ORGANIZATIONS, REORGANIZATIONS, AMALGAMATIONS, DIVISIONS AND DISSOLUTIONS: CROSS-BORDER ASSETS, DOUBLE TAXATION AND POTENTIAL RELIEF UNDER THE U.S.-CANADA TAX TREATY*

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I. INTRODUCTION

The entry into force of agreements such as the Agreement Establishing the World Trade Organization and the North American Free Trade Agreement[1] has promoted the expansion of trade and encouraged the consolidation of enterprises within various jurisdictions. Many such consolidations involve assets on both sides of the U.S.-Canada border. These corporate restructurings, which are occurring to take advantage of new trade opportunities, require consideration of the tax consequences associated with the transfer of ownership of business assets in one tax jurisdiction between legal entities in another tax jurisdiction.[2] These tax issues are the focus of this paper, in particular, the potential for double taxation in the context of a corporate reorganization, amalgamation, division or similar transaction involving Canadian assets owned by a U.S. taxpayer. This issue is particularly timely given the recent implementation of the Third Protocol to the U.S.-Canada

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[1] Marrakesh Agreement Establishing the World Trade Organization, Apr. 15, 1994, LEGAL INSTRUMENTS-RESULTS OF THE URUGUAY ROUND vol. 31, 33 I.L.M. 81 (1994); North American Free Trade Agreement, Dec. 17, 1992, 32 I.L.M. 298 (1993) [hereinafter NAFTA].

[2] The European Communities adopted Council Directive 90/434 on the Common System of Taxation Applicable to Mergers, Divisions, Transfers of Assets and Exchanges of Shares Concerning Countries of Different Member States, 90 O.J. (L 225) to mitigate the tax costs of a cross-border merger.

Tax Treaty,[3] effective January 1, 1996, and the potential impact on U.S. taxpayers of Canada's October 2, 1996, proposals for the taxation of nonresidents ceasing to carry on business in Canada.[4]

In a perfect world, the trend toward free trade would herald the tax-free transfer of assets between business enterprises for income tax purposes. Unfortunately, tax and trade laws operate quite independently, and most tax systems were neither designed nor intended to encourage corporate organizations, reorganizations or dissolutions involving assets located in another tax jurisdiction. Furthermore, most tax systems, including those of the United States and Canada, generally restrict the tax-deferred status of transferred assets to resident corporations and shareholders,[5] and impose tax on most outbound transactions.[6] These restrictions, while recognizing a country's legitimate right to tax income,[7] create the potential for double taxation when the assets which are the subject of a corporate restructuring

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[3] Convention on Double Taxation, Taxes on Income and Capital, Sept. 26, 1980, U.S.-Can., T.I.A.S. No. 11,087, at 2 [hereinafter U.S.-Canada Tax Treaty]; Protocol Amending the 1980 Tax Convention with Canada, June 14, 1983, T.I.A.S. No. 11,087, at 63 [hereinafter 1983 Protocol]; Protocol Amending the 1980 Tax Convention with Canada, Mar. 28, 1984, T.I.A.S. No. 63 [hereinafter 1984 Protocol]; Protocol Amending the 1980 Tax Convention with Canada, June 14, 1995, S. Treaty Doc. No. 104-4, 104th Cong., 1st Sess. (1995) [hereinafter 1995 Protocol].

[4] CAN. DEP'T FIN., NOTICE OF WAYS AND MEANS MOTION TO AMEND THE INCOME TAX ACT (Oct. 2, 1996).

[5] *See, e.g.*, I.R.C. § 367(b) (1994); I.T.A. subsection 85(1).

[6] The United States, for example, taxes many outbound transactions pursuant to I.R.C. § 367(a) (1994). Canada imposes a departure tax as well as deeming a transaction to be a disposition of assets at fair market value when a corporation emigrates from Canada. I.T.A. section 219.1. Proposals announced on October 2, 1996, by the Canadian Department of Finance will result in a deemed disposition of trust assets where a trust ceases to be resident in Canada, as well as for assets owned by nonresident persons who cease to carry on business in Canada.

[7] I.R.C. § 367, for example, currently taxes what would otherwise be a tax-free restructuring if it occurred domestically, solely to preserve the United States' ability to tax. Outbound transfers are taxed to prevent the removal of assets from the U.S. tax jurisdiction prior to the realization of economically accrued gain. Inbound transfers are also restricted because they facilitate permanent elimination of deferred U.S. corporate tax on repatriated foreign earnings. *See* STAFF OF JOINT COMMITTEE ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, 256-66 (Comm. Print 1976); *see also* John P. Seines Jr., *Income Tax Implications of Free Trade*, 49 TAX L. REV. 675, 688 (1994).

in one country are not all located within that country's tax jurisdiction.[8]

Consider, for example, the case of a U.S. parent corporation with a Canadian branch that transfers its Canadian real property to a U.S. subsidiary corporation in exchange for stock. While this transaction is taxable in Canada because it is the disposition of taxable Canadian property,[9] it is a nonrecognition transaction in the United States.[10] As with most nonrecognition exchanges, the appreciation is preserved in the basis of the assets received, the real property and the stock of the subsidiary corporation so that it will not be recognized for United States tax purposes until subsequent disposition.[11] Thus, double taxation occurs because while countries such as the United States and Canada tax their citizens and resident aliens on their worldwide income and offer relief from double taxation by way of a foreign tax credit where foreign tax has been paid, to qualify for relief, it is generally necessary that a taxable event occurs both domestically and abroad, in the same tax period.[12] Thus, as the above example demonstrates, double taxation may occur as a result of the Canadian tax payable, either because of an immediate timing problem with respect to the U.S. foreign tax credit, since there would be no currently taxable U.S. income at the time of the exchange,[13] or because the applicable U.S. credit will have expired before an actual disposition or other taxable event occurs in the United States.[14]

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[8] Many free trade advocates argue that free trade policy requires greater tax-free treatment of cross-border reorganizations. The rationale is that as business structures must change in response to international business needs, tax impediments should not hinder free trade and capital mobility. *See, e.g.*, Brian Arnold & Neil Harris, *NAFTA and the Taxation of Corporate Investment: A View From Within NAFTA*, 49 TAX L. REV. 529 (1994); *see also* Paul McDaniel, *Formulary Taxation in the North American Free Trade Zone*, 49 TAX L. REV. 691 (1994) (arguing that there is a need to reexamine existing tax treaties and legislation once a regional free trade zone has been created).

> It is not the position of the authors that trade policy should necessarily dictate tax policy. Rather, the authors believe that changes in trade policy have created a need to review the current tax treaty system with a view to determining whether it adequately addresses the new tax problems that arise as a result of a free trade regime.

[9] I.T.A. paragraph 115(1)(b); U.S.-Canada Tax Treaty, *supra* note 3, at art. XIII.

[10] I.R.C. § 351 (1994).

[11] *See infra* notes 122-134 and accompanying text (discussing the tax aspects of corporate organizations).

[12] I.R.C. § 901(a); I.T.A. section 126; *see also* REVENUE CAN., INTERPRETATION BULLETIN IT-270R2, FOREIGN TAX CREDIT, ¶ 13 (as revised Feb. 11, 1991), *available in* LEXIS, Intlaw Library, TNI File.

[13] I.R.C. §§ 351, 358, 362.

[14] I.R.C. §§ 904(c), 274(a)(4)(A).

A second example of this timing problem, and the potential for double taxation, occurs in a merger of two U.S. corporations when one corporation holds shares in a Canadian subsidiary, primarily holding real estate located in Canada.[15] The merger will result in a disposition of the shares in the Canadian subsidiary.[16] While this disposition is a taxable event in Canada,[17] it will not be currently taxable in the United States pursuant to I.R.C. § 368(a)(1)(A).[18]

Common to both of the above transactions is that neither resulted in an economic realization of proceeds nor a change in beneficial ownership. Nonetheless, since the transactions involved the transfer of Canadian assets between U.S. corporations, the proceeds are subject to immediate Canadian, but not U.S., tax.

There are, in fact, few transactions involving corporate or other business organizations residenced in one country that will qualify for nonrecognition in both countries if the assets transferred consist of real property or branch assets located across the Canadian-U.S. border. This is because of a fear of losing jurisdiction to tax any accrued gain if the tax is not imposed at the time of the actual transfer. Thus, the transfer of U.S. assets to a Canadian corporation which might otherwise qualify as a nonrecognition exchange under both I.R.C. § 351 and I.T.A. section 85,[19] will generally be taxable in the United States under I.R.C. § 367(a)(1), unless it falls within the active trade or business exception.[20] Conversely, a transfer to a U.S. corporation may qualify for nonrecognition under I.R.C. § 351, but would fail under I.T.A. section 85 which requires that the transferee be a taxable Canadian corporation. Because corporate reorganizations involving cross-border assets are common, a comprehensive solution to potential double taxation is necessary.[21]

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[15] *See* U.S.-Canada Tax Treaty, *supra* note 3, at art. XIII(3)(b)(ii). The merger would result in taxation in Canada where the value of the shares of the subsidiary is derived primarily from real property. *See generally* I.T.A. subsection 115(1).

[16] *Id.*

[17] *See* I.T.A. section 54 (defining "disposition"); subsection 115.1 (defining taxable Canadian property); U.S.-Canada Tax Treaty, *supra* note 3, at art. XIII(3)(b)(ii).

[18] *See infra* notes 198-212 and accompanying text (discussing the fundamentals of an A-reorganization).

[19] *See infra* notes 135-143 and accompanying text (providing an overview of I.T.A. section 85).

[20] I.R.C. § 367(a)(3) (1994).

[21] This is particularly true in the NAFTA block of countries. Currently, treaties between Canada, the United States and Mexico all contain different provisions regarding the taxation of corporate reorganizations.

One solution to this problem of double taxation in the context of the United States and Canada was the introduction of Article XIII(8) to the U.S.-Canada Tax Treaty.[22] Article XIII(8) was specifically intended to solve

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[22] U.S.-Canada Tax Treaty, *supra* note 3, at art. XIII(8).

Similar provisions have been included in the Canadian tax treaties with Mexico, the Netherlands and, until recently, France. *See* Convention Between Canada and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Apr. 2, 1957, Can.-Neth., S.C. 1986, c.48, part 1; S.C. 1994, c.7, Sched. VII (Second Protocol) art. XIII(6) [hereinafter Canada-Netherlands Tax Treaty]; Convention Between the Government of Canada and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income; Apr. 8, 1991, Can.-Mex., S.C. 1992, c.3, part III, art. XIII(5) [hereinafter Canada-Mexico Tax Treaty]; Convention Between Canada and France for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, *as amended by* Protocol, Jan. 16, 1987, Can.-Fr., S.C. 1974-75-76 c.104, part 1, former art. XIII(4) [hereinafter Canada-France Tax Treaty].

The Canada-Mexico Tax Treaty applies only to amalgamations, divisions and reorganizations involving shares. *See* Canada-Mexico Treaty, *supra*, at art. XIII(5).

The provision in the Canada-France Tax Treaty was repealed in a protocol to the treaty in December 1995. Revenue officials indicated that the main reason was ongoing compliance and enforcement problems.

Article XIV(8) of the U.S.-Netherlands Tax Treaty contains a paragraph similar to that in the U.S.-Canada Tax Treaty but imposes a more affirmative obligation on the Competent Authority of a Contracting State to defer tax in circumstances in which recognition is deferred under the laws of the other state. This deferral is conditional on later collectibility of taxes. The Memorandum of Understanding provides the following explanation. "For example, under the domestic law of the United States, a foreign corporation that qualifies as a 'United States real property holding corporation' is taxed in some circumstances if it transfers its assets to a U.S. corporation in a reorganization. In such a case, only if the shareholders of such foreign corporation agree to reduce basis (if and only to the extent available) by 'closing agreement' can the tax that otherwise would be imposed on such alienation be reasonably imposed or collected at a later time." *See generally* PETER BLESSING, INCOME TAX TREATIES OF THE UNITED STATES, § 12.02(1)(a), at 12-7 (1996).

Article XIII(4) of the U.S.-Spain Tax Treaty permits the source country to tax gains on stock dispositions if the taxpayer held at least 25% of the company's stock during the 12 months preceding the alienation of stock. Paragraph 10 of the 1990 Protocol provides that alienations under Article XIII(4) do not include certain transfers between members of a group of companies that file consolidated returns. *See* Editorial Comment § 67.12 Spain, Article 13: "Taxation and Foreign Related Transactions," Mathew Bender and Co. 67-26.

Article XIII(4) of the U.S.-Mexico Tax Treaty generally permits the source country to tax gains from the sale of a closely held company in which the seller held a 25% or greater participation. Paragraph 13 of the 1992 Protocol provides that in cases where Article XIII(4) of the Treaty permits the source country to tax capital gains from the sale of shares, certain tax-free reorganization rules may eliminate the source country tax. *Id.* at 51-32.

timing problems resulting from the alienation of assets "in the course of a corporate organization, reorganization, amalgamation, division or similar transaction"[23] and, after January 1, 1996, "other organizations."[24] Specifically, Article XIII(8) provides where "profit, gain or income with respect to the alienation is not recognized for the purpose of taxation" in the state of residence of the alienator, the Competent Authority in the taxing state may agree, subject to terms and conditions, to defer the recognition of the profit, gain or income with respect to such alienation so as to avoid double taxation.[25] The result is a deferral of taxation at the discretion of the Competent Authority of the taxing state. Ideally, the deferral will be granted until such time that there is a taxable disposition of the asset in the nonrecognition State, as this would facilitate a matching of foreign tax credits with domestic tax liability.

United States residents who own Canadian assets need to be concerned about Canadian tax liability and double taxation relief, particularly if a corporate restructuring involves the transfer of Canadian assets. This paper discusses the taxation of U.S. residents in these circumstances and the potential for relief under Article XIII(8) of the U.S.-Canada Tax Treaty. It begins by outlining the general Treaty provisions for the taxation of capital gains and, in particular, the provisions that establish Canada's jurisdiction to tax. The discussion then turns to the potential relief available under Article XIII(8) of the U.S.-Canada Tax Treaty . This is followed by a series of examples to illustrate when tax issues may arise for the U.S. taxpayer during the course of a corporate organization, reorganization or dissolution. The Article also discusses when relief may be available and, perhaps more importantly, when the U.S. taxpayer can anticipate that relief will not be offered.

In order to qualify for Article XIII(8) relief, a corporate transaction must qualify for nonrecognition treatment under both the Canadian and U.S. tax laws. The Article provides a description of the Canadian corporate nonrecognition provisions and a description of corresponding U.S. provi-

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[23] U.S.-Canada Tax Treaty, *supra* note 3, at art. XII(8).

[24] The words "other organizations" were added by the Third Protocol to the U.S.-Canada Tax Treaty and became effective after January 1, 1996. Article XIII(8) is implemented under Canadian domestic law through the provisions of I.T.A. section 115.1. This provision is very generally worded and would accommodate similar provisions in other Canadian tax treaties whether or not yet currently in force. Canada is one of the first countries to include such a provision in a tax treaty.

[25] U.S.-Canada Tax Treaty, *supra* note 3, at art. XIII(8).

sions. It also provides a detailed and practical analysis of both the Canadian Competent Authority function and the procedures for the U.S. taxpayer to obtain relief under Article XIII(8). The paper concludes with a discussion of some potential problem areas and planning suggestions.

The Treaty provisions are analyzed from the perspective of a U.S. taxpayer with potential Canadian tax liability. Contrary to usual procedure, which requires a U.S. taxpayer to seek treaty relief from the U.S. Competent Authority, under Article XIII(8), relief must be sought by a U.S. taxpayer with Canadian assets from the Canadian Competent Authority. The Treaty provisions are, of course, reciprocal. The paper concludes with a discussion of some double taxation problems that continue to exist under the U.S.-Canada Tax Treaty for an organization or reorganization and some general suggestions for solutions.

II. U.S.-CANADA TAX TREATY

Both Canada and the United States tax the worldwide income of their citizens and residents,[26] as well as the domestic source income of nonresidents.[27] This broad definition of income often leads to double taxation, which can be relieved by either foreign tax credits[28] or deductions allowed by the country of citizenship or residency.[29] The U.S.-Canada Tax Treaty attempts to limit the incidences of double taxation while preserving each country's right to tax certain income.

The U.S.-Canada Tax Treaty[30] is based on the OECD Model Treaty, subject to a number of additional refinements.[31] The OECD Model Treaty comes replete with extensive commentaries documenting the understanding of the various signatories and the general intent of each treaty provision. The Supreme Court of Canada has recently held that the OECD Model

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[26] I.R.C. §§ 1, 11(a), 61; I.T.A. section 2.

[27] I.R.C. §§ 2(d), 11(d), 871(b), 872(a), 882(a); I.T.A. section 3 and part XIII.

[28] I.R.C. §§ 27(a), 901(a); I.T.A. section 126.

[29] I.R.C. §§ 164(a), 275(a)(4)(A); I.T.A. subsection 20(12).

[30] *See supra* note 3 and accompanying text (providing the background of the U.S.-Canada Tax Treaty and its subsequent protocols).

[31] Model Convention on Income and Capital, Report of the Committee on Fiscal Affairs, Organization for Economic Cooperation and Development, Paris, [hereinafter OECD Model Treaty]. In 1996, the OECD had 27 signatory members and three pending members.

Treaty forms part of the "legal context" of the U.S.-Canada Tax Treaty[32] and that it is of "high persuasive value" in the interpretation of treaties.[33] The Canadian Supreme Court's view reflects a long held belief by many Treaty signatories that the OECD Model Treaty and its Commentary represents a consensus between member countries as to the proper model agreement relating to the taxation of income and the avoidance of double taxation. It is, therefore, an important source of information in determining the proper taxation of capital gains under the U.S.-Canada Tax Treaty.

Article XIII of the OECD Model Treaty, the provision governing capital gains, looks to a general notion of "alienation." The Commentary provides that "alienation of property" refers not only to "capital gains" from the sale or exchange of property, but also to a partial alienation, expropriation, transfer to a company in exchange for stock, the sale of a right in property, gifts, and the testamentary passing of property at death.[34] The OECD Model Treaty limits the ability of one State to tax the capital gains of a citizen or resident of the other Contracting State to two circumstances. The first is with respect to gains from the alienation of immovable property located in that state. The gains are taxable in the state in which the property is situated. This provision would also apply to immovable property forming part of the assets of a permanent establishment or, in the case of a business providing personal services, a fixed base. The OECD Model Treaty does not include under this provision the alienation of shares or other interests when the primary aim of the business enterprise is to hold immovable property. Under the OECD Model Treaty, however, the contracting states are free to add such a provision, as was done in the case of the U.S.-Canada Tax Treaty.[35]

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[32] *See* Crown Forest Industries v. the Queen, 2 C.T.C. 64 [1995] (S.C.C.); *see also* Francois Vincent, *Crown Forest Industries: The OECD Model Tax Convention as an Interpretive Tool for Canada's Tax Conventions*, 4 CAN. TAX. J. 38 (1996).

[33] *See* David A. Ward, *Principles To Be Applied in Interpreting Tax Treaties*, 25 CAN. TAX J. 263, 264 (1977) (arguing that the Commentary should be used unless Canada has recorded disagreement by making a specific reservation); *see generally* Crown Forest Industries v. the Queen, 2 C.T.C. 64 [1995] (S.C.C.).

[34] OECD Model Treaty, *supra* note 31, at art. XIII and Commentary. The phrase "capital gain" is intended to have a wider scope than the phrase "sale or exchange" which was used in earlier agreements and led to problems when there were deemed dispositions. *See, e.g.*, Krafve v. MNR, 84 C.T.C. 2021 (T.C.C.) (holding a voluntary transfer of shares to a trust was not a "sale or exchange" under the terms of the 1942 U.S.-Canada Tax Treaty).

[35] *See* U.S.-Canada Tax Treaty, *supra* note 3, at art. XIII(3)(b)(ii)-(iii).

The second circumstance in which gains from the alienation of an asset will be subject to host-country taxation is where the asset is moveable property forming part of the business property of a permanent establishment of an enterprise or pertaining to a fixed base used for performing independent personal services. The term "moveable property" would include all assets related to the permanent establishment or fixed base except immovable property. This term is also broad enough to include incorporeal assets such as goodwill, and licenses,[36] and results in host-country taxation on the disposition of these assets. The paragraph makes it clear that the provision will apply to individual assets of the permanent establishment or fixed base, as well as to the alienation of the permanent establishment or fixed base itself[37] if either are sold as a going concern.

III. THE TREATMENT OF CAPITAL GAINS UNDER THE U.S.-CANADA TAX TREATY

The provisions in the U.S.-Canada Tax Treaty relating to the tax treatment of capital gains are based on the OECD Model Treaty. Before Treaty relief is relevant, however, liability, if any, under Canada's domestic tax law must be determined because the Treaty operates to limit Canada's ability to tax when the Treaty conditions are met.[38] A U.S. taxpayer must be concerned about the circumstances under which Canada may impose a tax on the disposition of a Canadian asset by a nonresident and the limits imposed on that right to tax. In short, it is when Canada's right to tax is preserved under the Treaty that double taxation may occur, so that relief under Article XIII(8) may be necessary.

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[36] OECD Model Treaty, *supra* note 31, at art. XIII and Commentary.

[37] According to the OECD Model Treaty, the provision will only apply with respect to capital gains resulting from the alienation of the enterprise and not necessarily from the alienation of an interest in the enterprise. The distinction lies in whether the property was owned by the alienator. The example offered is a partnership. In some countries, capital assets of a partnership are treated as owned by the partners. In others, the assets are treated similarly to assets owned by corporations. The result is that the alienation of a partnership interest is treated like the alienation of a share and is only taxable in the country of residence. *Id.*

[38] It is commonly agreed by most OECD members that the Treaty does not give a right to tax, but rather operates to limit the ability to tax which is established under a country's domestic law.

A. Liability to Tax

Under I.T.A. section 115, nonresidents of Canada are subject to tax on capital gains from the disposition of "taxable Canadian property."[39] Some of the most common examples of assets falling within this definition include real estate situated in Canada, capital property used in carrying on a business in Canada, and shares of a private corporation resident in Canada.[40] Taxable Canadian property also includes an interest in a partnership in which at least 50% of the fair market value of partnership assets consist of Canadian resource properties, timber resource properties, income interests in trusts, or any other taxable Canadian property. The amount added to a nonresident's taxable income from taxable Canadian property, is any excess of taxable capital gains over allowable capital losses from the disposition of taxable Canadian property, including gains arising from deemed dispositions.[41] Proceeds of the disposition, whether actual or deemed, equal either the fair market value of the property in a non-arm's length transaction or actual proceeds in an arm's length transaction.[42]

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[39] This term is defined in I.T.A. paragraph 115.1(b) and I.T.A. subsection 248(1) for the purposes of I.T.A. section 128.1 (change in residence) and I.T.A. subsection 2(3) (tax payable by nonresident persons). The definition of "taxable Canadian property" in I.T.A. subsection 248(1) also applies to corporations that are granted Articles of Continuance or similar constitutional documents pursuant to I.T.A. subsection 250(5.1) where the Articles of Continuance were granted after 1992.

[40] "Taxable Canadian property" also includes units of certain unit trusts resident in Canada, capital interests in trusts other than unit trusts resident in Canada, and property deemed by another provision of the I.T.A. to be taxable Canadian property. *See, e.g.*, I.T.A. paragraph 128.1(4)(e). The October 2, 1996, Notice of Ways and Means proposed a further expansion of the definition to include, after October 1, 1996, property that is a share of the capital stock of a nonresident corporation and an interest in a partnership or an interest in a nonresident trust that would be taxable Canadian property under I.T.A. paragraph 115(1)(b). CAN. DEP'T FIN. NOTICE OF WAYS AND MEANS MOTION TO AMEND THE INCOME TAX ACT (Oct. 2, 1996).

[41] I.T.A. subparagraph 115(1)(a)(iii).

[42] I.T.A. subsection 69(5); REVENUE CAN., INTERPRETATION BULLETIN IT-420R3, NON-RESIDENTS INCOME EARNED IN CANADA, March 30, 1992, ¶ 17 (as revised Feb. 20, 1995), *available in* LEXIS, Intlaw Library, TNI File.

B. Article XIII[43]

Article XIII of the U.S.-Canada Tax Treaty limits Canada's right to tax gains[44] on the disposition of taxable Canadian property under the two general circumstances described in Article XIII in the OECD Model Treaty: when there is an alienation of either Canadian real property[45] or personal property forming part of a permanent establishment or fixed base of the U.S. resident in Canada.[46] These are discussed more fully below.

1. Real Property

Gains derived by a U.S. resident from the alienation of "real property" situated in Canada will be subject to Canadian tax.[47] Article XIII(3) defines "real property" situated in Canada to include real property as defined in Article VI of the Treaty. Article VI(2) provides that "real property" shall

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[43] Article XIII was originally introduced in the 1942 U.S.-Canada Income Tax Convention. At that time, the introduction of a Treaty provision to address capital gains was viewed by many as excessively cautious because the possibility of a Canadian capital gains tax was regarded as unlikely. However, since the role of capital and gains from sale or employment of capital were, in the post war period, the focus of various world committees, including the U.N. Committee for Economic Development, a capital gains provision was added to the Treaty. It was not until three decades later that Canada actually enacted a tax on capital gains as part of Tax Reform in 1971. For a discussion of this point, see Howard Stikeman Q.C., *Gains on Alienation of Property, in* IFA: SPECIAL SEMINARS ON INTERPRETING TAX TREATIES 33 (DeBoo ed., 1977).

[44] *See infra* note 91 (defining the word "gains" as meaning "capital gains"). There is no definition of "capital gain" for purposes of the U.S.-Canada Tax Treaty. Under general treaty interpretation rules, this would result in the domestic law of the Contracting State controlling unless the context in which the term is used requires a definition independent of domestic law. In other words, the meaning of the term "capital gain" must be found under the domestic laws of Canada since it is the contracting state with the right to tax. For Canadian tax purposes, a "capital gain" is described as the gain from the disposition of any property, timber resource property, an interest of a beneficiary under a mining reclamation trust, an interest in an insurance policy, and certain objects designated under the Canadian Cultural Property Export Review Board. I.T.A. subsection 39(1).

[45] U.S.-Canada Tax Treaty, *supra* note 3, at art. XIII(1). The term "immovable property" in the OECD Model Treaty has been replaced by the term "real property" in the U.S.-Canada Tax Treaty. *See* U.S.-Canada Tax Treaty, *supra* note 3, at art VI.

[46] *Id.* at art. XIII(2).

[47] *Id.* at art. XIII(1).

have the same meaning as under the I.T.A.,[48] and shall include: "rights to explore for or to exploit mineral deposits, sources and other natural resources, and rights to amounts computed by reference to the amount or value of production from such resources."[49] "Real property" situated in Canada also includes a the corporate stock of a company where the share's value is derived principally[50] from real property situated in Canada,and an interest in a partnership, trust or estate the value of which is derived principally from real property situated in Canada.[51]

Additionally, the U.S.-Canada Tax Treaty definition of "real property" may affect a much broader category of nonresident real property holders. When asked about a similarly worded provision under the Canada-United Kingdom Tax Treaty,[52] Revenue Canada indicated the definition of "real property" may also include shares of a Canadian corporation engaged in manufacturing and processing, if the greater part of the value of the corporate assets is derived from the plant and property.[53] It is not clear if value is historic or based on the net or gross value of the property.[54] Thus,

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[48] "Real property" in Article VI of the Treaty includes real property as defined under the tax laws of the Contracting State in which the property in question is situated, "including any option or similar right in respect thereof." *Id.* at art. VI(2).

[49] *Id.*

[50] *See* REVENUE CAN., INTERPRETATION BULLETIN IT-173R2, CAPITAL GAINS DERIVED IN CANADA BY RESIDENTS OF THE UNITED STATES (Jan. 30, 1989) (as revised by Special Release Feb. 12, 1996), *available in* LEXIS, Intlaw Library, TNI File) [hereinafter INTERPRETATION BULLETIN IT-173R2].

[51] According to the 1984 technical notes to the Treaty, the term "principally" means more than 50%. STAFF EXPLANATION ON PROPOSED PROTOCOL TO THE U.S.-CANADA INCOME TAX TREATY (prepared for the April 26, 1984, hearing of the U.S. Foreign Relations Committee) [hereinafter 1984 Technical Explanation]. It has also been approved by the Canadian Department of Finance. REVENUE CAN., Release No. 84-128 (Aug. 16, 1984). *See also* U.S. TREAS. DEP'T TECHNICAL EXPLANATION OF THE MARCH 17, 1995 PROTOCOL, (June 17, 1995) [hereinafter 1995 Technical Explanation]. The Canadian Minister of Finance agreed that the Technical Explanation accurately reflects understandings reached in the course of negotiation Department of Finance News Release 95-048 (June 13, 1995).

[52] *Canada-United Kingdom Tax Convention Act*, Dec. 18, 1980, Can.-U.K., S.C. 1980-81-82-83, c.44, part X, *and* 1995 Protocol, enacted in Canada by S.C. 1995, c.34, Royal Assent, November 8, 1995 (enacting art. XIII(5)(a)).

[53] The Canadian treaties between West Germany and Belgium specifically exempt such shares from the capital gains provisions. *See Canada-Belgium Income Tax Convention Act*, 1976, May 29, 1975, Can.-Bel., S.C. 1974-75-76 c.104, part II, art. XIII(3); *Canada-Germany Tax Agreement Act*, 1982, July 17, 1981, Can.-F.R.G., S.C. 1980-81-82-83 c.156, art. XIII(4).

[54] *See also* REVENUE CAN., TECHNICAL INTERPRETATION March 1991-179, APPLICATION OF ARTICLE 13 OF THE CANADIAN-UNITED KINGDOM INCOME TAX TREATY, (March 1991). Revenue Canada stated:

if unintended tax consequences are to be avoided, a careful analysis of the assets of a Canadian subsidiary is required before any form of corporate merger involving the Canadian shares is implemented. Finally, in the opinion of the Revenue Canada, real property also includes options and convertible debentures when the value of the underlying shares is derived principally from real property situated in Canada.[55] Therefore, the potential for double taxation exists in situations where these assets are part of a U.S. corporate restructuring.

2. *Personal Property*

Article XIII(2) of the U.S.-Canada Tax Treaty addresses the taxation of gains derived by a U.S. resident on the alienation of personal property located in Canada. Article XIII(2) provides that such gains will be taxable in Canada only if the alienated property is either part of the business property of a permanent establishment[56] which the U.S. resident had in

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> A determination of from what shares derive their value or the greater part of their value is essentially a question of fact that can only be made after considering all of the relevant facts including the manner in which the underlying assets are financed and the obligations pertaining to such assets.

Id.

[55] REVENUE CAN., TECHNICAL INTERPRETATION 9426405, ARTICLE XIII(3) U.S.-CANADA CONVENTION-SHARE INCLUDED OPTION, (Feb. 10, 1995); REVENUE CAN., TECHNICAL INTERPRETATION 9532295, CONVERTIBLE DEBENTURE, (Mar. 16, 1996).

[56] The term "permanent establishment" is defined in Article V(1) of the Treaty as "a fixed place of business through which the business of a resident of (the United States) is wholly or partly carried on." The term specifically includes a place of management, a branch, an office, a factory, a workshop, a mine, oil or gas well, quarry and any other place of extraction of natural resources. *Id.* at art. V(2)(a)-(f). In addition, a building site or construction or installation project that continues for more than 12 months will be considered a permanent establishment. *Id.* at art. V(3). Finally, the use of a drilling rig or ship in the other contracting state for a period of more than three months in any twelve month period to explore for or exploit natural resources will fall within the definition. *Id.* at art. V(4).

Canadian cases have followed U.S. jurisprudence in holding that to be a "permanent establishment," an office must be staffed and capable of carrying on the business of the taxpayer, and plants or other facilities must be equipped to carry on the taxpayer's business activity. *See* Richard G. Tremblay, *Permanent Establishments in Canada*, 2 J. INT'L TAX 305, 307 (1992). Revenue Canada has, however, adopted a broad view of what constitutes a site or installation project. In a recent ruling, Revenue Canada was asked to consider whether a U.S. corporation which sold to and later installed computer software for an

Canada within the twelve month period preceding the date of alienation or pertain to a fixed base[57] which is available to the U.S. resident for the purpose of performing independent personal services or which was so available within the twelve month period preceding the date of alienation. These rules apply to both the alienation of the individual assets of the permanent establishment or fixed base, as well as the alienation of either the entire permanent establishment[58] or the entire fixed base if sold as a going

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unrelated Canadian corporation had a permanent establishment in Canada where employees of the U.S. corporation provided installation and maintenance services in Canada. Citing several authorities, Revenue Canada concluded that although testing computer software and setting up a data base is not likely an installation project, an installation project does not need to be related to a construction project. *Canadian Technical Interpretation, Reorganization and Foreign Division*, July 5, 1994 ¶ 3241, Report No. 46, Window on Canadian Tax Newsletter, THE TAX WINDOW (CCH) 9 (Apr. 1995). Revenue Canada has stated that a foreign corporation may have a permanent establishment in Canada and may be carrying on business in Canada if one of its employees provides expertise as a project manager for a job of the Canadian subsidiary. A permanent establishment may also exist where the Canadian subsidiary makes space available to a foreign corporation. *Id.*

[57] The term "fixed base" is not defined in the Treaty. In INTERPRETATION BULLETIN, *supra* note 50, Revenue Canada stated:

> A fixed base would include, for example, a physician's consulting room, the office of an architect or the office of a lawyer. It would not be uncommon for such a fixed base to be located at the place in Canada where a resident of the United States stays temporarily and performs independent personal services while in Canada. However, the department has taken the position that an individual will not be considered to have a fixed base if the period in Canada for performing the independent personal services is less than 61 days and the services in Canada are not performed on a reoccurring basis.

[58] This requires analysis of whether a wholly-owned subsidiary will be viewed as a permanent establishment of the United States parent corporation. Under the Treaty, a resident of the United States is not deemed to have a permanent establishment in Canada merely because the United States resident carried on business in Canada through an agent of independent status. U.S.-Canada Tax Treaty, *supra* note 3, at art. V(5). Revenue Canada has stated that "while it is possible for a wholly-owned subsidiary to be an independent agent of its nonresident parent, there are no precise tests to determine whether a person is an independent agent of another person." Technical Interpretation 9314270, "Permanent Establishments and Independent Agents," (June 14, 1993). Permanent establishment status for the subsidiary would result in tax liability for the U.S. parent on the basis of the parent's profit attributable to the permanent establishment if the subsidiary is not an independent agent. Query would it also result in liability under Article XIII for the U.S. parent when assets of the U.S. subsidiary are alienated? The argument for liability would be based on the Treaty right to tax gains on the alienation of assets that form part of a permanent establishment of

concern.[59]

3. Other Gains

Gains from the alienation of property other than the real property and personal property described above is only taxable in the Contracting State of which the alienator is resident.[60] Accordingly, in the case of U.S. citizens disposing of Canadian assets, the disposition will result only in U.S. tax liability. Article XIII(5) provides an exception to this general rule and reserves Canada's right to tax an individual who is a resident of the United States on gains from the alienation of property in defined circumstances. Specifically, if the individual was a resident of Canada for 120 months during any period of twenty years prior to the alienation of the property or was a resident of Canada during the ten years immediately prior to the alienation of the property, and owned the property at the time of ceasing to be resident of Canada, Canada retains its right to tax.[61]

Finally, a transitional rule recognizes the fact that under provisions of the 1942 U.S.-Canada Tax Treaty, gains derived by a resident of the United States from the sale or exchange of assets located in Canada were exempt from tax in Canada if the U.S. resident did not have a permanent establishment in Canada at any time during the taxable year in which the sale or exchange occurred.[62] This transitional rule, where applicable, reduces the amount of the capital gain that would otherwise be subject to Canadian tax under the 1980 Treaty, provided certain conditions are met.[63]

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a nonresident. Taxing the U.S. parent corporation in these circumstances seems absurd when one considers that ownership of the assets belongs to the subsidiary.

[59] *See generally* Michael G. Quigley, *Permanent Establishments Under the Canada-United States Tax Treaties—The Old and the New*, N.C. J. INT'L L. & COM. REG. 362, 363 (1981).

[60] U.S.-Canada Tax Treaty, *supra* note 3, at art. XIII(4).

[61] *Id.* at art. XIII(5). The exception also permits Canada to tax gains on the disposition of certain replacement property acquired in substitution for property owned at the time of ceasing to be resident of Canada if the replacement property was acquired in an alienation transaction the gain on which was not recognized for taxation in Canada.

[62] *Id.* at art. XIII(9).

[63] *Id.* The person must either have owned the asset on September 26, 1980, and been a resident of the United States on that date and at all times until the alienation or have acquired the asset in a transaction which qualified as a nonrecognition transaction for Canadian tax purposes. The reduction will not apply if the asset formed part of the business property of a permanent establishment or fixed base in Canada, to an asset owned at any time after September 26, 1980, and before the alienation by a nonresident of the United States or to the

IV. TREATY SOLUTIONS

A. Corporate Organizations, Reorganizations, Amalgamations, Divisions or Similar Transactions

As discussed, Article XIII(8) of the U.S.-Canada Tax Treaty was intended to solve timing problems that result in double taxation upon the alienation of assets "in the course of corporate organizations, reorganizations, amalgamations, divisions or similar transactions"[64] and, after January 1, 1996, "other organizations." A number of threshold issues must be addressed to determine for whom and under what circumstances relief will be granted.

1. Residence

Relief is limited to those taxpayers who are considered "resident[s]" of the other Contracting State. Canadian taxpayers applying for relief are also subject to the general limitation imposed under the Limitation of Benefit provisions.[65] These provisions were considerably expanded under the Third Protocol to prevent so called "treaty shopping" and are used by the United States to restrict access to Treaty benefits.[66]

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alienation of an asset that was acquired by a person at any time after September 26, 1980, and before the alienation in a transaction other than a nonrecognition transaction.

[64] U.S.-Canada Tax Treaty, *supra* note 3, at art. XIII(8). *See infra* note 19.

[65] U.S.-Canada Tax Treaty, *supra* note 3, at art. XXIXA. Canadian residents seeking Treaty relief are subject to the Limitation of Benefit provision which is applied by the United States, but not Canada. Canada may, however, have developed its own domestic version of the Limitation of Benefits Article. *See, e.g.*, Crown Forest Industries v. The Queen, 2 C.T.C. 64 [1995] (S.C.C.) (restricting the meaning of "resident" for treaty purposes).

[66] The Third Protocol added Article XXIXA to limit the benefits of the Treaty to *bona fide* residents of Canada. It is applied only for the purpose of the application of the Treaty by the Unites States. Article XXIXA(7) provides that the Article does not restrict either country's right to deny the benefits of the Treaty if abuse of the provisions of the Convention is a reasonable conclusion. Under this Article, only "qualifying persons" as defined in Article XXIXA(2), are entitled to full Treaty benefits. If a resident of Canada is not entitled to the benefits of the Treaty under this Article, that taxpayer can request the U.S. Competent Authority to grant such benefits. Treaty benefits may be granted if the U.S. Competent Authority determines that the principal purpose of the taxpayer's creation and existence is not to obtain Treaty benefits, or if it is inappropriate to deny Treaty benefits given the purpose of the Limitation on Benefits Article.

Article XIII(8) applies when a "resident of a contracting state" alienates property under circumstances in which the alienation is not recognized for the purposes of taxation in the alienator's state of residence. The wording of the Article was expanded under the Third Protocol to include organizations of noncorporate entities such as partnerships and trusts.[67] However, it is unclear whether, or the extent to which, a partnership, joint venture, or other unincorporated association of persons, is to be considered a resident of either Canada or the United States for purposes of the Treaty.[68] In this regard, a close examination of Canadian and U.S. domestic tax provisions is required to determine when Treaty relief will be available.

Unfortunately, Canadian domestic tax provisions also fail to provide rules for determining the residence of partnerships.[69] For Canadian tax purposes, a partnership is treated as a "separate nontransparent entity for the purposes of the computation of net income or loss, but is treated as a flow-through or transparent entity for the purposes of calculating the taxable income of the partners."[70] Accordingly, the residence of individual partners will generally be relevant only to determine if domestic rollover provisions may be utilized by the partnership on the transfer of assets to, or from, the partnership.[71]

A nonresident partner will be considered as carrying on business in Canada through a partnership operating in Canada and will also be considered to have a permanent establishment in Canada.[72] A nonresident

[67] Formerly, Article XIII(8) was restricted to transactions involving corporations.

[68] *See generally* Carol A. Dunahoo, Associate International Tax Counsel, United States Department of the Treasury *in* Richardson, Tobin, et al., *Summary of International Tax Planning 1: Canada-U.S. Cross Border Issues*; THE PROCEEDINGS OF THE FORTY-SIXTH TAX CONFERENCE, 1994 CONFERENCE REPORT (Toronto: CANADIAN TAX FOUNDATION, 1995) 24:1 at 24:5; Carl F. Streiss, *Issues Relating to Tax Treaties*, CTF 45:1 at 45:14; and H. Kellough and P. McQuillan, *Canadian Taxation of Domestic and Foreign Partnerships*, International Fiscal Association, 1995 Conference, Toronto.

[69] This is probably because partnerships are not viewed as being taxpayers for most tax purposes.

[70] *See* David R. Allgood, *Alternatives for Single Project Joint Ventures In Canada*, 2 J. INT'L TAX 92 (1992).

[71] *See, e.g.*, I.T.A. subsections 96(8), 102(1). *Income Tax Conventions Interpretation Act*, R.S.C. 1985, c.I-4, *as amended*, further provides that for the purpose of the application of a treaty and the I.T.A. to a person who is resident in Canada, a partnership, of which the person is a member, is neither a resident nor an enterprise of that other state.

[72] *See supra* note 56 (defining "permanent establishment"); for cases related to this concept see Randall v. The Queen, 1 C.T.C. 268 [1985] (F.C.T.D.); Grocott v. The Queen, 1 C.T.C. 2311 [1995] (T.C.C.); Robinson Trust v. R., 2 C.T.C. 2685 [1993] (T.C.C.); No. 630

partnership consisting of nonresident partners will also be considered a "person" for Canadian withholding tax purposes under Part XIII of the I.T.A.[73] However, to claim treaty relief, the partnership must be resident in the United States. However, because the partnership itself is not liable for tax in the United States, it appears that it cannot be a resident of the United States for Treaty purposes. Therefore, the partnership entity will be disqualified from Treaty protection. Thus, if a U.S. partnership disposes of taxable Canadian property, the issue arises as to whether Article XIII(8) relief will be available at all. Revenue Canada appears to adopt at least a partial "look through" approach in these circumstances. According to Revenue Canada, when taxable Canadian property is disposed of, each partner must comply with I.T.A. section 116 and report the gain on the disposition of the property.[74] One author states, "this seems to imply that each partner is considered to have disposed of the partner's proportional share of the partnership's taxable Canadian property as though the partner had individual ownership in such property."[75] If this interpretation is correct, partners resident in the United States should be entitled to claim Treaty relief, including relief under Article XIII(8), on their share of the gain from the alienation of partnership property. A representative of the United States Department of the Treasury commented that the United States authorities also generally apply a "look through" approach to analyzing partnerships in the Treaty context and that Treaty benefits are granted to the extent that the partners themselves qualify for such benefits.[76] Although neither Canada nor the United States has resolved the question of where a partnership is a resident for Treaty purposes and under what circumstances relief may be sought by a partner or partnership under Article XIII(8), the amendments to Article XIII(8) in the Third Protocol would suggest that

v. MNR, 22 Tax A.B.C. 91 [1959] (T.A.B.); Enterprise Blaton-Aubert v. MNR, C.T.C. 609 [1972] (F.C.T.D.).

[73] I.T.A. paragraph 212(13.1)(b) and part XIII.

[74] "Revenue Canada Round Table," *in* REPORT OF THE PROCEEDINGS OF THE THIRTY-NINTH TAX CONFERENCE, 1987 CONFERENCE REPORT (Toronto: CANADIAN TAX FOUNDATION, 1988), 47:47.

[75] Streiss, *supra* note 68, at 45.19.

[76] *See* Donroy, Ltd. v. United States, 301 F.2d 200, 208 (9th Cir. 1962) (holding that a partnership was not a legal entity separate from its partners). See also Robert Unger, 58 T.C.M. 1157 (1990), in which the United States Tax Court applied the aggregate theory of partnership under which the partners are regarded as holding an undivided interest in the assets of the partnership.

partners are not necessarily precluded from claiming U.S.-Canada Tax Treaty benefits in some circumstances.[77]

2. Alienation

In addition to the residence requirement, a second prerequisite for Article XIII(8) relief is that a nonresident alienate property be situated in the other contracting state. The term "alienation" was added in the 1980 to the U.S.-Canada Tax Treaty replacing the words "sale or exchange." This amendment extended the provision to other types of dispositions such as deemed dispositions when considered taxable events under the laws of either Canada or the United States.[78] Deemed dispositions will generally arise in one or both countries in circumstances where there is a change in the use of assets, gifts, distributions and debt modifications.[79] In the future, it would appear a deemed disposition will also occur with respect to business assets when a nonresident ceases to carry on business in Canada, if the assets were used to carry on business.[80]

3. In the Course of a Corporate or Other Organization, Reorganization, Amalgamation, Division or Similar Transaction

Article XIII(8) refers to "the alienation of property in the course of a corporate or other organization, reorganization, amalgamation, division, or similar transaction."[81] In the case of a United States resident seeking relief from the Canadian Competent Authority, the meaning of this clause must be

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[77] *See also* U.S.-Canada Tax Treaty, *supra* note 3, at art. XXVI(3)(f). The Competent Authorities of both Contracting States have agreed to resolve by mutual agreement "the elimination of double taxation with respect to a partnership."

[78] *See* INTERPRETATION BULLETIN, *supra* note 57, ¶ 1.

[79] *See* Derek T. Dalsin, *Dispositions of Property by Nonresidents: Tax Deferral by Ministerial Discretion*, 39 CAN. TAX J. 77, 84 (1991).

[80] *Id.*

[81] The words "other organization" were added by the Third Protocol to the Canada-U.S. Tax Treaty effective after Jan.1, 1996. The term "reorganization" is not a defined term in Canadian jurisprudence. For Canadian tax purposes the words "winding-up," "discontinuance" and "reorganization" refer to the corporation's business, not to the corporate entity itself. In Merritt v. MNR, C.T.C. 226 [1940-41], the Exchequer Court felt no need to attempt any precise definition, holding that the treatment of the business in that case fell "somewhere within the meaning and spirit of those words."

found in Canadian domestic law.[82] Unfortunately, neither the complete phrase nor all of the individual words are defined for Canadian tax purposes. Additionally under Article XIII(8), relief is possible only if the transaction meets the requirements of a nonrecognition provision in both the United States and Canada but for the fact that the transferor is a nonresident in one of the countries. There are four main provisions which govern corporate organizations and reorganizations on a tax-deferred basis in the Canadian tax system.[83]

4. To Avoid Double Taxation

Article XIII(8) allows the Competent Authority to enter into a nonrecognition agreement with the person acquiring the asset "in order to avoid double taxation."[84] The notion of "double taxation" when used in this context is unclear. Technically, double taxation occurs when the "same gain" is taxed in the "same hands" by two jurisdictions. The taxation of the same economic benefit in different legal hands would not, therefore, fall within the traditional definition of double taxation.[85] This latter form of economic

[82] The basic rule, unless specifically altered in the Treaty, is that the country in which the income arises or in which the asset or business is situated, will have the first jurisdiction to tax. It follows that it will therefore also be the country which imposes its view of what the Treaty means, which is generally determined by its own jurisprudence. *See* Article III of the OECD Model Treaty; *supra* note 31; *see also* Catherine A. Brown, *General Problems: Interpretation and Application of Double Taxation Agreements*, *in* TAX ASPECTS OF THE TRANSFER OF TECHNOLOGY: THE ASIA PACIFIC RIM, CANADIAN TAX PAPER No. 87 (Toronto: CANADIAN TAX FOUNDATION, 1990) 12, 13. Generally, the words "winding-up, discontinuance and reorganization" refer to the corporation's business, not to the corporate entity itself. "Business" may be defined widely enough, or narrowly enough, to include almost any corporate activity; therefore, any change from one type of business to another may be construed as a "winding-up, discontinuance or reorganization" of a business.

[83] These provisions include: I.T.A. section 85, a transfer of assets to a corporation by a taxpayer (including a partnership) in exchange for stock, a stock for stock exchange under I.T.A. section 85.1 in which the shareholders of one corporation exchange their shares for shares in another corporation, an amalgamation under I.T.A. subsection 87(1), and the winding-up of a subsidiary into a parent under I.T.A. subsection 88(1).

[84] U.S.-Canada Tax Treaty, *supra* note 3, at art. XIII(8).

[85] *See* Commentary to Article 13, OECD Model Treaty, *supra* note 31. *See generally* Manuel Pires, *International Juridical Double Taxation of Income*, Series on International Taxation No. 11, Kluwer and Taxation Publishers.

double taxation is often the result in a corporate reorganization.[86]

A second concern is the relevance, if any, of the words "to avoid double taxation" contained in Article XIII(8) to the scope of the potential relief available. This wording is found in the U.S.-Canada Tax Treaty, but is not in the Canadian tax treaties with the Netherlands, or Mexico, or the former provisions in the tax treaty with France.[87] The inclusion of this phrase in the U.S.-Canada Tax Treaty appears to limit relief to situations where an overall gain would otherwise result from the transaction. It appears that relief will not be available under Article XIII(8) in order to preserve a loss which would otherwise result upon reorganization.[88] Accordingly, planning to preserve losses would be difficult under the U.S.-Canada Tax Treaty but may be available under other treaties which do not contain the equivalent wording "to avoid double taxation."

[86] For example, a U.S. parent corporation may transfer an asset to a U.S. subsidiary corporation in a transaction which is taxable in Canada, but which falls within a nonrecognition provision under U.S. tax law. As a result, the parent transferor corporation is taxed by Canada on the gain accrued on the transferred asset and, on a subsequent disposition of the asset by the subsidiary corporation, the subsidiary will be subject to United States tax liability on the same accrued income preserved in the subsidiary corporation's transferred basis in the asset acquired. *See, e.g.*, *infra* part V.A. (providing examples and citations). Notwithstanding the fact that two different legal persons are taxed on the gain as a result of the initial alienation and subsequent disposition, it would appear that the Canadian Competent Authority is providing Article XIII(8) relief. Double taxation is, therefore, clearly not limited to double taxation of the same taxpayer. Instead, it would appear to equate more loosely with the notion of double taxation of the same economic gain to those with a common economic interest.

[87] *See* Canada-Netherlands Treaty, *supra* note 22, at Sched. VII (Second Protocol) Article XIII(6); Canada-Mexico Treaty, *supra* note 22, at art. XIII(5); Canada-France Treaty, *supra* note 22, at art. XIII(4) (*repealed*).

[88] Telephone conversation between the Author and the Canadian Competent Authority, May 1996 (*copy of notes on file with the author*). In the facts presented by the Competent Authority, the relief sought was a deferral of the loss recognition by a rollover of the asset at its adjusted cost base. The parties sought to preserve the potential loss for later use. The Canadian Competent Authority indicated that relief is available only if there is an overall gain on the disposition of assets and, thereby, the potential for double taxation. This view was affirmed in the 1984 Technical Explanation to the Treaty which provides that an agreement with respect to a deferral of gain will be granted only to the extent necessary to avoid double taxation of the income. *See* 1984 Technical Explanation to the Canada-U.S. Tax Treaty, *supra* note 54.

5. *Income, Profits or Gain*

As previously discussed, Article XIII(8) was introduced to provide relief from double taxation in the course of a "corporate organization, reorganization, amalgamation, division or similar transaction."[89] The provision, although housed in Article XIII, appears to go well beyond providing relief in situations where capital gains arise.[90] While, the relief is specifically directed to "income, capital and profit" as well as to capital gains,[91] the Treaty was intended to accommodate many of the tax issues, associated with a potential deferral, including adjustments for potential recapture and the realization of other income amounts or profit.[92] The Canadian provisions which formerly implemented Article XIII(8) were also directed at income generated by depreciable property, Canadian resource property, foreign resource property, eligible capital property and inventory, as well as

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[89] U.S.-Canada Tax Treaty, *supra* note 3, at art. XIII(8).

[90] I.T.A. section 115.1, which implements the Treaty provision, includes a tax deferral for capital property (including depreciable property), Canadian resource property, foreign resource property, eligible capital property and inventory otherwise subject to Canadian tax.

[91] *See* 1984 Technical Explanation, *supra* note 51. In a recent technical interpretation, Revenue Canada confirmed that the word "gains" in Article XIII of the Canada-U.S. Tax Treaty means "capital gains." The Ruling provided the following commentary:

> It is our view that where an income tax convention or agreement uses the word "gains," it is referring to capital gains: otherwise the term "income," "business profits" or some other specific type of income is generally referred to. If the word "gains" included income in addition to capital gains, the phrase "profits, income or gains" as used throughout the Convention (e.g. Article XIII(8), Article XXIV(2)(a), 3(b), and 4(a)) would not be so used for there is no need to repeat the word "income" in that phrase. Furthermore, if the word "gains" also included income in addition to capital gains, then gains derived from the alienation of real property as described in Article XIII(1) would include income from the alienation of real property (e.g. recapture of capital cost allowance) and there would not be any need of the specific provisions of para I of Article VI. In addition, the Convention was patterned on the OECD Model Convention and Article XIII of that convention clearly indicates that it is only applicable to capital gains.

See Can. Rev. Rul. 9518087.

[92] It is important to note that where relief is being sought from the Canadian Competent Authority, the profit, gain or income will be the amount determined for Canadian and not United States tax purposes.

nondepreciable capital property.[93] Although these specific references have been replaced by a broader provision, the underlying intent remains to provide relief for more than just capital gains on an alienation. This certainly exceeds the scope of capital gains taxation as originally envisioned in Article XIII of the OECD Model Treaty and Canada's previously stated position on the role of Article XIII of the U.S.-Canada Tax Treaty.[94]

Notwithstanding the apparent broadness of Article XIII(8), the fact that relief is available with respect to "income, gain or profits" may, in some cases, still result in the double taxation of income or gains. For example, Article XIII(8) will not provide assistance if a basis or pool tax reduction exists at the time of disposition of an asset. This is often the situation with regard to Canadian resource property.[95] As a result, the amount of income actually realized on the alienation may be nil or nominal when compared to

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[93] Former I.T.A. section 115.1, *as amended by* 1993, c.24, s.51 after 1984.

[94] *See, e.g.*, REVENUE CAN., TECHNICAL INTERPRETATION 95108087, GAINS IN U.S. TREATY AND LIFE INSURANCE PROCEEDS, Sept. 13, 1995; *see also* Richard Deboo, *Problems in Tax Treaty Interpretation, in* INTERNATIONAL FISCAL ASSOCIATION - CANADIAN BRANCH, TEXTS OF SEMINAR PAPERS, May 14, 1985 (Toronto: DeBoo ed., 1985), at 43. The question posed was whether Revenue Canada considered recapture realized on a disposition of real property situated in Canada by a U.S. resident to be a gain from the alienation of such property within the meaning of Article XIII or whether it was income from the alienation of such property within the meaning of Article VI. Revenue Canada's response was as follows:

> It is our view that Article XIII of the Canada-U.S. Treaty basically follows the OECD model. Since the model clearly refers to capital gains, we are of the view that the term "gain" as used in Article XIII of the Canada-U.S. Income Tax Convention refers to capital gains. Accordingly, recapture of CCA (depreciation) will fall within Article VII, Article XIV or Article VI, depending on the circumstances, and any capital gain will fall under Article XIII.

[95] It may also indirectly cause acceleration of Canadian tax on the future resource income of a nonresident taxpayer. For a comprehensive discussion of this issue, see Dalsin, *supra* note 79, at 86-87. For Canadian tax purposes, oil and gas acquisition costs, exploration expenses, and development expenses are accumulated in pools. These are called cumulative Canadian oil and gas expense (CCOGPE), I.T.A. subsection 66.4(5); cumulative Canadian exploration expense (CCEE), I.T.A. subsection 66.1(6); and cumulative Canadian development expense (CCDE), I.T.A. subsection 66.2(5). Upon the disposition of Canadian resource property, the proceeds are first applied to reduce these pools beginning with the CCOGPE pool. I.T.A. subsection 66.2(5). A negative balance in the CCOGPE pool will reduce the CCDE pool, and a negative balance in that pool will be taxed as income. *See generally* Div. B, Subdiv. E, I.T.A. section 66. A U.S. alienator of Canadian resource property would be required to utilize its tax pools, with respect to a variety of oil and gas related expenditures, before "profit, gain or income" would be recognized for Canadian tax purposes. *Id.*

the subsequent tax liability in the United States on the later disposition of the asset. Unless the definition of "income" for Treaty purposes includes the mandatory reduction of resource pools on disposition, the relief under Article XIII(8) may be largely unavailable.

A similar result may occur if a depreciable asset which is part of a permanent establishment or fixed base in Canada is transferred from a U.S. parent corporation to its U.S. subsidiary. Depreciable assets are also subject to a pooling concept under Canadian law.[96] On the disposition of a depreciated asset, recaptured income, if any, is taxable.[97] However, if the asset is part of pool of assets, it will not result in recaptured income until the cost base of the other assets in the pool has also been recovered.[98] Thus, if the pool contains multiple assets, little or no taxable income may result on the alienation of a particular depreciable asset for Canadian tax purposes if the undepreciated capital cost of the class exceeds the deemed proceeds.[99] Nonetheless, the asset's low basis will be preserved in the U.S. transferee's hands and the same gain will be subject to U.S. tax on a later disposition.[100]

B. *Nonrecognition and Timing Problems for Individuals*

In addition to corporations and other organizations, individuals of the resident state are also exposed to double taxation as a result of a transaction involving the cross-border transfer of assets. Two common examples include the transfer of Canadian branch assets by an individual to a U.S. corporation in exchange for stock and the receipt of shares by a U.S. minority shareholder on the amalgamation of two Canadian corporations, one of which holds Canadian real property the value of which exceeds 50% of the value of the corporation. In both situations, the U.S. resident will be immediately subject to Canadian tax. Assuming that these transactions meet the requirements for nonrecognition in the United States, Treaty relief from double taxation will be needed.[101] An individual has two options under these circumstances.

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[96] *See* I.T.A. paragraph 20(1)(a); I.T.A. section 13; Schedule 2 of the Regulation; parts XI and XVII of the Regulations.

[97] I.T.A. subsection 13(1).

[98] I.T.A. subsection 13(2).

[99] I.T.A. subsection 13(21).

[100] I.R.C. §§ 61(a)(3), 358, 362, 1001.

[101] I.R.C. § 351 (1994); I.R.C. § 367 (1994); I.R.C. § 368.

The first option is to seek relief under Article XIII(8) of the U.S.-Canada Tax Treaty. The second form of relief may be found in Article XIII(7) of the Treaty.

According to the 1984 Technical Explanation to the Treaty, Article XIII(7) was intended:

> [t]o coordinate United States and Canadian taxation of gains where an individual is subject to tax in both Contracting States and one Contracting State deems a taxable alienation of property by the person to have occurred, while the other defers but does not forgive taxation with respect to the gain. Under those circumstances the individual can elect in his annual return for the year to be liable to tax in the Contracting State which is deferring recognition.[102]

The individual will be liable for tax in the contracting state as though he or she had sold and repurchased the property for an amount equal to its fair market value.[103] However, Article XIII(8) relief, which results in a deferral, may be preferable.

V. SEEKING TREATY RELIEF: SOME CLASSIC EXAMPLES

In summary, the U.S.-Canada Tax Treaty exempts proceeds from the disposition of taxable Canadian property from Canadian taxation except to the extent provided in Article XIII which allows Canada to tax gains generated from the disposition of real property situated in Canada.[104] The definition of real property situated in Canada is expanded to include shares of stock in a company the value of whose shares is derived principally from real property situated in Canada.[105] Canada may tax gains generated from the disposition of personal property, forming part of the business property of a permanent establishment or personal property pertaining to a fixed base

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[102] *See* 1984 Technical Explanation, *supra* note 51.

[103] U.S.-Canada Tax Treaty, *supra* note 3, at art. XIII(7). Consideration might also be given by a U.S. partner who is an individual, to the potential for Article XIII(8) relief. Such relief may be available under the wording in the Third Protocol which now includes "other organizations."

[104] *Id.* at art. XIII(1).

[105] *Id.* at art. XIII(3)(b)(ii).

and employed for the purpose of performing independent personal services.[106]

Article XIII(8) provides relief from double taxation when property is alienated and profit, gain or income is generated with respect to such alienation. If the contracting state of residence allows for nonrecognition, for example, the United States, Article XIII(8) permits the U.S. taxpayer to request the Canadian Competent Authority to grant relief from the recognition. This provides tax symmetry between the two Contracting States as to the character and the timing of the transaction for tax purposes.

A. *Examples*

The following examples illustrate some of the circumstances where double taxation may occur on a corporate organization or reorganization. To eliminate potential tracing problems, the examples assume the recipient of the assets in each transaction intends to retain the assets received.

1. *Article XIII(1) Liability*

a. *Example 1*

U.S. Parent transfers investment real property situated in Canada to a 90% owned U.S. Subsidiary in exchange for Subsidiary stock. The transaction is tax-deferred in the United States under I.R.C. § 351. If the real property had been held as a capital asset by a Canadian resident and the transfer had been to a taxable Canadian corporation, the transaction would have qualified as a rollover under I.T.A. subsection 85(1). Nevertheless, the transfer of the real property is subject to Canadian tax under Article XIII(1) of the Treaty.

b. *Example 2*

U.S. Parent owns all of the stock of a U.S. Subsidiary. The U.S. subsidiary owns all of the stock of a taxable Canadian corporation. The value of the shares of the taxable Canadian corporation is derived principally from real property situated in Canada. The U.S. subsidiary is liquidated into the U.S. Parent. The U.S. Parent and U.S. Subsidiary receive nonrecognition treatment under I.R.C. § 332 and I.R.C. § 337, respectively. Under Canadian

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[106] *Id.* at art. XIII(2).

tax law, I.T.A. subsection 88(1) provides for nonrecognition on the winding-up of a 90% owned subsidiary by a parent if both corporations are taxable Canadian corporations. Nevertheless, the transaction will be subject to Canadian tax under Articles XIII(1) and XIII(3) of the U.S.-Canada Treaty.

c. *Example 3*

U.S. Corporation A owns investment real property situated in Canada. Corporation A and unrelated U.S. Corporation B consolidate to form U.S. Corporation C. The consolidation constitutes a tax-free reorganization under I.R.C. § 368(a)(1)(A). If the predecessor corporations were taxable Canadian corporations, the transaction would qualify as an amalgamation under I.T.A. subsection 87(1). Nevertheless, under Article XIII(1) the transfer by Corporation A of the real property situated in Canada to Corporation C will be subject to Canadian tax.

d. *Example 4*

U.S. Corporation A holds only real property situated in Canada. The shareholders of Corporation A transfer all of their Corporation A stock to U.S. Corporation B solely in exchange for voting stock of Corporation B. Corporation B owns 100% of Corporation A immediately after the exchange. The stock exchange qualifies as a tax-deferred reorganization under I.R.C. § 368(a)(1)(B) and would also receive tax-free treatment under I.T.A. section 85.1, if Corporation A and Corporation B were taxable Canadian corporations. Nevertheless, the transaction will be subject to Canadian tax under Articles XIII(1) and (3).

2. *Article XIII(2) Liability*

a. *Example 1*

U.S. Parent conducts business through a Canadian branch. Parent transfers the branch assets to a newly organized U.S. Subsidiary in exchange for all of the Subsidiary stock. I.R.C. § 351 provides for nonrecognition on the transfer of the branch assets. The transaction would receive tax-deferred rollover treatment if the newly formed subsidiary were a taxable Canadian corporation. Nevertheless, the transfer of the branch assets will be taxable in Canada under Article XIII(2).

b. Example 2

Both U.S. Corporation A and U.S. Corporation B carry on oil and gas operations in Canada through a branch. Corporation A and Corporation B consolidate to form U.S. Corporation C. The consolidation is a tax-deferred A reorganization under I.R.C. § 368(a)(1)(A). If taxable Canadian corporations were involved, the transaction would also qualify as an amalgamation under I.T.A. subsection 87(1). Nevertheless, the transfer of the branch property will be subject to tax in Canada under Article XIII(2). In this situation, both predecessor corporations would have to seek Treaty relief under Article XIII(8).

3. Other Transactions

The above transactions illustrate some of the common circumstances in which Article XIII(8) relief may be required. However, relief from the Canadian Competent Authority may be required in circumstances where the potential for Canadian taxation is less obvious. For example, consider a U.S. shareholder who owns 5% of the shares of a Canadian corporation whose assets consist primarily of Canadian real property that proposes to amalgamate with another Canadian corporation. The U.S. shareholder will receive shares of the amalgamated corporation in exchange for its current share holdings. In the United States, the transaction will qualify as a statutory merger or consolidation under I.R.C. § 368(a)(1)(A) and receive nonrecognition treatment. In addition, it will not be taxable in the United States for international tax purposes as the transaction falls within an exception to recognition under I.R.C. § 367(a)(2).[107] Nevertheless, the exchange will be taxable in Canada as a result of the operation of Article XIII(1). If the shareholder is an individual, an election can be made under Article XIII(7) to incur immediate U.S. tax liability in order to utilize the foreign tax credit. Where the U.S. shareholder is a corporation, however, relief must be sought solely under Article XIII(8). It appears that Canadian Competent Authority relief will, in principle, be available under these circumstances. I.T.A. subsection 87(8) provides tax-free rollover treatment to a Canadian shareholder on a foreign merger. Since the relief would have been available

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[107] Treas. Reg. § 1.367(a)-3T(b) (1996).

to a Canadian taxpayer under the I.T.A., relief should be available to a U.S. resident in similar circumstances.[108]

B. When Treaty Relief Will Be Provided

The circumstances under which Article XIII(8) relief will typically be granted by the Canadian Competent Authority can be summarized as follows:

> 1. The transaction involves a corporate organization, reorganization or dissolution that does not result in the economic realization of proceeds on disposition.
>
> 2. The transaction does not place Canadian tax claims on a subsequent disposition at greater risk than under the current ownership structure. For example, if the asset is merely being transferred from a nonresident operating company to a nonresident subsidiary, relief has been granted with appropriate conditions for tracing of the transferred asset. However, if the transfer is to be followed by a subsequent disposition of the shares of the subsidiary, no relief has been available since the ability of Revenue Canada to tax on the ultimate disposition of the asset is impaired.[109]
>
> 3. The disposition, or contemplated disposition, of property results from a transaction for which a deferral would have been available if the parties were residents of Canada. In each of the examples described above, nonrecognition treatment would have been available to a Canadian taxpayer under the I.T.A..[110] The reason nonrecognition is not available to the U.S. nonresident under these provisions is solely because the nonresident fails to meet Canadian residency requirements as required by the I.T.A..

[108] *See* REVENUE CAN., Correspondence-418, CANADA-UNITED STATES TAX TREATY-CORPORATE REORGANIZATIONS, (Oct. 1990).

[109] The Third Protocol to the Treaty adds "Assistance in Collection" provisions that may change this result. *See generally* U.S.-Canada Tax Treaty, *supra* note 3, at art. XXVI(A).

[110] *See* I.T.A. sections 85, 87; I.T.A. subsection 88(1).

4. The transaction is not specifically prohibited for nonresidents on a deferred basis under another provision of the I.T.A.. The parties must not be subject to a specific prohibition under the I.T.A. with respect to the deferral.

5. The deferral is not contrary to the spirit of the I.T.A.. The transaction must not be an attempt to indirectly circumvent specific tax prohibitions which would otherwise prevent the transaction or to circumvent the spirit or intent of the I.T.A..

C. When Relief Will Not be Provided

The circumstances under which relief under Article XIII(8) of the U.S.-Canada Tax Treaty will be denied are really the mirror images of the circumstances under which relief will be granted. Nonetheless, some of the particular factors considered where relief is generally denied are as follows:

1. Perhaps the factor that generates the most denials of relief by the Canadian Competent Authority is the concern that Canada may not be able to later identify or enforce a claim against the deferred gain. Therefore, on a subsequent change in beneficial ownership of the assets, the transaction must not place Canadian tax claims at greater risk than under the present ownership structure.[111] The Canadian Competent Authority may impose conditions on the agreement granting the deferment to assure the tracing of property. For example, in order for relief to be granted, the acquiror of the property may have to report for a period of years to the Canadian Competent Authority to demonstrate continued ownership. If the ability of Canada to enforce its tax claim is sufficiently uncertain, relief will not be granted.[112]

I.T.A. section 115.1(2) contains a provision that places the acquiror in the same tax position as the original transferor

[111] Dalsin, *supra* note 79, at 85-86, 88.
[112] I.T.A. subsection 85(1).

with regard to the property on its later disposition, as a condition to relief under I.T.A. section 115.1. The provision states as follows:

> Where rights and obligations under an agreement described in subsection (1) have been transferred to another person with the concurrence of the Minister, that other person shall be deemed, for the purpose of subsection (1), to have entered into the agreement with the Minister.[113]

2. The deferral is specifically prohibited for nonresidents. For example, the I.T.A. does not permit the rollover of real property to a corporation by a nonresident except in very limited circumstances.[114] Specifically, the nonresident must use the real property during the year in a business carried on in Canada.[115] Thus, if a nonresident individual who is not carrying on business in Canada sought to transfer real property to a U.S. corporation, I.T.A. subparagraph 85(1.1)(a) would specifically prohibit the transfer on a deferred basis. In that case, relief would also be denied under Article XIII(8).

3. The I.T.A. provides the nonresident the ability to defer recognition of gain or income on the transaction. For example, although the I.T.A. specifically prohibits the rollover of real property by nonresidents in most circumstances, an elective rollover is available to nonresidents who hold the property as capital property and who carry on business in Canada during the year. In that case, no relief will be granted under Article XIII(8).

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[113] I.T.A. subsection 115.1(2).

[114] I.T.A. paragraphs 85(1.1)(a), (h). A nonresident may transfer capital property that is real property or an option in respect of real property if it is used during the year in a business carried on in Canada by that person.

[115] For this purpose, real property includes an interest in real property or an option in respect of real property owned by a nonresident person (other than a nonresident insurer). *See* I.T.A. paragraph 85(1.1)(h), which was added by a 1991 technical bill and applies with respect to dispositions made from 1985 onwards.

Fortunately, this overall prohibition on relief if an election is available may not be absolute. For example, it appears that the prohibition will not apply with respect to elections concerning "replacement property."[116] Elections under I.T.A. subsections 13(4), 14(6) and 44(1) will be available where an alienation occurs and the vendor acquires further property qualifying as "replacement property" in the same taxation year. Notwithstanding that an elective provision is available with respect to replacement property, it would appear that Revenue Canada will allow the taxpayer to choose whether or not to elect to reduce the resulting gain or income from the disposition of the property before seeking relief under Article XIII(8). According to Revenue Canada, if the taxpayer does elect to reduce the gain or income for Canadian tax purposes, it is the reduced amount that will be relevant for purposes of Article XIII (8) of the Treaty.[117] Similarly, it appears that a nonresident will not be required to utilize any carryover losses in determining net gain.

4. Relief will be granted only if the dispositions described in Article XIII(8) results in a net gain to the nonresident taxpayer. In other words, Article XIII(8) relief will be granted only to the extent required to avoid double taxation. Therefore, a net profit, gain or income is necessary.[118] In addition, I.T.A. section 115.1 relief must be applied consistently to all such dispositions that take place as part of a particular transaction within the taxable period. A taxpayer cannot, for example, realize losses and attempt to defer gains in the same transaction. In the case of relief sought from the Canadian Competent Authority, net gain is computed for Canadian, not U.S. tax purposes. Thus, a nonresident taxpayer must experience a net gain under Canadian tax law

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[116] I.T.A. subsection 44(5).

[117] *See* "Revenue Canada Round Table," *in* REPORT OF PROCEEDINGS OF THE THIRTY-SIXTH TAX CONFERENCE, 1983, CONFERENCE REPORT, (Toronto: CANADIAN TAX FOUNDATION, 1984) Q. 34.

[118] INTERPRETATION BULLETIN, *supra* note 50.

from the property alienated within the taxable period in a transaction described in Article XIII(8), and all such property transferred must be considered in the request for relief. Revenue Canada has indicated that the nonresident taxpayer does not have to use carryover losses otherwise available in computing net gain.

5. Before relief is sought under Article XIII(8), a U.S. taxpayer must verify that nonrecognition is the tax result in the United States, that the United States is the contracting state of residence and, finally, that recognition is the tax result in Canada. If it is determined that deferment will occur in both contracting states, Article XIII(8) is inapplicable and clearly unnecessary, since double taxation will not result from such a transaction.[119] Article XIII(8) is also inapplicable if recognition is the tax result in the United States, the contracting state of residence, and nonrecognition is the tax result in Canada, the nonresident state where the alienation occurred.[120]

6. Relief on the alienation of property in a transaction described in Article XIII(8) is available to a nonresident only if the transaction would result in deferral to a resident of Canada in similar circumstances. The transaction must, therefore, meet the requirements for nonrecognition under both Canadian and U.S. tax provisions, assuming the taxpayer is a resident of both jurisdictions for purposes of analysis.[121] In short, Treaty relief is not intended to grant deferrals to nonresidents in circumstances where relief would not otherwise be available to Canadian residents. This restriction on the availability of relief under Article XIII(8) requires an understanding of when a deferral is or is not available under Canadian tax law.

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[119] Priv. Ltr. Rul. 9024082 (1990).

[120] Dalsin, *supra* note 79, at 9.

[121] John A. Calderwood, *The Competent Authority Function: A Perspective From Revenue Canada*, *in* REPORT OF PROCEEDINGS OF THE FORTY-FOURTH TAX CONFERENCE, 1992 CONFERENCE REPORT (Toronto: CANADIAN TAX FOUNDATION, 1993) 39:17.

D. *Corporate Nonrecognition Provisions in Canada and the United States*

1. *Transfers of Property to a Corporation*

I.R.C. § 351 and I.T.A. section 85 provide for nonrecognition on the transfer of property to a corporation in exchange for its stock. Absent these sections, an exchange of property for stock constitutes a disposition of property at fair market value.[122] Tax deferment reflects a policy decision that a transfer of property to a corporation in exchange for stock represents a continuation of investment in a modified form, rather than a liquidation, and, therefore, it is not a proper time to tax. I.R.C. § 351 is a mandatory provision that allows nonrecognition on the transfer of property to a new or existing corporation, if the transferors have control of the corporation immediately after the transfer.[123] I.T.A. section 85 is elective and does not contain a "control" requirement.[124] Because continuity of interest is not a factor, I.T.A. section 85 applies to a wider range of circumstances.

Specifically, I.R.C. § 351 provides that no gain or loss will be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in the corporation, if the transferors are in control of the corporation immediately after the exchange.[125] "Control" is defined as direct ownership of stock possessing at least 80% of the total combined voting power of all classes of voting stock and at least 80% of the total number of shares of each class of nonvoting stock.[126] If the transferor receives boot in addition to the stock, gain, if any, will be recognized to the extent of the boot received.[127] Loss, however, will not recognized.[128] While nonrecognition treatment is permitted if the corporation assumes

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[122] I.R.C. § 61(a)(3) (1994); I.R.C. § 1001(a)-(b) (1994); I.T.A. section 54 (defining "disposition"); I.T.A. section 69.

[123] A voluntary contribution to capital by a shareholder is treated for tax purposes similarly to a I.R.C. § 351 exchange. I.R.C. § 118(a) (1994); I.R.C. § 362(a) (1994); Treas. Reg. § 1.118-1 (1996).

[124] Nevertheless, "control" is relevant for a number of purposes in determining the operation of I.T.A. section 85. *See, e.g.*, I.T.A. subsection 85(4) which addresses the ability of the transferor to claim a loss on the transfer of property to a controlled corporation. CAN. DEP'T FIN., NOTICE OF WAYS AND MOTIONS MOTION (June 20, 1996) (proposing to replace this provision with new I.T.A. subsections 40(3.4) and (3.6)).

[125] I.R.C. § 351(a) (1994).

[126] I.R.C. § 368(c) (1994).

[127] I.R.C. § 351(b) (1994).

[128] *Id.*

liabilities or takes property subject to liabilities,[129] the transferor will recognize gain if the aggregate amount of liabilities exceed the basis in the property transferred.[130] The basis of the stock received by the transferor is the same as the basis of the transferred assets prior to the exchange, increased by any gain recognized to the transferor on the transfer and decreased by the value of any boot and debt relief received.[131] Boot received is given a fair market value basis.[132] At the corporate level, the transferee corporation does not recognize gain or loss on the receipt of money or other property in exchange for its stock.[133] With regard to the property received in the exchange, the transferee corporation receives a basis equal to the transferor's basis in the assets, increased by any gain recognized to the transferor on the transfer.[134] Thus, the unrecognized gain or loss on the exchange is preserved in both the basis of the stock received by the transferor and the property received by the corporation.

I.T.A. section 85 is comparable to I.R.C. § 351. The Canadian provision provides that a taxpayer who transfers eligible property to a taxable Canadian corporation in exchange for consideration that includes the stock of the corporation, may elect an amount, not less than the cost of the asset and not greater than its fair market value, as the proceeds on the disposition of the asset.[135] The election permits a rollover of the basis of the transferred asset to the stock received by the transferor as well as to the asset received by the corporation. I.T.A. section 85 will not operate unless the taxpayer receives consideration from the corporation which includes shares of the corporation's stock. The section also permits the receipt of other types of consideration, however, the receipt of non-share consideration may result in gain recognition if the consideration exceeds the tax cost of the transferred asset. A taxpayer who transfers property to a controlled corporation is not entitled to recognize loss on the disposition. Nevertheless, the taxpayer is allowed to "bump up" the cost basis of the stock received from the corporation by the amount of the disallowed loss.[136] As there is no

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[129] I.R.C. § 357(a) (1994).

[130] I.R.C. § 357(c) (1994).

[131] I.R.C. § 358(a)(1) (1994).

[132] I.R.C. § 358(a)(2) (1994).

[133] I.R.C. § 1032(a) (1994).

[134] I.R.C. § 362(a) (1994).

[135] I.T.A. paragraphs 81(1)(b) and (c).

[136] I.T.A. subsection 85(4) and proposed I.T.A. subsection 40(3.4). CAN. DEP'T FIN., NOTICE OF WAYS AND MEANS MOTION (June 20, 1996).

requirement of control immediately after the exchange, I.T.A. section 85 is more versatile than I.R.C. § 351, and, within limits, the transferor can elect the amount of income or gain which will be recognized on the transfer.

The I.T.A. section 85 rollover is available to any taxpayer,[137] whether resident or nonresident, who disposes of eligible property to a taxable Canadian corporation. Generally, a "taxable Canadian corporation" is a taxable corporation incorporated in Canada.[138] Only "eligible property" can be rolled over under I.T.A. section 85.[139] The following types of property are specifically excepted from rollover treatment: real property which is held as inventory, any interests in or options in respect of real property which form part of the inventory of the taxpayer,[140] and real property including interests and options in respect of real property owned by a nonresident, unless the property is used during the year by the taxpayer in a business carried on in Canada.[141]

I.T.A. section 85 requires the transferor taxpayer and transferee corporation jointly to elect tax deferment treatment.[142] This election allows the parties to specify an amount, within specified parameters, which will be deemed to be the proceeds on the disposition and the cost of acquisition.[143] The application of these provisions is demonstrated by the following example. A taxpayer transferring land with a basis of $50 and a value of $100 and the transferee corporation can elect to treat $50 as the deemed proceeds on the disposition. This results in a deferral of all gain recognition. The taxpayer's basis in the stock received from the corporation and the corporation's basis in the asset received will be $50. If the taxpayer and the

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[137] The term "taxpayer" includes any person whether or not liable to pay tax. "Person" is broadly defined to include an individual, trust, and a corporation. I.T.A. subsection 248(1). I.T.A. subsections 85(2) and (3) provide comparable treatment to transfers of property by a partnership to a corporation.

[138] I.T.A. subsection 89(1).

[139] I.T.A. subsection 85(1.1) defines "eligible property" as "capital property (other than real property, or an interest in or an option in respect of real property, owned by a nonresident); eligible capital property; inventory (other than real property, an interest in real property or an option in respect of real property); accounts receivable in respect of which no election has been made; Canadian resource properties; foreign resource properties; certain property used in an insurance business; real property that is capital property and is used by a nonresident in the course of carrying on a business in Canada; and a NISA Fund No. 2."

[140] I.T.A. paragraph 85(1.1)(f).

[141] I.T.A. paragraphs 85(1.1)(a) and (g).

[142] I.T.A. subsection 85(6).

[143] I.T.A. paragraph 85(1)(a).

corporation elect to treat $75 as the deemed proceeds on disposition, a $25 capital gain will be recognized by the taxpayer and the resulting basis will be $75.

There are upper and lower limits on the amount that may be agreed upon by the transferor and the corporation as the deemed proceeds on disposition. First, the amount elected in respect of an asset cannot exceed its fair market value; if so, the fair market value is deemed to be the amount elected.[144] Second, the elected amount cannot be less than the value of any non-share consideration received from the corporation.[145] Where the elected amount is less than the value of the non-share consideration received, the value of the boot is deemed to be the elected amount.[146] The purpose of this lower limit is to prevent a taxpayer from actually realizing and extracting the economic value of a gain without recognizing the gain for tax purposes. If the consideration received from the corporation exceeds this range, other tax consequences will follow either in the form of a shareholder benefit[147] or a deemed dividend.[148]

2. *Corporate Divisions*

Tax-deferred corporate divisions are available under both the U.S. and Canadian tax systems. I.R.C. § 355 permits a tax-free division of a corporate enterprise into two separate corporations owned by the shareholders of the original corporation. A corporate division pursuant to I.R.C. § 355 need not be part of a corporate reorganization.[149] If the parent corporation distributes either all or a controlling portion of the stock of an existing controlled subsidiary, the transaction is governed by I.R.C. § 355.[150] If the parent corporation transfers part of its assets to a newly-formed subsidiary and then distributes the subsidiary stock, the transaction in its entirety will constitute a divisive D reorganization and must satisfy the requirements of I.R.C. § 368(a)(1)(D) and § 355.[151] Canada does not have a code section which specifically addresses corporate divisions. However, I.T.A. section 85

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[144] I.T.A. paragraph 85(1)(c).
[145] I.T.A. paragraph 85(1)(b).
[146] *Id.*
[147] I.T.A. section 15.
[148] I.T.A. section 84.
[149] I.R.C. § 355(a)(2)(C) (1994).
[150] I.R.C. § 355(a)(1)(A) (1994).
[151] I.R.C. § 368(a)(1)(D) (1994).

can provide nonrecognition to a Canadian "butterfly reorganization."[152]

A transaction qualifying for nonrecognition under I.R.C. § 355 may take the form of a spin-off, a split-off or a split-up. A spin-off consists of a distribution by the parent corporation to its shareholders of stock in a controlled subsidiary.[153] A split-off is similar to a spin-off, except that the shareholders of the distributing corporation surrender part of their stock in the distributing corporation for stock in the controlled corporation.[154] In a split-up, the distributing corporation distributes the stock of two or more controlled corporations to its shareholders in complete liquidation. If the stringent requirements of I.R.C. § 355 are met, each pattern qualifies as a tax-free division; however, if the transaction fails I.R.C. § 355, the distributions will be treated as either a dividend, redemption or a liquidation in accordance with the pattern implemented.

I.R.C. § 355 is a complex anti-avoidance provision, enacted to prevent corporations from bailing out earnings at capital gain rates.[155] Currently, I.R.C. § 355 also serves as a backstop to the repeal of the General Utilities Doctrine,[156] assuring a tax at the corporate level on the distribution of appreciated assets as part of a plan of reorganization.[157] Thus, a corporate division must satisfy the many statutory requirements of I.R.C. § 355 and its accompanying judicial doctrines in order to receive tax deferment. Briefly, I.R.C. § 355 permits a corporation to make a tax-free distribution of the

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[152] *See infra* text accompanying notes 172-175.

[153] A spin-off is analogous to a dividend as the shareholders of the distributing corporation do not surrender stock in exchange for the distributed stock.

[154] A split-off is analogous to a redemption.

[155] The maximum tax rate imposed on net capital gain is 28%. I.R.C. § 1(h).

[156] I.R.C. § 355(c)-(d) (1994). *See* General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935). The General Utilities Doctrine provided that a distributing corporation did not recognize gain or loss on the distribution of appreciated or depreciated property to its shareholders with respect to its stock on a liquidating and non-liquidating distribution. HOWARD E. ABRAMS & RICHARD L. DOERNBERG, FEDERAL CORPORATE TAXATION § 4.04, at 90-93 (1995). The doctrine resulted from the broad application of the Supreme Court's decision and was codified in I.R.C. § 311 as to non-liquidating distributions and I.R.C. § 336 as to liquidating distributions. I.R.C. § 311 (1994) and I.R.C. § 336 (1994) were amended by the Tax Reform Act of 1986 and now generally provide for corporate level gain on the distribution of appreciated assets in liquidating and non-liquidating distributions.

[157] I.R.C. § 355(c)-(d) (1994). If the stock distribution is preceded by a D reorganization, the treatment of the distributing corporation is governed by I.R.C. § 361. I.R.C. § 361(c) was added to prevent the use of I.R.C. § 355 to avoid recognition of corporate gain on the sale of a business.

stock[158] of a controlled subsidiary[159] provided that the transaction is being carried out for a legitimate business purpose,[160] is not being used principally as a device to bail out earnings and profits,[161] the requisite continuity of interest is maintained[162] and each corporation has actively conducted a business for five years or more.[163] If the requirements of I.R.C. § 355 are met, the shareholders and security holders of the distributing corporation will not recognize gain or loss on the distribution of stock or securities.[164] In the case of a distribution of securities, if the principal amount of the securities of the controlled corporation received by the distributee shareholder exceeds the principal amount of the distributing corporation's securities surrendered, the value of the excess is treated as boot.[165] The distribution of this and other forms of boot does not necessarily disqualify a transaction under I.R.C. § 355, but it will cause the distributee shareholder to recognize any realized gain, usually as ordinary income, to the extent of the boot received.[166] The aggregate basis of the nonrecognition property received by the distributee shareholder in a I.R.C. § 355 distribution is the aggregate basis of the shareholder's stock, increased by gain recognized and decreased by money and the fair market value of boot received in the exchange. This aggregate basis is then allocated among the stock or securities received or retained in proportion to their relative fair market value.[167] The boot receives a fair market value basis.[168]

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[158] I.R.C. § 355(a)(1)(D). The distributing corporation must distribute all the stock of the controlled corporation or, at least, an amount of stock sufficient to constitute control within the meaning of I.R.C. § 368(c). I.R.C. § 368(c) defines "control" to mean ownership of stock possessing at least 80% of the total combined voting power and at least 80% of the total number of shares of all other classes of stock. I.R.C. § 355(a)(1)(D)(ii) (1994).

[159] I.R.C. § 355(a)(1)(A) (1994).

[160] *See* Treas. Reg. § 1.355-2(b) (1989). A business purpose must exist for the distribution of the stock of the controlled corporation. Treas. Reg. § 1.355-2(b)(2) (1989).

[161] I.R.C. § 355 does not apply to a transaction used principally as a device for the distribution of earnings and profits of the distributing or the controlled corporation, or both, at capital gains rates. I.R.C. § 355(a)(1)(B) (1994); Treas. Reg. §§ 1.355-2(d)(1), 1.355-2(d) (1989).

[162] Treas. Reg. § 1.355-2(c)(1) (1989).

[163] I.R.C. § 355(b)(2)(B) (1994).

[164] I.R.C. § 355(a)(1) (1994).

[165] I.R.C. §§ 355(a)(3)(A) (1994); I.R.C. § 356(d)(2) (1994).

[166] I.R.C. §§ 355(a)(4)(A) (1994); I.R.C. § 356 (1994).

[167] I.R.C. § 358(a)-(b) (1994).

[168] I.R.C. § 358(a)(2) (1994).

If one or more corporations are formed as a preparatory step to a qualifying corporate division, the transaction as a whole is a D reorganization. A divisive D reorganization is a transfer by a corporation of all or part of its assets to another corporation if immediately after the transfer the transferor corporation, or one or more of its shareholders, or any combination thereof, is in control of the transferee corporation, but only if the stock or securities of the transferee corporation are distributed in a distribution that qualifies under I.R.C. § 355.[169] The transferor corporation does not recognize gain or loss on the transfer of its assets to the controlled corporation, and takes an exchange basis in the stock and securities received.[170] The newly formed controlled corporation does not recognize gain on the issuance of its stock[171] and takes the assets with a transferred basis.[172]

A divisive corporate reorganization is also possible for Canadian tax purposes provided there is significant continuity of interest in the property of the distributing corporation. Such divisive reorganizations in Canada are commonly referred to as "butterfly transactions." The essence of a Canadian butterfly is that property of a corporation is transferred to one or more corporate shareholders in proportion to their share interest in the corporation in exchange for shares on a tax-deferred basis using I.T.A. section 85.

Subsequently, shares of the transferee corporations owned by the transferor corporation are redeemed and the shares of the transferor corporation owned by the subsidiary of the transferees are redeemed, thereby triggering intercorporate deemed dividends.[173] These dividends are deductible pursuant to I.T.A. subsection 112(1) provided specific tax avoidance provisions are met.[174] Thus, a transaction which would otherwise give rise to a capital gain is executed using the integration mechanism which permits the tax-free flow of intercorporate dividends. The policy reason for permitting a distribution of profits free of a capital gains tax under these circumstances is that there is no true economic disposition of the property. The shareholders still retain their proportionate beneficial interest in the assets of the corporation, but only in a different form.

[169] I.R.C. § 368(a)(1)(D) (1994).
[170] I.R.C. § 358(a)(1) (1994).
[171] I.R.C. § 1032(a) (1994).
[172] I.R.C. § 362(b) (1994).
[173] I.T.A. subsection 84(3).
[174] I.T.A. subsection 55(3).

The "double-wing butterfly" is the term commonly used to describe a divisive reorganization in which all types of corporate property are distributed to all shareholders. The transactions will occur on a rollover basis so long as the provisions of I.T.A. subsection 55(2) are not violated. I.T.A. subsection 55(2) is directed at arrangements designed to convert a capital gain on a corporate disposition into a tax-free intercorporate dividend.

I.T.A. subsection 55(2) will not apply if a dividend is received as part of a series of transactions and does not result in a disposition of property to, or a significant increase in the interest in any corporation of, any person who deals at arm's length[175] with the dividend recipient. A second exception is provided if a dividend is received in the course of a reorganization in which property of a corporation is transferred to certain of its corporate shareholders with each transferee corporation receiving its pro rated share of each type of property so transferred, based on the fair market value of its shares of the transferor corporation. This exception is limited to those situations in which there is a degree of continuity of interest in the underlying assets of the corporation. Thus, a tax-deferred corporate distribution is available only, "where no one has acquired a direct or indirect equity interest in the distributing corporation in contemplation of the distribution and there is a continuity of interest, after the distribution, in the distributed assets by the shareholders of the transferee corporation and in the remaining assets of the distributing corporation by the remaining shareholders of the distributing corporation".[176] Thus, I.T.A. paragraph 55(3)(b) will only accommodate the tax-deferred division of one corporation into two or more corporations if the shares of the corporation continue to be owned by the shareholders of the original corporation, and the tax-deferred division of a corporation's assets is among its corporate shareholders. In any other situation, the distribution will result in a gain to the transferor.

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[175] I.T.A. section 251 sets out the rules for establishing whether parties are dealing at arm's length. I.T.A. paragraph 55(5)(e) further provides that for the purposes of I.T.A. section 55, brothers and sisters are deemed to be dealing with each other at arm's length and not to be related to each other. As well, I.T.A. subsection 55(4) adds an anti-avoidance provision. Where the principal purpose of one or more transactions or events is to cause two or more persons to not deal with each other at arm's length so as to make I.T.A. subsection 55(2) inapplicable, for the purposes of I.T.A. section 55, those persons shall be deemed to deal with each other at arm's length.

[176] *See* DEP'T FIN., TECHNICAL NOTES, (Nov. 1994).

3. *Stock-for-Stock Exchanges*

Under both the U.S. and Canadian tax systems, stock-for stock exchanges are also given nonrecognition treatment. A B reorganization is the acquisition of the stock of one corporation in exchange solely for the voting stock of the acquiring corporation, or its parent,[177] provided the acquiring corporation has control of the target corporation immediately after the transaction, whether or not the acquiring corporation had control immediately before the acquisition.[178] The term "solely" has been interpreted to preclude the use of any consideration other than voting stock of either the acquiring corporation or its parent.[179] However, the receipt of other consideration in lieu of fractional shares in the acquiring corporation is permitted.[180] Additionally, control of the target corporation need not be acquired in one transaction.[181] A creeping acquisition of control can qualify as well as an increase in ownership by a corporation that already has control of the target corporation. Minority shareholders unwilling to accept acquiring corporation stock cannot receive cash or other property directly from the acquiring corporation lest the "solely for voting stock" requirement be violated. It has been possible for the target corporation to redeem the stock of the dissenting shareholders with its own funds[182] or the shareholders of the acquiring corporation to purchase the stock of dissenters.[183] If a transaction qualifies as a B reorganization, the Internal Revenue Code provides generally for the nonrecognition of any gain or loss to the target corporation's shareholders[184] and the acquiring corporation[185] on the exchange of stock. The target corporation shareholders' basis in the target stock transferred becomes both the shareholders' basis in the acquiring

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[177] I.R.C. § 368(a)(1)(B) (1994). A combination of parent and acquiring corporation stock cannot be used. Treas. Reg. § 1.368-2(c) (1986). A valid B reorganization will not be disqualified if the acquiring corporation distributes the stock of the target corporation to a controlled subsidiary. I.R.C. § 368(a)(2)(C) (1994).

[178] I.R.C. § 368(a)(1)(B) (1994).

[179] Helvering v. Southwest Consolidated Corp., 315 U.S. 194, *reh'g denied* 316 U.S. 710 (1942).

[180] Rev. Rul. 66-365, 1966-2 C.B. 116.

[181] Treas. Reg. § 1.368-2(c).

[182] Rev. Rul. 68-285, 1968-1 C.B. 147.

[183] Rev. Rul. 68-562, 1968-2 C.B. 157.

[184] I.R.C. § 354(a) (1994).

[185] I.R.C. § 361(a) (1994).

corporation stock received[186] and the acquiring corporation's basis in the target stock received.[187]

I.T.A. section 85.1 allows shareholders who exchange the stock of a taxable Canadian corporation for the stock of a Canadian corporation[188] to receive tax-deferred treatment.[189] The exchange must be solely for shares of a single class of the acquiring corporation's treasury stock. No non-share consideration may be received on the transaction.[190] The parties to the exchange must also be dealing at arm's length before and after the exchange.[191] The shareholders of the target and the acquiring corporation are considered not to have dealt at arm's length after the exchange if the shareholders of the target, or the shareholders together with persons with whom the shareholders did not deal at arm's length, controlled the acquiring corporation or owned more than 50% of the fair market value of all outstanding shares of the stock of the acquiring corporation.[192] The rollover is not mandatory and the shareholder may recognize any portion of the gain or loss realized on the transaction. If gain or loss is not recognized, the basis of the shareholder's old stock is rolled over into the basis of the new stock, thus, preserving any unrecognized gain or loss on the exchange.[193] The basis of the shares to the acquiring corporation is the lesser of the fair market value of the shares and their paid-up capital[194] immediately before the exchange.[195]

4. *Mergers or Amalgamations*

The tax systems of both the United States and Canada contain provisions allowing for the combination of two or more corporations without recogni-

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[186] I.R.C. § 358(a)(1) (1994).

[187] I.R.C. § 362(b) (1994).

[188] Generally, a Canadian corporation is a corporation that is resident in Canada and was incorporated in Canada. I.T.A. subsection 89(1).

[189] I.T.A. section 85.1 is inapplicable if the parties to the exchange have filed an election under I.T.A. subsections 85(1) or 85(2). I.T.A. paragraph 85.1(2)(c). The stock on both sides of the exchange must be capital stock or noninventory stock. I.T.A. subsection 85.1(1).

[190] I.T.A. paragraph 85(2)(d).

[191] I.T.A. paragraph 85.1(1)(a).

[192] I.T.A. paragraph 85.1(1)(b).

[193] I.T.A. paragraph 85.1(1)(a).

[194] I.T.A. subsection 89(1) provides the definition of "paid up capital." For tax purposes the computation of paid up capital begins with stated capital for corporate law purposes. A number of tax adjustments are then made.

[195] I.T.A. paragraph 85.1(1)(b).

tion of gain or loss.[196] I.R.C. § 368(a)(1)(A) defines an A reorganization as a statutory merger or consolidation. Typically, in the United States, under a state merger statute, the assets and liabilities of the target corporation are transferred to the acquiring corporation and the target corporation dissolves by operation of law. The shareholders of the target receive stock or debt instruments of the acquiring corporation, cash or other property, or any combination of such consideration. A consolidation in the United States involves a similar transfer of assets and liabilities of two or more corporations to a newly created corporate entity with the shareholders of the target corporations becoming shareholders of the new corporation by operation of law.

I.T.A. section 87 permits the tax-free fusion of two or more corporations into a newly created corporate entity.[197] The shareholders and the creditors of the transferor corporations become the shareholders and creditors of the amalgamated corporation. To qualify as an amalgamation under this provision, a corporate entity which is a continuation of the amalgamated corporations must result from the exchange. Therefore, in comparing an amalgamation to an A reorganization, only a transaction similar to a consolidation, is possible.

An A reorganization is defined simply as an statutory merger or consolidation.[198] As the Internal Revenue Code provides no further requirements, to preserve the Congressional intent for nonrecognition, the doctrines of continuity of interest and continuity of business enterprise are important considerations for the qualification of a transaction as an A reorganization.[199] The continuity of interest doctrine requires that the shareholders of the target corporation receive a propriety interest in the acquiring corporation sufficient to justify treating the transaction as a tax-free reorganization rather than a taxable sale.[200] For advance ruling purposes,

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[196] In order to qualify as a reorganization the transaction must be an merger or consolidation effected pursuant to local corporate law. Treas. Reg. § 1.368-2(b)(1) (1986).

[197] In general, corporations may amalgamate only with other corporations governed by the same corporate statutes. *See e.g.*, *Canada Business Corporations Act*, R.S.C. c c-44, section 181. An exception is provided by some provinces on the amalgamation of a parent and wholly owned subsidiary where one is extra-provincial. *See, e.g., Business Corporations Act of Alberta*, S.A. 1981, C.B-15, section 180.1(1).

[198] I.R.C. § 368(a)(1)(A) (1994). I.R.C. § 368 also allows for triangular mergers. I.R.C. § 368(a)(2)(c), (D), (E).

[199] Treas. Reg. § 1.368-1(b) (1986).

[200] Southwest Natural Gas Co. v. Commissioner, 189 F.2d 332, 334 (5th Cir. 1951).

the shareholders of the target corporation must receive stock in the acquiring corporation which is equal in value to at least 50% of the value of all formerly outstanding stock of the target corporation.[201] To be characterized as an A reorganization, the transaction must also satisfy the continuity of business enterprise doctrine.[202] This doctrine requires that the acquiring corporation either continue the target corporation's historic business or use a significant portion of the target corporation's historic business assets.[203]

If the transaction qualifies as an A reorganization, the target corporation, the shareholders of the target corporation and the acquiring corporation receive nonrecognition treatment.[204] Generally, the target corporation does not recognize gain or loss on an exchange of property solely for stock and securities of the acquiring corporation.[205] The target corporation can also receive boot without gain or loss recognition if the boot is distributed to the target shareholders pursuant to the plan of reorganization.[206] In addition, the distribution by the target corporation to its shareholders of stock and obligations of the target or the acquiring corporation will not trigger gain or loss, however, the distribution of other property may result in gain recognition.[207] The target shareholders recognize gain only to the extent property other than stock and securities of the acquiring corporation are received[208] and the acquiring corporation does not recognize any gain or loss on the distribution of its stock and securities.[209] The target shareholders receive an exchange basis in the stock and securities received and a fair market value basis in any boot,[210] and the acquiring corporation receives a transferred

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[201] Rev. Proc. 77-37, 1977-2 C.B. 568, 569. The courts have found sufficient continuity of interest where the shareholders of the target corporation received stock of the acquiring corporation worth less than 50% of the value of the target corporation's stock. *See, e.g.*, John A. Nelson Co. v. Helvering, 296 U.S. 374, 376-77 (1935) (38% continuity sufficient).

[202] Treas. Reg. § 1.368-1(b).

[203] Treas. Reg. § 1.368-1(d)(2) (1986).

[204] I.R.C. §§ 354, 361, 1032.

[205] I.R.C. § 361(a) (1994).

[206] I.R.C. § 361(b)(1) (1994). The assumption by the acquiring corporation of the liabilities of the target is not treated as boot. I.R.C. § 357(a) (1994).

[207] I.R.C. § 361(c) (1994).

[208] I.R.C. § 356(a)(1) (1994). If the principal amount of the securities received exceed the principal amount of the securities surrendered, the fair market value of the excess is treated as boot. I.R.C. § 354(a)(2) (1994); I.R.C. § 356(d) (1994).

[209] I.R.C. § 1032(a) (1994).

[210] I.R.C. § 358(a) (1994).

basis in the assets received from the target corporation.[211] The tax attributes of target corporation are carried over to the acquiring corporation.[212]

For Canadian income tax purposes, an amalgamation is a merger of two or more taxable Canadian corporations which results in the amalgamating corporations continuing as one amalgamated corporation. No new corporate entity is created.[213] Rather, all of the property and liabilities of the amalgamating corporations become the property of the amalgamated corporation and all of the shareholders of the amalgamating corporations receive stock of the amalgamated corporation.[214] The most common patterns are vertical and horizontal amalgamations.[215] The corporate entity resulting from the amalgamation carries forward the tax attributes of the merged corporations.[216] The shareholders of the target corporations receive an exchange basis in the stock of the amalgamated corporation[217] and the amalgamated corporation receives a transferred basis in the assets received from the target corporations.[218]

Finally, for Canadian tax purposes certain corporate transactions are deemed to be amalgamations.[219] A deemed amalgamation occurs, for example, where a corporation and one or more of its wholly-owned subsidiaries, or two or more corporations each of which is a wholly-owned subsidiary of the same corporate parent, are merged and no shares are issued

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[211] I.R.C. § 362(b) (1994).

[212] I.R.C. § 381(a) (1994). Complex loss limitation rules apply if the loss corporation undergoes a significant change of ownership. *See* I.R.C. § 382 (1994) (providing the limitations on net operating loss carry forwards and certain built-in losses following an ownership change).

[213] For a discussion of two Canadian corporate law cases dealing with the effect of an amalgamation, see The Queen v Black & Decker Marine Co., Ltd., I.S.C.R. 411 [1975], and Commcorp Financial Services Inc., 3 Alta L.R. (3d) 177 [1995] (Q.B.).

[214] I.T.A. subsection 87(1).

[215] In a vertical amalgamation, a parent corporation is merged with one or more subsidiary corporations to form the amalgamated corporation. Thus, a vertical amalgamation is similar in effect to the winding-up of a subsidiary into its parent corporation. A horizontal amalgamation is the merger of two or more corporations to form the amalgamated corporation.

[216] I.T.A. subsection 87(1.2) (new corporation is a continuation of the old corporation with regard to listed provisions); I.T.A. paragraph 87(2)(l) (new corporation can utilize unused research expenditures of old corporation); I.T.A. subsection 87(2) (rules for the rollover of particular types of property).

[217] I.T.A. subsection 87(4).

[218] I.T.A. paragraph 87(2)(e).

[219] I.T.A. subsection 87(1.1).

by the amalgamated corporation.[220] Similar to an A reorganization, the Canadian merger provisions also allow for triangular amalgamations. If two or more taxable Canadian corporations merge to form an amalgamated corporation that immediately after the merger is controlled by a taxable Canadian corporation, the stock issued by the parent corporation is deemed to be issued by the new corporation.[221]

5. *Corporate Dissolutions*

The dissolution of a corporation results in recognition of gain or loss at both the shareholder and corporate levels in both the United States and Canada. With the repeal of the General Utilities Doctrine, the distributing corporation in the United States is treated as having sold its assets to the shareholders at fair market value.[222] However, the provision contains complex rules limiting the ability of a liquidating corporation to recognize losses on the distribution.[223] The shareholders of the distributing corporation are considered to have exchanged their stock for an amount equal to the fair market value of the property received from the corporation and the basis of the property in the hands of the shareholder is to its fair market value.[224] Similarly, assets distributed by a Canadian corporation when winding-up are deemed to have been disposed of by the corporation at fair market value.[225] The shareholders are entitled to receive, in either cash or property an amount equal to the paid-up capital without any tax consequences.[226] However, if a shareholder receives cash or property in excess of the paid-up capital of its stock, the excess will be treated as a deemed dividend.[227] In addition, the

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[220] I.T.A. subsection 87(1.4) (defining wholly-owned subsidiary).

[221] I.T.A. subsection 89(9).

[222] I.R.C. § 336(a) (1994).

[223] I.R.C. § 336(d) (1994).

[224] I.R.C. § 334(a) (1994).

[225] I.T.A. subsections 69(5), 88(2); *see also* REVENUE CAN., INTERPRETATION BULLETIN IT-126R, MEANING OF WINDING-UP, March 20, 1995; REVENUE CAN., INTERPRETATION BULLETIN IT-149R4, WINDING-UP DIVIDEND, June 28, 1991. Generally, full loss recognition is allowed. I.T.A. paragraph 69(5)(a)(ii); *see also* I.T.A. subsections 85(4), (5.1). Although no rollover is available on a winding-up, I.T.A. subsection 88(2) does provide some tax relief in the form of special rules to facilitate the distribution of the capital dividend account and the pre-1972 capital surplus on hand.

[226] I.T.A. subsection 84(2); *see* I.T.A. subsection 89(1) (defining paid up capital).

[227] I.T.A. subsection 84(2).

taxpayer will be deemed to have disposed of the shares.[228] Proceeds of disposition are, however, reduced by the amount of any deemed dividend received in the transaction.[229] The result, where the paid-up capital and cost basis of the share are the same, is that no capital gain will be realized on the winding-up.[230]

Both Canada and the United States provide exceptions to recognition upon the liquidation of a subsidiary corporation its corporation. If the requirements of I.R.C. § 332(b) are met, the distribution of property by a subsidiary to a parent in complete liquidation constitutes a nonrecognition event for both the parent and the subsidiary.[231] To qualify for nonrecognition treatment, the parent corporation must own a specific amount of the subsidiary stock and the liquidating distributions must occur within a specified time period.[232] Specifically, the parent corporation must own stock that constitutes at least 80% of the total voting power of the outstanding subsidiary stock with a value equal to at least 80% of the stock of the subsidiary corporation, without regards to certain nonvoting stock that is limited and preferred as to dividends.[233] The "80% stock-ownership test" must be met on the date of adoption of the plan of liquidation and must continue until the final liquidating distribution.[234] Additionally, the liquidating distributions must occur either within a single taxable year, or within a 3-year period from the close of the taxable year in which the first distribution occurs.[235]

If the above requirements are satisfied, the parent corporation recognizes no gain or loss on the receipt of property distributed in a complete liquidation of the subsidiary corporation.[236] The property distributed to the parent corporation has a substituted basis in the hands of the parent equal to the subsidiary's basis.[237] In the case of property distributed to a shareholder other than the parent corporation, the minority shareholders receive taxable exchange treatment and a fair market value basis in the assets received on

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[228] I.T.A. subsection 84(9).

[229] I.T.A. paragraph 54(j) (defining proceeds of a disposition).

[230] I.T.A. section 39.

[231] I.R.C. § 332(a) (1994); I.R.C. § 337(a) (1994).

[232] I.R.C. § 332(b) (1994).

[233] I.R.C. § 332(b)(1) (1994); I.R.C. § 1504(a)(2) (1994).

[234] I.R.C. § 332(b)(1) (1994).

[235] I.R.C. § 332(b)(2)-(3) (1994).

[236] I.R.C. § 332(a) (1994).

[237] I.R.C. § 334(b) (1994).

the liquidation.[238] In the liquidation of a subsidiary to which I.R.C. § 332 applies, the subsidiary corporation recognizes no gain or loss on distributions to the parent corporation.[239] As to distributions to the minority shareholders, the subsidiary corporation will recognize gain on the distribution of appreciated assets but generally no loss will be recognized.[240] The tax attributes of the liquidated subsidiary will generally carry over to the parent corporation.[241]

I.T.A. subsection 88(1) provides that a taxable Canadian corporation,[242] which is at least 90% owned by another taxable Canadian corporation, can be wound up into its parent on a tax-free basis. Immediately before winding up, the parent corporation must own not less than 90% of the stock of each class of stock of the subsidiary corporation and the remaining shares must have been owned by shareholders with whom the parent corporation was dealing at arm's length.[243] Generally, the assets and liabilities of a subsidiary are rolled over into its parent without triggering immediate gain or loss recognition. If these requirements are met, the rollover is mandatory. The proceeds from the distribution of the subsidiary corporation's property to the parent corporation are deemed to be the cost amount of the property which is generally the adjusted cost basis of the property.[244] The cost amount of depreciable property is the undepreciated capital cost.[245] The accounts receivables of the subsidiary are transferred to the parent corporation at face amount.[246] The subsidiary's inventory is deemed to be distributed to its parent corporation at the lower of its cost and fair market value.[247] The parent corporation is deemed to acquire the assets of the subsidiary at a cost basis equal to the deemed proceeds on disposition of the subsidiary corporation.[248] The parent corporation is treated "as stepping

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[238] I.R.C. § 334(a) (1994).

[239] I.R.C. § 337(a) (1994).

[240] I.R.C. § 336(a) (1994).

[241] I.R.C. § 381(a) (1994).

[242] *See supra* notes 198 and 199 (defining a taxable Canadian corporation).

[243] I.T.A. section 251. Related persons are deemed not to deal with each other at arm's length.

[244] I.T.A. subparagraph 88(1)(a)(iii); *see* I.T.A. subsection 248(1) (defining "cost amount"). The proceeds on disposition to the subsidiary in the case of Canadian resource property is deemed to be nil. *See* I.T.A. subparagraph 88(1)(a)(I).

[245] I.T.A. subparagraph 88(1)(a)(iii).

[246] I.T.A. paragraph 88(1)(e.2).

[247] I.T.A. paragraph 88(1)(a).

[248] I.T.A. paragraph 88(1)(c).

into the shoes" of the subsidiary corporation by taking over the assets at their tax values.[249] Although the parent corporation cannot recognize loss on the winding up, it may recognize capital gain.[250] The parent corporation is deemed to have disposed of the stock in the subsidiary for proceeds equal to the greater of: (1) the paid-up capital of the stock or the tax value of the subsidiary's net assets after deducting liabilities, whichever is the lesser; and (2) the adjusted cost basis of the stock immediately before the winding-up.[251] The rollover is not available for assets transferred to minority shareholders which are deemed to have been sold at fair market value.[252] Thus, any gain and loss will be recognized at both the subsidiary and shareholder levels.[253]

VI. MUTUAL AGREEMENT AND THE COMPETENT AUTHORITY PROCEDURE

The Competent Authorities, of both the United States and Canada, assist taxpayers with respect to matters covered in the Mutual Agreement Procedure provisions of tax treaties in the manner specified in those provisions.[254] The Mutual Agreement Procedure of the U.S.-Canada Tax Treaty permits taxpayers to request assistance of the Competent Authority when the actions of one or both of the contracting states will result in taxation not in accordance with the Treaty.[255] Competent Authority assistance is also available with respect to issues specifically dealt with in other provisions of a Treaty. Article XIII(8) of the U.S.-Canada Tax Treaty is such a provision. It permits taxpayers to request deferment of profit, gain or income with respect to property alienated in the course of a corporation or other organization, reorganization, amalgamation, division or similar transaction in order to avoid double taxation.[256]

A. *Article XIII(8) Competent Authority Procedure*

Article XIII(8) of the U.S.-Canada Tax Treaty provides for a rather unusual departure from the normal Competent Authority procedure. Article

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[249] I.T.A. paragraph 88(1)(a).
[250] I.T.A. paragraph 88(1)(b).
[251] I.T.A. paragraph 88(1)(b).
[252] I.T.A. paragraph 69(5)(a).
[253] I.T.A. paragraph 69(5)(a); *see also* I.T.A. paragraph 88(2)(b).
[254] U.S.-Canada Tax Treaty, *supra* note 3, at art. XXVI. Article XXVI of the U.S.-Canada Tax Treaty establishes the general Mutual Agreement Procedure.
[255] *Id.* at art. XXXVI(1).
[256] *Id.* at art. XIII(8).

XIII(8) allows a U.S. taxpayer to apply to the Canadian Competent Authority to defer recognition of gain incurred in the course of a corporate or other organization restructuring to the extent necessary to avoid double taxation. The intent of the provision is to coordinate the tax laws of the United States and Canada with respect to income recognition in such a restructuring by providing for nonrecognition in Canada to the U.S. taxpayer if that taxpayer would receive nonrecognition in the United States. It becomes operative only upon request by a U.S. taxpayer to the Canadian Competent Authority. Under Article XIII(8), the Canadian Competent Authority has complete discretion as to whether to accept the petition of the U.S. taxpayer, grant the relief sought and, if granted, impose any terms and conditions it considers necessary.[257]

I.T.A. section 115.1 implements Article XIII(8) and provides:

> Notwithstanding any other provision of this Act, where the Minister and another person have, under a provision contained in a tax convention or agreement with another country that has the force of law in Canada, entered into an agreement with respect to the taxation of the other person, all determinations made in accordance with the terms and conditions of the agreement shall be deemed to be in accordance with this Act.[258]

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[257] The 1984 Technical Explanation provides:

> This deferral shall be for such time and under such other conditions as are stipulated between the person who acquires the property and the competent authority. The agreement of the competent authority of the State of source is entirely discretionary and will be granted only to the extent necessary to avoid double taxation of income. This provision means, for example, that the United State's competent authority may agree to defer recognition of gain with respect to a transaction if the alienator would otherwise recognize gain for United States tax purposes and would not recognize gain under Canada's law. The provision only applies, however, if alienation described in paragraph 8 result in a net gain. In the absence of extraordinary circumstances the provisions of the paragraph must be applied consistently within a taxable period with respect to alienation described in the paragraph that take place within that period.

[258] I.T.A. subsection 115.1 (1).

Originally, I.T.A. section 115.1[259] gave effect only to relieving provisions contained in tax treaties prescribed in regulation section 7400. Prior to the redrafting of I.T.A. section 115.1 and the repeal of Regulation section 7400 in 1994,[260] only Article XIII(8) of the U.S.-Canada Tax Treaty and an identical provision in Article 13(6) of the Canada-Netherlands Tax Treaty[261] were prescribed in the regulations.[262] Former I.T.A. section 115.1 provided that with respect to the alienation of capital property, the amount agreed upon by the vendor, purchaser, and Minister of National Revenue was deemed to be the vendor's proceeds of disposition and the purchaser's cost of the property.[263] This section also contained detailed rules regarding the tax treatment provided to depreciable capital property of a prescribed class,[264] Canadian resource property, foreign source property, eligible capital property and inventory.[265] Former I.T.A. section 115.1 also contained two prerequisites for the deferral of taxation. First, the Minister of National Revenue must have agreed to the deferral pursuant to a prescribed tax treaty. Second, the nonresident vendor and the purchaser must have jointly elected in prescribed form T2024 within the prescribed time and in accordance with terms and conditions required by the Minister of National Revenue.[266]

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[259] This version of I.T.A. subsection 115.1 was added by S.C. 1987, c.46, s.42(1), and was applicable to taxable years commencing after 1984.

[260] I.T.A. section 115.1 was substituted by s.51 of S.C. 1993, c.24 (Bill C-92; Royal Assent June 10, 1993), re-enacted as S.C. 1994, c.7 (bill C-15), Sch VIII), applicable after 1994; Regulation section 7400 applied for purposes of the former version of I.T.A. section 115.1. It was repealed in 1993, retroactive to 1988.

[261] Canada-Netherlands Tax Treaty, *supra* note 22. Article XIII(8) of the U.S.-Canada Tax Treaty and Article 13(6) of the Canada-Netherlands Tax Treaty are identical except the Netherlands Treaty provision does not contain the language that the Competent Authority may agree to a deferral "in order to avoid double taxation." The omission of this language appears to imply a broader basis for deferral than is provided in the U.S.-Canada Tax Treaty. Dalsin, *supra* note 79, at 85.

[262] Regulation 7400(1)(a) prescribed Article XIII(8) of the Convention between Canada and the United States with Respect to Taxes on Income and on Capital, signed at Washington D.C. on September 26, 1980, *as amended by* the protocol signed in Ottawa on June 14, 1983, and the protocol signed at Washington on March 28, 1984. Regulation 7400(1)(a) also prescribed Article XIII; *see supra* Canada-Netherlands Tax Treaty, note 3, at (6).

[263] *See supra* note 261 (former I.T.A. subsection 115.1(c)).

[264] *Id.* (former I.T.A. subsection 115.1(d)).

[265] *Id.* (former I.T.A. subsection 115.1(e)).

[266] *See generally* Calderwood, *supra* note 121 (discussing these prerequisites); Dalsin, *supra* note 79 (discussing these prerequisites).

In 1994, a new I.T.A. section 115.1 was substituted and a new procedure for review was initiated. This new section provides that where the Minister of National Revenue and a taxpayer enter into an agreement under a provision of a tax treaty with another country that has the force of law in Canada, the terms and conditions of such agreement will govern the taxation of the taxpayer notwithstanding the provisions of the I.T.A. that would otherwise apply. This broad and generally worded section was intended to continue the provision's prior applications and to extend the relief to a broader range of transactions.[267]

There are no specific procedures for seeking relief under I.T.A. section 115.1. However, Revenue Canada has issued Information Circular 71-17R4[268] which provides procedures to assist individuals, corporations, or any other persons subject to Canadian income taxes who seek assistance from the Canadian Competent Authority under the general Mutual Agreement Procedures contained in Canadian international tax treaties.[269] According to the circular, no specific form is required for the request, only a letter signed by the taxpayer.[270] The Circular lists the information required to be included in the request such as the particulars of the taxpayer, the taxation years or periods involved, the specific issues raised, any relevant facts, and any possible bases on which to resolve the issues.[271]

Interpretation Bulletin IT-173R2[272] also provides the following comments with respect to the correct procedure for obtaining Article XIII(8) relief:

> To achieve such a deferral, the person or partnership who acquires that property and the vendor must petition the

[267] INTERPRETATION BULLETIN, *supra* note 50, ¶ 2.

[268] 1995-06-02 C.T.S. 1054, Requests for Competent Authority Consideration Under Mutual Agreement Procedures in Income Tax Conventions, Information Circular, IC-71-17R4 (May 12, 1995).

[269] The Mutual Agreement Procedure provisions of the U.S.-Canada Tax Treaty require the case to be presented to the Canadian Competent Authority by a Canadian resident or national. Thus, the Circular is written from the perspective of a Canadian resident taxpayer making a request for assistance from the Canadian Competent Authority. Nevertheless, the Circular is referenced with respect to requests under Article XIII(8) made by a United States resident to the Canadian Competent Authority, and will provide some general guidelines to United States residents seeking Canadian Competent Authority assistance under Article XIII(8) of the U.S.-Canada Tax Treaty.

[270] *Id.*

[271] IC-71-17R4, *supra* note 271, ¶ 11.

[272] INTERPRETATION BULLETIN, *supra* note 50, ¶ 2.

> competent authority in Canada to defer the taxation . . . . If the Canadian competent authority accedes to the request, an agreement must be entered into between the authority and the petitioners under which the deferral of taxation will be in effect for such time and under such other conditions as are stipulated in the agreement. Since the purpose of paragraph 8 of Article XIII of the 1980 Convention is to avoid double taxation, relief will only be granted to the extent necessary to avoid such double taxation. This provision is only applicable where alienation, in the circumstances stated, result in a net gain (i.e. gains exceed losses) . . . .[273] Such an agreement may deal with (but is not restricted to) such matters as the vendor's proceeds of disposition and purchaser's cost of property in Canada (e.g., as capital property). Subsection 115.1(1) can apply to an agreement that concerns a completed or a proposed transaction.[274]

If relief is granted, I.T.A. subsection 115.1(2) places the acquiror in the same tax position as the original transferor with regards to the property on a subsequent disposition.[275] As discussed previously,[276] the Canadian Competent Authority has granted I.T.A. section 115.1 relief under Article XIII(8) in limited circumstances. Relief is most often granted for transactions which do not result in the economic realization of proceeds from the disposition.[277] The transaction must potentially result in nonrecognition in Canada as well as the United States. The transaction must otherwise satisfy the requirements of a Canadian provision allowing for the deferment of

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[273] *Id.* ¶ 10.

[274] *Id.* ¶ 11.

[275] I.T.A. subsection 115(2) provides as follows:

> Where rights and obligations under an agreement described in subsection (1) have been transferred to another person with the concurrence of the Minister, that other person shall be deemed, for the purpose of subsection (1), to have entered into the agreement with the Minister.

[276] *See* discussion *supra* part V.B. (discussing when Article XIII(8) treatment will be granted).

[277] *See* "Revenue Canada Round Table," TAX PLANNING FOR CANADA-U.S. AND INTERNATIONAL TRANSACTIONS, CORPORATE MANAGEMENT TAX CONFERENCE (Toronto: CANADIAN TAX FOUNDATION, 1994), 22:12.

inclusion into income except for the problem of nonresidency.[278] The transaction must also not be prohibited for nonresidents under a provision of the Canadian tax laws. In addition, the transaction cannot be contrary to the spirit of the I.T.A. or designed to evade Canadian tax liability.

Perhaps the factor that generates the most denials of relief by the Canadian Competent Authority is the concern that Canada may not be able to later identify or enforce a claim against the deferred gain. Thus, the transaction must not place Canadian tax claims on a subsequent change in beneficial ownership of the assets at greater risk than under the present ownership.[279] The Canadian Competent Authority may impose conditions in the agreement granting the deferment to assure the tracing of property.[280] Finally, if the ability of Canada to enforce its tax claim under I.T.A. section 115.1 agreement is sufficiently uncertain, relief will not be granted.[281]

B. United States Competent Authority Procedure

Article XIII(8) of the U.S.-Canada Tax Treaty permits a U.S. resident to request the Canadian Competent Authority to defer recognition properly imposed on profit, gain or income from the alienation of property in the course of a organization, reorganization or similar transaction which is provided nonrecognition treatment under U.S. tax laws. However, if the U.S. resident believes that Canada improperly imposed a tax upon the transaction, a request for assistance must be made to the U.S. Competent Authority under the Mutual Agreement Procedure.[282] If the U.S. Competent Authority cannot arrive at a satisfactory unilateral solution, it will attempt to resolve any issues arising as to the interpretation or application of the Treaty[283] by mutual agreement with Canada.[284] Article XXVI lists particular matters that the Competent Authorities may agree upon, however, the Competent

[278] *Id.*; Calderwood, *supra* note 121, at 39:17.

[279] Dalsin, *supra* note 79, at 85-86, 88.

[280] For example, the acquiror of the property may have to report for a period of years to the Canadian Competent Authority to guarantee continued ownership.

[281] *See* discussion *supra* part V.C. (discussing when Article XIII(8) relief will not be granted).

[282] U.S.-Canada Tax Treaty, *supra* note 3, at art. XXVI.

[283] The 1995 Protocol Article 14 of the Protocol adding para. 6 to Article XXVI of the Treaty. JCT Releases, *Explanation of Protocol to United States-Canada Income Tax Treaty II(G)*.

[284] U.S.-Canada Tax Treaty, *supra* note 3, at art. XXVI(2).

Authorities may consult together for the elimination of double taxation in cases not provided for in the Treaty.[285]

Revenue Procedure 96-13[286] details the procedures for requesting assistance from the U.S. Competent Authority under the provisions of any income, estate or gift tax treaty to which the United States is a party. If a request is accepted, the U.S. Competent Authority will consult with the appropriate foreign Competent Authority and attempt to reach a mutual agreement that is acceptable to all parties. Unless otherwise permitted under an applicable tax treaty, the U.S. Competent Authority will only consider requests for assistance from U.S. taxpayers.[287]

VII. POTENTIAL PROBLEM AREAS

Although Article XIII(8) of the U.S.-Canada Tax Treaty provides for relief from double taxation to many types of taxable entities and for many nonrecognition transactions, the provision does not provide relief on the alienation of assets under other circumstances. One example, is that of Canadian resource property which consists of oil and gas assets.[288] Under Canadian law, the nonresident vendor is required to utilize its tax pools before "profit, gain or income" will be recognized for Canadian tax purposes.[289] Thus, although there is no actual income, profit or gain as a result of the alienation, the alienator will have recognized full gain for Canadian tax purposes. Article XIII(8) potentially provides a valuable instrument for establishing relief from double taxation. Nevertheless, unless it is interpreted and applied in a manner that would address issues such as resource pool reductions on the alienation of an asset, double taxation will not be relieved.

A second example where relief from double taxation will not be available arises from the threshold requirement that an asset be disposed of in the course of a corporate reorganization.[290] A specific example, also the

[285] *Id.* at art. XXVI(3).

[286] Rev. Proc. 96-13, 1996-3 I.R.B. 31, *superseding* Rev. Proc. 91-23, 1991-1 C.B. 534, and Rev. Proc. 91-26, 1991-1 C.B. 453.

[287] Rev. Proc. 96-13.

[288] *See supra* note 94 and accompanying text.

[289] I.T.A. section 66.

[290] Many common instances exist in which a mismatching of nonrecognition provisions occurs. For example, in the case of the sale of a family home, the United States requires that a replacement home be purchased at a cost greater than the selling price of the former home.

subject of a recent Canadian Revenue Ruling, is the expropriation of an asset belonging to a U.S. resident.[291] Revenue Canada determined that relief under Article XIII(8) was not available notwithstanding that double taxation would likely result, because the disposition did not occur in the course of reorganization[292] but rather as the result of expropriation. Therefore, no Treaty relief was available.

The Treaty relief available is also not referenced in terms of what will occur when consideration is paid by the acquiror of the asset. Unless the amount of any consideration paid is reflected in the tax cost of the alienated asset, double taxation may occur. Accordingly, clarification of the treatment which the Competent Authority will give to any consideration paid in a transaction for which Article XIII(8) relief is being sought is necessary. In addition, the parties should insure that the treatment of consideration paid is reflected in the specific relief requested and granted.

Article XIII(8) relief is subject to the complete discretion of the Competent Authority of the recognition state, which may impose any terms and conditions considered necessary. This discretion is presumably directed at protecting the country's future right to tax the gain. Nevertheless, the uncertainty as to the scope adds a high level of unpredictability to planning a transaction. In a letter to the Canadian Minister of Finance and International Tax Counsel and the Department of Treasury, industry representatives made the following plea while the Third Protocol to the Treaty was being negotiated:

> Because of the discretionary nature of Article XIII(8), the absence of guidance in both Canada and the United States on common circumstances where Article XIII(8) relief will

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I.R.C. § 1034. The like kind exchange provisions are not generally matched by the replacement property rules of I.T.A. section 44. I.R.C. § 1031. *See generally* D. Miller, "United States Citizens Moving to Canada," 93 Corporate Management Tax Conference, 1993 "Tax Planning for Canada-U.S. and International Transactions" (Toronto: Canadian Tax Foundation: 1994) p. 16-1.

[291] Rev. Rul. 9500205 - Expropriation, Business and General Division, Income Tax Rulings and Interpretations Directorate (July 18, 1995).

[292] To the extent that the event resulted in nonrecognition in the United States because a replacement property was acquired, the individual, according to Revenue Canada, could utilize the provisions of Article XIII(7). As discussed above, that provision allows an individual to elect in his or her tax return for the year of disposition to be liable for tax in the United States to avoid timing problems and the potential for double taxation.

> be available and the cost and time delays in dealing with competent authorities, Article XIII(8) has not been an effective mechanism for relieving double taxation for most cross-border reorganizations. Examples of situations where relief will be granted and a streamlined system for granting relief are needed.[293]

Among the recommendations made were the issuance of regulations to carry out the intentions of Article XIII(8) and a system of "closing agreements" together with the option to recognize gain in either jurisdiction.

The discretionary nature of the provision may also make the government of a foreign country the active facilitator and, perhaps, the critical decision maker in a given transaction. This will occur because the foreign government can allow or deny relief from potential double taxation. Where relief is denied there is no appeal from the decision. There is also no appeal on the nature of the conditions imposed where relief is granted. Of further concern, this absolute discretion exists in a situation where a decision by the Competent Authority to reduce or eliminate double taxation will necessarily affect revenues of that Contracting State for the current and future years.[294]

Complete discretion also invites either country to grant or deny relief based on subjective or random factors such as the policy, or the perceived policy, of the other country at that point in time with respect to a certain type of transaction. This problem of perceived reciprocity became particularly apparent with respect to requests for relief for transfers of real property.[295] Both Canada and the United States were denying relief to taxpayers of the other country on the basis that the other country was denying similar relief. Aside from the "obvious and unacceptable 'Catch 22' problem,"[296] it seems particularly unfair that double taxation relief for a particular taxpayer should be tied not only to the absolute discretion of the Competent

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[293] TREASURY DEPARTMENT CORRESPONDENCE: 90 TNT 118-17, Doc. 90-3910 (Apr. 30, 1990).

[294] *See* Calderwood, *supra* note 121, at 39:1.

[295] The IRS, for example, apparently rejected an Article XIII(8) application by a Canadian individual to transfer a condominium to a Canadian corporation and explained that its decision was based, in part, on a decision by the Canadian Competent Authority not to allow I.R.C. § 351 transfers by U.S. persons. *See* Nathan Boidman, *Fundamental Problems for the Cross-Border Tax Advisor, in* CANADIAN-AMERICAN TAX ISSUES: CROSS-BORDER COMMENTARY, Feb. 7, 1990, at 90 TNI 6-63, *available in* Lexis, Intlaw Library, TNI File.

[296] *Id.*

Authority of another nation, but as well as to the whims or political agenda of his or her own countrymen.

It also became apparent from discussions with Canadian Revenue Authorities that there is a lack of symmetry in the procedures, requirements and conditions imposed by each country. From a Canadian perspective, it appears that the United States generally imposes more conditions on Canadian residents than the Canada Competent Authority imposes in a similar case.[297] However, this is speculative because the process, relief offered and actual conditions imposed under Article XIII(8) are a matter of complete secrecy.

This level of secrecy in Article XIII(8) proceedings also adds to the uncertainty and unpredictability inherent in seeking relief. Without the guidance of prior fact patterns and general or specific conditions imposed for relief, it is extremely difficult to plan a cross-border organization, reorganization or similar transaction. Practically, no reason exists why the circumstances and conditions under which relief has been offered in the past should not be made available to the public so long as the confidentiality of the parties is maintained. This argument is strengthened by the fact that while neither Revenue Canada nor the Internal Revenue Service would be bound by the rulings in future transactions, the documentation would provide useful guidelines and signposts for future cross-border transactions.

Another problem is that there is no consistency among the Treaty partners in addressing the issue of cross-border organizations, reorganizations or dissolutions. This is particularly unfortunate in a regional trade block where businesses should be able to organize on a level playing field. Within the NAFTA group, at a minimum, the treaty provisions between the three NAFTA signatories could be standardized in the area of relief from double taxation for corporate restructurings. It has also been suggested that consideration be given to the development of a trilateral advance ruling process for cross border reorganizations.[298]

Finally, and perhaps of a more general nature, is the matter of treaty overrides. Although double taxation agreements are considered part of the

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[297] Canada, for example, does not require a private letter ruling which seems a prerequisite to U.S. relief and is very time consuming to acquire, according to recent estimates, one to one and a half years. No doubt, many requirements are imposed by the Canadian Competent Authority on U.S. residents which are not requested by the U.S. Competent Authority from Canadian residents.

[298] *See* Arnold & Harris, *supra* note 8, at 582.

"supreme law of the land" in the United States, the United States has adopted a later in time rule in overriding treaty provisions.[299] This has alarmed U.S. treaty partners in the past[300] and, perhaps in response, a measure was added in the Third Protocol to the U.S.-Canada Tax Treaty which requires the appropriate authorities to meet to consider changes to the Treaty if the United States unilaterally makes changes under its domestic law which affects the rights of a Canadian resident under the Treaty.[301] The purpose of such a meeting is presumably to deny benefits on a bilateral basis. Actual or threatened U.S. treaty overrides will clearly add an additional element of uncertainty to the future availability of Treaty relief under Article XIII(8).

VIII. PLANNING

The potential for double taxation and the corresponding relief available under Article XIII(8) of the U.S.-Canada Tax Treaty invite some planning around the Treaty provisions. The following outlines some potential planning opportunities.

A. Purifying a Non-Qualifying Subsidiary

Canadian tax liability will result where a U.S. resident disposes of shares of a corporation where the value of the shares is derived "principally" from real property.[302] If a Canadian corporation initially meets this test, steps may be taken to prevent the alienation of the shares of the corporation from being considered the alienation of real property situated in Canada. These steps might include altering the asset mix of property held by the corporation by disposing of the Canadian real estate or resource properties with the least amount of appreciation and reinvesting the proceeds in assets which are not real property. This may assist in bringing the value of the real property to

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[299] *See* Richard L. Doernberg, *Overriding Tax Treaties: The United States Perspective*, 9 EMORY INT'L. REV. 71 (1995).

[300] *See* Catherine A. Brown, *The Canada-United States Tax Treaty: Its Impact on The Cross-Border Transfer of Technology*, 9 TRANS. L.J. 79 (1996).

[301] *See* U.S.-Canada Tax Treaty, *supra* note 3, at art. XXIX(7).

[302] As previously discussed, "principally" has been interpreted to mean that more than 50% of the value of the corporation is derived from real property.

an amount below 50% of the total value of assets held by the corporation.[303] Alternatively, the corporation could mortgage or otherwise encumber the real property in order to reduce its value. The mortgage proceeds could then be invested in assets the value of which would result in the value of the real property equalling less than 50% of the overall value of the corporation. Since it is not clear if the value of the real property or of the remaining corporate assets is historic or based on the net or gross value of the property,[304] some caution should be expressed about the potential need for Article XIII(8) relief if the second form of planning is being undertaken.

Other techniques that might be used to reduce the value of shares of a corporation treated as real property situated in Canada and, thus, eliminate the risk of double taxation on the deemed disposition in Canada, include declaring a dividend to the parent corporation in cash or in kind in order to reduce the value of the subsidiary's shares.[305] The dividend would be subject to a 5% withholding tax but this may be preferable to the capital gain rate on the disposition of the shares and the need to seek Treaty relief.[306] The subsidiary corporation could also declare a stock dividend or increase the paid-up capital of the shares held by the parent. Either of these actions will result in immediate Canadian tax liability with respect to the amount of the deemed dividend[307] and result in a 5% withholding tax, but will also

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[303] The October 2, 1996 Notice of Ways and Means Motion will extend to five years (from twelve months) the time period for determining the status of shares of non-resident corporations, partnership interests, and interests in non-resident trusts as determined by reference to the underlying assets.

[304] *See* INTERPRETATION BULLETIN, *supra* note 50, ¶ 2.

[305] For a good discussion of this and other planning opportunities, see John Gregory, *Disposing of Canadian Businesses by Non-Residents: A Canadian Perspective*, *in* 1996 Corporate Management Tax Conference, Canadian Tax Foundation (Toronto) Tab. 19, at 20.

[306] *See* I.T.A. section 245 which contains a General Anti-Avoidance Rule Information Circular, IC-88-2 "General Anti-Avoidance Rule - Section 245 of the Income Tax Act," October 21, 1988, ¶ 7. Revenue Canada considered a situation where a U.S. resident proposed a dividend strip to eliminate the capital gain which would otherwise result on the disposition of shares of a Canadian subsidiary which owns real property in Canada. The dividend strip is followed by a sale to an arm's length party. The amount of the dividend does not exceed the income earned and retained by the Canadian subsidiary during the vendor's holding period. Revenue Canada found that the dividend strip would not be subject to the anti-avoidance provisions. Careful note should be made of the fact that the dividend did not exceed income earned during the holding period.

[307] I.T.A. paragraphs 53(2)(a), 53(1)(b).

result in a reduction of a capital gain realized on the disposition of the shares and thus the potential for double taxation.[308]

B. Reducing Risk on Fluctuations in Asset Values

The potential for Treaty relief might also invite a taxpayer to consider applying for relief in situations where there may be fluctuations in the value of the real property. The Canadian Competent Authority generally provides relief in the form of a rollover of the asset at its adjusted cost basis. No regard is made of the current fair market value of the asset at that time. If the asset later decreases in value and is disposed of by the acquiror, it is the actual proceeds which are used in determining Canadian tax liability. This is in contrast to the U.S. Competent Authority which preserves not only the basis, but the fair market value of the asset at the time relief is provided as well for the purpose of determining future tax liability. By transferring the asset at its current cost basis, the taxpayer would be guarding against future decreases in the asset value until such time as the asset is actually disposed of. At that time, tax liability will be limited to the proceeds received, not the value of the asset at the time of the transfer.

IX. FUTURE TRENDS

In the past, the operation of Article XIII(8) has been limited by concerns of enforcement and compliance. The new protocol to the U.S.-Canada Tax Treaty has expanded the obligations and level of cooperation between the two governments in two significant ways which will affect the taxation of capital gains. First, Article XXIX(B)(5) will now provide relief where a U.S. resident individual dies owning "taxable Canadian property."[309] The Canadian tax that would otherwise be payable as a result of a deemed disposition under I.T.A. subsection 70(5) as a consequence of the death of a taxpayer may now be deferred under I.T.A. subsection 70(6) if the property passes to the U.S. resident's spouse or, in certain circumstances, a "spouse

[308] *See generally* I.T.A. section 212; I.T.A. subsection 55(1) (placing limits on this form of tax planning).

[309] For a good discussion of this issue, see M. Atlas, *The New Spousal Rollover in the U.S.-Canada Tax Treaty*, part 1, CCH, March 7, 1994, No. 1252.

trust."[310] Prior to the Third Protocol, this rollover would not have been available in any circumstance in which a U.S.citizen was a nonresident for Canadian tax purposes.

Second, new Article XXVIA has been added to the Treaty.[311] The Article provides that each country will undertake to collect the other country's taxes as if they were its own taxes. Although the obligation to collect the taxes is not mandatory,[312] the new provision represents an important development in both Canadian and U.S.[313] treaty policy.[314] The assumption of these new treaty obligations may also be a good starting place for resolving some of the issues of compliance and collection which has restricted access to relief in the past. We may, therefore, look forward to an expanded and more generous access to the relief provisions under Article XIII(8) of the U.S.-Canada Tax Treaty.

The new potential for Treaty relief may be occurring just in time to relieve double taxation in a huge new area of potential liability. Currently, if a U.S. corporation carries on business in Canada through a branch office or an

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[310] A U.S. trust for a spouse qualifies for this relief upon application by the trust. Revenue Canada will treat the trust as a Canadian resident trust under such terms and conditions satisfactory to Revenue Canada and for the period of time specified in the agreement.

[311] The Third Protocol entered into force for most purposes on January 1, 1996. The new Article will apply to taxes that are "finally determined" after the date that is 10 years before the date on which the protocol enters into force. The United States collection assistance will begin for taxes determined after Jan. 1, 1985.

[312] Paragraph 3 of Article XXVIA provides that the Competent Authority being requested to provide assistance "may" accept the request, and if the request is accepted, the taxes owing in the requesting county are treated as taxes owing under the laws of the requested country. Any taxes collected must be paid to the Competent Authority of the requesting State. A country cannot provide collection assistance in respect of taxes owing by a company that derives its legal status from the requested State. Therefore, Canada could not obtain assistance from the United States in collecting Canadian taxes from a company incorporated in the United States, but which meets the Canadian resident test under the central management and control test.

[313] The United States has recently added collection assistance provisions to a number of its treaties including the treaty with the Netherlands and the treaties with France and Sweden.

[314] This provision is similar to the provision on assistance in recovery of tax claims that is in the Convention on Mutual Assistance in Tax Matters, among the member States of the Council of Europe according to the JOINT COMMITTEE ON TAXATION: STAFF EXPLANATION (JCS-15-95) of the Proposed Protocol to the United States-Canada Income Tax Treaty; Prepared for May 25, 1995, Senate Foreign Relations Committee Hearing: Issued May 25, 1995.

individual operates through a fixed base, there is no Canadian tax liability if the nonresident person simply ceased to carry on business in Canada and the assets return to the use of the nonresident entity. There is, however, no change in legal ownership and no disposition for Canadian tax purposes. Recent proposed changes to the I.T.A.[315] will operate to deem any capital property used by a nonresident person at any time after October 1, 1996, in carrying on a business in Canada, that ceases at any subsequent time to do so, to have been disposed of by that person for proceeds equal to the property's fair market value at that time. To the extent that business is carried on through a permanent establishment or fixed base in Canada, it appears Canada will have a right to tax any gain with respect to branch or fixed base assets under Article XIII. If implemented in its current form, this proposal will create a new area of potential tax liability in Canada, with no corresponding liability in the United States, for which Article XIII(8) relief will clearly be necessary.

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[315] *See* CAN. DEP'T FIN., NOTICE OF WAYS AND MEANS MOTION TO AMEND THE INCOME TAX ACT (Oct. 2, 1996).