CANADIAN TAX *Highlights*

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US Model Treaty Ends US Fincos

On May 20, 2015, the US Treasury released proposed amendments to the US model treaty with an accompanying technical explanation. The proposals target treaty abuse and harmful tax practices. Two proposals have a significant impact on US financing corporation structures: (1) treaty benefits are denied to related-party interest, royalties, and other income (in article 21) if the recipient is taxed on the income at a low rate because of a so-called special tax regime; and (2) treaty benefits are denied to income that is allocated to an exempt PE.

A special tax regime is defined as any legislation, regulation, or administrative practice that provides a preferential effective tax rate to the particular income, including a reduction of the tax rate or tax base. A special tax regime includes notional interest deductions on equity and administrative ruling practices.

The proposals list seven exceptions to a special tax regime:

1) a regime that does not disproportionately benefit interest, royalties, or other income (a notional deduction on equity is always considered to disproportionately benefit interest and is thus not excepted);
2) a royalty regime that requires substantial activities to be performed in the residence state;
3) a regime that implements the principles of article 7 (business profits) or 9 (associated enterprises), such as an advance pricing agreement;
4) a regime that applies principally to a specified nonprofit entity;
5) a regime principally applicable to an entity if substantially all of its activity is to provide or administer pensions or retirement benefits;
6) a regime that facilitates investment in a specified collective investment vehicle; and
7) a regime agreed to by the contracting states because it does not result in a low effective rate of taxation.

The special tax regime appears to capture the typical Luxembourg finco structure that suffers base erosion in Luxembourg because dividends paid on preferred shares are treated as interest for Luxembourg tax purposes. The proposals only refer to notional deductions on equity, so it is unclear whether the proposal intends to catch a finco (for example, in Luxembourg or the Netherlands) that is funded by an interest-free loan on which notional interest expense is claimed.

The proposals do not appear to capture repo structures. A typical repo structure involves a Canco that owns preferred shares in a USco that are debt for US tax purposes and equity for Canadian tax purposes: dividends on the shares are deductible as interest expense in the United States and are typically Canadian tax-free to the Canco as exempt surplus dividends. The proposals give an example of acceptable regimes: those that allow standard deductions, accelerated depreciation, corporate consolidation, dividends-received deductions, loss carryovers, and foreign tax credits. The Canadian FA and surplus system may fall into the category of a "dividends-received deduction" regime and thus may not be a special tax regime.

Tower structures are not caught because they do not involve cross-border interest payments.

Under the exempt PE proposals, treaty benefits are denied if the income recipient allocates some or all of the US-source income to its foreign PE and the combined effective rate on that income is less than 60 percent of the normal corporate tax rate in the applicable recipient home country. The proposal applies to a Luxembourg finco with a US branch that lends to a related US entity. Under US tax law, the branch may be viewed as not engaged in a US trade or business and its income is thus not taxed in the United States. However, Luxembourg allocates most if not all of the Luxembourg finco's income to the US branch, and under Luxembourg tax law the income earned by a foreign PE in a treaty country is not taxed in Luxembourg. The combination of the differing US and Luxembourg tax treatments results in low or no tax on the interest income. The exempt PE proposals deny treaty benefits—in this case, the treaty withholding tax rate on the interest paid to Luxembourg.

The special tax regime proposal is similar to a new proposal in the revised discussion draft on BEPS Action 6 (treaty abuse) released on May 22, 2015. The US Treasury proposals are open for a 90-day public comment period. The final updated model is expected to be released without further public consultation. Note that the updated model has no immediate effect on any treaty currently in force unless and until it is renegotiated and

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ratified by the United States and its treaty partner to incorporate the proposals.

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ITC Allocation in BC Ferry Case

A business (other than a financial institution) that provides both taxable and exempt supplies must use the allocation rules in section 141.01(5) of the Excise Tax Act to determine the amount of input tax credits (ITCs) to claim on its GST/HST return. Generally, the taxpayer must use a fair and reasonable method to determine the allocation of its inputs to taxable and exempt supplies. The TCC in *British Columbia Ferry Services* (2014 TCC 305) provides a good overview of ITC allocation rules for a non-financial institution.

On the facts, BC Ferry operated vessels that offered ferry transportation services, an exempt supply. Some vessels also provided taxable supplies such as catering, room rentals, and retail store sales. For vessels that offered both taxable and exempt supplies, BC Ferry allocated ITCs by using a "deck-by-deck" formula that considered whether a particular deck of the vessel was used to provide exempt, taxable, or common (both exempt and taxable) supplies.

The CRA assessed BC Ferry for GST/HST, taking issue with three main aspects related to the taxpayer's ITC allocation: (1) classification of an infrastructure deck (which housed the engine and other mechanical components) as common use; (2) classification of stateroom rentals as separate taxable services; and (3) a full ITC on a new imported ferry: the CRA said that the ferry was not imported for use primarily in commercial activities.

Contrary to the CRA's position, the TCC concluded that an infrastructure deck was reasonably classified as a common-use deck because some portion of the deck was indirectly connected to its taxable supplies, and the taxable supplies would not have occurred without the support of the infrastructure deck equipment. Furthermore, the TCC disagreed with the CRA and said that stateroom rentals were a single supply separate from the supply of ferry transportation services because a stateroom was not an essential component of the overall supply of transport services. The court also concluded that stateroom rentals were a taxable supply, and BC Ferry was entitled to ITCs thereon.

However, the TCC agreed with the CRA that BC Ferry was not entitled to ITCs for its new imported ferry: it was capital property imported "primarily" for use in exempt transportation services. Although BC Ferry's own deck-by-deck allocation method (which the TCC said was fair and reasonable) determined that 56.6 percent of the vessel was used for commercial activities, the TCC relied on the relative weight of qualitative and quantitative evidence to determine whether capital property was acquired or imported primarily for commercial activity. In the TCC's view, the qualitative analysis required a conceptual determination of the first, important, or chief use of the property, and the quantitative analysis required a determination of percentage use.

The TCC concluded that, on the facts, the qualitative evidence was sufficient to displace the quantitative evidence and that the vessel in question was imported primarily for use in the provision of exempt ferrying services, BC Ferry's core services. The TCC said, "The ancillary [taxable] services are just that—ancillary, that is, subordinate to its core business activities." The main reason that BC Ferry acquired and imported the ferry was to provide exempt transportation services: BC Ferry needed to replace a vessel that had sunk in order to provide ferry services on its northern routes. Thus, ETA subsection 199(2) operated to deny ITCs claimed.

The TCC's decision on the first two issues appears to be unassailable. But the quantitative-versus-qualitative analysis is more debatable. Qualitative evidence may displace quantitative evidence, but in the GST/HST context this should occur only in the rarest of cases. ITCs are linked to commercial activities because the GST is a multi-stage value-added tax that is intended to be borne by the final consumer. On the facts, 57 percent of the vessel was used to make taxable supplies and the government was the main beneficiary of that percentage because it collected GST on those taxable services, and yet ITCs were denied. The result is not good tax policy and is inconsistent with the architecture of the GST. Another question is whether, if 57 percent of revenues are from taxable services, the core business can still be exempt ferry services. It seems reasonable to conclude, on the basis of the vessel's ultimate use—primarily the provision of taxable supplies—that full ITCs should have been allowed. However, the decision has not been appealed.

The decision in *BC Ferry* is authority for the proposition that even if the ITC allocation methodology is fair and reasonable, the qualitative evidence can take precedence when one is determining whether capital property was acquired "primarily" for the making of taxable or exempt supplies. Thus, a taxpayer must look beyond the 50 percent quantitative threshold to determine whether it should claim ITCs on its capital personal property.

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US Tax Return Filings

IRS *News Release* IR-2015-70 (April 10, 2015) contains helpful but not exhaustive information about the filing obligations of US citizens and resident aliens abroad. Generally, a US citizen and resident alien whose tax home and abode are outside the

United States and Puerto Rico must file form 1040 "U.S. Individual Income Tax Return") by Monday, June 15, 2015; a filing extension is generally available until October 15, 2015 on request. A resident alien is a person who is a lawful permanent resident (has a green card) or who spends sufficient time in the United States to meet the "substantial presence" residence test. US citizens and resident aliens are taxed on worldwide income, which must be reported on form 1040, but they must also make significant reports of foreign income and assets on a number of different forms.

In addition to form 1040, the US FBAR reporting requirements affect most of these US taxpayers. The FBAR is a US Treasury (not an IRS) form that reports certain foreign accounts (including a bank account and a brokerage or securities account). A US taxpayer who has foreign financial accounts that exceed in aggregate US$10,000 at any time during 2014 must file form 114, "Report of Foreign Bank and Financial Accounts (FBAR)," by June 30, 2015. The FBAR must now be filed electronically.

The FBAR is not filed as part of form 1040 or with the IRS, but a US taxpayer should be aware that schedule B, part III, of form 1040 also requires disclosure of foreign financial accounts of any magnitude. Many US taxpayers abroad also must file form 8938 ("Statement of Specified Foreign Financial Assets") by the form 1040's due date if foreign asset values exceed thresholds.

The good news is that form 8891 ("U.S. Information Return for Beneficiaries of Certain Canadian Registered Retirement Plans"), which reports Canadian retirement plan holdings, generally does not have to be filed with the IRS in respect of an RRSP or a RRIF for 2014 and subsequent years if the US taxpayer files a form 1040 for the year and reports annual distributions from the plan. However, there are exceptions to this new rule. And even if form 8891 does not have to be filed, forms 114 and 8938 (referred to above) may still need to be filed to report retirement plan holdings.

A taxpayer should also be careful about making currency conversions in his or her US filings. For forms 114 and 8938, a December 31 exchange rate is required. But the automatic December 31 requirement does not apply to form 1040, whose instructions describe exchange rate requirements in more detail.

A US taxpayer may need to file form 3520 ("Annual Return To Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts") or another form such as a form 5471 ("Information Return of U.S. Persons with Respect to Certain Foreign Corporations"), 8621 ("Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund"), 8858 ("Information Return of U.S. Persons with Respect to Foreign Disregarded Entities"), or 8865 ("Return of U.S. Persons with Respect to Certain Foreign Partnerships"), which are generally due at the same time as the form 1040. The taxpayer may have significant IRS reporting obligations on these and other forms with respect to a distribution from a foreign trust; a gift or bequest received from a foreign taxpayer; and a holding in a foreign corporation, partnership, or disregarded entity.

Certain US citizens and resident aliens abroad may use the IRS "Free File" to prepare and electronically file their tax returns for free. (See the e-file link at irs.gov.) However, Free File is not available to a non-resident alien who must file form 1040NR ("U.S. Nonresident Alien Income Tax Return"). Publication 54 ("Tax Guide for U.S. Citizens and Resident Aliens Abroad") is also available at irs.gov.

A non-resident alien (any individual who is not a US citizen or a US resident alien) who has income from a US source may also need to file a return on April 15 (generally for US-source wages) or on June 15 (depending on the type of US income). Moreover, a person who considers himself or herself to be a non-resident alien—but who spends time in the United States—may be in fact a US resident. Under the Code, there are two primary ways to be a resident alien: by meeting the substantial presence (or so-called days test) or by holding a green card. Even if a US residence test is met under the Code, the individual may still be exempt from US taxation of worldwide income if one of two exceptions is met: (1) the closer-connection exception or (2) a treaty exemption. Form 8840 ("Closer Connection Exception Statement for Aliens"), on which a claim is made for a closer-connection exception to US income tax residence status, is due on June 15. However, the claim is not available to a taxpayer if he or she has spent 183 days or more in the United States in the 2014 calendar year; in that case, the taxpayer may still be eligible to make a treaty claim that he or she is a resident of the particular treaty country and is not a US resident. A treaty-based return requires significant disclosures to the IRS: a green-card holder must be especially careful because a claim of non-US residence may jeopardize his or her green-card status.

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No Foreign Exchange Gain on PUC Reduction

A recent technical interpretation (CRA document no. 2014-0560571I7, January 22, 2015) says that a Canco does not realize a foreign exchange gain or loss under subsection 39(2) on its FA's return of capital. On the TI's facts, Canco invested US$200 million in common shares of its US wholly owned FA (Foreignco) when the Canada-US exchange rate was at par. In 2009, Foreignco returned to Canco US$99 million of the common shares' PUC. In the interim, the Canada-US exchange rate had shifted and the US$99 million that Foreignco paid to Canco had a value of Cdn$108.9 million. Canco reported the return of capital in Canadian dollars.

In 2009, did Canco have a foreign exchange gain under subsection 39(2) on the PUC reduction? The TI said no, because under the scheme of the Act any return of PUC on the shares of a non-resident corporation reduces the shares' ACB (paragraph 53(2)(b)). Gains or losses that reflect exchange rate fluctuations are captured if the shares' ACB expressed in Canadian dollars goes negative (subsection 40(3)) or if the shares are disposed of (subsection 40(1)).

The CRA's position in the TI is somewhat surprising given its view on the application of subsection 39(2) to repayments of foreign currency denominated debt. For example, in CRA document no. 2009-0327061C6 (October 9, 2009), which dealt with the tax consequences of a US-dollar loan's repayment, a Canadian resident took out a US$300,000 mortgage to buy a property in the United States in 2005. The taxpayer made monthly mortgage payments from 2005 until 2009 and then repaid the mortgage balance (US$250,000) out of a recently received inheritance. In the interim the Canadian dollar had appreciated relative to the US dollar, a change that benefited the taxpayer. The CRA opined on the tax consequences of each mortgage payment from 2005 through 2009 and of the lump-sum payment in 2009.

In the 2009 document, the CRA said that a foreign exchange gain or loss is computed by converting the repayment amount to Canadian currency at the exchange rate in effect at the repayment date and by converting to Canadian currency the portion of the loan repaid at the exchange rate that was in effect when the loan was made. The difference between the two amounts is the gain or loss subject to subsection 39(2). Thus, if the Canada-US exchange rate was at par when a US-dollar-denominated loan was taken out and principal of US$1,000 was repaid when the exchange rate was US$1/Cdn$1.10, the repayment was worth Cdn$1,100. or Cdn$100 more than the Cdn$1,000 value of the US$1,000 (the repaid amount) when the loan was first entered into.

In 2014-0560571I7, the CRA acknowledged that Canco arguably realized a foreign exchange gain in the same way that a lender would realize a foreign exchange gain on the repayment of a portion of a foreign-currency-denominated loan. However, the CRA is of the view that the Act contemplated a different scheme for the taxation of a return of capital from a non-resident corporation (subsections 40(1) and (3) and paragraph 53(2)(b)). If subsection 39(2) also applied, then double taxation would arise.

The US dollar has recently appreciated relative to the Canadian dollar, and thus the TI's conclusions may be welcomed by a Canadian corporation that wishes to repatriate capital from its US FAs. Conversely, if a jurisdiction's currency has depreciated relative to the Canadian dollar, the return of capital by an FA in that jurisdiction will not produce a capital loss under subsection 39(2) that can be used by the Canadian shareholder.

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Crowdfunding

Crowdfunding involves soliciting, via the Internet, donations of small amounts of money from a potentially large number of persons in order to raise financing for projects, products, services, loans, or equity. A recent panel at an International Bar Association conference on cross-border finance and capital markets in London dealt with crowdfunding. Although there were no Canadian speakers, the tax and other legal issues that were discussed are similar in many jurisdictions. Forty-seven crowdfunding platforms were identified, including Kickstarter (www.kickstarter.com). As of the date of the conference, a total of US$1,506,939,361 had been pledged to Kickstarter projects, involving 77,957 successfully funded projects and 7,848,742 total backers. Kickstarter returns the funds if the minimum amount required for a project is not raised. Payments are made through a payment service provider.

Persons or companies (on Kickstarter, "creators") may solicit donations directly through a blog, Facebook page, or website. Creators solicit donations in order to achieve a financial goal, such as raising funds for a medical treatment or mitigating damage wrought by a natural disaster such as a hurricane. Donors (on Kickstarter, "backers") do not expect a return. If the creator is not a registered charity, no charitable receipt is issued: the donation is a non-deductible gift from the backer and is not taxable to the creator.

Funds may be solicited in return for a product—the so-called rewards model. The smartwatch company Pebble Technology Corp. raised US$1 million in less than an hour through Kickstarter, a record speed for Kickstarter fundraising. By the end of the day, the company had raised more than US$6.1 million to fund Pebble Time, its latest wearable computer: more than 29,500 supporters each pledged enough money to receive a watch in return for their pledge. Crowdfunding may also raise funds to enable a creator to make a music recording for which the backer cannot take a tax deduction; however, the creator is taxable on the receipt as income. HST may apply on funds raised (if the funds are income from a business) and on the delivery of an item as a promotional gift (if it is given in consideration of the cash donated). The CRA has said that the funds raised are income from carrying on a business (document no. 2013-0484941E5, August 16, 2013). An internal interpretation (document no. 2015-0579031I7, April 1, 2015) confirmed that funds received in a crowdfunding arrangement for the development of a product are income unless there is evidence that the funds represent a loan or equity. Related business expenses are deductible. The CRA relied on IT-334R2 ("Miscellaneous Receipts," February 21, 1992, at paragraph 4) to conclude that voluntary payments received in the course of carrying on a business are taxable

In some cases, funds are solicited for a loan or an equity interest in a business. If funds are solicited for a loan, the loan presumably has a maturity date and an interest rate and sets

dates for interest payments. Interest paid on a loan solicited from a non-resident should not attract Canadian withholding tax if the loan is arm's-length. Interest expense on funds borrowed by a Canadian business may be deductible, and there is no income inclusion to the recipient for the amount of the loan.

Similarly, the issuer of an equity investment is not taxable on the funds raised, although there may be securities law concerns. Equity financing via crowdfunding provides low-cost funds, allows quick access to funding, and expands the range of targeted potential investors. An investor may realize a capital gain or a capital loss on a disposition of the shares. If the issuer company is not public, there is no a secondary market, and securities law may restrict or disallow trading. The shareholding structure may be similar to a private equity issue for which there is a mandate to sell the business or buy out investors after, say, five years.

A partnership may have been created if investors receive a share of profits in lieu of shares. The investor-partner may be taxable on income allocations.

The commercial risks for an investor include the failure or bankruptcy of the platform, the insolvency of the actual business or issuer, the potential for fraud, and the risk that more funds than are required will be raised.

Canada does not have any specific tax legislation regulating crowdfunding. Securities regulators in British Columbia, Quebec, Saskatchewan, New Brunswick, Manitoba, and Nova Scotia have adopted, and Ontario has proposed, securities law amendments to regulate crowdfunding. The Ontario proposal (limits each investor to $2,500 in a single investment and $10,000 over a calendar year; an issuer is limited to raising $1.5 million over 12 months. A prescribed disclosure document must be delivered to potential investors and may require ongoing disclosure obligations after the offer is closed. To protect investors, an offering must be completed through a registered funding portal. However, the startup crowdfunding exemptions recently promulgated by the provinces listed above (other than Ontario) provide exemptions from the prospectus requirements and from the dealer registration requirement, both subject to conditions.

The platform provider may be required to do due diligence to ensure that correct information is provided by its customers, to effect some risk analysis, and to set out the risk factors. The fee earned by the platform provider is taxable as income and may be subject to HST.

The US Jumpstart Our Business Startups Act, enacted on April 5, 2012, contemplates a new exemption to allow crowdfunding without a prospectus. Investors may be required to do their own due diligence on the company. The issuer is still liable for material misstatements or for omissions of material information.

Sweden does not have specific legislation governing fundraising through crowdfunding sites, but there is a ban on advertising to more than 200 persons. Only a public company can make a public offer of shares and be publicly traded; infringement of this provision results in commercial and civil sanctions. Norway, Finland, and Denmark have similar rules. Ireland has no specific legislation and does not currently regulate crowdfunding; existing regulatory regimes may apply. The only form of crowdfunding currently allowed in Ireland is the lending of funds at interest by an individual to a company, project, or consumer (peer-to-peer lending). In the Netherlands, crowdfunding is on the political agenda, and there are regulating regimes for loans: a limit of €40,000 per individual or of 100 projects per lender applies (for equity, the applicable limit is €20,000 or 100 projects per issuer). In the United Kingdom, an online portal may perform due diligence and act as a nominee for investors; it may also receive dividends, manage disclosure, and earn a percentage of funds raised and/or of investor profits.

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The US Net Investment Income Tax

The US net investment income tax (NIIT) applies at a rate of 3.8 percent on certain net investment income (NII) of a US individual, an estate, or a trust whose income exceeds a specified amount. This article summarizes the NIIT and its regulatory effect on a US trust and an individual who resides in Canada.

Assume that Mr. and Mrs. X, Canadian residents and not US persons under the Code, want to buy realty in New York City with the expectation that it will appreciate over the next 10 years. Previously, Mr. and Mrs. X would have been advised to establish a US domestic non-grantor trust (Code section 7701(a)(30)(E)) to acquire the property for the benefit of their two children (one or both of whom might take up US tax residence) because a US domestic trust avoids the foreign non-grantor trust accumulation distribution rules if and when either child becomes a US resident. However, that plan does not consider the potential NIIT on the US domestic trust's gain on sale of the property. For now, a foreign trust avoids the NIIT, and the accumulation distribution rules may be avoided if a regular distribution program for distributable net income is adopted.

NII generally includes, but is not limited to, interest, a dividend, a capital gain, rental income, a royalty, and a non-qualified annuity; income from a business involved in the trading of financial instruments or commodities (a trader); and income from a business whose activity is passive to the taxpayer (Code section 469). NII is calculated by allocating certain expenses to gross investment income such as investment interest expense, brokerage fees, and fiduciary expenses for an estate or trust.

NIIT applies to an individual who has NII and whose modified adjusted gross income exceeds a threshold—which is not

indexed for inflation—that varies according to the taxpayer's filing status. The threshold amounts are illustrated in the accompanying table. NIIT also applies to a trust or an estate that has undistributed NII and whose adjusted gross income exceeds the threshold for the highest tax bracket: for the 2015 tax year that bracket is attained when taxable income reaches $12,300.

Filing status	Threshold amount
Married and filing jointly	$250,000
Married and filing separately	$125,000
Single	$200,000
Head of household with a qualifying dependant	$200,000
Qualifying widow or widower with a dependent child	$250,000

NIIT does not apply if the modified adjusted gross income does not exceed the applicable threshold. If the threshold is exceeded, the tax is imposed on the lesser of the excess and the NII. Assume that Mr. Y is a single Canadian citizen who has just obtained his green card and moved to the United States. In 2015, Mr. Y earns $170,000 in wages and $50,000 in dividends; his modified adjusted gross income is $220,000, and his threshold is $200,000. In addition to income tax, Mr. Y pays NIIT of US $760 at a flat 3.8 percent rate on $20,000, which is the excess of modified adjusted gross income over the threshold. In this particular case, NIIT is not imposed on the $50,000 of net investment income.

Only if the grantor of a US grantor trust is a US person—a US resident or a US citizen—is he or she subject to NIIT. If the grantor of a grantor trust is a foreign person, such as a Canadian resident who is not a US citizen, then, generally, the NIIT does not apply to the foreign grantor. However, a foreign grantor trust exists only if (1) the trust is revocable or (2) the grantor and/or his or her spouse are the only persons who are able to receive distributions during the grantor's lifetime.

A foreign non-grantor trust is NIIT-exempt; thus, a foreign investor may choose a foreign trust as its investment vehicle for US realty. Previously, a US domestic trust was typically used even if the beneficiaries were not US-resident or US-citizen individuals because, as mentioned above, if the trust paid US federal income tax on its earned but undistributed income, no further tax applied to the beneficiaries when those accumulated funds were distributed. (Prior years' undistributed net income is deemed to be distributed after the current year's distributable net income and before capital.) A 3.8 percent tax on an accumulated gain may be too high a price to pay for the benefit of limited filing obligations.

Assume further that Mr. and Mrs. X purchase their US realty through a foreign non-grantor trust, which later sells the property for a capital gain of $250,000. The trust has no other income or capital, and the capital gain is not distributed to the child beneficiaries. Mr. and Mrs. X and their children are Canadian citizens and residents and do not have dual Canada-US citizenship. The trust is not subject to NIIT on $237,700 (the excess of adjusted gross income over the $12,300 threshold for trusts), and the potential saving is $9,032.60 (3.8% × $237,700).

The NIIT applies in principle on the distribution of accumulated income to the US beneficiary of a foreign non-grantor trust. However, the IRS has yet to issue guidance that addresses this rule's implementation. Thus, for the time being, the US beneficiary of a foreign non-grantor trust who receives an NII distribution is not subject to NIIT.

Generally, the NIIT does not apply to a US non-resident non-citizen individual, such as a Canadian resident who is not a US citizen or who is a dual-resident individual treated as a Canadian resident under the residence tiebreaker provision in the Canada-US treaty. Exceptions apply that parallel the individual's income tax status:

1) If the individual elects to file a joint tax return with a US-citizen spouse (Code section 6013(g)), he or she is a US resident for income tax purposes. Under the final regulations, the US non-resident non-citizen individual can obtain an increased exemption by making an election. If he or she does not make an election, the US citizen spouse's threshold is $125,000 (the same as that of a married person filing separately). However, the threshold is increased to $250,000 if the individual makes an election by checking the box on part 1 of form 8960 ("Net Investment Income Tax—Individuals, Estates, and Trusts"), which is .used to calculate the NIIT.
2) A dual-status resident who is not a US citizen is a part-time US resident if he or she moves from the United States to Canada or vice versa; NIIT applies only on NII that is generated while he or she is a US resident.

Under the regulations, no foreign tax credit is allowed against the NIIT. The preamble states that a foreign tax credit is not allowed if a treaty has language similar to article 23(2) (Relief from Double Taxation) of the 2006 US model treaty. Article 24(4) of the Canada-US treaty contains language similar to the model treaty article; consequently, a foreign tax credit for the NIIT likely is not allowed.

If a US trust is used, NIIT may be avoided if NII distributions are made to US non-resident non-citizen beneficiaries such as Canadian residents who are not US persons. Because the US tax rate for a domestic trust is steeply graduated, the distribution to a Canadian resident may not result in a significant overall tax increase.

If a US trust generates US rental income, NIIT may be avoided if the individual who carries out the rental activity is

a real estate professional (defined in Code section 469(c)(7)(B)) and the real estate rental activity rises to the level of an active trade or business as set out in Code section 162.

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Determination of Taxpayer's Loss

A technical interpretation (2014-0550351C6, November 18, 2014) confirms that the CRA will not issue a determination of loss "with all due dispatch" to a taxpayer that requests a determination when it files its return: traditionally, that determination occurs after a CRA audit. The CRA says that it cannot issue a determination when it receives a filed return because the CRA must first ascertain that the loss is different from the loss reported by the taxpayer on its return of income, as required by subsection 152(1.1).

Generally, in a year when a taxpayer has section 3 income, the CRA must make an initial assessment "with all due dispatch." The CRA's ability to reassess generally expires within a specified time after an initial assessment. The same rules apply for a year when a taxpayer has a non-capital loss or a net capital loss, but the rules do not have the same effect because losses can be carried forward and their quantum remains open to adjustment until the year when they are used or become statute-barred.

There is a process for fixing the quantum of a loss in subsection 152(1.1), but this process is not traditionally undertaken until after an audit. The process can begin only after the CRA "ascertains" that the loss differs from the amount reported by the taxpayer—which may take a long time—and a loss may be relevant for 20 or more years after the year when it is incurred. This deferral may create uncertainty for a taxpayer's tax positions and may subject a taxpayer to a burdensome requirement to maintain records of the year of the loss until the year that it is ascertained.

In 2013, the Tax Executives Institute recommended that Finance consider amending the Act to require the CRA to make initial determinations of losses for a taxation year at the same time and in the same manner as the initial determination of income for that year. Finance expressed support for an interpretation of subsection 152(1.1) that allows a taxpayer to request a determination of the amount of a loss when it files its return. If that interpretation is not feasible, Finance said at the time that an amendment to this rule may be worth consideration.

Addressing this issue in the TI, the CRA notes that two conditions must be satisfied in subsection 152(1.1) before a notice of loss determination can be issued: (1) the CRA must ascertain that the amount of a taxpayer's non-capital loss for a taxation year differs from the loss reported in the taxpayer's income tax return, and (2) the taxpayer must ask the CRA to determine the amount of the loss.

The CRA clarifies that when it accepts a taxpayer's return as filed, it has not yet "ascertained" that the amount of the taxpayer's loss differs from the amount the taxpayer reported in the return. Therefore, when the taxpayer files the return showing a loss, the first condition required for a loss determination has not yet been met, and thus the CRA cannot issue at that time a loss determination based solely on the taxpayer's request.

The CRA notes that its interpretation has been confirmed by the courts. The CRA says that for a taxpayer to achieve the result sought by the request, the Act must be amended to require that the CRA issue a notice of loss determination if the taxpayer requests one at the time that it files its return.

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Government Retirement Income, Part 2

In Canada, an individual may be eligible to receive retirement pensions from two government sources: (1) the Canada Pension Plan (CPP) or the Quebec Pension Plan (QPP); and (2) Old Age Security (OAS). Retirement benefits from both the CPP/QPP and, to a certain extent, OAS can be tailored to the needs of individuals and couples. This article discusses OAS; CPP and QPP were discussed in "Government Retirement Income, Part 1" (*Canadian Tax Highlights*, May 2015.)

Old Age Security. The OAS pension is a monthly payment available to a former or present Canadian who lives anywhere in the world and fulfills the requirements. Unlike eligibility for the CPP, eligibility does not depend on past employment. An important change in the age requirement (65 or older) is discussed below. Two other requirements depend on the recipient's country of residence, as shown in table 1. In some cases, residence in a country with which Canada has a social security agreement satisfies the OAS minimum residence requirement.

Table 1 Residence Requirements for OAS Eligibility

	Living in Canada	Living outside Canada
Canadian citizen or permanent resident	At the time of application	On the day before leaving Canada
Minimum years of residence (in Canada since turning age 18) . . .	10	20

OAS benefits are subject to a reduction (clawback) if the recipient's net income is above a certain threshold ($72,809 for 2015). Therefore, for example, a person who receives the maximum OAS benefit of $6,765 in 2015 (based on second-quarter rates) is subject to a clawback if his or her 2015 net

income exceeds $72,809; the benefit is fully clawed back at $117,909. To determine the clawback for a particular year, Service Canada estimates the repayment in accordance with the person's net income on his or her income tax return for the previous year. However, a calculation on the current personal income tax return determines the actual clawback based on the actual current year's net income. OAS benefits are adjusted quarterly, based on the consumer price index.

Changes to OAS. In July 2013, the federal government implemented several changes to the OAS system. First, the age of eligibility gradually increases from age 65 to 67, over six years beginning in April 2023: a person born in April 1958 turns age 65 in April 2023. Table 2 shows how eligibility is affected. For example, a person born in April or May 1960 (just after the midpoint between March 1958 and February 1962) is eligible to receive his or her OAS benefits at age 66 years and one month. Second, a recipient can now defer starting his or her OAS benefit for up to 60 months after the date of eligibility. Deferring the start date of OAS receipts permanently increases the monthly payment by 0.6 percent for every month of deferral. An individual benefits most from deferring receipt if he or she is subject to the clawback in the first 60 months of eligibility. Third, most individuals no longer have to apply for OAS benefits: they are automatically enrolled and automatically receive payments.

Table 2 Age Requirements for OAS Eligibility

Year of birth	Age when eligible for OAS
Before April 1958	65 (unaffected)
After March 1958 and before February 1962	Between 65 and 67 (gradually increases commensurate with birthdate)
After January 1962	67

In summary. An individual whose net income is sufficient to trigger OAS clawback should generally defer receipt of the benefit until the earlier of the time that the clawback no longer applies and age 70; this deferral may reduce or eliminate the clawback. Deferral after the would-be recipient attains the age of 70 reaps no benefit for him or her. In addition, deferral of the receipt of OAS benefits increases the benefit ultimately received: the monthly benefit is permanently increased because of the deferral.

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Deposit Forfeited to Non-Resident

An internal technical interpretation (2013-0479861I7, March 16, 2015) confirms that if a Canadian taxpayer purchases real property located in Canada from a non-resident vendor and the sales agreement is cancelled, a deposit forfeited by the taxpayer to the non-resident vendor is not taxable Canadian property (TCP). As a result, section 116 does not apply to the forfeited deposit. However, the CRA also says that the non-resident vendor has disposed of a right under a contract and that right may be taxable as either Canadian-source income or a capital gain.

Assume that a non-resident of Canada (Mr. NR) owns Canadian real property that meets the definition of TCP. Mr. NR enters into an agreement to sell the property to a Canadian resident (Mr. C). As part of the agreement, Mr. C pays a deposit to Mr. NR. Mr. C is subsequently unable to complete the transaction, and the agreement is cancelled; the deposit is forfeited to Mr. NR.

TCP is defined in section 248 to include, among other things, real or immovable property situated in Canada and an option in respect of, or an interest in (or for civil law a right in), real or immovable property situated in Canada, regardless of whether the property exists. Generally, when a non-resident person disposes of TCP (other than depreciable property or excluded property defined in subsection 116(6)), a 25 percent withholding tax is required (subsection 116(5)).

For the purposes of the Act, a "disposition" is defined in subsection 248(1) to include any transaction or event by which there is a whole or partial redemption, acquisition, or cancellation of property if the property is an agreement of sale or similar property, or an interest (or, for civil-law purposes, a right) in it. If the property is a debt or any other right to receive an amount, the definition includes any transaction or event by which the debt or other right is settled or cancelled. In determining whether real property or an interest in real property constitutes TCP, subsection 248(4) states that, for the purposes of the Act, an interest in real property "does not include an interest as security only derived by virtue of a[n] . . . agreement for sale or similar obligation.

The TI says that if a buyer (Mr. C) forfeits a deposit to a vendor (Mr. NR) because the buyer fails to complete a purchase under a sales agreement, a disposition of a right under a contract has occurred. Although this disposition results in either income or capital gain to the vendor, the CRA notes that this disposition does not constitute a disposition of TCP.

The CRA refers to *Howe v. Smith* ((1884), 27 Ch. D. 89 (CA)), which described a deposit in real property transactions as "a guarantee that the contract should be performed" and a "security for the completion of the purchase." This definition was also cited in the British Columbia Court of Appeal case of *Tang v. Zhang* (2013 BCCA 52). On the basis of these cases, if an agreement between a buyer and vendor states that an amount is a deposit, it is treated as such unless there is a contrary provision in the agreement, and the amount's legal nature as a deposit must generally be respected for the purposes of the Act.

In the TI, the CRA concludes that the forfeited deposit is a disposition of a security interest derived by virtue of the purchase agreement between Mr. NR and Mr. C. The forfeited

deposit, or a portion of it, may therefore be taxable in Canada to Mr. NR as either Canadian-source income or a capital gain. However, section 116 does not apply to the disposition, because the property disposed is not an interest in real property as defined in subsection 248(4), and therefore it is not TCP as defined in subsection 248(1).

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US BEA Information Filing

The US Bureau of Economic Analysis (BEA) is an agency of the US Department of Commerce and is governed by the International Investment and Trade in Services Survey Act. The BEA conducts mandatory and voluntary surveys to collect data on foreign direct investments into the United States, US direct investments abroad, and US international services transactions. The data collected can be viewed on the BEA website (www.bea.gov). Under the governing legislation, information provided in the surveys cannot be presented in a manner that allows the filer to be identified, and the completed surveys cannot be used for tax, investigatory, or regulatory purposes. Copies retained in a lawyer's files are immune from legal process. The most recent mandatory filing is due June 30, 2015.

US direct investment abroad. The BEA has an annual filing requirement for a US person (a corporation, partnership, trust, non-profit entity, or individual) investing abroad and a foreign person investing in the United States. However, many practitioners became aware of the BEA filing requirements only because of a recent form BE-10 survey ("Benchmark Survey of U.S. Direct Investment Abroad") that is required every five years by a US person that has a foreign affiliate. The most recent BE-10 survey was for 2014; the form was due in March 2015, but an extension to June 30, 2015 was given for first-time filers. According to the BEA, preparing a form BE-10 is likely to take 144 hours for each response.

Form BE-10 must be filed by any US person that has a foreign affiliate—that is, direct or indirect ownership or control of at least 10 percent of the voting stock of an incorporated foreign business enterprise, or an equivalent interest in an unincorporated foreign business enterprise, at any time during the person's 2014 fiscal year. A US person that had no FAs during its 2014 fiscal year must file a form BE-10 claim for not filing; failure to file that form carries the same penalties as a failure to file a form BE-10 for a reporting company. Filing is required even if the reporter is not contacted by the BEA.

If a US individual, estate, trust, or non-profit entity owns more than 50 percent of a US business enterprise that in turn owns an FA, then the reporting person is the US business enterprise. However, if any direct financial transaction occurs between the FA and the individual, trust, or non-profit entity, that transaction must be included in the US business enterprise's report.

Other reporting required of a US investor in a foreign business enterprise includes a form BE-577 ("Quarterly Survey of U.S. Direct Investment Abroad: Direct Transactions of a U.S. Reporter with Foreign Affiliate") and a form BE-11. A form BE-577 is a quarterly survey of US direct investment abroad that must be filed within 30 days of the end of the US reporter's fiscal quarter (45 days of the end of the final quarter). Reporting is required only if the reporter is contacted by the BEA; a certificate of exemption may then apply. Reporting is required if (1) the directly owned FA has more than $60 million (positive or negative) in total assets, annual sales or gross operating revenue (net of sales tax), or annual net income after foreign tax, and (2) the indirectly owned FA meets the $60 million threshold and has more than $1 million of intercompany debt with the US reporter.

Form BE-11 is an annual survey of financial and operating data of the US reporter and its FA. Various thresholds apply. Reporting is required if the BEA contacts the reporter; a certificate of exemption may then apply.

Foreign direct investment in the United States. A form may also be required to be filed by a US business enterprise if there is foreign direct investment in the United States. Form BE-13 ("Survey of New Foreign Direct Investment in the United States") is a survey of new foreign direct investment in the United States; the form's purpose is to capture new investment transactions when a new foreign direct investment in the United States relationship is created (a minimum investment of $3 million) or when an existing US affiliate of a foreign parent establishes a new US legal entity, expands its US operations, or acquires a US business enterprise (a minimum investment of $3 million). The initial report must be filed no later than 45 days after the investment transaction. The information filed also identifies new US affiliates that meet the criteria for other required BEA filings. (A US affiliate is defined similarly to a foreign affiliate, mutatis mutandis.) The form must be filed regardless of whether the person is contacted by the BEA; if the BEA does request a filing, a claim for exemption may then apply.

Form BE-605 ("Quarterly Survey of Foreign Direct Investment in the United States: Transactions of U.S. Affiliate with Foreign Parent") must be filed quarterly for foreign direct investment in the United States to report positions and transactions between a US affiliate and its foreign parent or foreign affiliates thereof. Form BE-605 is also required for any US affiliate that became inactive or was established, acquired, liquidated, or sold during the reporting period and meets the over $60 million (positive or negative) threshold. Quarterly reports must be filed within 30 days after the close of the fiscal quarter (45 days after the year-end.) An entity that is required to report will be contacted by the BEA, although a claim for exemption may apply. An entity is exempt if the values of the affiliate's total assets, annual sales, or gross operating revenues and annual net income (loss) were each no more than $60 million. No report is

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required unless the reporter is contacted by the BEA; a claim for exemption may then apply.

Form BE-15 is an annual survey of foreign direct investment in the United States designed to report annual financial and operating data of US affiliates. Reporting is required only if the reporter is contacted by the BEA; a claim for exemption may then apply. The threshold for filing is an investment of at least $40 million into the United States. A one-time exemption may be filed if the foreign voting ownership (or equivalent) falls below 10 percent, if the US affiliate is fully consolidated or merged into another US affiliate, or if each of total assets, sales or gross operating revenues, and net income is no more than $40 million (positive or negative). After the initial filing, the BE-15 claim for exemption is not required annually from a US affiliate that meets the exemption criteria, unless the BEA contacts the would-be filer and the US business enterprise is exempt from filing.

Form BE-12 is a benchmark survey of foreign direct investment in the United States and is conducted every five years. The most recent survey covered the fiscal year ending in 2012. A response is required from reporting entities even if they are not contacted by the BEA.

The penalties are severe. Failure to file results in a civil penalty ranging from US$2,500 to US$25,000. Wilfully not filing carries a penalty of not more than US$10,000; an individual may face imprisonment for one year. Upon conviction, any officer, director, employee, or agent of a corporation who knowingly participates in these violations may be punished with a similar fine, imprisonment, or both.

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