff classification of imported goods is an essential component of the analysis and planning and should be conducted by the importer prior to engaging in an international transaction. Some considerations in classifying the goods are as follows:

- Materials of which the goods are composed;
- Primary function performed by the goods;
- Means of operation of any mechanical goods;
- Use to which the goods will be put;
- Other goods that will be used in conjunction with, or that will be incorporated in, the goods;

Goods are classified according to their physical characteristics and, occasionally, their usual end-user rather than according to actual end-use, or whether or not they are of a class or kind manufactured in Canada.

While there is no clear-cut rule that establishes a relationship between the degree to which a good is processed and the rate of duty that applies to its classification, it is often the case that goods that are more fully processed carry a higher rate of customs duty.

Accordingly, the degree to which the good is finished may impact on the amount of duty payable. Importers should take this into account when determining their sourcing practices.

Origin

The origin of goods determines, in part, the tariff treatment to be applied. Within a single line of tariff classifications, there are a number of potential rates of duty, depending on the origin of the goods. The tariff treatment may vary as between goods imported from the United States, Chile, Mexico, or Israel, and those from elsewhere. Canada has free trade agreements with these countries and is developing other free trade agreements. The most-favoured-nation tariff treatment applies in respect of goods imported from these countries unless they qualify pursuant to specific rules of origin, which have been promulgated under the free trade agreements. If so, the duties are generally reduced to zero. This assists, in particular, when importing goods that would otherwise carry high rates of duty that, in turn, would make them uncompetitive. Similarly, an importer may choose to source from a "free trade partner" country in order to gain an advantage over other importers who have to pay higher rates of duty.

The rules of origin vary with each tariff classification. Generally, the rules contemplate that goods coming from a qualifying country (e.g., the U.S.) will have originated there or undergone some form of transformation before export to Canada. These rules are rather sophisticated

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IN BRIEF

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This past year was a landmark year for tax developments in Canada. Below is a brief outline of some of the more significant ones.

Treaty Shopping

In a key decision, the Tax Court of Canada has stated that international treaty shopping is not, in itself, abusive. In refusing to strike down a tax planning arrangement involving a company that migrated from the Cayman Islands to Luxembourg, the court held that reliance on the Canada-Luxembourg international tax treaty was appropriate in the circumstances, and not an abuse. The case, MIL Investments, is interesting for many reasons, including the well-articulated judgement of Mr. Justice Bell, and the size of the amount in dispute (a capital gain of over $400,000,000).

For many years, the Canadian tax authorities had taken the position that so-called treaty shopping was abusive, and would be challenged. The general anti-avoidance rule (GAAR) was amended to specifically encompass international tax treaties. For GAAR to apply, however, there must be abusive tax avoidance. According to the Tax Court, reliance on the plain wording of a treaty will not, in itself, constitute abusive tax avoidance, regardless of whether the Canada Revenue Agency likes the result. In what may be viewed as a rebuke, it was stated that if Canada wishes to limit the application of its international tax treaties, it should put specific limitation provisions in them. Virtually all U.S. tax treaties contain so-called limitation of benefits provisions, which significantly restrict the benefits of the treaties.

The case has been appealed to the Federal Court of Appeal, and tax practitioners as well as their clients will anxiously await the appeal's results.

Eligible Dividends

The proposal to create a two-tier dividend system in Canada will proceed, and be in force for the 2006 taxation year. Dividends from Canadian public companies will be taxed at a reduced rate. Also, dividends from Canadian private companies, where income has been subject to tax at the high corporate tax rate, will be considered eligible dividends, if so designated, and subject to the reduced rate of tax.

As at the date of writing this article, the eligible dividend rules had not been passed into law, although draft legislation has been written. It is very likely that these rules will become law, and a subsequent edition of Tax Perspectives will deal with them in detail.

The most obvious change resulting from these rules is the reduction in tax rates for eligible dividends. However, there are many other implications, some of which may not be immediately apparent. For example, the old rules of thumb on purchase and sale of a business where the seller traditionally has preferred to sell shares should now be revisited. An asset sale may now be preferable in some circumstances. Also, new techniques are now available in estate planning which deserve consideration. Lastly, owner-managers may wish to reconsider their remuneration strategies, taking dividends instead of bonuses, or simply leaving income in the corporation to be taxed there.

Non-resident Trust & Foreign Investment Entity Rules

As mentioned earlier, draft legislation was again reintroduced dealing with non-resident trusts and foreign investment entities. The legislation is virtually identical to that which was to come into force January 1, 2003. However, the effective date has now been postponed to January 1, 2007.

The non-resident trust rules expand the circumstances where a non-resident trust will be subject to Canadian tax by being deemed Canadian resident. Trusts created by non-residents, to which no Canadian resident has transferred property, will still be exempt. Trusts created by immigrants to Canada will still be exempt for the first sixty months of the immigrant's residency.

The foreign investment entity rules are an extremely complex piece of legislation, dealing with the taxation of foreign mutual fund type investments. These rules will affect a wide range of clients, if they come into force as proposed. The rules are unduly complex, although certain deficiencies in previous versions of the rules have been corrected. A future article in Tax Perspectives will describe these rules in more detail, if they are passed into law.

Foreign Reporting – Penalties Applied

The Canada Revenue Agency is now applying penalties for late-filed foreign reporting forms. The penalties range, depending on the form and its lateness, from $100 to many thousands of dollars. The penalty applies per instance of deficiency. If ten forms were required in a year, and were late, ten penalties could be applied. Anyone having uncertainty concerning the rules for foreign reporting should immediately seek qualified professional advice.

Minority Governments And Tax Changes continued from front cover

reintroduced with an effective date of January 1, 2007 (previously it was to apply from 2003). Unfortunately, the draft legislation is virtually identical to its many previous versions, meaning that the problems with this legislation have been ignored.

Enough of 2006. What about 2007?

In his November economic address, Mr. Flaherty hinted at a number of new initiatives, but only in very general terms. We shall have to wait for the March 19 federal budget to see exactly what will be in store.

There is much speculation that we will see an increase in SR&ED tax credit incentives. There could be an increase in the limit applicable to Canadian-controlled private corporations eligible for the 35% credit rate (rather than the standard 20% rate). It could also take the form of a refundable credit, which might potentially be transferable to shareholders. Some people may recall the system in place in the 1980s, which unfortunately became subject to widespread abuse. A more robust system could be designed, which would allow for the transfer of SR&ED tax credits, especially between a corporation and its shareholders, without the problems that the old system created.

We may see a further drop in the GST rate, from 6% to 5%.

We expect to see further support for small business, possibly with a drop in tax rates or a further increase in the income eligible for the low corporate tax rate (just increased in 2007 to $400,000).

Lastly we may see expanded relief on capital gains, where the proceeds are reinvested.

But what has not been discussed, and is badly needed, is a drop in personal tax rates. Depending on the province, our top personal rate is still up to 10% above the U.K. and 15% above the U.S. While the battle of the deficit has been won, it has been fought by individual taxpayers on whose backs the tax burden still falls the hardest.

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but they provide excellent opportunities for importers to reduce their import tax liability.

Value for Duty

The third component in relation to determining the amount of customs duties payable is the value for duty. In general, the value for duty is based on the price in a sale for export to Canada to a purchaser in Canada. But, in some cases, the sale price cannot be used, in which case an alternative method is applied.

From a planning point of view, it is possible to organize transactions so as to minimize the base upon which a rate of duty will be applied. The base may be structured to segregate portions of the price as between *(i)* the price paid for the goods, and *(ii)* amounts payable for non-dutiable elements. Among these non-dutiable elements are certain management fees, royalties, licence fees, transportation costs and insurance of the goods from the place of direct shipment to Canada, and the construction, erection and other services provided in relation to the goods once imported into Canada. The allocation of the price amongst these various components will mitigate the amount of duties payable. This type of planning involves careful consideration of the allocations as well as proper documentation for support, in the event of a customs audit.

Other Forms of Relief

One can reduce or eliminate customs duty on qualifying goods through duties relief incentives.

Under duty deferral programs, importers can defer, or be relieved of, the payment of duties. The Duties Relief Program enables importers to import goods without having to pay duties and taxes (with the exception of GST) when the goods are to be exported or incorporated into the production of goods to be exported. The Drawback Program contemplates that duties will be refunded on imported goods when these goods are exported. Finally, a bonded warehouse is a facility operated by the private sector and regulated by the Canada Border Services Agency. In such a warehouse, the importer may store imported goods without having to pay duties and GST, as long as the goods are not released in Canada.

There are also remissions and temporary importation programs that may permit goods to enter Canada duty-free.

Conclusion

To minimize customs duties and, hence, import taxes, the astute importer will arm itself with various customs duty minimization strategies discussed above as well as others, which may apply, depending on specific circumstances. Savings of customs duties go directly to the profit line and can convert otherwise unprofitable transactions into those which contribute meaningfully to the success of the business entity. The importer must be cognizant that planning must be done within a context of compliance. Accordingly, it is important to obtain experienced advice to assist in import tax planning.

reductions) coupled with a scale back of prior tax rate reductions for wealthy individuals are expected.

Conclusion

Continued focus on financial statement transparency, cross border transactions and undue tax avoidance coupled with the Democratic tax legislative priorities will pressure U.S. international tax planning in 2007. But the "$64,000 question" still remains unanswered – Will the U.S. Estate Tax be scrapped in 2010? We shall have to wait and see.

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Tax Perspectives is published by the Tax Specialist Group (TSG).
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