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AVOIDING DOUBLE TAXATION AFTER THE US REGULATIONS

— *Max Reed and Charmaine Ko*[1]

On August 1, the United States Internal Revenue Service (the "IRS") released 250 pages of explanations and proposed regulations (the "Proposed Regulations")[2] related to the transition tax that is found under Code section 965 of the Internal Revenue Code (the "Code").[3] The most important part of these regulations relate to how US citizens in Canada, that are subject to the transition tax under Code section 965, can use taxes paid to Canada to minimize their double tax exposure. The take away points of this article are:

- The regulations do not affect the use of foreign tax credit carryforwards to use prior tax to offset US tax paid;
- There are a couple of strategies that should be considered to maximize the foreign tax credits in light of the proposed regulations:
  - Using the Canada-US Tax Treaty[4] to claim a full foreign tax credit; and/or
  - Generating Canadian tax by way of increasing the paid-up capital ("PUC") of the US shareholder's shares.

Both strategies have some risk to them. First, though, it makes sense to start with an outline of the risk posed by section 965.

Note that this article is written in an argumentative fashion, meaning that it makes the case for both strategies. It does not necessarily explore all nuances of either strategy. It is not a substitute for formal advice and any US citizen in Canada subject to Code section 965 should consult a tax advisor.

Background on Section 965

Put simply, Code section 965 poses a significant double taxation risk for US citizens in Canada because of a potential timing mismatch. Many US shareholders of Canadian corporations owe US tax in 2017 thanks to Code section 965. However, these same shareholders will again be subject to Canadian tax when the profits of their Canadian corporation are distributed to them as dividends. Unfortunately, at that time, Canada would not be obligated to provide a foreign tax credit for Code section 965 tax already

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[2] Prop. Treas. Reg. § 1.965-5, 83 Fed. Reg. 39514 [Prop. Reg. § 1.965-5].

[3] 26 USC § 965 (2017).

[4] *Convention Between Canada and the United States of America with Respect to Taxes on Income and Capital*, 26 September 1981, Tax Treaties (CCH) [Canada-US Tax Treaty].

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paid to the US, as it was US tax imposed on Canadian-sourced income. Left unaddressed, the double tax risk would be significant. This is not news.

Previously, we recommended that extra tax be generated in Canada to mitigate the double tax exposure, either through a distribution in 2017, or one in 2018 and the excess tax carried back against the 2017 US tax liability. For lack of a better term, we refer to this as an "Equalization Dividend". Our view was (and remains) that the Canadian tax (whether generated in 2017 or 2018) provides a dollar for dollar credit against the Code section 965 tax. Or, to put it in more technical terms, this foreign tax credit was not subject to the "grind down" in Code section 965(g).[5] Our view is rooted in the text of the statute and the legislative history.[6]

The IRS' View in the Proposed Regulations

The Treasury Department ("Treasury") has taken a different view in the Proposed Regulations. The Proposed Regulations indicate that foreign taxes generated on a distribution of earnings and profits subject to the 965 inclusion would be subject to the Code section 965(g) grind down. That would reduce the Canadian tax available for the foreign tax credit by 55.7% on the cash portion and 77.1% on the non-cash portion.[7] Specifically, Prop. Reg. 1.965-5(b), which interprets Code section 965(g), reads:

> Rules for foreign income taxes paid or accrued. [. . .] **Similarly, no deduction or credit is allowed for the applicable percentage of net basis taxes imposed on a United States citizen by the citizen's jurisdiction of residence upon receipt of a distribution of section 965(a) previously taxed earnings and profits or section 965(b) previously taxed earnings and profits.**[8] [emphasis added]

From its plain meaning, it does not restrict the use of foreign tax credit carryforwards from prior years. Prop. Reg. 1.965-5(b) only applies the grind down to distributions of previously taxed income under Code section 965.

Still, to put it lightly, the proposed regulation is problematic for a US citizen in Canada who is trying to avoid double tax. There are, however, a few potential planning strategies to maximize the value of the credit and avoid the grind down.

The Canada-US Tax Treaty Provides a Full Foreign Tax Credit

The first strategy is to take the position that the Canada-US Tax Treaty provides a full credit. While this position is more complex, there is an outline of it in brief below. Since it is directly contrary to an IRS proposed regulation, this position obviously has some risk to it and may need to be disclosed. But as is noted below, the very purpose of the Canada-US Tax Treaty is to minimize double taxation.[9]

To start out, income from the Code section 965 inclusion is generally foreign source income under the Code. The Equalization Dividend is also foreign source income. Although not a dividend under Code section 959 since it is previously-taxed income ("PTI") for US tax purposes, the Equalization Dividend would qualify as a dividend under Treaty Article X(3).[10] That means that under Treaty Article XXIV it is Canadian-source income.[11] Obviously, Canadian tax paid on the Equalization Dividend is foreign tax. The application of the grind down to the Equalization Dividend causes double taxation in two different ways.

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[5] 26 USC § 965(g) (2017).

[6] See https://skltax.com/grind-foreign-tax-credits-code-section-965-inclusion/ for an outline of this position.

[7] 26 USC § 965 (g)(i)(ii)(2017).

[8] Prop. Reg. § 1.965-5(b), *supra* note 2.

[9] Canada-US Tax Treaty, *supra* note 4, at preamble ("Canada and the United States of America, desiring to conclude a Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital. . .").

[10] *Ibid* at Art. X(3) ("The term "dividends" as used in this Article means income from shares or other rights, not being debt-claims, participating in profits, as well as income subjected to the same taxation treatment as income from shares by the taxation laws of the State of which the company making the distribution is a resident").

[11] *Ibid* at Art. XXIV (Elimination of double taxation).

First, it limits the full utilization of the Canadian tax paid as a US credit, thereby causing a US citizen in Canada to ultimately pay tax to both the US and Canada on Canadian source income, in situations where the Canadian tax paid is equal to or may even exceed the US tax owing on the Canadian source income. For instance, if the Canadian company had $100 of earnings subject to the transition tax under Code section 965, the US citizen in Canada would have a US tax liability of $17.54 (assuming the 15.5% rate applied to the entire $100). If the grind down did not apply to the tax paid on an actual distribution, the Canadian company would only have to distribute $43.85 (assuming a 40% tax rate in Canada). The rule under Prop. Reg. 1.965-5(b), however, requires the US citizen to pay tax to Canada which substantially exceeds the US tax liability in order to fully offset the US tax liability on the Canadian source income by way of a foreign tax credit. That is, the Canadian company would have to distribute $98.98 and pay $39.60 in Canadian tax to have a sufficient amount of foreign taxes to carryback and fully offset the US tax liability of $17.54.

Second, future distributions beyond 2018 that are subject to Canadian tax cannot be used to offset any US tax paid on the section 965 inclusion in 2017. That's because the US foreign tax credit carryback is limited to one year.[12] There are a number of arguments as to why the Canada-US Tax Treaty should provide a full credit despite Prop Reg. 1.965-5(b).

A. The General Principles of Treaty Interpretation

The resolution of an alleged conflict between domestic law and a treaty in the US relies on the principles of treaty interpretation developed by the US Supreme Court.[13] The US Constitution plays a central role in US tax law and treaty interpretation.[14] The US Constitution's supremacy clause provides that federal statutes and treaties "shall be the supreme law of the land".[15] Therefore, domestic tax statutes and tax treaties are considered to be equal and on the 'same footing'.[16]

Long-established case law holds that where possible, the Code and the Treaty should be read harmoniously to give effect to both.[17] Where there is no conflict, the last-in-time rule is inapplicable.[18] Generally, a conflict occurs where the Code overrides the Treaty. These overrides are possible. However, the Supreme Court has held that such overrides must be explicit[19] and that legislative silence does not constitute an override.[20] Consistent with this rule, such overrides elsewhere in the Code are explicit. Consider for example:

- Code section 7874(f) which specifically overrides treaty obligations in the case of inversions.
- Code section 884(e) which clearly overrides treaties with respect to the Branch Profits Tax.
- Code section 894(c) which denies treaty benefits to certain hybrid entities.
- The limitations on the foreign tax credit with respect to the AMT under former section 59(a).[21]

[12] 26 USC § 904(c).

[13] Juan Angel Becerra, *Interpretation and Application of Tax Treaties in North America* (Amsterdam: IBDF, 2013) at 165 [Bacerra].

[14] *Ibid* ("The interpretation of treaties is a question of law in the United States").

[15] See US Const Art. VI, § 2, cl 2.; Robert R. Olivia "Conflicts Between US Tax Treaties and Tax Statutes" (1994) 44:5 *Canadian Tax Journal* 1314 at 1315 [Olivia].

[16] See *Ibid* at 1315; *Whitney v Robertson*, 124 US 190 at 194 (1888) [*Whitney v Robertson*].

[17] See *Whitney v Robertson*, *supra* note 15 at 194; *Pekar v Commissioner*, 113 T.C. 158, at 161 (1999) ("the Code and the treaty should be read harmoniously, to give effect to each."); *Pigeon River Improvement, Slide & Broom Co. v Charles W. Cox, Ltd.*, 291 US 138 at 160-61 (1934) ("But the intention to abrogate or modify a treaty is not to be lightly imputed to the Congress").

[18] See *Chae Chan Ping v United States*, 130 US 581 at 600 (1889); *Whitney v Robertson*, *supra* note 15 at 195.

[19] *Cook v United States*, 288 US 102 at 120 (1933) ("A treaty will not be deemed to have been abrogated or modified by a later statute unless such purpose on the part of Congress has been clearly expressed").

[20] *Roeder v Islamic Republic of Iran*, 195 F Supp (2d) 140 at 175 (D.C. 2002) ("The Supreme Court has unequivocally held that legislative silence is not sufficient to abrogate a treaty or a bilateral executive international agreement. When a later statute conflicts with an earlier agreement, and Congress has neither mentioned the agreement in the text of the statute nor in the legislative history of the statute, the Supreme Court has conclusively held that it cannot find the requisite Congressional intent to abrogate. (quoting *Trans World Airlines, Inc. v Franklin Mint Corp.*, 466 US 243 at 252 (1984)) (citations omitted).").

[21] This section has been addressed in a long line of cases. Section 59(a) explicitly overrode the United States treaty obligations. Thus, it is easily distinguished from section 965(g).

This is important given that both section 965 and the legislative history thereof are silent on the provision's interaction with the Treaty.[22] Therefore, section 965 does not reflect an explicit override of the Treaty as found elsewhere in the Code. This conclusion is supported by the principles of statute and treaty interpretation. Generally, statute and treaty interpretation begin with a close reading of the text.[23] The plain or ordinary meaning of the words generally controls the interpretation unless the result is inconsistent or ambiguous.[24] Notably, "there is [. . .] a firm and obviously sound canon of construction against finding implicit repeal of a treaty in ambiguous congressional action."[25] The Supreme Court has "many times set its face against treaty interpretations that unduly restrict rights a treaty is adopted to protect."[26] The language of section 965 does not provide for an explicit Treaty override. The Supreme Court case law supports a liberal interpretation of treaties that aims to "give effect to the purpose which animates [the treaty]."[27]

The purpose of the Treaty is to eliminate double taxation, and this is clearly stated in the preamble and Article XXIV.[28]

B. There Is a Credit Available Under Article XXIV(4)(b)

The first route to a credit is under Article XXIV(4)(b). The text of Article XXIV(4) reads in full:

> Where a United States citizen is a resident of Canada, the following rules shall apply:
>
> (a) Canada shall allow a deduction from the Canadian tax in respect of income tax paid or accrued to the United States in respect of profits, income or gains which arise (within the meaning of paragraph 3) in the United States, except that such deduction need not exceed the amount of the tax that would be paid to the United States if the resident were not a United States citizen; and
>
> (b) for the purposes of computing the United States tax, the United States shall allow as a credit against United States tax the income tax paid or accrued to Canada after the deduction referred to in subparagraph (a). The credit so allowed shall not reduce that portion of the United States tax that is deductible from Canadian tax in accordance with subparagraph (a).[29]

While paragraph 4(a) refers only to Canadian FTCs on US source income, paragraph 4(b) is broader. It generally mandates that a US citizen in Canada gets a foreign tax credit against US tax for tax paid to Canada after the application of paragraph 4(a). If the value of the credit in paragraph 4(a) is zero, then the credit in paragraph 4(b) is not limited. There is no limitation in paragraph 4(b) to US source income. It applies regardless. The Technical Explanation to the 1980 treaty confirms this:

> The rules of paragraph 1 are modified in certain respects by rules in paragraphs 4 and 5 for income derived by United States citizens who are residents of Canada. Paragraph 4 provides two steps for the elimination of double taxation in such a case. [. . .]
>
> The second step, as provided in paragraph 4(b), is that the United States allows as a credit against United States tax, subject to the rules of paragraph 1, the income tax paid or accrued to Canada after the Canadian

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[22] See Guidance Regarding the Transition Tax Under Section 965 and Related Provisions; Proposed Rule, 83 Fed. Reg. 39514, Background (outlining the proposed regulations under § 965 and making no mention of any US treaty or convention); An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, Pub.L. No. 115-97, 131 Stat. 2195, at Section 14103 (amending § 965 and making no mention of any US treaty or convention).

[23] *Air France v Saks*, 470 US 392 at 396-7 (1985) ("The analysis must begin, however, with the text of the treaty and the context in which the written words are 'used'"). See also *Maximov v United States*, 373 US 49 at 54 (1963) ("Moreover, it is particularly inappropriate for a court to sanction a deviation from the clear import of a solemn treaty between this Nation and a foreign sovereign, when, as here, there is no indication that application of the words of the treaty according to their obvious meaning effects a result inconsistent with the intent or expectations of its signatories") and *Medellin v Texas*, 552 US 491 at 506 (2008) ("The interpretation of a treaty, like the interpretation of a statute, begins with its text").

[24] *U.S. v Stuart*, 489 US 353 at 365 (1989) [*U.S. v Stuart*]. ("The clear import of treaty language controls unless application of the words of the treaty according to their obvious meaning effects a result inconsistent with the intent or expectations of its signatories." Citing other US Supreme Court cases.)

[25] *Trans World Airlines, Inc. v Franklin Mint Corp.*, 466 US 243 at 252 (1984).

[26] *Kolovrat v Oregon*, 366 U.S. 187 at 193-194 (1961); see also Becerra, *supra* note 13 at 166.

[27] *U.S. v Stuart*, *supra* note 22.

[28] Canada-US Tax Treaty, *supra* note 4 at preamble and Art. XXIV.

[29] *Ibid* at art XXIV(4).

credit for U.S. tax provided by paragraph 4(a). The credit so allowed by the United States is not to reduce the portion of the United States tax that is creditable against Canadian tax in accordance with paragraph 4(a).[30]

As an aside, the importation of the principles of Article XXIV(1) into XXIV(4) goes beyond the scope of the text of XXIV(4). This is odd, but one cannot read into the text of Article XXIV(4) a limitation which is not present in the text itself. Taken on its face, the technical commentary indicates that the credit under XXIV(4)(b) applies to more than just US source income.

Regardless, the examples in the technical explanation demonstrate that the US must provide a credit for Canadian tax on Canadian-source income, but after the Canadian credit on US-source income. If the Canadian credit on US-source income would be zero, then the US would be obligated to provide a full credit for tax paid to Canada by a US citizen resident in Canada. That is the case under Code section 965 and the Equalization Dividend. This is one reason why the Treaty grants the full credit. The other is found under paragraph XXIV(1).

C. There is a credit available under Article XXIV(1)

Another, not mutually exclusive, route to the same result is under Article XXIV(1). The express text of Article XXIV(1) provides a US citizen with a credit against US tax for Canadian tax paid to prevent double taxation.[31] If not for the Proposed Regulations (and perhaps the text of Code section 965(g)), a Canadian-resident US citizen would get a full credit against the US tax owing under Code section 965 for the Canadian tax generated by the Equalization Dividend.

The primary limitation in Treaty Article XXIV(1) is "subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof)."[32]

On a reading of the text of Article XXIV(1) itself, the scope of this limitation is constrained significantly in two ways. First, US domestic law can certainly limit the Treaty credit, but it has to be done in a way that does not change the general principle that there is a credit available. It is clear, and the technical commentary to the 1980 version of the Treaty supports this, that the domestic law limitation language refers to the general foreign tax credit limitations (such as the baskets found under section 904) found under the Code.

Second, the US domestic law limitation is also restricted in its scope by the presence of paragraphs XXIV(4) and XXIV(5).[33] The text of Article XXIV(1) indicates that the entire article (including the domestic law limitation portion) is "subject to the provisions of paragraphs 4, 5, and 6."[34] This reading is supported by two authoritative sources. First, the 1980 Treaty Technical commentary reads: "The rules of paragraph 1 are modified in certain respects by rules in paragraphs 4 and 5 for income derived by United States citizens who are residents of Canada."[35] Second, the DC Circuit stated indirectly in distinguishing the Canada-US Tax Treaty from the US-German Tax Treaty, "The U.S.-Canada Treaty provision we examined contained a clause subjecting its tax credit to limitations of U.S. law, but it also explicitly conditioned the tax credit and arguably the limitation itself on subsequent paragraphs of the treaty."[36] As noted above, the plain meaning of paragraph XXIV(4) is to provide a credit to Canadian-resident US citizens for tax paid to Canada — full stop. These restrictions on the scope of the US domestic law limitation support the view that Article XXIV would provide a credit.

Even under a broader reading of the limitation, our view is that there is an argument that the Proposed Regulations do not properly limit the Treaty credit under Code section 965. The text of the treaty is where the interpretive analysis

[30] Treasury Department Technical Explanation of the Convention between the United States of America and Canada with Respect to Taxes on Income and on Capital signed at Washington, D.C. on September 26, 1980, as amended by the Protocol signed at Ottawa on June 14, 1983 and the Protocol signed at Washington on March 28, 1984., https://www.irs.gov/pub/irs-trty/canatech.pdf [hereinafter, "Technical Explanation"].

[31] Canada-US Tax Treaty, *supra* note 4 at Art. XXIV(1) ("[. . .] the United States shall allow to a citizen or resident of the United States, or to a company electing to be treated as a domestic corporation, as a credit against the United States tax on income the appropriate amount of income tax paid or accrued to Canada").

[32] *Ibid*.

[33] *Ibid* at Art. XXIV(4) & (5).

[34] *Ibid* at Art. XXIV(1).

[35] Technical Explanation, *supra* note 28 at Art. XXIV example 6.

[36] *Haver v Commissioner*, 444 F (3d) 656 at 659 (D.C. Cir. 2006).

begins and the plain or 'ordinary' meaning of the treaty controls the interpretation of the text.[37] The purpose of the Canada-US Tax Treaty is to avoid double taxation and prevent fiscal evasion with respect to taxes on income and on capital.[38] Relief from double taxation is achieved through the rules in Article XXIV. Given that there is no express override in Code section 965, the interpretive approach to a conflict between Code section 965 and Article XXIV of the Treaty should "give effect to the purpose which animates"[39] the treaty. This is because "[e]ven where a provision of a treaty fairly admits of two constructions, one restricting, the other enlarging, rights which may be claimed under it, the more liberal interpretation is to be preferred."[40] Lastly, the Court of Appeals for the Federal Circuit has stated that "if doubt exists as to the construction of a taxing statute, the doubt should be resolved in favor of the taxpayer."[41]

That means a few things:

- The limitation under US domestic law for Article XXIV(1) is narrow in scope.
- The preferred reading of Code section 965 and the Proposed Regulations is one that allows both to accomplish their objectives.
- Any limitation on the Treaty credit with respect to Code section 965 has to be explicit.
- If there are two competing interpretations, the one that grants more rights is to be preferred.

Taking these principles and applying them to Code section 965 and the Proposed Regulations, it is clear that there is no Treaty override. Both Code section 965 and the Proposed Regulations are silent with respect to their interaction with US tax treaties generally. In fact, the word "treaty" appears nowhere in the text of Code section 965, the Proposed Regulations, or the Conference Report explaining that section. Thus, it cannot be said that Code section 965 expressly overrides the Treaty, since it does not refer to the Treaty at all. That means that the Treaty and Code are not in conflict. Absent an express Treaty override, the Treaty and Code have to be read harmoniously to give effect to both. The only interpretation that harmonizes the Treaty and the Code and gives effect to the Treaty's plain meaning and purpose to prevent double taxation is to allow US citizens in Canada a full FTC for the Equalization Dividend.

The Code can bear a reading that the grind down does not apply to the equalization dividend and this is supportable both on its express text and the legislative history.[42] Obviously, the IRS has adopted a different interpretation in the Proposed Regulations, but our prior interpretation still finds support. As above, the plain text of the Treaty provides a US foreign tax credit for tax paid to Canada under XXIV(1) and XXIV(4)(b). The Treaty's purpose is to prevent double taxation. Since the Code can support a reading that the grind down does not apply to the Equalization Dividend, and the Treaty grants the full FTC, then overriding the Proposed Regulations with the Treaty can also be viewed as harmonious with the Code

Even admitting that the IRS' interpretation of section 965(g) under the Proposed Regulations is the only possible one, allowing the full FTC is still in harmony with the Treaty. It would just mean that while section 965(g) generally applies to reduce the FTC on the Equalization Dividend, a very narrow class of taxpayers (US citizens in Canada) are excluded because of a very specific and narrowly available Treaty benefit. Recall that the case law instructs that where two interpretations are offered, the one that liberally construes the Treaty and enlarges benefits is to be preferred.

In short, then, there is an argument that:

- The Equalization Dividend and associated foreign tax are Canadian source;
- Limiting the foreign tax credit poses a double tax risk;

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[37] *U.S. v Stuart*, *supra* note 22 at 365 ("The clear import of treaty language controls unless application of the words of the treaty according to their obvious meaning effects a result inconsistent with the intent or expectations of its signatories").

[38] Canada-US Tax Treaty, *supra* note 4 at preamble.

[39] *U.S. v Stuart*, *supra* note 22 at 368.

[40] *U.S. v Stuart*, *supra* note 22 at 368.

[41] *Xerox Corp. v United States*, 41 F (3d) 647 at 655-56 (Fed. Cir. 1994).

[42] See https://skltax.com/grind-foreign-tax-credits-code-section-965-inclusion/ for an outline of this position. Put briefly, the text of section 965(g) only applies to the deemed paid credit and not to the Equalization Dividend because the latter is not "with respect to any amount for which a deduction is allowed under this section". The legislative history and statutory context support this reading. Obviously, the IRS has taken a different interpretation in the Proposed Regulations.

- A credit should be available under the plain meaning of Article XXIV(4);
- Under normal circumstances, there would be eligibility for a full US foreign tax credit under Treaty Article XXIV(1);
- Treaty Article XXIV(1) is subject to the limitations of US domestic law;
- The text of Article XXIV(1) narrows the scope of how those limitations apply;
- In interpreting how those limitations apply, and more generally the interaction between the Treaty and the Code, the Treaty and Code need to be read harmoniously;
- The Code can limit the Treaty, but such a limitation has to be explicit;
- Code section 965 and the Proposed Regulations are silent as to the application of the Treaty;
- The only harmonious reading favours allowing the full FTC;
- Thus, there is no explicit override and the grind down does not apply to US citizens resident in Canada.

This position would likely require advising the client of the risk and disclosing the position to the IRS on Form 8833. Although we think this position is legally tenable, it is obviously not without risk. Using a Treaty to override an IRS regulation, even where the law is somewhat clear, is not for the faint of heart.

Generate the Canadian Tax by Way of Increasing the PUC

A second option is to adjust the way the Canadian tax is generated. As noted above, the Proposed Regulations apply the grind down to FTCs generated by the "receipt of a distribution of section 965(a) previously taxed earnings and profits." But what if the FTC were generated by something that was not a "distribution" for US tax purposes? Under Canadian tax law, it is possible to generate tax by increasing a corporation's paid-up capital ("PUC"). Under this approach, the corporation first increases its stated capital for corporate law purposes by the amount that it wishes to distribute. This increase to stated capital results in a corresponding increase to PUC for purposes of the *Income Tax Act* (Canada) ("ITA"). As a result, subsection 84(1) deems the corporation to have paid a dividend in an amount equal to the PUC increase.

The US tax system has no equivalent concept of PUC. Thus, from a US tax perspective there has been no contribution or distribution. The lack of a "distribution" would arguably avoid the grind down. Under Treas. Reg. 1.904-6(a)(1)(iv), where foreign tax is imposed on an item of income that does not constitute income for US tax purposes, that foreign tax paid is allocated to the general basket — the same basket to which the majority of the section 965 inclusion is likely to be allocated.

When a distribution is made in the future, it would constitute a return of capital for Canadian tax purposes with the appropriate corporate resolution. Pursuant to subsection 84(4) of the ITA, the distribution of property (including cash) on a return of capital by a corporation to a shareholder does not give rise to a dividend, so long as the amount of the capital return is less than or equal to the PUC of the shares on which the capital is being returned. To avoid problems, the return of capital stage should be delayed until the money is needed. Only the amount of cash needed to pay the tax should actually be withdrawn.

For US federal tax purposes, a later distribution would be PTI. The Canadian tax generated earlier would not be associated with the distribution of PTI. While the US step-transaction doctrine may be applicable, particularly if all the cash is taken out in the same year as the initial PUC bump or shortly thereafter, that risk is reduced if the distributions are delayed.

The exact corporate law mechanics of this approach will vary by province. Further, some attention would have to be paid to those taxpayers that have already declared a dividend in a prior year. But from a combined Canada/US tax perspective, it seemingly generates the necessary foreign tax to fully offset the section 965 inclusions without being subject to the grind down. Any US citizen in Canada who is considering this suggestion should certainly consult a tax advisor.

Conclusion

The Proposed Regulations present a significant obstacle to US citizens in Canada who want relief from the double tax risk posed by Code section 965. While the Proposed Regulations make this task more complex, our view is that it is still achievable under either the Treaty based argument or by way of an adjusted approach to generate the Canadian tax. If a taxpayer wants to be extra cautious, both approaches might be used together.

CURRENT ITEMS OF INTEREST

Upcoming Tax Changes To Improve Competitiveness

In recent months, Minister of Finance Bill Morneau has been hinting that the government is considering its response to the competitiveness issue created as a result of income tax changes in the United States. The Minister has already ruled out a cut to the corporate tax rate, but has provided examples such as enhancing capital cost allowance and interest deductibility. A recent article by Bloomberg drops a few more hints of what might be in store.[1] Bloomberg spoke with a government official who is familiar with the plans. The official said that the tax changes will be unveiled with the fall economic statement, which is expected in the coming weeks. The official again suggested that no broad reduction to the corporate tax rate should be expected, and commented that changes to capital cost allowance is one of the measures under consideration.

IRS Issues Proposed Regulations on Global Intangible Low-Taxed Income for US Shareholders

On September 13, 2018, the IRS issued proposed regulations concerning global intangible low-taxed income under section 951A of the Internal Revenue Code.

Government Announces EI Premiums Rate for 2019

The government announced that the EI premium rate for 2019 will be $1.62 per $100 of insurable earnings, which is a decrease of 4 cents from the 2018 rate.

Joint Committee Submits Comments Regarding Draft Legislation

On September 10, 2018, the Joint Committee on Taxation of the Canadian Bar Association and Chartered Professional Accountants of Canada submitted its comments regarding the draft legislative proposals dated July 27, 2018. The comments and recommendations relate specifically to the new reporting requirements for trusts, the at-risk rules for multi-tier partnerships, cross-border surplus stripping, and changes relating to the foreign affiliate rules.

Draft Legislative Proposals Regarding Political Activities of Charities

On September 14, 2018, the Department of Finance released draft legislative proposals to amend the *Income Tax Act* which relate to charitable activities of registered charities. In response to the recent *Canada Without Poverty* decision (2018 DTC 5088 (ONSC)), this draft legislation proposes to make amendments to the Act to the effect that:

- most references to political activities with respect to charities (including the 10% buffer for non-partisan political activities) will be removed;
- charities will continue to be prohibited from providing direct or indirect support of, or opposition to, a political party or candidate for public office; and
- it will be clarified that charitable organizations must be constituted and operated exclusively for charitable purposes.

As governed by common law, charities can continue to engage in political activities as long as the activities are incidental and ancillary to the fulfillment of their charitable purposes. If enacted, these proposed changes will apply

[1] https://www.bloomberg.com/news/articles/2018-09-12/canada-said-to-plan-competitiveness-boost-but-no-broad-tax-cut

retroactively to audits and objections that are currently suspended. Stakeholders can submit their written comments to the government by October 13, 2018.

Tax Relief for Livestock Producers

Agriculture and Agri-Food Canada has released its list of designated regions in which livestock producers are eligible for the livestock tax deferral provision in 2018. These regions have been affected by drought, flooding, or excess moisture. Livestock farmers in these regions can defer a portion of their proceeds from selling their breeding livestock in 2018 until 2019. This deduction is provided by subsection 80.3(1), and the prescribed regions will eventually be prescribed in Regulation 7305.01(1).

RECENT CASES

Whether a company was liable to repay a loan during a period after issuance of a section 224 Requirement to Pay

The Minister assessed Albert and Christine De Vries for tax under section 160 of the *Income Tax Act* (the "Act") in relation to dividends paid in 2010 by their wholly-owned company Imperial Pacific Gardens Inc. ("IPG"). Section 160 allows the Minister to recover tax from a non-arm's length transferee of property if the consideration is less than fair market value. IPG operated a greenhouse business that was originally financed by a loan from Paul Houweling. The greenhouse business would face challenges due to lack of access to water. A nearby pulp mill which Houweling had anticipated would provide water refused, despite having provided water to previous owners of the greenhouse property. "Water Litigation" ensued and Houweling would promise not to collect his loan until after the litigation was resolved. In 2004, the CRA reassessed Houweling for tax and issued IPG a section 224 requirement to pay ("RTP") for the amount he had loaned the business. Section 224 of the Act permits the interception of monies owed to tax debtors. IPG did not pay any amount to the Minister. IPG's liability turned on whether the loan was contingent on the resolution of the water litigation or not. Webb J had determined in an earlier related decision that the loans IPG owed to Houweling were demand loans and not contingent on the water litigation. The respondent, however, had not pleaded issue estoppel. His application under section 58 of the *Tax Court of Canada Rules* (General Procedure) for a determination of the question of issue estoppel was therefore dismissed.

Appeals allowed. Paris J determined that at the time the Minister issued the RTP, IPG and Houweling had made a binding contract modification to delay repayment of the amounts owing until the resolution of the water litigation. The modification was binding despite a lack of fresh consideration because the reasoning in *Rosas v. Toca*, 2018 BCCA 191, applied. As a matter of commercial efficiency, the legitimate expectations of parties with respect to contract modifications are upheld by courts absent duress, unconscionability, or other public policy concerns which would render an otherwise valid modification unenforceable. The respondent's counter-argument that enforcing a retroactive agreement was unfair was not convincing. Tax law is to be applied to the results of private law, and the agreement to modify was not retroactive as it predated the issuance of the RTP. As a result of these findings, there was no amount owing by IPG to Houweling during the relevant time and therefore no amount owing by IPG under section 224 as a result of its failure to make any payment to the Minister under the RTP.

¶50,033, *De Vries v. The Queen*, 2018 DTC 1119

Refund of withholding tax properly denied where payment properly characterized as a restrictive convenant

The corporate taxpayer, which was a non-resident of Canada, applied for a refund of $750,000 in taxes which had been withheld from a payment made to it by a Canadian resident. Such application was based on an argument that the corporation was entitled to a treaty exemption, as it was a resident of Luxembourg at the time of payment. The application was refused by the Minister on the basis that the payment was a restrictive covenant payment per section 56.4 of the *Income Tax Act* (the "Act"), which did not benefit from treaty relief, and the taxpayer appealed.

The appeal was dismissed. The Tax Court of Canada held that the issues for determination in the appeal were whether the payment made was properly characterized as a "restrictive covenant" under section 56.4 of the Act and whether

the disputed amount was properly withheld under paragraph 212(1)(*i*) of the Act. The definition of "restrictive covenant" set out in subsection 56.4(1) provides that such term includes an agreement entered into that affects or is intended to affect, in any way whatever, the acquisition or provision of property or services by the taxpayer. The Court reviewed the material facts of the transaction and concluded that the essential nature, character and substance of that transaction was a share sale by the appellant and other shareholders to a third party. The transaction included a Letter Agreement by which the appellant agreed to waive its veto right under a Unanimous Shareholders Agreement. The consideration paid under the Letter Agreement to the appellant was $3,000,000, and the taxes in dispute were withheld from that amount. The Court held that while the Letter Agreement was not a necessary precondition to the share sale transaction, it was required in order to settle a disagreement between the appellant and another shareholder. The Court concluded that, in that sense, it "affected" or was "intended to affect" the proposed disposition of shares, as set out in the definition of "restrictive covenant" in subsection 56.4(1). On that basis, the Tax Court found that it was a "restrictive covenant" as defined in the statute and as such was not eligible for treaty relief. Withholding taxes were properly withheld and remitted under section 212, and the appeal was therefore dismissed.

¶50,032, *Pangaea Holdings v. The Queen*, 2018 DTC 1113

Assessment for section 116 tax upheld where taxpayer not making necessary reasonable inquiries

The taxpayer, who was a resident of Canada, purchased, from a non-resident vendor, a condominium unit located in Toronto. The transaction was completed without the vendor having obtained a section 116 clearance certificate from the Minister or having deducted and remitted to the Minister withholding tax equal to 25% of the purchase price. The Minister issued an assessment under section 116, and the taxpayer appealed from that assessment.

The appeal was dismissed. The Tax Court of Canada held that the issue in the appeal was whether the purchaser, acting through his lawyer, had fulfilled the requirements of subsection 116(5)(*a*). That paragraph required a purchaser to withhold and remit 25% of the purchase price unless, after reasonable inquiry, he had no reason to believe that the vendor was not resident in Canada. The Minister's assessment was based on an assumption of fact that the appellant, in his role as purchaser, had, after making such reasonable enquiry, reason to believe that the vendor was not resident in Canada. The Tax Court of Canada noted that the vendor did not occupy the Toronto condominium, which was rented to a third party, that the vendor's address for service was in California, and that communications to the purchaser's lawyer indicated that all documents would be signed by the vendor in California. As well, the vendor's assertion that he was not a non-resident was made, not in a sworn affidavit, but in an unsworn declaration. The Court held that those facts constituted "red flags" which were suggestive of non-residency, notwithstanding the assertions of the vendor to the contrary. In the Court's view, it was obvious that "reasonable inquiry" entailed consideration of not just what was asked, but also of the responses received. The Court held that the failure of the purchaser's lawyer to pursue the inquiry with follow-up questions led to the conclusion that the actions taken did not constitute "reasonable inquiry", as required by section 116. Finally, the Court held, in the alternative, that for similar reasons the purchaser had "reason to believe that the [vendor] was not resident in Canada". The purchaser was obligated to withhold and remit 25% of the purchase price and had failed to do so. His appeal was therefore dismissed.

¶50,031, *Kau v. The Queen*, 2018 DTC 1112

Appeals from imposition of penalties for gross negligence allowed in part

The two appellants each had their return for the 2008 taxation year prepared by the same accountant, and the appellant Khaled's return for 2009 was prepared by the same person. Each such return contained false claims for business losses and the Minister reassessed, denying the business losses and imposing penalties for gross negligence under subsection 163(2). The taxpayers appealed from the imposition of those penalties.

The appeals were allowed in part. The Tax Court of Canada held that the imposition of penalties under section 163(2) required that a false statement be made in a return and that the taxpayer either have actual knowledge of the making of such false statement or that the false statement was made in circumstances amounting to gross negligence on the part of the taxpayer. While it was clear that false statements had been made on the taxpayers' returns, the Court rejected the Minister's position that the appellants had had actual knowledge of those false statements. The Court held, rather, that the question for determination was whether the appellants had been grossly negligent (which could include willful blindness) in relation to the making of those false statements. The Court reviewed the circumstances in which

the returns were prepared and filed and concluded that, with respect to the 2008 returns, the conduct of the appellants did not rise to the level of gross negligence. The imposition of penalties for gross negligence for that year was therefore not justified. With respect to the 2009 return of the appellant Khaled, however, the Court held that there were warning signs which should have alerted him to the need to make further inquiries. His failure to do so amounted to willful blindness amounting to gross negligence, for which penalties under subsection 163(2) were properly imposed.

¶50,030, *Mahdi and Lashin v. The Queen*, 2018 DTC 1111

INTERNATIONAL NEWS

Corporate Tax Rates Continue To Fall, Says OECD

This article originally appeared in Wolters Kluwer's Global Tax Weekly Issue 305.

Countries have used recent tax reforms to lower taxes on businesses and individuals, with a view to boosting investment, consumption, and labour market participation, continuing a trend that started a couple of years ago, according to the OECD.

This is the conclusion of the OECD's Tax Policy Reforms 2018 report, published on September 5, which describes the latest tax reforms across 35 OECD members, Argentina, Indonesia, and South Africa, and which identifies major tax policy trends.

The report notes that significant tax reform packages were introduced in Argentina, France, Latvia, and the United States, with a strong focus on both supporting investment and enhancing fairness. Other countries have introduced tax measures in a more piecemeal fashion, it said.

With regards to corporate taxes, the OECD found that the trend towards lower corporate tax rates has continued, driven largely by reforms in high-tax jurisdictions. However, while corporate tax cuts appear to be regaining momentum, they are not falling on the same scale as before the financial crisis, the OECD said. According to the report, the average corporate tax rate across the OECD is 23.9 per cent in 2018, down from 32.5 per cent in 2000.

"Among the countries that introduced significant corporate tax reforms were a number with high corporate tax rates, where tax reform was long overdue," observed Pascal Saint-Amans, Director of the OECD Centre for Tax Policy and Administration. "While these corporate tax cuts have created some concerns of a 'race to the bottom', most of these countries appear to be engaged in a 'race to the average', with their recent corporate tax rate cuts now placing them in the middle of the pack. We will be closely watching how other countries respond to this trend in the future."

Another recent trend identified by the OECD in its review was the introduction by several countries of personal income tax cuts, particularly for those on low and middle incomes. A common strategy has been to increase earned income tax credits, which can achieve dual goals of improving labor market participation and enhancing the progressivity of the tax system, it said.

However, reforms to social security systems have been limited, while value-added tax burdens have largely stabilized, the report found, with South Africa the only jurisdiction to increase its standard rate of VAT in 2018. However, high VAT rates have led many countries to look for alternative ways of raising additional VAT revenues, notably through tax administration and anti-fraud measures, the OECD said.

Other trends identified in the review include widespread excise tax increases, which are largely intended by governments to discourage consumption of alcohol and tobacco, while taxes on sugar-sweetened beverages are also becoming more common, having recently been introduced in Ireland, South Africa, and the United Kingdom.

Environmental tax reforms have continued to focus on energy taxes, where efforts have been made to go beyond road transport, the OECD noted. However, tax reforms outside of energy and vehicles, such as taxes on waste, plastic bags, or chemicals, have been less prevalent.

EU Still Pursuing New Digital Tax

This article originally appeared in Wolters Kluwer's Global Tax Weekly Issue 305.

The European Commission is continuing to push for the adoption of a digital services tax.

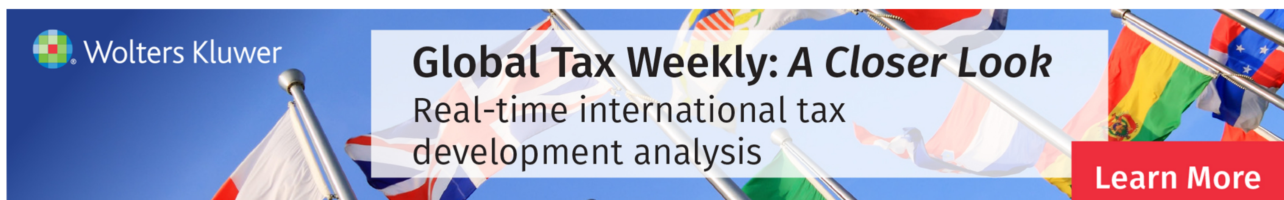
Speaking to reporters after a meeting of European finance ministers, Commission Vice-President Valdis Dombrovskis argued that the EU "needs a modern taxation system, which reflects the developments in our economies." He explained that all those who spoke at the meeting "agreed that it is important that digital companies pay their fair share."

Dombrovskis said that a long-term solution on digital taxation is being sought at an international level, with the OECD and the G20 the preferred channels through which this could be achieved. However, in the meantime, the Commission has proposed an interim solution of a digital services tax.

Dombrovskis stressed that the Commission "fully supports the Austrian Presidency in its efforts to swiftly adopt our proposal for an interim solution." He said that the Presidency has kept the issue of digital taxation "high on the agenda" and that progress "is being achieved".

Dombrovskis revealed that "many member states" had given "positive signals" during the meeting. The Commission "look[s] forward to turning words into deeds."

The Commission has proposed the introduction of a temporary three per cent excise tax on turnover from certain online activities. The Commission's preferred long-term solution is reform of the corporate tax rules to ensure that profits are registered and taxed where businesses have significant interaction with users through digital channels.



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