THOMSON REUTERS

# PRACTICAL U.S./INTERNATIONAL TAX STRATEGIES

WORLDTRADE EXECUTIVE
*The International Business Information Source*

**www.wtexec.com/tax.html**
The International Business Information Source™

A Twice-Monthly Report on US/International Tax Planning

**February 28, 2010**
**Volume 14, Number 4**

## Articles


***International Tax Planning***

***U.S.*--New HIRE Act Will Impact Foreign Investment Vehicles: Tax and Reporting Requirements Target Fund Managers and Investors**
*By Jill E. Darrow, Robert Loewy, Reid A. Mandel and Ziemowit T. Smulkowski (Katten Muchin Rosenman LLP) ............................ p. 2*

***U.S.*--Court Addresses (Again!) Employee Stock Option Expenses for Transfer Pricing Purposes: Ninth Circuit Reverses Itself and Holds that the Arm's-Length Standard Controls in Determining if Employee Stock Option Expenses Must Be Shared Among Related Parties Under Pre-2003 U.S. Transfer Pricing Rules**
*By Andrew S. Mason, Andrew P. Solomon, S. Eric Wang, Aditi Banerjee and Donald L. Korb (Sullivan & Cromwell LLP) .......... p. 4*

**Treasury and IRS Issue Guidance on FBAR Filings**
*By William C. Benjamin, J. Barclay Collins and Anthony Jude (AJ) Picchione (Wilmer Cutler Pickering Hale and Dorr LLP) ............ p. 8*

***Canada*--Tax Measures in Canada's 2010 Federal Budget**
*By Wanda Rumball and Andrew Spiro (Blake, Cassels & Graydon LLP) ............................................................................ p. 3*

**CRA Responds to the New GST/HST Legislative Proposals on Financial Services: Some Previously Exempt Services are now Taxed**
*By Alan Kenigsberg and Jean-Guillaume Shooner (Stikeman Elliott LLP) ..................................................................................... p. 11*

**Department of Finance Releases Draft Foreign Affiliate Amendments Affecting Acquisitions and Reorganizations: Changes for Canadian Multinationals with Foreign Affiliates**
*By Chris Van Loan and Sabrina Wong (Blake, Cassels & Graydon LLP) ............................................................................ p. 13*


## IN THIS ISSUE

**Payments to Some Foreign Banks and Foreign Hedge Funds Subject to 30 Percent Withholding Tax**
Legislation signed into law on March 18 contains provisions to force foreign banks, hedge funds and private equity funds to disclose information on U.S. account holders. The law requires U.S. taxpayers to withhold tax on payments and deposits to financial companies that don't comply. Page 2

**Canada's Budget Eases Tax Compliance Restrictions on Foreign Investors**
Effective immediately, foreign investors will no longer be subject to many tax and compliance requirements on sales of most Canadian shares. Many of the bureaucratic burdens on cross-border venture capital and private equity investments in Canada have also been eased. Page 3

**Arm's Length Standard Prevails in Court of Appeals Reversal of *Xilinx* Decision**
In the March 22 decision, the court upheld the supremacy of arm's length as the principle standard for transfer pricing determinations. The decision is particularly significant for multinationals that conduct substantial operations through foreign subsidiaries. Page 4

**More Financial Services Now Subject to Canada's Goods and Services Tax**
Many financial services that had been exempt are now subject to Canada's Goods and Services Tax or Harmonized Sales Tax, according to a recent notification by Canada's Revenue Agency, including management, administrative, marketing and promotional services. Page 11

***Advisory Board page 6***

International Tax Planning

# New HIRE Act Will Impact Foreign Investment Vehicles

## *Tax and Reporting Requirements Target Fund Managers and Investors*

By Jill E. Darrow, Robert Loewy, Reid A. Mandel and Ziemowit T. Smulkowski (Katten Muchin Rosenman LLP)

On March 18, President Obama signed the Hiring Incentives to Restore Employment Act (Act). As a revenue offset, the Act includes provisions originally proposed as part of the Foreign Account Tax Compliance Act of 2009.

Several revenue offset provisions are likely to affect both fund managers and investors in non-U.S. hedge funds, commodity funds, private equity funds, securitization vehicles and other investment entities. These are:

**1. Withholding Tax on Dividend-Equivalent Payments**

Currently, payments on equity swaps to foreign persons generally are not subject to U.S. withholding tax even as to payments determined by reference to dividends paid on the underlying U.S. stock (dividend-equivalent payments). Under the Act, dividend-equivalent payments made to foreign persons on or after September 14, 2010, on equity swaps (except as described below) or pursuant to a securities lending or "repo" transaction (or other derivatives to be specified that may include certain forward contracts or other financial contracts referencing stock of U.S. corporations) will be subject to a 30 percent U.S. withholding tax. Currently outstanding instruments are not grandfathered.

Jill E. Darrow (jill.darrow@kattenlaw.com) is a Partner, and Robert Loewy (robert.loewy@kattenlaw.com) is Special Counsel, in the New York office of Katten Muchin Rosenman LLP. Reid A. Mandel (reid.mandel@kattenlaw.com) and Ziemowit T. Smulkowski (ziemowit.smulkowski@kattenlaw.com) are Partners in the firm's Chicago office. Ms. Darrow's practice is concentrated in tax law, and particularly in the areas of partnerships, joint ventures, limited liability companies, subchapter S corporations, hybrid companies, publicly-traded partnerships, and real estate limited partnerships and REITs. Mr. Loewy's practice is focused on tax planning and litigation. He advises domestic and foreign companies, partnerships and individuals on U.S. and international tax issues, including taxation of financial instruments and products, and hedge funds. Mr. Mandel's practice is concentrated in federal income taxation and asset securitizations. Mr. Smulkowski's practice is concentrated in federal income tax issues related to mergers and acquisitions, private equity, venture capital, and real estate investments.

Dividend-equivalent payments on equity swaps made to foreign persons prior to March 18, 2012, will only be subject to 30 percent withholding if the swap involves any of the following: *(i)* in connection with entering the swap, the foreign person transfers the underlying security to the swap counterparty; *(ii)* upon termination of the swap, the swap counterparty transfers the underlying security to the foreign person; *(iii)* the underlying security is not readily tradable on an established securities market; *(iv)* in connection with the swap, the underlying security is posted as collateral by the swap counterparty to the foreign person; or *(v)* the swap is of a type specifically designated in future Internal Revenue Service (IRS) guidance. (This list is more inclusive than the list of equity swaps that the IRS had targeted in an Industry Directive issued January 14, 2010.) Beginning March 18, 2012, dividend-equivalent payments made to foreign persons on even equity swaps that do not involve any of the foregoing circumstances will be subject to a 30 percent U.S. withholding tax unless future IRS guidance identifies the applicable instrument or transaction as one not having the potential for the avoidance of U.S. withholding taxes on U.S.-source dividends.

**Dividend-equivalent payments made to foreign persons on equity swaps will be subject to a 30 percent U.S. withholding tax.**

For equity swaps and other financial instruments covered by these rules, withholding will apply to the gross amount of each dividend-equivalent payment. Accordingly, a 30 percent withholding tax may be imposed on an amount which, under the terms of the applicable instrument, exceeds the actual net payment made to the foreign person.

**2. New Withholding Tax Regime**

Under current law, U.S.-source fixed or determinable

*HIRE Act*, continued on page 9

# Tax Measures in Canada's 2010 Federal Budget

By Wanda Rumball and Andrew Spiro (Blake, Cassels & Graydon LLP)

While the lead-up to and the media coverage of the federal budget introduced on March 4, 2010 (Budget) was heavily skewed towards deficit control, there was no shortage of significant tax proposals in the Budget, including the following:

- effective immediately, unless an employer elects to forgo its deduction, employee stock option holders will be disqualified from capital gains rate taxation if their options are cashed out instead of being exercised, and the deferral rules for public company stock options introduced in the 2000 budget will be repealed;
- effective immediately, foreign investors will no longer be subject to potential tax and compliance requirements on sales of Canadian shares that do not constitute a real property interest;
- the proposed "foreign investment entity" regime, first announced in 1999 but never enacted, will be abandoned, and the related proposed "non-resident trust" rules will be relaxed; and
- new rules will be enacted to curb loss transfer transactions achieved on conversion of income trusts and foreign tax credit planning schemes.

The Minister of Finance also announced a public consultation on proposals to require reporting of certain types of "aggressive" transactions, similar in some respects to measures previously proposed in Quebec.

Despite the fact that the government faces a significant budgetary deficit, no changes were made to the planned phased reductions in corporate tax rates nor were any changes proposed to personal tax rates.

In the remainder of this article, we discuss these and other business tax measures contained in the Budget.

## Employee Stock Option Rules

### *No Deduction for Cash-out*

Generally, the Income Tax Act (Tax Act) provides that the grant of an employee stock option is a non-event. At the time of exercise, the employee is taxed on the in-the-money value of the option. This deemed benefit is treated as employment income. Provided certain conditions are met, the option benefit is eligible for a 50 percent deduction—effectively resulting in the option benefit being taxed at capital gains rates.

Capital gains rate taxation is generally available upon the realization of the option benefit, whether by actual exercise of the option into underlying shares, or by the "cash-out" of the option pursuant to the exercise by the holder of a right to be paid the in-the-money value in cash. A well-known opportunity existed for an employer to claim a deduction on the cash-out of its employees' options. It is understood that the availability of such a deduction in the context of a change of control of the employer is the subject of ongoing litigation. However, even the Canada Revenue Agency (CRA) has acknowledged that the deduction was available where options are cashed out in the ordinary course.

**No changes were made to the planned phased reductions in corporate tax rates nor were any changes proposed to personal tax rates.**

The Budget ends this opportunity by generally denying option holders the right to capital gains rate taxation where their options are cashed out unless the employer elects to forgo a deduction in respect of the cash-out payment. Thus, either the employer can claim a deduction or the employee can be entitled to capital gains rate taxation on the payment, but not both.

In many public M&A transactions completed through plans of arrangement, it has been customary for the options to be cashed out by the target. While this may still be a viable approach, there will now be a need to determine, as a business matter, whether the employer will agree to forgo a deduction so that option holders will choose to cash out options rather than exercise options in advance of the transaction.

### *End of Deferral*

In 2000, the stock option rules were amended to permit an employee to defer the employment income inclusion on the exercise of up to C$100,000 of qualifying public company options until the year of sale of the underlying shares. This measure was intended to allow employees to exercise options without having to then sell their shares on the market in order to fund the resulting tax liability. Effective immediately, this deferral rule is being repealed.

*Budget Tax Measures*, continued on page 16

Wanda Rumball (wanda.rumball@blakes.com) is a Partner in the Calgary office, and Andrew Spiro (andrew.spiro@blakes.com) is an Associate in the Toronto office, of Blake, Cassels & Graydon LLP. Both authors specialize in tax. Ms. Rumball practices in all areas of domestic and cross-border corporate taxation, including mergers, acquisitions, equity and debt financings, reorganizations and executive compensation. Mr. Spiro's practice is focused on domestic and international corporate tax, taxation of income trusts, mutual fund trusts, real estate investment trusts and other investment vehicles, and structured products.

# Court Addresses (Again!) Employee Stock Option Expenses for Transfer Pricing Purposes

## *Ninth Circuit Reverses Itself and Holds that the Arm's-Length Standard Controls in Determining if Employee Stock Option Expenses Must Be Shared Among Related Parties Under Pre-2003 U.S. Transfer Pricing Rules*

By Andrew S. Mason, Andrew P. Solomon, S. Eric Wang, Aditi Banerjee and Donald L. Korb (Sullivan & Cromwell LLP)

**Summary**

In a major taxpayer victory, the U.S. Court of Appeals for the Ninth Circuit, in *Xilinx, Inc. v. Comm'r* (2010 U.S. App. LEXIS 5795 (March 22, 2010)), reversed its earlier decision and affirmed the Tax Court's decision that the arm's-length standard controls in determining whether employee stock option (ESO) expenses in cost sharing agreements related to developing intangibles are subject to transfer pricing. The Court of Appeals upheld the Tax Court's determination that unrelated parties jointly developing intangibles and transacting on an arm's-length basis would not include ESO expenses in a cost sharing agreement, and therefore such expenses are not subject to reallocation under pre-2003 U.S. transfer pricing rules. The new decision is a dramatic reversal of the Ninth Circuit's prior decision in May 2009 (which decision had been withdrawn on January 13, 2010) that related companies sharing expenses of developing intangibles (such as intellectual property) must share costs attributable to ESOs (and thus, must share any deductions associated with such costs) even if such sharing would be inconsistent with the arm's-length standard that generally governs transfer pricing rules under U.S. tax law and under U.S. international tax treaties.

The new decision by the Court of Appeals is particularly significant for multinational taxpayers, especially those taxpayers involved in high technology or similar businesses that have substantial operations conducted through foreign subsidiaries. Many businesses, as a matter of practice, did not allocate to non-U.S. subsidiaries the costs of stock-based compensation issued by a U.S. parent on the basis that unrelated parties transacting on an arm's-length standard would not share such costs. Instead, the U.S. parent would claim the full amount of stock-based compensation costs as deductible business expenses on its U.S. tax returns. Reallocation of a portion of these expenses to a foreign subsidiary, as would have been required under the withdrawn Court of Appeals decision, would have effectively reduced the amount of deductible and creditable business expenses available to the U.S. parent and deferred the benefit of those deductions until such time as the related income was repatriated from the foreign subsidiary to the U.S. through a distribution or otherwise.

As a technical matter, the *Xilinx* decision applies to a prior version of the Treasury Regulations that were amended in 2003. The post-2003 Treasury Regulations explicitly require reallocation of stock-based compensation expenses to offshore subsidiaries. However, the *Xilinx* decision will have direct impact on many companies

**The new decision by the Court of Appeals is particularly significant for multinational taxpayers, especially those taxpayers involved in high technology or similar businesses that have substantial operations conducted through foreign subsidiaries.**

*Xilinx*, continued on page 5

Andrew Mason (masona@sullcrom.com) is a Partner whose practice is focused on tax aspects of real estate, project finance, leveraged lease, mergers, acquisitions, and international transactions. Andrew Solomon (solomona@sullcrom.com) is Managing Partner of the firm's Tax Group. His practice is concentrated in tax planning and dispute resolution, including taxation of complex financial products and transactions. S. Eric Wang (wangs@sullcrom.com) is a Partner whose practice is concentrated on planning and transactional matters for U.S. and foreign clients, and particularly structuring cross-border investments and U.S. tax issues related to tax structured financing, acquisitions and joint ventures and debt restructuring. Aditi Banerjee (banerjeea@sullcrom.com) is an Associate whose practice is focused on tax. Donald Korb (korbd@sullcrom.com) is a Partner and head of Sullivan & Cromwell LLP's Tax Controversy Practice. He is the former Chief Counsel for the Internal Revenue Service. Messrs. Mason and Solomon are in the New York office, Mr. Wang and Ms. Banerjee are in the London office, and Mr. Korb is in the Washington office, of Sullivan & Cromwell LLP.

## Xilinx *(from page 4)*

involved in ongoing transfer pricing disputes with the IRS for pre-2003 taxable years. Indeed, the *Xilinx* case has been of great interest to the business community and tax practitioners, several of whom expressed their concerns through amicus briefs, which appear to have been given serious consideration by the Court of Appeals.

Beyond the impact on pre-2003 taxable years, the *Xilinx* decision has significant ramifications because it upholds the supremacy of the arm's-length standard as the principal standard for transfer pricing determinations. The Court of Appeals decision is based on the principle that the arm's-length standard trumps transfer pricing requirements that are inconsistent with the arm's-length standard, because the primary purpose and intent of the U.S. transfer pricing rules is to put related parties on tax parity with unrelated parties, or, in other words, to conform related party transactions to the arm's-length standard. The fact that the U.S. Treasury Department has espoused the primacy of the arm's-length standard in its Technical Explanations of U.S. international tax treaties was also given serious weight by the court.

**The *Xilinx* decision upholds the supremacy of the arm's-length standard as the principal standard for transfer pricing determinations.**

An interesting question that remains unanswered is to what extent the Court of Appeals decision calls into question current U.S. Treasury Regulations that require cost sharing even where the costs are not shared by unrelated parties transacting on arm's-length terms. The concurring opinion notes that it is an "open question" as to whether current Treasury Regulations (amended in 2003) adequately address the ambiguity and inconsistency at the heart of the Xilinx case.

### Background

#### *1. Cost Sharing Provisions Under Code Section 482*

Code Section 482 authorizes the IRS to adjust and allocate income, deductions and other tax items among related parties in order to prevent tax evasion and to reflect the proper allocation of income among related parties. The regulations under Code Section 482 generally require related party transactions and arrangements to conform to an arm's-length standard. Under the relevant Treasury Regulations in question, the IRS would adjust tax items with respect to a qualified cost sharing arrangement relating to the development of intangibles only to the extent necessary to make each participant's share of all costs of intangible development equal to such participant's share of reasonably anticipated benefits attributable to the development. In 2003, the Treasury Department amended these regulations to provide that stock-based compensation must be counted as a cost of developing intangibles and would therefore be subject to transfer pricing adjustment under these rules. However, the question before the court in *Xilinx* is the treatment of these expenses under the rules as they were in effect from 1997 to 1999, before this amendment.

#### *2. The Prior* Xilinx *Decisions*

The *Xilinx* case involves a U.S. corporate taxpayer that researched, developed, manufactured, marketed and sold integrated circuit devices and related development software systems. The taxpayer established an Irish subsidiary, Xilinx Ireland (XI), in 1994, and the taxpayer and XI entered into a cost sharing agreement in 1995 providing joint ownership of any new technology developed by either XI or the taxpayer. This agreement did not specifically address whether expenses attributable to ESOs issued by the taxpayer would constitute a cost to be shared under the agreement. In 1996, the taxpayer and XI entered into two agreements to allow XI employees to acquire options for the taxpayer's stock. The agreements provided that XI would pay the taxpayer for the "cost" of the exercise of the stock options, in an amount equal to the spread between the stock's market price on the exercise date and the exercise price. XI made such payments to the taxpayer in the taxable years in question from 1997 to 1999.

The ESOs issued by the taxpayer during the relevant tax years consisted of incentive stock options (ISOs), nonstatutory stock options (NSOs), and employee stock purchase plan shares (ESPPs). An employee is generally taxed on the spread between the fair market value and the exercise price of NSOs on exercise but is only taxed on ISOs and ESPPs if the employee sells the stock in certain "disqualifying dispositions." Employers such as the taxpayer receive a corresponding deduction when the employees recognize income. Accordingly, from 1997 to 1999, the taxpayer claimed deductions for amounts attributable to its employees' exercises of NSOs and disqualifying dispositions of ISOs and ESPPs. The taxpayer also claimed R&D credits based in part on these expenses.

The IRS disallowed a portion of the deductions claimed by the taxpayer and imposed accuracy-related penalties on the basis that the taxpayer should have shared the ESO expenses with XI under the cost sharing agreement to the extent the ESOs were issued to employees involved in or supporting R&D activities. By shifting a portion of these costs to XI, the IRS, in effect, significantly reduced the amount of expenses deductible by the taxpayer and taken into account for purposes of determining the taxpayer's R&D credits. The deductions would instead be allocable to XI, and any benefit from the deductions would generally be deferred until XI's related income is repatriated to the

*Xilinx*, continued on page 6

## Xilinx *(from page 5)*

U.S. (by dividend or otherwise).

*a. The Tax Court Decision*—The taxpayer challenged the IRS's determination in the Tax Court on the grounds that the ESO expenses in question were not "costs" for this purpose as unrelated parties transacting on arm's-length terms would not share ESO-related costs. The Tax Court held in favor of the taxpayer and held that the arm's-length standard was controlling, and therefore, ESO costs would be subject to transfer pricing only if unrelated companies under an arm's-length standard would share such costs. The Tax Court found that such costs would not be shared under an arm's-length standard, based on evidence and testimony from experts that, in practice, unrelated companies do not explicitly share such costs and that, further, unrelated parties would not want to share such costs as the valuation of this cost would be difficult to calculate, would be unpredictable and subject to significant fluctuation, and would lead to perverse incentives—for example, the cost-sharing partner would have a perverse incentive to diminish the stock price of its joint venture partner in order to minimize the spread-based cost that it would have to bear. The IRS also conceded that unrelated parties would not share ESO-related costs.

*b. The Original Court of Appeals Decision*—On appeal, the Ninth Circuit found that the regulatory provision requiring the arm's-length standard to be applied "in every case" was inconsistent and irreconcilable with the regulatory provision that required related parties to share "all" costs of intangible development in proportion to their share of reasonably anticipated benefits from such development (the "all-costs requirement"). The court concluded that the bright-line rule under the all-costs requirement addressed a particular type of related party transaction—intangible product development—and that, with respect to such transactions, the specific bright-line rule overrode the general arm's-length standard requirement. The court also held that the all-costs requirement did not violate the Ireland-U.S. Tax Treaty, which designates the arm's-length standard as the appropriate standard for determining whether related party transactions would be subject to

*Xilinx,* continued on page 7


## Advisory Board

**Richard E. Andersen**
Arnold & Porter LLP (New York)

**Joan C. Arnold**
Pepper Hamilton LLP (Boston)

**Sunghak Baik**
Ernst & Young (Singapore)

**William C. Benjamin**
Wilmer Cutler Pickering Hale and Dorr LLP (Boston)

**Steven D. Bortnick**
Pepper Hamilton (New York)

**Joseph B. Darby III**
Greenberg Traurig LLP (Boston)

**Rémi Dhonneur**
Kramer Levin Naftalis & Frankel LLP (Paris)

**Hans-Martin Eckstein**
PricewaterhouseCoopers (New York)

**Jaime González-Béndiksen**
Baker & McKenzie (Juarez)

**Jamal Hejazi, Ph.D.**
Gowlings, Ottawa

**Marc Lewis**
Sony USA (New York)

**Howard M. Liebman**
Jones Day (Brussels)

**Keith Martin**
Chadbourne & Parke LLP (Washington)

**William F. Roth**
BDO Seidman, LLP

**Kevin Rowe**
Reed Smith (New York)

**Eric D. Ryan**
DLA Piper (Palo Alto)

**John A. Salerno**
PricewaterhouseCoopers LLP (New York)

**Michael J. Semes**
Blank Rome LLP (Philadelphia)

**Douglas S. Stransky**
Sullivan & Worcester LLP (Boston)

**Michael F. Swanick**
PricewaterhouseCoopers LLP (Philadelphia)

**Edward Tanenbaum**
Alston & Bird LLP (New York)

**Guillermo O. Teijeiro**
Negri & Teijeiro Abogados (Buenos Aires)

**David R. Tillinghast**
Baker & McKenzie LLP (New York)

**Eric Tomsett**
Deloitte & Touche LLP (London)

## Xilinx *(from page 6)*

transfer pricing adjustments. The court concluded that the treaty was not violated, because the treaty's saving clause reserves the ability of Ireland or the U.S. to apply its domestic law to its own citizens and residents even if such laws conflict with the treaty. On January 13, 2010, the Court of Appeals withdrew this decision in anticipation of the new opinion discussed below.

**The New Ninth Circuit Decision**

The new opinion by the Court of Appeals echoes the Tax Court decision and the earlier Court of Appeals decision in finding that the arm's-length standard requirement is irreconcilable with the all-costs requirement. However, the court rejected the earlier Court of Appeals decision's holding that the specific all-costs requirement should control when conflicting with the general arm's-length standard requirement. The court here instead held that, while it is a canon of construction in textual interpretation that a specific rule trumps the general rule where the two conflict, this is just one among many interpretative tools and is not binding on the court, particularly when other evidence is available that shows the intent and purpose of the rules in question.

**According to the court, the purpose of the transfer pricing regulations is to achieve tax parity between related party transactions and unrelated party transactions.**

According to the court, the purpose of the transfer pricing regulations is to achieve tax parity between related party transactions and unrelated party transactions. In order to reach this conclusion, the court relied on the fact that the Treasury Department's Technical Explanation of the Ireland-U.S. Tax Treaty explicitly refers to the arm's-length principle in describing U.S. domestic transfer pricing provisions under Code Section 482. Accordingly, the court found that the intent and purpose of the regulatory provisions is to impose the arm's-length standard as the controlling standard for transfer pricing purposes and that therefore, to the extent the all-costs requirement conflicts with the arm's-length standard, the arm's-length standard prevails. The court reasoned that if the arm's-length standard is trumped by the all-costs requirement, then the purpose of the regulatory provisions to impose an arm's-length standard is frustrated because the taxpayer would not have tax parity with an independent taxpayer who would not share such costs with an unrelated party.

It is interesting to note that the concurring opinion was issued by one of the judges who had found in favor of the IRS in the earlier Ninth Circuit decision. In explaining his change of opinion, the judge took issue with the IRS's response to the taxpayer's appeal of the earlier Ninth Circuit decision. In its response, the IRS argued that the result of the earlier decision was correct but not the reasoning, because the arm's-length standard and the all-costs requirement were not actually in conflict. Instead, the IRS argued that the all-costs requirement was a gloss on the arm's-length standard to address a situation in which there is no comparable transaction between unrelated parties to which the related parties may conform. According to the concurring opinion, the IRS contended that the economic situation of related parties would be materially different from that of unrelated parties, because related parties would be less concerned about exposing themselves to each other's fluctuations in stock price since the related parties are already exposed to such fluctuations by virtue of their common ownership. The concurring opinion found that this argument for reconciling the two provisions was too complex and theoretical, rendering the regulatory provisions ambiguous and unfair to taxpayers who were not given clear, fair notice of how the regulations would affect them.

© Sullivan & Cromwell LLP 2010 ❑

THOMSON REUTERS

PRACTICAL U.S./INTERNATIONAL TAX STRATEGIES

**Senior Editor:** Scott P. Studebaker, Esq.
**Assistant Editor:** Edie Creter
**Contributing Editor:** George Boerger, Esq.
**Special Interviews:** Scott P. Studebaker
**Marketing:** Jon Martel
**Production Assistance:** Dana Pierce

**PRACTICAL U.S./INTERNATIONAL TAX STRATEGIES**
is published by
WorldTrade Executive,
a part of Thomson Reuters
P.O. Box 761, Concord, MA 01742 USA
Tel: 978-287-0301, Fax: 978-287-0302
*info@wtexec.com*
*www.wtexecutive.com*
*Copyright © 2010 by Thomson Reuters/WorldTrade Executive*
*This publication is sold or otherwise distributed with the understanding that the authors, editor and publisher are not providing legal, accounting, or other professional service. If legal advice or other expert assistance is required, the services of a competent professional person should be sought. Reproduction or photocopying — even for personal or internal use — is prohibited without the publisher's prior written consent. Multiple copy discounts are available.*

# Treasury and IRS Issue Guidance on FBAR Filings

By William C. Benjamin, J. Barclay Collins and Anthony Jude (AJ) Picchione (Wilmer Cutler Pickering Hale and Dorr LLP)

On February 26, 2010, the Internal Revenue Service issued guidance relating to filing requirements for Forms TD F 90-22.1, Reports of Foreign Bank and Financial Accounts (FBARs), due on June 30, 2010 (including 2008 FBARs for which the due date was previously deferred from June 30, 2009 to June 30, 2010). The IRS guidance relates to *(i)* persons with signature authority over, but no financial interest in, foreign financial accounts; *(ii)* the treatment of "commingled funds," including hedge funds and private equity funds; and *(iii)* foreign persons and entities present in the United States.

In addition, the Treasury Department published a Notice of Proposed Rulemaking (Proposed Rules)[1] in response to comments requested in IRS Notice 2009-62.[2] The Proposed Rules would expand current reporting exceptions, although not to the extent requested in comments. The Treasury has requested comments on the Proposed Rules by April 27, 2010.

Although the IRS and Treasury guidance may provide some relief from the FBAR filing requirement for certain persons, as of the time that this article was submitted for publication, Congress was considering a bill that would impose separate information reporting requirements for U.S. individuals who own interests in, among other things, foreign hedge funds and foreign private equity funds if the aggregate value of such interests totals at least $50,000.[3]

**IRS Notice 2010-23 (Notice)[4]**

*Persons with Signature Authority:* For persons with signature authority over, but no financial interest in, a foreign financial account, the Notice postpones until June 30, 2011 the filing date for FBARs that would have otherwise been due on June 30, 2010. For calendar years 2008 and prior, this provision further extends the deadline extension provided in IRS Notice 2009-62. The Notice also clarifies that these deferred FBARs will be required to be completed in accordance with whatever FBAR guidance is in effect at the time they are filed in the future, perhaps signaling a possible relaxation of the applicable rules.

*Foreign Commingled Funds:* Previous statements by IRS and Treasury officials suggested that private investment funds would be considered "commingled funds" subject to reporting on an FBAR. The Notice provides that the term "commingled funds" shall be interpreted to apply only to "mutual funds" for 2009 and prior years. Under the Proposed Rules, mutual funds would include only those which issue shares available to the general public that have a regular net asset value determination and regular redemptions. Accordingly, a financial interest in or signature authority over a foreign hedge fund or private equity fund will not require an FBAR filing for 2009 or prior years. Thus, any reporting of interests in or signature authority over foreign hedge funds and foreign private equity funds will apply, if at all, only prospectively for 2010 or future years. The treatment of such funds for 2010 and later years is yet to be determined and is reserved in the Proposed Rules.

*FBAR Questions on Federal Tax Forms:* Certain IRS Forms (e.g., Schedule B of IRS Form 1040) require a taxpayer to disclose any foreign financial accounts in which the taxpayer has a financial interest or over which the taxpayer has signature authority. The Notice states that for tax years 2009 and prior, provided the taxpayer has no other reportable financial accounts, any persons that qualify for relief under the provisions discussed in the two previous paragraphs above should check "no" in response to such questions on IRS Forms.

**IRS Announcement 2010-16 (Announcement)[5]**

*Foreign Person Reporting:* The Announcement clarifies that foreign persons (persons who are not U.S. citizens or residents, U.S. partnerships, U.S. corporations, or U.S. estates or trusts) are not required to file an FBAR for 2009 or earlier years, even if they have been present in, or doing business in, the United States. The Proposed Rules include a similar clarification.

**Treasury Notice of Proposed Rulemaking (Proposed Rules)**

The Proposed Rules are not currently effective. Thus, to the extent the Proposed Rules provide an exemption or clarification that would be relevant for the 2009 FBAR

*FBAR*, continued on page 9

William C. Benjamin (william.benjamin@wilmerhale.com) is a Partner in Wilmerhale's corporate and transactional department, and a member of the Tax Practice group. He is a co-chair of the firm's International Transactions group. His practice is focused on the legal and tax aspects of international business transactions. He is a member of the *Tax Strategies* Advisory Board. J. Barclay Collins (barclay.collins@wilmerhale.com) is a Partner in Wilmerhale's tax department, where his practice is concentrated in tax considerations of commercial transactions, tax disputes and compliance, corporate and partnership tax planning, and structuring of corporate acquisitions and divestitures. Anthony Jude (AJ) Picchione (anthony.picchione@wilmerhale.com) is a Senior Associate in Wilmerhale's Tax Practice group. Messrs. Benjamin and Picchione are in the firm's Boston office, Mr. Collins is resident in the firm's Washington office.

## FBAR *(from page 8)*

due on June 30, 2010, there is no express indication that the Proposed Rules may be relied upon.

The Proposed Rules include guidance on the following issues, among others:

- FBAR reporting is required only of "United States persons" as defined in the Internal Revenue Code (with minor adjustments).
- U.S. persons working outside the United States who have signature authority over foreign financial accounts of foreign entities must report such signature authority on an FBAR, although simplified reporting rules are provided. Previously, such employees could be exempted from withholding if a U.S. parent corporation included foreign subsidiary accounts on a consolidated FBAR.
- The situations in which signature authority arises appear to be limited to delivery of instructions directly to the financial institution (or person performing the services of a financial institution) with whom the financial account is maintained.
- The filing exemption for employees solely with signature authority over foreign financial accounts has been expanded to include employees of registered broker-dealers and investment advisors in respect of their services to mutual funds.
- Consolidated FBAR reporting is expanded to non-corporate subsidiaries such as LLCs.
- Public universities and state pension, retirement and welfare funds and their employees are exempt from FBAR reporting. However, private universities and retirement plans are not exempt.
- Participants in certain retirement plans and IRAs and beneficiaries of trusts that file an FBAR are exempt from duplicative FBAR reporting obligations.

The Proposed Rules do not address many of the comments submitted to Treasury over the last several months. Specifically notable omissions include the following:

- A significant impetus for the Proposed Rules was a Treasury statement that interests in foreign hedge funds and private equity funds were considered foreign financial accounts subject to FBAR reporting. The Proposed Rules do not address the treatment and reserve on this issue, although no filings will be required for 2009 and prior years in accordance with the Notice. As noted above, there is a bill currently pending in Congress that would impose a reporting requirement on U.S. persons who own interests in such funds, although not through an FBAR.
- No clarity is provided regarding whether a U.S. person must look through multi-tiered foreign structures to report foreign financial accounts of foreign entities below the first foreign entity in the chain.
- No broad-based exemption is provided for educational institutions and other exempt organizations and their employees.
- Duplicative reporting of accounts has been addressed only to a limited extent.

The Treasury noted that it had reviewed the comments previously submitted, but did not provide any analysis of its reasoning for not providing the relief requested.

---

[1]Amendment to the Bank Secrecy Act Regulations—Reports of Foreign Financial Accounts, 75 Fed. Reg. 8844 (proposed February, 26, 2010) (to be codified at 31 C.F.R. pt. 103).
[2]2009-35 I.R.B. 260 (August 31, 2009).
[3]H.R. 2847, 111th Cong. (2010).
[4]2010-11 I.R.B.
[5]2010-11 I.R.B. ❑

## HIRE Act *(from page 2)*

annual or periodical (FDAP) payments made to non-U.S. persons such as interest and dividends are subject to a 30 percent U.S. withholding tax unless the withholding agent can establish that the recipient is eligible for an exemption from withholding or a reduced rate of withholding under an income tax treaty. However, capital gains and U.S.-source interest payments eligible for the "portfolio interest" exemption are not subject to the 30 percent withholding tax.

Effective generally for payments made on or after January 1, 2013, a 30 percent U.S. withholding tax will be imposed on a broad category of U.S.-source payments (withholdable payments) made to "foreign financial institutions" (FFIs) that have not entered into an agreement with the IRS to provide annual information concerning U.S. account holders. In addition to FDAP payments currently subject to 30 percent withholding (such as dividends and interest not eligible for the portfolio interest exemption), withholdable payments will now include all payments of U.S.-source interest and any gross proceeds from the sale of assets, such as stock and securities, that can generate U.S.-source dividends or interest. As defined in the Act, FFIs include not only foreign banks and foreign custodial agents, but also any foreign entity that is engaged primarily in investing in or trading securities, partnership interests, commodities or derivatives. Thus, foreign hedge funds, private equity funds, securitization vehicles and other foreign investment vehicles generally will be required to comply with the annual tax reporting requirements described below in order to avoid the imposition of the 30 percent U.S. withholding tax on U.S.-source payments made to them that would not otherwise be subject to 30

*HIRE Act*, continued on page 10

## HIRE Act *(from page 9)*

percent withholding under current law. (It is expected that widely held foreign mutual funds will be exempted by future IRS guidance from having to comply with these rules.) The January 1, 2013, effective date is intended to provide sufficient time for fund managers to bring existing foreign investment vehicles into compliance with the new withholding tax regime.

Reporting generally will be required as to each U.S. person that holds any debt or equity interest in an FFI (other than an interest that is regularly traded on an established securities market) or that holds any financial account with an FFI. However, reporting is not required as to the following U.S. persons: publicly-traded corporations; tax-exempt organizations and IRAs; the United States, a State or a U.S. possession or a political subdivision or wholly-owned agency of either; a bank; a real estate investment trust (REIT); a U.S. mutual fund; or a charitable remainder trust (collectively, "exempted U.S. persons"). In addition to obtaining and providing information as to direct holders, FFIs will need to look through certain non-U.S. entities. Specifically, in the case of any non-U.S. entity holding a debt or equity interest in the FFI, the FFI must obtain and provide information as to U.S. persons that own more than 10 percent of such non-U.S. entity, or, if the non-U.S. entity is itself an entity that is engaged primarily in investing in or trading securities, partnership interests, commodities or derivatives, as to U.S. persons that own any interest in such foreign entity.

**Several revenue offset provisions are likely to affect both fund managers and investors in non-U.S. hedge funds, commodity funds, private equity funds, securitization vehicles and other investment entities.**

Similarly, a 30 percent U.S. withholding tax will be imposed on payments made to foreign entities, including foreign corporations, that are not FFIs, unless the foreign entity certifies that it does not have any non-exempted 10 percent U.S. owners or provides information regarding such owners. An exemption from these rules is provided for certain foreign entities, including publicly-traded corporations and members of their affiliated group, entities organized under the laws of a possession of the United States, and any foreign government or political subdivision of a foreign government. Notwithstanding the general 2013 effective date, the foregoing expanded withholding tax provisions will not apply to debt obligations that are outstanding on March 18, 2012, nor will they apply to the gross proceeds from any disposition of such obligations.

### 3. Foreign Account Reporting

Effective generally for calendar years beginning 2011, U.S. individuals must report with their tax returns any interest in the following if the aggregate value of such assets exceeds $50,000: *(i)* foreign financial accounts (which includes interests in FFIs); and *(ii)* foreign issued stock, securities or derivatives with a foreign counterparty, in each case, unless held in an account maintained with a U.S. financial institution. This is in addition to the FBAR reporting of foreign bank and financial accounts.

### 4. Annual PFIC Reporting

Each U.S. shareholder of a passive foreign investment company (PFIC) will be required to file annually a statement of their PFIC holdings information statements with their tax returns, beginning (for individuals) with their 2010 tax returns. The form of such statement has not yet been disclosed.

© 2010 Katten Muchin Rosenman LLP ❑

WorldTrade Executive's
INTERNATIONAL TAX
Strategies Series

Check out WorldTrade Executive for the international tax planning resources you need . . .

www.wtexec.com/tax.html

- Mexico Tax, Law & Business Briefing
- Global Transfer Pricing Solutions
- White Paper on Tax Reform in Japan
- Using Treaties and Holding Companies for Latin American Tax Planning
- Russia Tax, Law & Business Briefing
- China Tax and Financial Planning Briefing

Please see our regional Practical International Tax Strategies periodicals covering *China, Asia, Europe, Mexico, Latin America* and the *US.*

Also sign up for our FREE international tax strategies electronic briefing - www.wtexec.com/briefing.html

# CRA Responds to the New GST/HST Legislative Proposals on Financial Services

## *Some Previously Exempt Services are Now Taxed*

By Alan Kenigsberg and Jean-Guillaume Shooner (Stikeman Elliott LLP)

On February 11, 2010, the Canada Revenue Agency (CRA) released Goods and Services Tax/Harmonized Sales Tax (GST/HST) Notice No. 250 (CRA Notice) in response to the proposal to change the definition of "financial services" in the Excise Tax Act (Act) announced in a News Release and Backgrounder issued by the Department of Finance on December 14, 2009 (Backgrounder). The Department of Finance stated that such proposal is intended to "clarify" and confirm the government's policy intent that certain services such as management, administration, marketing and promotional services do not constitute financial services and are therefore subject to GST/HST.

In the CRA Notice, the CRA states that the proposals to change the legislation "reaffirm the longstanding policy intent and provide certainty with respect to the application of GST/HST." Surprisingly, the CRA uses the CRA Notice to completely reverse a number of its own published positions with respect to what constitutes an exempt service of "arranging for" a financial service. Financial institutions and businesses dealing with financial institutions should carefully examine whether or not they are affected by these policy changes, and whether services previously considered exempt from GST/HST are now taxable.

### The New Legislative Proposals

According to the Backgrounder, the legislative proposals, once drafted, will specifically provide that the following activities will not constitute exempt financial services under the Act and will therefore be subject to GST/HST: *(i)* investment portfolio management and administration activities; *(ii)* certain facilitatory services that are preparatory to an actual or intended financial service such as market research, product design, document preparation or processing, customer assistance, advertising, promotional or similar activities; and the collection, collation or provision of information; and *(iii)* credit management services such as credit checking, valuation, authorization services, making decisions relating to a grant or an application for credit, creating and maintaining records relating to a grant or an application for a grant of credit on behalf of the credit provider, and monitoring payment records or dealing with payments. The Backgrounder also states that "The proposals would apply to all supplies of these services made after today, as well as to past transactions where the suppliers treated these services as taxable."

**Financial institutions and businesses dealing with financial institutions should carefully examine whether services previously considered exempt from GST/HST are now taxable.**

### The CRA Notice

#### *Investment Portfolio Management and Administration Services*

In the CRA Notice, several examples are provided to illustrate the CRA's interpretation of how certain investment management services will be subject to GST/HST once the proposed changes have been drafted and enacted. In one example, the CRA examines services rendered by an investment dealer who arranges to purchase units of a mutual fund for an investor and who receives a commission for such purchase as well as a "trailer commission or fee" paid annually from the fund manager. It is specified in this example that the prospectus states that the trailer commission or fee is "being paid in recognition of the investment advice and ongoing administrative services rendered by the investment dealer to the investors." Based on these facts, the CRA concludes that these services would not be a supply of a financial service, and that the trailer commission or fee would be subject to GST/HST. This answer is contrary to the CRA's previously published position in GST Policy Statement

*Taxing Financial Services*, continued on page 12

Alan Kenigsberg (akenigsberg@stikeman.com) is a Partner in the Toronto office, and Jean-Guillaume Shooner (jgshooner@stikeman.com) is an Associate in the Montreal office, of Stikeman Elliott LLP. Mr. Kenigsberg's practice is focused on cross-border tax planning, commodity taxation (including Goods and Services Tax and provisional sales taxes), customs, excise taxes and transfer pricing. Mr. Shooner's practice is concentrated in tax planning and tax issues related to mergers, acquisitions, corporate reorganizations, commodity taxation and customs.
The authors would like to thank Glenn A. Cranker (gcranker@stikeman.com) for his collaboration in writing this article.

## Taxing Financial Services *(from page 11)*

P-119 (dated February 22, 1994) where the CRA stated in an identical fact situation that trailer commissions or fees are not subject to tax.

According to the Backgrounder, the amendments will apply to all supplies of investment management services rendered under an agreement where *(i)* consideration for the supply becomes due or was paid without becoming due after December 14, 2009; or where *(ii)* all the consideration for the supply became due or was paid on or before December 14, 2009, unless the supplier did not charge, collect or remit GST/HST in respect of the supply or in respect of any other supply that includes an investment management service and that is made under the agreement. In other words, according to the Backgrounder, the amendments, once drafted, should treat all future supplies of these services, all current supplies that have not yet been billed, and all past supplies where the manager charged GST/HST, as being taxable.

**The CRA appears to be taking a fairly aggressive stand on the retroactivity of the legislation.**

Notwithstanding the wording in the Backgrounder, the CRA appears to be taking a fairly aggressive stand on the retroactivity of the legislation. Indeed, in the CRA Notice, the example is provided of an investment manager who enters into an agreement with an investor to provide management advice, collects and remits GST/HST for a certain period of time under the agreement, and then decides to stop collecting and remitting GST/HST in June 2009 under that same agreement. According to the CRA, the investment manager would still have been required to collect and remit GST/HST in respect of the consideration paid by the investor for the investment management services provided prior to December 14, 2009, notwithstanding they may have stopped charging GST/HST based on case law which held that their services were not subject to GST/HST. In this example, the CRA essentially takes the position that if tax was ever charged under a particular agreement, all services that have ever been rendered under that agreement will retroactively become taxable. This is particularly troubling, as companies that stopped charging GST/HST on their supplies in good faith will now be subject to interest and penalties for failing to collect a tax that the courts had said was not payable. Further, companies will now have to go back to their customers to claim several months of additional GST/HST, if they are able to do so under their agreements.

Based on the proposals to change the legislation, the rebate claim of a person for GST/HST charged by an investment manager in good faith on discretionary investment management fees would now appear to be obsolete. In this respect, the CRA mentions that rebate application forms for GST/HST "paid in error" for GST/HST paid on investment management services will not be processed at this time, and if the proposals to change the legislation are enacted as they are described in the Backgrounder, such rebate claims will be denied.

***Facilitatory Services and Credit Management Services***

The CRA also provides certain factual examples to illustrate how GST/HST will apply to so-called facilitatory services and credit management services pursuant to Finance's proposals. Several of the examples set out in the CRA Notice appear to be virtually identical to examples previously published by the CRA in GST/HST Policy Statement P-239 dated January 30, 2002 (P-239), with the only real difference being that where the CRA formerly stated that these services were exempt financial services, the CRA now states that they are taxable.

In the first example of facilitatory and credit management services, an automobile dealership has a financing department where employees assist customers in obtaining financing for the purchase of an automobile (i.e., obtaining credit information, completing loan application forms, explaining the different types of loans, determining the interest rate, making recommendations to the bank, etc.). For every loan provided to a customer, the dealership receives a commission from the financial institution. While the CRA formerly considered that this service fell within the definition of "arranging for" a financial service, and was thus exempt from GST/HST, the CRA is now of the view that such supply would be taxable for GST/HST purposes.

In the second example, a corporation that provides specialized group insurance coverage for members affiliated with particular organizations such as banks and large retailers hires a telemarketing agency to conduct the necessary insurance coverage-placing activities with the group members. The telemarketing agency explains the insurance coverage available, answers questions regarding the insurance coverage, screens the eligibility of the person, prepares the application, and forwards the completed applications to the corporation that grants final approval. The telemarketing agency is compensated on a per-hour basis. In this example, the CRA has also changed its position from P-239 and now considers that these supplies will be taxable.

In a third example, a corporation wants to sell the business carried on by its subsidiary and enters into an agreement with a business broker service whereby the broker will facilitate the sale of the shares of the subsidiary. In this respect, the broker has to perform various services including: obtaining "listing" for the sale of the business;

*Taxing Financial Services,* continued on page 13

## Taxing Financial Services *(from page 12)*

assisting the corporation in calculating the price at which the subsidiary's shares will be offered; assisting the corporation in putting together financial and operating information; advertising the subsidiary's business as being for sale; contacting potential purchasers; acting as intermediary between the corporation and the purchaser in negotiating the terms of purchase and sale; etc. Again, contrary to what is provided for in P-239, the CRA states that such brokerage services would now be taxable.

The CRA also provides numerous other examples of services that will now be considered taxable. The CRA did not provide a single example of a service that would still be considered to be "arranging for" a financial service under paragraph (l) of the definition of "financial services" in the Act and thus exempt from GST/HST, and based on the CRA's interpretation of the proposed (but not yet drafted) legislation, it is unclear what services would still be exempt from GST/HST under this provision. In this respect, the CRA confirmed to the authors during a phone conversation that facilitatory services offered by an intermediary in the financial services industry, such as mortgage brokerage services, are likely to be taxable under the new regime.

***Reassessment by the CRA***

For all the legislative proposals, the Department of Finance indicated in the Backgrounder that any reassessments based on the proposed amendments would have to be made on or before the later of: (1) the day that is one year after the day the proposed amendments enter into force; and (2) the last day of the period for reassessment otherwise allowed under the Act for making the reassessment. While we would expect that the additional one year period should only apply to periods that are not already statute-barred, the wording in the Backgrounder implies that the CRA could assess periods that were already statute-barred so long as the assessment is made within a year of the proposed amendments receive royal assent. In the CRA Notice, the tax authorities simply restate Finance's comments without any further explanation. In any event, service providers to financial institutions that previously regarded their services as exempt should be aware that they might be reassessed beyond the normal reassessment period.

© Stikeman Elliott LLP ❑

# Department of Finance Releases Draft Foreign Affiliate Amendments Affecting Acquisitions and Reorganizations

## *Changes for Canadian Multinationals with Foreign Affiliates*

By Chris Van Loan and Sabrina Wong (Blake, Cassels & Graydon LLP)

On December 18, 2009, the Department of Finance released a package of technical amendments to the foreign affiliate rules (December 18th Proposals). Although many of the proposals are consistent with previously released draft legislation, others have been restructured; some proposed changes take a completely different approach from earlier proposals. The December 18th Proposals only deal with certain aspects of the foreign affiliate rules. There are many issues still to be addressed, including proposed amendments to the rules governing mergers, liquidations, and other reorganizations involving foreign affiliates, which are still being reviewed by the Department of Finance. Nonetheless, Canadian multinationals with foreign affiliates should carefully review this latest legislative initiative.

Chris Van Loan (chris.vanloan@blakes.com) and Sabrina Wong (sabrina.wong@blakes.com) are Partners with the Toronto office of Blake, Cassels & Graydon LLP. Mr. Van Loan specializes in the taxation of capital market transactions and structured products, the taxation of international operations, financings, corporate reorganizations, and mergers and acquisitions. Ms. Wong's practice is focused on international tax, corporate finance, investment vehicles, and corporate reorganizations.

### Changes to Regulations Governing Calculation of Surplus and Deficit Accounts of Foreign Affiliates

The regulations to the Income Tax Act (Canada) (Act) contain detailed rules for calculating surplus and deficit accounts of foreign affiliates of Canadian taxpayers. These accounts are necessary for determining the tax treatment to a Canadian corporation of dividends received or deemed to be received from a foreign affiliate.

***(a) Acquisition of Control***

Although the Act contains a number of rules that affect the tax attributes of a corporation when control has been acquired, no similar rules apply to foreign affiliates of Canadian taxpayers. The December 18th Proposals introduce a new rule that will adjust the surplus accounts of a foreign affiliate directly owned by a Canadian corporation when control of the Canadian corporation has been acquired. In such circumstances, the surplus and related underlying foreign tax accounts of the affiliate will be reduced when the aggregate of the "tax-free surplus balance" and the adjusted cost base of the shares of such

*Foreign Affiliates,* continued on page 14

## Foreign Affiliates *(from page 13)*

foreign affiliate exceeds the fair market value of the shares of the foreign affiliate owned by the Canadian corporation. The purpose of this rule is to "grind" amounts that may be repatriated to the Canadian corporation by way of dividend free of Canadian tax.

The term "tax-free surplus balance" is a new term that will generally comprise the exempt surplus balance of the foreign affiliate and any other foreign affiliates in which it had a direct or indirect interest, as well as a grossed-up amount of foreign taxes paid by such foreign affiliates in respect of their taxable surplus balances.

This rule generally applies to acquisitions of control that occur after December 18, 2009 and will also apply where the relevant Canadian corporation owns the shares of a foreign affiliate through a partnership.

***(b) "88(1)(d) Bump" and Surplus Accounts***

New rules have been proposed to limit increases in the adjusted cost base of shares of a foreign affiliate where such shares were owned by a Canadian corporation that has been wound-up into or amalgamated with its Canadian parent. There had been previously announced changes that would limit the "bump" in these situations and these, as modified by the December 18th Proposals, will generally apply for wind-ups or amalgamations occurring after February 27, 2004. The changes to the rule will limit the amount of the "bump" to the extent that the Canadian subsidiary involved has received dividends after its acquisition of control by its Canadian parent out of taxable or exempt surplus earned before the acquisition of control, which dividends are deductible under paragraph 113(1)(a) or (b) of the Act. This provision addresses some of the shortcomings that were contained in previously proposed paragraph 88(1)(d.4) of the Act, which presumably will now be abandoned.

For wind-ups or amalgamations that are preceded by an acquisition of control that occurred after December 18, 2009, a new rule will apply that takes a different approach from that described above. This rule will limit the availability of the "bump" to the adjusted cost-base of shares of a foreign affiliate owned by the Canadian subsidiary to the extent that the fair market value of the foreign affiliate's shares at the time of the acquisition of control of the Canadian parent exceeded the aggregate of the "tax-free surplus balance" of such affiliate (described above) and the adjusted cost base of such foreign affiliate's shares.

***(c) Section 93 Election and Surplus Accounts***

Where shares of a foreign affiliate are disposed of by a Canadian taxpayer or other foreign affiliate for non-share consideration, the Canadian taxpayer or other foreign affiliate will generally realize a gain or loss, subject to the special rules in section 93 of the Act and the related regulations that allow a Canadian corporate shareholder to elect to treat all or a portion of the proceeds of disposition as a dividend. The section 93 election essentially allows the Canadian corporate shareholder to access the surplus accounts of its foreign affiliates without receiving an actual dividend that could be subject to foreign withholding tax.

Previous proposed rules would require the surplus of the foreign affiliate and its subsidiaries to be computed on a consolidated basis for purposes of a section 93 election. The December 18th Proposals introduce a new "fill-the-hole" rule that will replace the previous draft consolidated surplus rules and will reduce the number of surplus account adjustments.

**Canadian multinationals with foreign affiliates should carefully review this latest legislative initiative.**

The fill-the-hole rule will apply where a foreign affiliate has an exempt deficit (FA1) and any shares of a lower-tier foreign affiliate (FA2) are acquired by the Canadian corporate shareholder or another foreign affiliate (including upon the winding-up of FA1, as well as dispositions or issuance of shares of FA2) in circumstances where FA1's interest in FA2 is diluted. Where it applies, the effect of the rule is to reduce the exempt deficit balance of FA1 and the exempt surplus balance of FA2 in a manner comparable to the result that would have occurred had a dividend equal to the "tax-free surplus balance" (described above) of FA2 been paid, immediately before the transaction, to the extent necessary to fill the hole in the FA1. The new rule also provides for increases to the adjusted cost base of the shares of FA2 and the shares of any other affiliate in between FA1 and FA2.

In light of the new fill-the-hole rule, the following previously proposed amendments to the regulations are being shelved:

- amendments that require the deficits of a foreign affiliate that is dissolved into another foreign affiliate to move up to the shareholder foreign affiliate on the dissolution; and
- amendments that require interest on inter-foreign affiliate debt incurred to acquire shares of another foreign affiliate in certain circumstances be applied to reduce the exempt surplus of the borrowing affiliate, the acquired affiliate and/or any lower-tier affiliates.

The fill-the-hole rule will apply to an acquisition of shares of a foreign affiliate that occurs after December 18, 2009 and will also apply where the shares of lower-tier foreign affiliates are held through partnerships. Taxpayers that had applied the previous proposed rules for dispositions of shares of a foreign affiliate prior to December 19, 2009 and have filed or will file section 93 elections may want to revisit the calculations relating to such election.

*Foreign Affiliates*, continued on page 15

## Foreign Affiliates *(from page 14)*

***(d) Rules Governing Surplus Adjustments on Reorganizations***

The structure of the regulations governing the adjustments to be made to foreign affiliate surplus and deficit accounts where there have been corporate reorganizations or certain share transactions is being significantly overhauled. With the exception of the new fill-the-hole rule, such changes are generally not intended to result in consequences different from those that would occur under existing rules. Rather, the intent is to streamline the rules while bringing them into line with the other proposed changes that have been discussed above.

***(e) Partnerships***

A number of provisions governing the calculation and treatment of surplus and deficit accounts of foreign affiliates held by partnerships are included in the December 18th Proposals. Generally, these rules adopt the same approach as that taken in subsection 93.1(1) of the Act in the context of foreign affiliate surplus and deficit account determinations where shares of a foreign affiliate are owned by a partnership. The newly proposed rules relating to surplus and deficit accounts are not intended to represent any substantive change to existing proposed rules; however, they are significantly more extensive than the existing proposed rules that they will replace.

***(f) Other Changes***

The December 18th Proposals also *(i)* introduce a definition of "permanent establishment" for purposes of various foreign affiliate provisions; *(ii)* deal with the treatment of eligible capital property held by a foreign affiliate; *(iii)* modify the foreign tax consolidation provisions in the regulations; and *(iv)* deem a portion of certain foreign oil and gas levies to be income taxes paid by a foreign affiliate for purposes of the regulations.

### Foreign Affiliate Elections

A number of amendments to the foreign affiliate rules were enacted in 2007 as part of the Budget and Economic Statement Implementation Act, 2007 (Bill C-28 Amendments). The Bill C-28 Amendments permit taxpayers to make various elections that will trigger earlier application of the amended provisions. The first of the two types of election available under the Bill C-28 Amendments is the so-called "Global Election," by which taxpayers can elect to apply a package of amendments to all of their foreign affiliates in most cases retroactively to 1995. The second election permits taxpayers to elect to have a specific amendment apply to all of their foreign affiliates—retroactively to 1995 (Individual Elections). The Individual Elections relate to the following amendments:

- relieving amendments to the recharacterization rule for interest on inter-foreign affiliate debt incurred to acquire shares of another foreign affiliate;
- the amendment to broaden the scope of the definition of foreign affiliate in respect of which a taxpayer has a "qualifying interest;"
- the new look-through rule for tiered partnerships and corporations;
- minor amendments to the rules that deem a foreign affiliate to be a "qualifying interest" foreign affiliate of a taxpayer or related to the taxpayer and another affiliate under certain circumstances;
- the amendment to exclude certain services from the definition of "services;"
- relieving amendments to the rule that deems certain income from the sale of property to be income from a business other than an active business.

Under the Bill C-28 Amendments, only the Global Election, once made, may be revoked; no Individual Election is revocable. In June 2008, the Department of Finance announced an 18-month extension of the deadline for making the Global Election and the Individual Elections so that the new deadline for corporate taxpayers with calendar taxation year-ends was December 31, 2009. The December 18th Proposals retained this deadline, but extend revocability to the Individual Elections. Thus, in addition to the Global Election, the Individual Elections made by a taxpayer can be revoked until the filing due-date for the taxpayer's taxation year that includes December 14, 2010 (in the case of a corporate taxpayer with a calendar taxation year-end, until June 30, 2011).

### Foreign Accrual Property Losses (FAPLs)

The carry-forward period for utilizing FAPLs is being extended to 20 years. This change, which had been previously announced, is designed to align these rules with the domestic loss carry-forward periods that have been repeatedly extended in recent years. Although generally effective for taxation years of foreign affiliates beginning after November 1999, the extension is phased in to mirror the extensions of domestic loss carryforward rules from five to seven years, then to 10 years and finally to 20 years. A foreign affiliate's FAPLs may still be carried back for three years.

Certain other changes have been made to the computation of and the mechanics of claiming FAPLs.

### Conclusion

The Department of Finance indicated that the government would accept comments on the December 18th Proposals until February 15, 2010. The December 18th Proposals do not include most of the previous proposals dealing with mergers, liquidations and other reorganizations of foreign affiliates. The Department of Finance indicated that those proposals will be included in a separate package of proposals to be issued in the near future.

© 2010 Blake, Cassels & Graydon LLP ❑

## Budget Tax Measures *(from page 3)*

No doubt this change was intended to address the all-too-common circumstance of employees who elected to defer the taxation of employment benefits on the exercise of options and continued to hold securities that ultimately dropped in value. The stock option employment benefit and corresponding tax is realized on the date of option exercise and any subsequent loss on the securities is, typically, a capital loss to the employee and cannot offset any portion of the stock option employment benefit. Some employees found themselves in a situation where the ultimate proceeds of disposition of the acquired securities were insufficient to pay the tax on the stock option employment benefit.

The Budget proposes to offer relief to those who have elected to defer the inclusion of public company employee stock option benefits and find themselves in that situation. Qualifying employees can elect to pay a special tax equal to the full proceeds of disposition of such securities (2/3 of such proceeds for Quebec residents) instead of the tax otherwise payable in connection with the corresponding stock option employment benefit. This special election is proposed to apply to all such securities sold before 2015, including sales in past years where a public company option deferral election has been made.

**Some employees found themselves in a situation where the ultimate proceeds of disposition of the acquired securities were insufficient to pay the tax on the stock option employment benefit.**

***Withholdings***

The Budget also purports to "clarify" the rules surrounding an employer's obligation to withhold and remit amounts in connection with the exercise of options to acquire securities that are not shares of a Canadian-controlled private corporation by amending the withholding rules to require employers to make withholdings from employees' remuneration on the hypothetical basis that the corresponding employment benefit (reduced where capital gains rates apply) has been paid as a cash bonus to the employee. The proposals provide no guidance as to where employers could source any such hypothetical cash to the extent that an employee's regular salary is insufficient to fund such withholding obligations, but provide that the Minister of National Revenue will not be entitled to consider the fact that the benefit arose from the acquisition of securities as a basis to discretionarily reduce withholdings. This could lead to particularly harsh results in circumstances where there is no public market for the securities (unless they are shares of a Canadian-controlled private corporation) that are subject to employee options. Stock option agreements may need to be amended to provide funding arrangements for such withholding.

These newly "clarified" withholding proposals are to take effect beginning in 2011.

### Non-resident Taxation

***Taxable Canadian Property***

One of the major impediments to attracting cross-border venture capital and private equity investment in Canada has been the taxation of gains on such investments and the invasive compliance burden imposed by the section 116 filing and withholding regime under the Tax Act. The section 116 process has become increasingly time-consuming, with the result that sellers frequently have 25 percent of their proceeds tied up in escrow for months, even when no tax is owed. While some changes to section 116 were announced in 2008, it is widely believed that those changes were defective, as they did not absolve a non-withholding purchaser of liability if the non-resident seller was ultimately found to be taxable on any gain from the sale.

The source of the problem is the very broad definition of "taxable Canadian property" (TCP) in the Tax Act. Unlike most OECD countries, Canada's domestic rules generally taxed non-residents on gains from sales of any non-listed shares. However, most Canadian tax treaties then exempted such gains from tax provided the shares were not a real property interest. It was frequently the case that selling shareholders would be entitled to treaty relief, but the process of proving that entitlement required disclosure of significant information regarding the identity and treaty status of the seller. This would lead to time-consuming and burdensome withholding and compliance obligations in situations where there was almost always no tax actually payable. Typically, private equity funds investing in Canada, particularly those having non-treaty country participants, would establish "blocker" entities in third countries to address the Canadian taxation of gains and to simplify the compliance burden.

The Budget introduces a welcome and long advocated change to this regime by dramatically narrowing the TCP definition. As a result, the time-consuming and invasive section 116 procedure will now apply only in a very narrow range of cases. Essentially, TCP will now consist only of:

- Canadian real property (including resource property);
- property used in a Canadian business;
- designated insurance property of insurers; and

*Budget Tax Measures,* continued on page 17

## Budget Tax Measures *(from page 16)*

- shares (or interests in trusts or partnerships) that are real property interests.

Options to acquire such types of property will also be TCP.

A share or other investment will generally be a real property interest at a point where, at that point in time, or at any time in the preceding 60 months, more than 50 percent of its fair market value was derived from Canadian real property. The five-year lookback is significant, and will require some diligence to verify in many M&A contexts.

This change should dramatically simplify many venture capital and private equity investments into Canada, by eliminating the need for "blocker" entities in many situations. There will, of course, be a need for buyers to satisfy themselves that the shares they are buying did not derive more than 50 percent of their value from real property in the preceding 60 months. Unfortunately, the Budget does not suggest that there will be a due diligence defense for a buyer who wrongly concludes that shares are not a real property interest. It is hoped that the legislation will provide some protection for buyers who reasonably rely on representations made to them by sellers regarding the status of shares as non-real property interests.

The Budget also proposes to amend a number of provisions in the Tax Act that deem shares received as consideration for the disposition of TCP to themselves be TCP from applying indefinitely to applying for a 60-month period following which the amended rules previously described would apply.

These rules apply to the determination of whether a property is TCP after March 4, 2010.

*Refunds of Withheld Amounts*

The Budget proposes a measure to counteract an anomaly affecting non-residents in respect of whom withholdings under Regulation 105 or under section 116 have been enforced as against the payor. Such assessments can occur outside the time within which the non-resident is entitled to file a tax return to claim a refund of such amounts. The Budget proposes to permit the Minister of National Revenue to refund an overpayment of tax withheld under Regulation 105 or section 116 if the application for such refund is made after March 4, 2010 and within two years after the date of the assessment.

**Foreign Investment Entity and Non-Resident Trust Rules**

There are three regimes in Canada that are designed to prevent the use of investments in foreign corporations or funds to avoid or defer Canadian tax. In general terms:

- The "foreign accrual property income" (FAPI) regime applies to require current taxation in Canada of passive income earned in a controlled foreign affiliate.
- The non-resident trust (NRT) rules apply to interests in non-resident trusts that have a direct or indirect Canadian beneficiary where the trust has directly or indirectly acquired property from a Canadian person that was related or was the uncle, aunt, nephew or niece of the Canadian beneficiary; where the non-resident trust is non-discretionary, the NRT rules apply a modified FAPI regime to certain beneficiaries of the trust and where the non-resident trust is discretionary, the trust itself is deemed resident in Canada and subject to Canadian tax on FAPI-type income.
- The offshore investment fund (OIF) rules apply a deemed income accrual regime to investments in non-controlled entities (corporations, partnerships, funds or trusts other than non-resident trusts) that derive their value primarily from portfolio investments where it may reasonably be considered that one of the main reasons for making the investment is to defer or avoid current tax in Canada.

**The five-year lookback is significant, and will require some diligence to verify in many M&A contexts.**

In 1999, the Minister of Finance announced proposed changes to tighten up the NRT provisions and replace the OIF regime with the foreign investment entity (FIE) rules. These proposed changes have been postponed and revised several times in response to criticisms that they were too complex, too broad, and impossible to administer. In the 2009 federal budget, the Minister of Finance announced that the Department of Finance would be reconsidering the proposed changes in response to the continuing criticisms.

*Foreign Investment Entities*

The Budget proposes to abandon the proposed changes to the FIE rules and to revert to the existing rules. This is a welcome announcement. The only change is to increase the prescribed rate of interest at which income on the FIE investment is deemed to accrue to the Canadian investor for Canadian tax purposes.

This measure is proposed to be effective for taxation years that end after March 4, 2010. Special measures apply to taxpayers who voluntarily filed their returns under the old proposed FIE rules.

*Budget Tax Measures*, continued on page 18

## Budget Tax Measures *(from page 17)*

***Non-Resident Trusts***

In the Budget, the Minister of Finance proposed to proceed with the basic format of the existing proposed NRT rules, but with some significant changes.

A major criticism of the proposed NRT rules is that they applied to legitimate investments in foreign commercial trusts. In order to address this concern, it is proposed that the exemption for commercial trusts would be simplified and expanded. The Budget also proposes a specific exemption for all tax exempt entities—including pension funds, Crown corporations and registered charities.

There are also proposed changes to the method of taxation of non-resident trusts and their beneficiaries that are caught by the rules. Under the previously proposed NRT rules, the non-resident trust is subject to Canadian tax on all of its income, regardless of who contributed the property from which the income was derived or the source of the income, with each Canadian resident contributor and Canadian resident beneficiary of the trust jointly and severally liable (with the non-resident trust) for the Canadian tax liability of the trust. Under the revised proposals, income from property acquired by the trust from Canadian resident contributors (and substituted property) (Resident Portion) will be attributed back to the Canadian contributors. Income not arising from the Resident Portion, other than Canadian-source income in respect of which non-residents are normally subject to Canadian tax, will be excluded from the trust's income. It is expected that the non-resident trust will ordinarily pay Canadian tax only on income derived from contributions from certain former Canadian resident contributors. In addition, as under the current proposals, there could be Canadian non-resident withholding tax on distributions from the non-resident trust to its non-resident beneficiaries, but this is intended to be only where the distributions are out of the Resident Portion.

**The "foreign accrual property income" regime applies to require current taxation in Canada of passive income earned in a controlled foreign affiliate.**

It appears that, if a non-resident trust is not caught by the revised NRT rules—i.e., in the case of exempt commercial trusts—the interest may be caught by the existing rules which apply a modified FAPI regime where the fair market value of the Canadian beneficiary's interest is equal to or exceeds 10 percent of the value of all interests in a non-resident trust. It is proposed that the modified FAPI rule will be broadened to apply to any resident beneficiary who, together with any non-arm's-length person, holds 10 percent or more of any class of interests in a non-resident trust.

The measures regarding non-resident trusts are generally proposed to apply for the 2007 and subsequent taxation years, except that attribution to Canadian resident contributors will apply only to taxation years ending after March 4, 2010. An election will be available to allow a trust to be deemed resident in Canada for the 2001 and following taxation years.

***Non-Resident Reporting***

In order to ensure that the CRA has the information to identify Canadian taxpayers that have invested in NRTs and FIEs, the Budget proposes to expand the foreign property reporting requirements in the Tax Act. It is also proposed to extend the reassessment period for interests in NRTs and FIEs by a further three years.

These proposed changes to the NRT and FIE proposals are a vast improvement over the old proposals. Our experience with the old proposals has told us, however, that the devil is in the details. The Budget proposals are given for public consultation with a view to developing revised legislation which will also be released for comment. Public comments are requested before May 4, 2010. The Budget announced that a panel consisting of respected tax practitioners will be formed to work with the Department of Finance in reviewing any issues identified in the comments received and in making recommendations on the design of the draft legislation.

### "Aggressive" Tax Planning

The Budget contains four initiatives purporting to target "aggressive" tax arrangements.

***SIFT Conversions and Loss Trading***

The Budget delivered the anticipated reaction to January media reports concerning the number of income trusts that were considering utilizing corporations with large tax losses in their conversion plans: the proposal of a rule similar to an existing rule—which deems an acquisition of control to occur on certain reverse take-overs of a corporation by another corporation—to deem control of a corporation to be acquired where its shares are exchanged for units of a SIFT trust or SIFT partnership. A companion rule is also proposed to prevent the acquisition of control of a corporation that is a subsidiary controlled by a SIFT trust solely because of the distribution of its shares to a SIFT wind-up corporation on a SIFT trust wind-up event.

The new rules apply to transactions undertaken after 4 p.m. EST March 4, 2010, other than transactions that the parties are required to complete under the terms of a written agreement entered into before that time. Where such agreements permit a party to abort the transaction

*Budget Tax Measures,* continued on page 19

## Budget Tax Measures *(from page 18)*

due to a change in the Tax Act, the new rules will also apply to the transaction.

***Foreign Tax Credit Generators***

The government has, for some time, indicated its concerns with Canadian corporations that have entered into transactions that have come to be known as "foreign tax credit generators." These transactions make use of the rules that allow a Canadian taxpayer to obtain a credit against Canadian tax for foreign taxes paid by the taxpayer. Although there are a number of variations, the structures have generally involved the Canadian taxpayer becoming a partner in a foreign partnership with a non-resident and claiming credits against Canadian tax for foreign taxes paid in respect of the partnership's activities. Another alternative involves a jointly owned foreign affiliate of the taxpayer that earns "foreign accrual property income" and obtains relief against the Canadian taxation thereof through the "foreign accrual tax" and "underlying foreign tax" mechanisms. The government believes that these transactions are structured to provide a Canadian taxpayer with credit for foreign taxes paid far in excess of the Canadian taxpayer's entitlement to profits or gains from the relevant structure. The CRA is in the process of challenging certain corporations that have entered into these types of transactions including through the application of the general anti-avoidance rule (GAAR).

The Budget proposes new rules affecting the foreign tax credit provisions applicable to Canadian taxpayers and the foreign accrual tax and underlying foreign tax mechanisms relevant to foreign affiliates of Canadian taxpayers. The purpose of these proposed changes is to limit the availability of relief for foreign taxes to the taxpayer's direct or indirect economic interest in the foreign vehicle, the activities of which have given rise to the foreign taxes paid. The proposal is to be effective for foreign taxes incurred in respect of taxation years ending after March 4, 2010, although the Budget papers indicate that the government will be accepting comments on the finalization of the legislation and encourages stakeholders to submit any such comments before May 4, 2010.

***Tax Avoidance Transaction Reporting***

The Budget announced a "public consultation" process on its proposal to implement a reporting regime to identify "avoidance transactions" which bear a high risk of constituting tax abuse, similar to the recently proposed "aggressive tax planning regime" in Quebec.

The proposals would require a taxpayer to report any tax avoidance transaction where two of the following three characteristics are present: (1) the promoter/tax advisor is entitled to fees that are attributable to the amount of the tax benefit, contingent upon obtaining the tax benefit or attributable to the number of taxpayers who participate in the transaction; (2) the promoter/tax advisor requires "confidential protection" about the transaction; and (3) the taxpayer (or a person who entered into the transaction for the benefit of the taxpayer) obtains "contractual protection" in respect of the transaction (other than a fee arrangement described in (1)).

According to the Budget papers, those characteristics (referred to as "hallmarks") are not themselves considered to be evidence of abuse, but their presence indicates a higher risk of abuse. For those taxpayers who fail to report such transactions, the Budget proposes to deny the tax benefit resulting from the transaction, which benefit could still be claimed if the taxpayer was prepared to pay penalties and supply any information required by the CRA. Such a taxpayer is still subject to regular audit and challenge by the CRA.

The proposals, although presented as "for consultation" are, as modified to take account of the consultations, proposed to apply to transactions entered into after 2010 *as well as transactions that are part of a series of transactions completed after 2010*.

**The Budget proposes to expand the foreign property reporting requirements in the Tax Act.**

While consultations are planned, it is suggested that the introduction of such a regime raises difficult questions regarding matters such as solicitor-client privilege.

***Specified Leasing Property Rules***

In recent years, some leasing companies and other financial institutions have carried out complex leveraged leasing transactions using certain types of property that are exempt from the "specified leasing property" rules. This has enabled the lessors to claim tax depreciation on the leased assets to shelter other income, including non-leasing income. An example of this is the transaction that was unsuccessfully attacked by CRA in the *Canada Trustco* case, which is one of the leading cases on the GAAR. One of the features of these structures is that they involve a lease of the exempt property to a non-resident or tax exempt lessee.

In order to curtail these types of arrangements, the Budget proposes to extend the application of the specified leasing property rules to otherwise exempt property that is subject to a lease to a government or other tax-exempt entity, or to a non-resident, unless the total value of the property that is subject to the lease is less than C$1-million. The Budget proposes to institute an anti-avoidance provision

*Budget Tax Measures*, continued on page 20

## Budget Tax Measures *(from page 19)*

to prevent the artificial division of property into leases to defeat the C$1-million threshold. These proposals apply to leases entered into after 4 p.m. EST March 4, 2010.

While this measure will curtail the use of the sophisticated tax planning structures that were successful in *Canada Trustco*, they could conceivably affect the taxation of regular leasing transactions involving exempt property. The *Canada Trustco* case involved the lease of trailers with a total value of C$120-million, but it is unclear whether any individual trailer was valued at more than C$1-million. If the effect of the proposed change is to catch a single "lease" of multiple items of equipment which have a total value of over C$1-million but an individual value of under C$1-million, it would appear that regular lease financing of exempt property to government institutions could be caught in some cases.

**The Budget contains four initiatives purporting to target "aggressive" tax arrangements.**

### Mineral Exploration

The temporary mineral exploration tax credit, the availability of which was extended in the 2009 budget, will be extended again. Thus, a 15 percent tax credit will be available for qualifying expenditures renounced under flow-through share agreements entered into on or before March 31, 2011.

### Consolidated Tax Returns

The Budget also indicated that the government will explore whether new rules for taxation of corporate groups, such as the introduction of a formal system of loss transfers or consolidated reporting, could improve the functioning of the tax system. While this would be a welcome and overdue change, as Canada is one of very few developed countries with no tax consolidation or group relief regime, such proposals have been considered in the past and have not been pursued in some measure due to provincial income tax issues.

### Previously Announced Measures

The Budget confirms the government's intention to proceed with a number of previously announced tax measures, as modified to take into account consultations and deliberations since their announcement, including:

- technical amendments to the foreign affiliate rules released in draft form on December 14, 2009 and the remaining measures released in draft in 2004 relating to foreign affiliates;
- improvements to the application of the GST/HST to the financial services sector released on September 23, 2009; and
- technical legislative proposals addressing recent court decisions on the GST/HST and financial services, announced on December 14, 2009.

The proposed GST/HST amendments exclude certain "credit management" services (e.g., evaluating or authorizing credit) and "preparatory" services (e.g., market research, document preparation, promotional services) from the definition of a financial service. The scope of these exclusions is unclear, but could fundamentally impact the financial services sector. All suppliers of financial services will need to review the GST/HST treatment of their services in light of these draft amendments.

Notably absent from the list are previously-announced changes to the rules regarding deductibility of interest and the promised introduction of a tax-deferred rollover for share exchanges involving a foreign corporation and Canadian corporation.

© 2010 Blake, Cassels & Graydon LLP ❑