

REPORT ON RECENT DEVELOPMENTS

April 2008

Borrowers take note – Withholding Tax on Interest Payments to Arm's Length Non-Residents Eliminated

Canada has recently passed legislation that eliminates Canadian withholding tax on interest (other than participating debt interest) paid or credited as of January 1, 2008 by a Canadian borrower to an arm's length non-resident lender, regardless of the lender's country of residence. This was initially announced in conjunction with changes proposed in the Fifth Protocol amending the Canada-U.S. Tax Treaty and was expected to come into force only after the ratification of the Protocol. Although the Protocol has not yet been ratified by the U.S., Canada decided to proceed with the elimination of its withholding tax for all arm's length non-residents.

Withholding tax continues to apply in non-arm's length situations. Once the Protocol is ratified, such tax will be phased out over a 3-year period, but only for interest paid to non-arm's length U.S. lenders.

Easing of Compliance on the Sale of Certain Taxable Canadian Property by Non-Residents

The Federal Budget of February 26, 2008 announced some favourable changes to the compliance procedure for non-residents selling taxable Canadian property. Under this procedure, which is set out in section 116 of the *Income Tax Act (Canada)* ("ITA"), the non-resident seller must apply for a clearance certificate in advance or within 10 days of a sale. In the absence of such a certificate at closing, the purchaser must withhold a significant portion of the selling

price and remit same to the tax authorities, failing which the Purchaser may become personally liable for such withholdings and penalties. Since the delays to obtain the certificate have become quite lengthy, it has become almost impossible to obtain a clearance certificate for closing, thus putting the purchaser in the position of having to withhold or face personal liability. This is particularly harsh in situations where the property being sold is treaty protected from tax in Canada. The Budget contains three proposals to address this.

First, the Budget proposals will provide an exemption from the withholding and clearance certificate requirements if the capital gain arising on the sale of the property is exempt from Canadian tax under the tax treaty between Canada and the seller's country of residence (typically, shares of a Canadian corporation). Where the treaty-exempt sale is between related persons, the purchaser must send a notice to the tax authorities within 30 days of the sale setting out basic information about the transaction. Note that sales of Canadian real estate will not benefit from this proposal since real estate is not exempted under the treaty structure.

The second proposal extends the situations where a purchaser is relieved of the withholding obligation after "reasonable inquiry". The relief currently applies if the purchaser determines, after "reasonable inquiry", that the seller was a resident of Canada. This will be extended to protect the purchaser who concludes, after "reasonable inquiry", that the seller is resident in a country with which Canada has a tax treaty provided that the gain is exempt under such treaty and

that the purchaser sends notice to the tax authorities within 30 days of the sale setting out basic information about the transaction.

The third proposal will exempt a non-resident from the obligation to file a Canadian income tax return in respect of a sale of taxable Canadian property where there is no tax payable by the non-resident for the year under Part I of the ITA, the non-resident is not liable to pay any outstanding amount for any previous year, and each taxable Canadian property sold by the non-resident in the year is either a treaty-exempt property or is a property for which a clearance certificate has been obtained.

The proposals, if enacted, will apply to dispositions after 2008. Quebec has announced that it will harmonize its legislation in this regard.

Quebec's Fight Against Aggressive Tax Measures

In the Quebec Budget tabled on March 13, 2008, the Finance Minister announced that, over the next three years, Quebec will inject \$5.3 million annually to fund a team specializing in managing, detecting, and shutting down so-called aggressive tax planning schemes (ATP schemes), i.e. tax avoidance arrangements that satisfy the letter of the law but abuse its spirit.

In addition, Quebec will intervene at the fiscal policy level by reviewing its anti-avoidance provisions, penalty regime, and disclosure mechanisms. A green paper on regulating ATP schemes is scheduled to be presented in the fall of 2008 to begin a public analysis which may lead to important legislative amendments in this area.

Restaurant Owners Beware - Sales Recording Modules and New Quebec Security Requirements

The Quebec Minister of Finance has reiterated in the Budget Speech of March 13, 2008, the implementation of new projects to fight tax evasion, including the installation of a sales recording module (SRM) in some

restaurants as part of a pilot project announced last January. The Minister had announced in the Budget Speech of March 23, 2006 that certain measures would be implemented to fight tax evasion in the restaurant sector. One of these measures would oblige restaurants to use a cash register equipped with an SRM to register sales and produce invoices. An SRM is described by Revenue Quebec as "a computer integrated into a secure case that records all commercial transactions (such as invoices, receipts, credit notes) in secure data storage for a period that complies with the requirements for record-keeping." Revenue Quebec estimates that about 30,000 SRMs will be installed in the restaurant sector. No specific date as of which the SRMs will be obligatory has been announced. Information sessions are currently being scheduled by Revenue Quebec for retailers of cash registers regarding a restaurant owner's forthcoming obligation to use a cash register equipped with an SRM.

Other measures that may impact restaurant owners (in particular those that have been assessed as part of the increased GST/QST audits conducted by Revenue Quebec), are amendments to the legislation to add to the situations under which Revenue Quebec can require a person to provide security as a condition for issuing or maintaining their QST and DAS registration. In particular, Revenue Quebec will now be able to request such security (which normally is equivalent to six months of remittances), from a person who was assessed gross negligence penalties under section 1049 of the *Taxation Act* (Quebec) during the preceding five years, or a person whose directors or senior officers have been assessed such a penalty. These amendments are in line with the tightening by Revenue Quebec of collection measures taken against restaurants that have been assessed for failure to declare sales and to remit the GST and QST collected in respect thereof.

Competition Between Security Holders and Revenue Quebec Deemed Trusts

Both the federal and provincial sales tax legislation impose an obligation on a GST/QST registrant to collect the GST/QST payable in respect of taxable supplies made by the registrant and remit same to the appropriate fiscal authorities. All too frequently the registrant uses the collected funds as operating capital for its business until it is financially strong enough to remit the funds to the fiscal authorities. Many of these businesses end up in financial ruin and the sales tax collected is lost.

In an effort to protect these funds, the government has attempted to create by statute a "deemed trust" which is intended to take priority over the assets of a debtor that may already have been given as security to a lender. The interpretation of the deemed trust rules has created problems for years, especially in the context of a bankruptcy.

Recently, the competing interests of a bank and the government's deemed trust were untangled by the Court of Appeal of Quebec in *Banque Nationale du Canada v. Ministère du revenu du Québec et al*¹. The Court of Appeal of Quebec decided, in a unanimous judgment, that in the context of a bankruptcy, the *Bankruptcy and Insolvency Act* ("BIA") prevails over provincial legislation and that the Federal and Quebec sales tax legislation cannot supersede the scheme of distribution established under the BIA. Therefore, the bank's security had priority.

Subsection 67(1) of the BIA defines the property of a bankrupt that is divisible among his creditors and specifically excludes property held by the bankrupt in trust for any other person. However, subsection 67(2) states that the existence of a provision in federal or provincial legislation that has the effect of deeming property to be held in trust for Her Majesty is not sufficient for property to be considered to be held in trust within the

meaning of subsection 67(1). Therefore, funds collected and held in a deemed trust on behalf of a government authority are not automatically carved out of the property of a debtor. (There is a specific exception for amounts collected under pension plan legislation and for income tax source deductions.)

After a historical review of the priority of payment scheme under the BIA and an analysis of the judicial status of deemed trusts, the Court of Appeal concluded that the deemed trust for collected GST and QST was not excluded from the definition of property of the debtor and was, therefore, subject to the scheme of distribution of the BIA. The Court of Appeal further stated that in the context of a bankruptcy sales tax becomes an ordinary debt and the BIA supersedes any other legislation that creates a priority.

The Court granted the bank priority over the tax debtor's property and did not accept Revenue Quebec's argument that the deemed trust gave them a super priority.

May I have a prescription, please?

Are you taking over-the-counter medications on the advice of a medical doctor? Do you suffer from seasonal allergies? Did you know that you should be asking for a prescription for these medications? The Tax Court of Canada recently rendered two decisions² on claims for a medical expense tax credit for over-the-counter medications prescribed by a medical doctor. In the first case, Mr. Norton had suffered a heart attack and as part of his post-heart attack drug therapy, he was prescribed 81mg ASA tablets (or low dose aspirin) together with high blood pressure and cholesterol controlling medications. The Canada Revenue Agency ("CRA") sought to refuse the claim for the medical expense tax credit on the prescribed low dose aspirin

¹ EYB 2007-127782

² *Norton v. The Queen*, 2007-1562(IT)I, 2008 TCC 29 and *Breger v. The Queen* 2006-378(IT)I, 2007 TCC 254

since it is available over the counter and is not required to be recorded by a pharmacist. In the second case, Dr. Breger claimed a medical expense credit for the cost of medicinal, nutritional and herbal supplements that he had prescribed for his wife's ailments, and which were recorded by a licensed pharmacist in the Province of Quebec. The CRA also refused Dr. Breger's claim on the basis that the medications were not required to be recorded by a pharmacist, since they could be purchased over the counter without the need for pharmacist intervention.

After reviewing the tax legislation and case law as well as the provincial legislation governing the practice of pharmacists (Mr. Norton is from B.C. and Dr. Breger is

from Quebec), both Tax Court judges found in favour of the taxpayers. The tax legislation only requires:

- (i) that the medication be used in diagnosis, treatment or prevention of disease, disorder or symptoms thereof;
- (ii) that it be prescribed by a medical practitioner; and
- (iii) that it be recorded by a pharmacist.

So don't forget your prescription, even for over-the-counter medications, and remember to have the pharmacist record it. These expenses will be eligible for the medical expense tax credit (provided you meet the other qualifications for claiming same) AND you will not be charged any sales taxes on your purchase.

Sweibel Novek News

We are pleased to welcome Me Steve Pereira to our firm. Steve was called to the Quebec Bar in 2005 and is in the process of completing the Masters in Taxation program at the Université de Sherbrooke. Prior to joining our firm, Steve was involved in tax planning and corporate commercial transactions.

We extend our warmest congratulations to our partner Carol Rabbat and François Talarico on the birth of their first child, a son, on March 28, 2008.

The material contained herein is necessarily of a general nature and cannot be regarded as legal advice. The members of our firm would be pleased to provide additional information. You may reach us at (514) 849-1188 or by e-mail as follows:

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