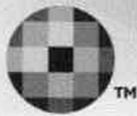

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Tax Profile

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The Admissibility of Hindsight in Tax-Purpose Valuations

By: Richard M. Wise, FCA, FCBV, FASA, MCBA, CVA – Wise, Blackman LLP, Montreal

The term "fair market value" is employed in several dozen provisions of the *Income Tax Act* (Canada) ("ITA") and extensively in the U.S. *Internal Revenue Code*. Fair market value is defined as:

> The highest price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.[1]

Fair market value is distinguished from other standards of value such as, for example, fair value, value to owner, liquidation value and value in use. Fair market value is an objective standard, determined without regard to the identity of the actual buyer or seller of the asset. It assumes a transaction of the subject property in a notional, or hypothetical, market in which both parties are uncompelled and assumed to have reasonable knowledge of the relevant facts.

An area of contention that frequently arises in reporting fair market value for income tax purposes is the admissibility of hindsight, or retrospective evidence, that may have been used in determining such value.

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It is a fundamental principle that value is determined as of a specific point in time (or valuation date) and is a function of known facts that existed and events anticipated (or forecasts made) as of that time. The valuation date is also referred to as the "effective date" or the "as of" date.

A "subsequent event" is an event that occurs after the valuation date.

Generally accepted accounting principles, for example, state that there are essentially two types of subsequent events:

(a) those that provide further evidence of conditions that existed at the financial statement date (which may require adjustments to be made to the statement), and

(b) those that are indicative of conditions that arose subsequent to the financial statement date (which do not require adjustments to the statement).[2]

Because factual evidence from subsequent events that occurred would not have been available to a willing and informed buyer and a willing and informed seller at the effective valuation date, only information that would have reasonably been anticipated *vis-à-vis* the future may be presumed by the parties at that date. That is, as hindsight would not have been available to a buyer and seller in an *open market* (real-world) transaction, it should not be admissible in reaching a valuation conclusion in a *notional market* transaction (e.g., as contemplated for income tax purposes).

In effect, the valuator must place himself or herself in the position of the hypothetical purchaser who would be evaluating and pricing the subject asset or business on the valuation date, viewed prospectively – as valuation is necessarily forward-looking, with the past sometimes being a guide to the future.

The use of hindsight information and the degree to which it is admissible for valuation purposes has been considered by the courts in a number of valuation cases. The issues have been typically addressed in the contexts of (a) taxation, (b) expropriation, and (c) shareholder dissent and oppression.

While retrospective evidence is inadmissible in reaching valuation conclusions for purposes of *notional* (hypothetical or imaginary) market valuations for tax purposes, it has sometimes been used by the courts to test (or confirm) the reasonableness of assumptions or projections that existed as of the valuation date in determining fair market value. That is, post-valuation date evidence may assist the court in deciding whether a *notional market* valuation opinion is reasonable.

The Courts' Views

Because the extent to which hindsight is admissible can be a key issue in valuation, some of the comments of the courts in this regard may be instructive.

In *The Queen v. National System of Baking of Alberta Ltd.*,[3] a capital gains tax matter relating to the valuation of publicly traded shares held by a taxpayer (involving the takeover of a public company 10 months after the valuation date), Mr. Justice Mahoney of the Federal Court – Trial Division stated: "I expressly rejected the validity of hindsight as probative of fair market value at a given date and took nothing that occurred after [the valuation date] into account".

Shortly thereafter, in *Connor v. The Queen*,[4] Justice Mahoney was again asked to consider subsequent events in determining value as of the valuation date. After his review, His Lordship stated: "The reasonableness of *projected* earnings may be measured against the yardstick of actual results without arriving at those projections by application of hindsight". [Emphasis added.]

In *Edmund Littler, Sr. v. The Queen*,[5] the Federal Court of Appeal addressed the valuation of shares for Canadian federal gift-tax purposes (at the time gifts were taxable under the provisions of the pre-1972 ITA). Two of the three appellate court justices held that the fair market value of the shares of Walter M. Lowney Company Ltd. (a Canadian public company) was the eventual $68 takeover price by Standard Brands of the United States and not the $24 stock market price on the valuation date. Such view was taken without the benefit of hindsight, being based, instead, on *facts actually existing* at the valuation date. The Court of Appeal, affirming the decision of the Trial Division, stated:

> The Minister [of National Revenue] had every reason to attribute to the value of a share in Lowney's a figure of $68.22 quite apart from what eventually took place in May 1968 .... As far as the Minister's decision is concerned, *it was not ... a case of hindsight at all. It was based on substantial facts existing prior to the transaction challenged herein.* [Emphasis added.]

Hence, the Court in *Littler* contrasted the use of retrospective evidence with the availability of facts "actually existing" at the valuation date.

Because fair market value is determined in a "notional" (imaginary) market for income tax purposes, it may be acceptable to use facts or information regarding an actual sale subsequent to the valuation date to help determine whether the valuation was reasonable, provided that there were open (actual) market circumstances that would not render the subsequent facts irrelevant (e.g., a sale under distress conditions).

An important issue raised by the Federal Court - Trial Division in the *Dominion Metal*[6] decision was whether, at

the relevant valuation date, the buyer, Ogilvie Mills, was a "special purchaser" in the notional market. That is, at the time Ogilvie acquired a property (that was the subject of the valuation) from Dominion Metal in 1974, it was a special purchaser;[7] however, as of the relevant valuation date a few years earlier in 1971, no evidence was led that supported the proposition that, *on the valuation date*, it was a special purchaser:

> . . . There is no evidence of Ogilvie Mills exerting any acquisitive clout or giving the mere impression of it to alert the notional buyer that at [*the valuation date*] the subject lands might have a considerably enhanced value over other locations simply because they were located next door to it. There is no evidence of notional movement by Ogilvie Mills in any direction. Even if one might establish the presence of Ogilvie Mills as a special purchaser [*18 months subsequent to the valuation date*], *I cannot readily see where as at* [*the valuation date*], Ogilvie Mills can fit into the special purchaser category.
>
> . . .
>
> . . . In the cases cited by the plaintiff and to which lengthy reference was made, there were facts which gave credence to the presence of special purchasers not only at the date of acquisition [in 1974] but at the relevant valuation date [in 1971] as well. In the case before me, I fail to find that kind of foundation upon which the presence of a special purchaser in the notional market [*at the valuation date*] may be reasonably established. . . . [Emphasis added.]

Other cases that found hindsight to be inadmissible include *Brunelle v. MNR*,[8] in which case Chairman Cardin of the Tax Review Board stated:

> In evaluating shares at a specific prior time there can be no doubt that it is a proper evaluation procedure to consider the company's actual earnings for the past three to five years. It is also proper to project the future earnings of the company on the basis of its past performance and that is done as accurately as possible by means of the weighted averages and the use of a realistic multiplier. However, in my opinion, which is supported by other members of this Board, *it is not proper in evaluating shares as of a prior date to use the company's actual record of surplus or extra earnings which occurred subsequent to [the valuation date] and which are not known or expected on [the valuation date]. In my view, this hindsight evaluation, whether it increase or decreases the value of the shares, cannot and does not establish the fair market value of the shares as at [the valuation date] and should not be employed in an evaluator's calculation* . . . . [Emphasis added.]
>
> . . .
>
> On the basis of the evidence presented to the Board in the appeals, there are no special facts or circumstances that existed on [the valuation date] which might permit anyone to expect or to foresee at that time any marked increase in the company's earnings in subsequent years.

Facts subsequent to the valuation date were admitted by the Federal Court–Trial Division in *J.A. Carruthers v. The Queen*[9] in order to test an assumption:

> The validity of this conclusion, which would be reasonable to make as of [the valuation date], can be verified by the fact that [Mr. Carruthers] did in fact leave the company in 1976 following the sale of his shares . . . in 1975 . . . .

The Court also noted that, in expropriation cases, sales of comparable properties subsequent to the date of expropriation – but not too long thereafter – may be admitted into evidence. The Court found no apparent reason why an assumption that could be made concerning the 1971 valuation date, i.e., that Mr. Carruthers would not remain long in the employ of the company should he and his wife have chosen to dispose of their shares, cannot find some support in the fact that this is what eventually took place:

> The price paid . . . to the Carruthers for their shares is of course in no way relevant to the valuation as at [the valuation date], for [the purchaser] was obtaining full control of the company and moreover *during the intervening years between 1971 and 1975 the company continued to prosper and the shares increased in value*. [Emphasis added.]

In *McClintock v. The Queen*,[10] the Tax Court relied on hindsight, concluding that it was appropriate given the particular facts of the appeal. In the Court's opinion, the trial judge must exercise discretion as to whether or not to apply hindsight to assist in adjudicating fair market value – particularly when there are no transactions of comparable properties immediately preceding the valuation date.

In the Tax Court of Canada decision in *Zeller Estate*,[11] Justice Campbell commented as follows in rejecting the hindsight used by the Canada Revenue Agency's valuator:

> The general position is that hindsight is inadmissible except to test the reasonableness of the assumptions made by the valuators. Justice Rip, as he was then, in *McClintock v. Canada*, 2003 TCC 259, stated at paragraph 54:
>
> > . . . First of all, it is the trial judge who must exercise his discretion whether or not, in the particular facts of an appeal, to use hindsight to assist in deciding whether a purported value of property is correct or in setting a value. This is particularly so when there are no sales of any comparable property immediately prior to the valuation date.
>
> Although each of the reports relies on post valuation data, I believe the use of the fiscal year 1999 by [the CRA's valuator], in calculating maintainable earnings, is a clear breach of the general hindsight rule because actual revenue results were used from the period after the val-

> uation date. Generally, hindsight should not be used in notional market valuations except in very limited circumstances. ... the information utilized by [the CRA's valuator] in the seven months subsequent to [the valuation date] would not have been available to a purchaser on that date. ....

Timing of Valuation on Death of a Taxpayer

For income tax purposes, fair market value is determined as of a specific date or point in time, generally when the transaction or deemed transaction occurs. As discussed below, a split second can sometimes have a material effect on the valuation conclusion reached.

In section 70 of the ITA, relating to deemed-dispositions on the death of a taxpayer, five individual and precise points in time are stipulated for purposes of fair market value determination, depending on the type or source of income deemed to be triggered.

Description	*ITA Section*	*Timing of Deemed Disposition for FMV Purposes*
Accrued periodic amounts (interest, rent, etc.)	70(1)	*Day* of death
"Rights or things" (receivables, etc.)	70(2)	*Time* of death
Capital property (investments, personal property)	70(5)	Immediately *before* death
Transfer (rollover) to spousal trust	70(7)	Immediately *after* death
Disposition by spousal trust	104(4)	At the *end of the day* on which the spouse dies

Four different points in time are identified in the very same section of the ITA (section 70). The legislators obviously had every intention of distinguishing among them when requiring value determinations for a decedent's final tax return.

The precise point in time as of which fair market value had to be determined for income tax purposes was addressed by the Federal Court of Appeal in *The Queen v. Mastronardi Estate*,[12] where at the time of Mr. Mastronardi's death, his corporation was owner and beneficiary of a term life insurance policy of $500,000 payable to the company. The policy was dated September 25, 1972 and had no cash surrender value. Mr. Mastronardi was required by the insurance company to have two independent physical examinations, which he had on August 28, 1972. He died suddenly, with no prior warning, of cardiac arrest on February 20, 1973 at the age of 51. Neither the deceased nor his immediate family was aware prior to his death that he was a likely or suspected candidate for the heart attack brought on by arteriosclerotic cardiovascular disease. The issue before the Court was whether the shares held by Mr. Mastronardi were to be valued on the basis of taking the insurance policy into account at the instant of death (as an asset of the corporation).

The Federal Court of Appeal agreed with the trial judge that there was a two-step "fiction" under subsection 70(5) of the ITA (which deems property to be disposed of immediately before a taxpayer's death at fair market value):

> The first fiction is that the taxpayer after he dies is deemed to have disposed of the subject property "immediately before [the taxpayer's] death".
>
> The second fiction is that he is deemed "to have received proceeds of disposition therefor equal to the fair market value of the property at that time".
>
> The problem is to determine what was the legislative concept ... of the [ITA] and apply such to the facts of this case.

The Trial Judge reached the following conclusions:

> The words "immediately before his death" ... should not be construed as meaning the equivalent of the instant of death; and also those words do not import a necessity of valuing [the shares] taking into account the imminence of death.
>
> In my view, therefore, ... [the valuation] must be considered as having taken place at some other time rather than at the instant of death ... and no premise of imminence of death of the deceased should form any part of such valuations.

The Court held that it was not necessary to take into account the amount of the insurance proceeds in valuing the shares of the corporation, as death was not contemplated "immediately before" (a split-second before) it occurred.[13]

The CRA's position, with respect to the imminence of death of a shareholder for which corporate life insurance is owned and where this factor is to be considered in valuing the shares, is that the following factors must be considered:

(a) The possibility that the insured will recover and not die;

(b) The effect that the loss of a key person would have on the business operations;

(c) Whether the share interest being valued represents a majority or minority position in the company; and

(d) The importance of factors other than the value of the policy, such as the anticipated future earnings of the company and prospects for cash distributions.[14]

Some Practical Issues

Often, at a particular point in time or on the valuation date, there is information that is known (factual) or knowable, reasonably foreseeable, probable and/or possible. Unexpected events cannot be considered; they would constitute pure hindsight.

Subsequent or Future Events

Examples of post-valuation date events include:

- Reasonably Foreseeable Events
  - Potential for new business – based on contract to be signed imminently;
  - Potential for a sale (although timing is not knowable);
  - Potential for share repurchases (although timing is not knowable);
  - Potential for settlement of a lawsuit (active settlement discussions);
  - Change in income tax provisions (Bill awaiting Royal Assent);
  - Change in corporation's dividend policy;
  - Retirement of key executive(s); and
  - Legislative/regulatory changes.

Reasonably foreseeable events as of a valuation date are considered in terms of *possibilities* and *probabilities* and not with the certainty that they would have actually occurred at a subsequent date.

- Possible Events
  - Loss of a key employee;
  - Commencement of a lawsuit (product liability, wrongful dismissal, oppression remedy);
  - Entry of a new competitor into market;
  - Change in dividend/distribution policies;
  - Recapitalizations of share capital;
  - Restructuring of the business;
  - Merger or acquisition;
  - Share buyback;
  - An initial public offering; and
  - An offer to sell business.
- Unforeseen and Unexpected Events (Inadmissible Hindsight)
  - A crash or surge in the market;
  - Failure of a competitor;
  - Loss of a key customer;
  - Loss of a key executive;
  - Loss of a key supplier;
  - Legislative changes;
  - Changes in foreign exchange rates; and
  - Tragedies (earthquake in Haiti, 9/11 World Trade Center terrorist attack).

Thus, there continues to be "debate" as to what is known, knowable, reasonably foreseeable, probable, possible and unforeseen/unexpected. Certain of the cases referred to have addressed this issue.

In summary, hindsight information (subsequent events) may serve to corroborate or provide evidence of fair market value but may not be used in the determination thereof.

Professional Standards

The professional standards promulgated by the valuation and accounting bodies mandate that their respective accredited members adhere to certain basic principles as regards post-valuation date or post-financial statement date information and events.

In the United States, for example, The Appraisal Foundation, through its *Uniform Standards of Professional Appraisal Practice* promulgated by The Appraisal Standards Board, states:[15]

> A retrospective appraisal is complicated by the fact that the appraiser already knows what occurred in the market after the effective date of the appraisal. Data subsequent to the effective date may be considered in developing a retrospective value as a confirmation of trends that would reasonably be considered by a buyer or seller as of that date. The appraiser should determine a logical cut-off because at some point distant from the effective date, the subsequent data will not reflect the relevant market. This is a difficult determination to make. Studying the market conditions as of the date of the appraisal assists the appraiser in judging where he or she should make this cut-off. In the absence of evidence in the market that data subsequent to the effective date were consistent with and confirmed market expectations as of the effective date, the effective date should be used as the cut-off date for data considered by the appraiser.
>
> Use of direct excerpts from then-current appraisal reports prepared at the time of the retrospective effective date helps the appraiser and the reader understand market conditions as of the retrospective effective date.
>
> CONCLUSIONS
>
> - A retrospective appraisal is complicated by the fact that the appraiser already knows what occurred in the market after the effective date of the appraisal.

- Data subsequent to the effective date may be considered in developing a retrospective value as a confirmation of trends.
- The appraiser should determine a logical cut-off.
- Use of direct excerpts from then-current appraisal reports prepared at the time of the retrospective effective date helps the appraiser and the reader understand market conditions as of the retrospective effective date.
- In the absence of evidence in the market that data subsequent to the effective date were consistent with and confirmed market expectations as of the effective date, the effective date should be used as the cut-off date.

The American Institute of Certified Public Accountants, in its *Statement on Standards for Valuation Services No. 1*, "Subsequent Events", states:

> 43. The valuation date is the specific date at which the valuation analyst estimates the value of the subject interest and concludes on his or her estimation of value. Generally, the valuation analyst should consider only circumstances existing at the valuation date and events occurring up to the valuation date. An event that could affect the value may occur subsequent to the valuation date; such an occurrence is referred to as a **subsequent event**. Subsequent events are indicative of conditions that were not known or knowable at the valuation date, including conditions that arose subsequent to the valuation date. The valuation would not be updated to reflect those events or conditions. Moreover, the valuation report would typically not include a discussion of those events or conditions because a valuation is performed as of a point in time – the valuation date – and the events described in this subparagraph, occurring subsequent to that date, are not relevant to the value determined as of that date. In situations in which a valuation is meaningful to the intended user beyond the valuation date, the events may be of such nature and significance as to warrant disclosure (at the option of the valuation analyst) in a separate section of the report in order to keep users informed .... Such disclosure should clearly indicate that information regarding the events is provided for informational purposes only and does not affect the determination of value as of the specified valuation date.

U.S. Internal Revenue Service *Revenue Ruling 59-60*[16] outlines and reviews, in general terms, the approach, methods and factors to be considered in determining the fair market value of shares of closely held corporations for estate and gift tax purposes. The Revenue Ruling states that: "Valuation of securities is, in essence, a prophesy as to the future and must be based on facts available at the required date of appraisal".

Former U.S. Defense Secretary Donald Rumsfeld delved into the subject when he said:[17]

> Reports that say that something hasn't happened are always interesting to me, because as we know, there are known knowns; there are things we know we know. We also know there are known unknowns; that is to say, we know there are some things that we do not know. But there are also unknown unknowns – the ones we don't know we don't know.
>
> I would not say that the future is necessarily less predictable than the past – I think the past was not predictable when it started.

Conclusion

Whether for income tax purposes (fair market value) or financial statement reporting purposes (fair value), value is determined as of a specific point in time. Hindsight is inadmissible; however, subsequent events may provide helpful information, such as in the following circumstances:

- Subsequent facts support projections or estimates actually existing at the valuation date.
- An arm's length sale of the subject property has occurred in the open market within a reasonably short period subsequent to the valuation date and there was no material change in conditions up to the time of sale and under no distressed conditions.
- The valuation was based on forecasts or projections.
- Subsequent events are used to test other assumptions about facts that had a bearing on the conclusions (for example, the bankruptcy of the subject company's largest customer less than a month after the valuation date, which was "foreseen" or "assumed" as of the valuation date).
- The only possible way to measure value at the relevant date is to work backwards from a subsequent sale within a reasonable period, using an amortization method and (other things being equal) taking into account, say, inflation.

Hindsight would accordingly be used only where the retrospective data provide evidence, or further evidence, of conditions that actually existed or could have been reasonably anticipated at the valuation date.

For income tax purposes, it might therefore be prudent to commission an independent valuation proximate to the valuation date (transaction date) when there is a non-arm's length transfer of a business or other economic interest. This should not only help to avoid a possible third-party civil penalty under section 163.2 of the ITA, but also for the valuation being considered as "self-serving" (as, for example, a valuation that is commissioned after a reassessment has been received). It may also help satisfy the CRA's requirements[18] for its recognition of a price adjustment clause.

Notes:

[1] *International Glossary of Business Valuation Terms*, June 2001, developed jointly by the American Institute of Certified Public Accountants, American Society of Appraisers, The Canadian Institute of Chartered Business Valuators, National Association of Certified Valuation Analysts and the Institute of Business Appraisers.

[2] *International Financial Reporting Standards*, 2010 edition, IAS 10, "Events after the Reporting Period". See also, Canadian Institute of Chartered Accountants *Handbook*, "Subsequent Events", Section 3820.04.

[3] 78 DTC 6018, at 6024; [1978] CTC 30.

[4] 78 DTC 6497; [1978] CTC 669.

[5] 78 DTC 6179; [1978] CTC 235.

[6] 86 DTC 6311 (F.C.T.D.).

[7] For a detailed discussion regarding special purchasers and their effect on fair market value, see, R.M. Wise, "The Effect of Special Interest Purchasers on Fair Market Value in Canada", *Business Valuation Review*, Vol. 22, No. 4, December 2003.

[8] 77 DTC 326; [1977] CTC 2506.

[9] 82 DTC 6009; [1982] CTC 5.

[10] 2003 DTC 576 (TCC), 2003 TCC 259.

[11] 2008 DTC 4441; 2008 TCC 426 (CanLII).

[12] 77 DTC 5217 (FCA), [1977] CTC 355; aff'g 76 DTC 6306 (FCTD), [1976] CTC 572.

[13] The ITA was subsequently amended (subsection 70(5.3)) to provide that, for deaths occurring after December 1, 1982, the value of a policy immediately before death would be its cash surrender value at that time; however, if the death occurred prior to that time, the insurance policy, as a component of the assets underlying the shares, would be valued "in accordance with normal valuation practices taking into consideration all facts relevant to the particular case". CRA Interpretation Bulletin IT-416R3, dated July 10, 1987, "Valuation of Shares of a Corporation Receiving Life Insurance Proceeds on Death of a Shareholder".

[14] CRA Information Circular 89-3, "Policy Statement on Business Equity Valuations", August 25, 1989, paragraph 41.

[15] *Statement on Appraisal Standards No. 3* (SMT-3), "Retrospective Value Opinions, Real Property, Personal Property".

[16] 1959-1 CB 237, Section 3.03.

[17] Defense.gov News Transcript: DoD News Briefing – Secretary Rumsfeld and Gen. Myers, United States Department of Defense (defense.gov), February 12, 2002.

[18] CRA Interpretation Bulletin IT-169, August 6, 1974, "Price Adjustment Clauses".

Cross-Border Nightmare[1]

By: Jack Bernstein, Aird & Berlis LLP, Toronto

I am involved on a file which is a textbook case on why knowledgeable tax advisers must be retained on cross-border investments.

FACTS

The following is a simplified version of the facts. An individual resident in Canada personally owned U.S. real estate. One U.S. property (vacant land) was sold to a U.S. purchaser. The sale was structured as an instalment sale with a down payment of 10% of the price and the balance of the purchase price being payable on the fifth anniversary of the sale. The purchaser withheld and remitted to the Internal Revenue Service ("IRS") 10% of the purchase price under the *Foreign Investment in Real Property Tax Act* ("FIRPTA"). The individual subsequently died and bequeathed all of his assets to his spouse.

A Canadian accountant undertook to do the tax planning and the compliance in both Canada and in the United States. For a variety of reasons, it took him eight years to file the U.S. return reporting the sale of the land. For Canadian tax purposes, a taxpayer must report a minimum of 20% of the capital gain each year where there is an instalment sale. The accountant filed the Canadian returns reporting one fifth of the gain in each year but claiming a foreign tax credit for U.S. tax (which wasn't payable) in each year. He also filed the U.S. returns claiming a credit for the tax withheld under FIRPTA and reporting one fifth of the gain in each year although this was not in accordance with the U.S. rules. Canada didn't accept the foreign tax credit for the U.S. taxes and the United States didn't accept the credit for the tax withheld under FIRPTA. When the client died, the accountant reflected the transfer of assets to the spouse on a tax-deferred basis in the terminal return for Canadian tax and forgot to file for U.S. estate tax.

PROBLEMS

(1) Section 6511(a) of the Internal Revenue Code ("IRC") requires that a U.S. tax return be filed to claim a credit for FIRPTA withholding within three years of the filing date of the return, or within two years of the payment, whichever is later. No refund is generally available for a late-filed return. In this case, no U.S. tax was exigible for the year of sale because of the U.S. instalment sale rules. The IRS takes the position that section 6511 applies to refunds of FIRPTA payments (see IRS FSA 199951002 (August 27, 1999)). The client was denied a refund or credit in the United States for the U.S. tax withheld by the purchaser on the sale. U.S. lawyers are attempting to obtain an offer of compromise in order to effectively obtain a refund of the FIRPTA withholding and avoid double taxation.

(2) The CRA denied the U.S. foreign tax credits claimed on the Canadian tax returns because U.S. tax was not payable in those years. There was also a problem as the land sale may have been inventory in Canada and could have been a long-term capital gain for the United States or a sale of the trade or business assets.

(3) The mismatch of the reporting under the Canadian and U.S. instalment sale rules is a problem. Canada requires that more gain be reported in each year (minimum 20%) than was taxable in the United States. As a result, there is double taxation. There is no credit in Canada for the U.S. tax payable in subsequent years when no Canadian tax is exigible.

(4) The accountant also reported on the U.S. return the interest on the balance of sale as income effectively connected to a trade or business taxed at

graduated rates rather than as passive income subject to 10% U.S. withholding tax. Attempts are being made to recharacterize these payments.

(5) By claiming the spousal rollover under subsection 70(6) of the ITA in the terminal Canadian tax return, the accountant foregoes the foreign tax credit for U.S. estate tax. He should have elected pursuant to subsection 70(6.2) of the ITA to deem the U.S. property to have been disposed of at fair market value so as to use the tax credit for U.S. estate tax and to bump the tax cost of the property to fair market value. There was some concern that the year was statute-barred. We filed amended returns with the alternative being an application to the competent authority under Article XXVI of the Treaty should the amended return not be accepted.

(6) The IRS required the client to pay all U.S. tax before any negotiation. This included all U.S. tax on the sale and on the interest income without the credit for the FIRPTA withholding and all U.S. estate tax. The IRS threatened to put the client on the Homeland Security List and deny her entry to the United States if all taxes were not paid.

Notes:

[1] The original article was first published in the May 2010 issue of *Canadian Tax Highlights* (Toronto: Canadian Tax Foundation).

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a Wolters Kluwer business

CCH Canadian Limited
300-90 Sheppard Avenue East
Toronto ON M2N 6X1
416 224 2248 • 1 800 268 4522 tel
416 224 2243 • 1 800 461 4131 fax
www.cch.ca