# Canadian Tax Highlights

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## US FSC Update

Last year the World Trade Organization (WTO) ruled that the US foreign sales corporation (FSC) regime constituted an illegal export subsidy. In response, President Clinton signed into law the FSC Repeal and Extraterritorial Income Exclusion Act of 2000, which replaced the FSC rules (Code sections 921-927) with a partial income exclusion for extraterritorial income. New companies have been prohibited from electing FSC status since October 1, 2000, but existing FSCs have until December 31, 2001 to comply with the new regime. The WTO reportedly released a confidential interim ruling on the extraterritorial income (ETI) regime on June 22, 2001, anticipating a final report a month later.

The FSC provisions provided US companies with tax benefits on foreign sales. The new ETI regime offers similar benefits to manufacturers and exporters (but does not require a separate foreign entity such as an FSC); abandons the foreign management requirement; retains the foreign economic processes requirement; and continues to make benefits available to C corporations, but also allows benefits to US individuals, partnerships, LLCs, S corporations, and certain electing foreign corporations. The ETI regime also adds an income exclusion for US alternative minimum tax purposes and generally carries forward the FSC regime's foreign destination and domestic content requirements.

In spite of EU challenges to the ETI regime in the WTO, the United States has taken affirmative steps for its implementation. Earlier this year, the IRS published form 8873, Extraterritorial Income Exclusion, for calculating extraterritorial income that is excluded from gross income for the tax year. On May 21, 2001, the IRS issued Rev. Proc. 2001-37, which provides guidance on three separate ETI regime elections available by checking the appropriate box on form 8873. First, a taxpayer may elect to exclude all or part of its eligible income from the ETI regime; for example, a taxpayer with significant foreign-source income may reap more US tax benefits from FTCs than from the partial ETI exclusion. Second, existing FSCs may elect to apply the ETI regime before 2002. Third, an eligible foreign corporation may access the ETI regime by electing to be treated as a domestic corporation—but not an S corp—for all purposes of the Code, but must waive US income tax treaty benefits: an ETI exclusion's advantages must be weighed against a possible net increase in US taxable income when worldwide income falls into the US tax net.

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## Securitization Accounting

CICA Accounting Guideline 12, "Transfers of Receivables" (AcG-12), issued in March 2001, provides accounting and reporting standards for sales, securitizations, and servicing of receivables and other financial assets. AcG-12, which significantly changes the accounting for and disclosure of securitizations and similar transactions, replaces EIC-9, issued in 1989 by the CICA Emerging Issues Committee. AcG-12 is fashioned along the lines of US FASB 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities, a Replacement of FASB Statement No. 125"; however, there are some key differences.

AcG-12 relies on a financial components approach that focuses on control: following a transfer of financial assets (or portions thereof) an entity recognizes the assets it controls and liabilities it has incurred, and derecognizes financial assets for which control has been surrendered and all liabilities that have been extinguished. Previous accounting guidance required that a transferor account for receivables transferred as a single unit that had been either entirely sold or entirely retained, an all-or-nothing approach that was difficult to apply in practice and produced inconsistent results. To achieve off-balance-sheet treatment under the new rules, a transferor-seller must achieve sale treatment and non-consolidation treatment. Generally, sale treatment is possible if the assets are isolated from the seller: the purchaser has the right to pledge or exchange the assets it receives, and the seller has surrendered control over the transferred assets. The rules are complex. If the purchaser achieves qualified special purpose entity

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(QSPE) status, it is not consolidated by the seller. Generally, a QSPE is legally distinct from the seller and simply acts as a flowthrough vehicle for the beneficial owner, operating on an "autopilot" basis and consisting of "brain-dead" passive assets. If the seller reports under US GAAP, and does not sell to a QSPE, the purchaser must meet US GAAP rules that require it to be structured with equity (legal form) equal to at least 3 percent of the total asset value from parties unrelated to the seller.

Off-balance-sheet treatment is generally essential to sellers to mitigate large corporations tax liability. In determining taxable capital, footnote disclosure forms part of the financial statements. AcG-12 significantly expands disclosure requirements for a company's securitized financial assets and the interests retained to encompass information about accounting policies, securitization volume, cash flows, key assumptions made in determining fair values of retained interests, and the sensitivity of those fair values to changes in key assumptions. Under the new rules, a company that retains an interest in securitized receivables must also, inter alia, disclose the amounts that have been derecognized—that is, recorded as sales—during the year linked to the particular category of amounts remaining on the balance sheet.

Disclosure is required if the lessor-seller retains a residual value interest in the leases securitized because there is "continuing involvement" by the lessor. It is no longer possible to convert operating leases to financial leases suitable for securitization: only leases that are guaranteed at the inception of the lease are eligible for sale treatment. Transfers of minimum lease payments relating to sales-type and direct-financing lease receivables are subject to the disclosure requirements because they meet the definition of a financial asset unless they are not guaranteed. The new rules do not apply if the lessor-seller only services the asset (rent collections, repos) and does not retain continuing involvement in the lease receivables sold. Alternatively, a lessor-seller may eliminate his continuing involvement in the assets sold through a third-party sale.

AcG-12 is mandatory for transfers of (interests in) financial assets and extinguishments of liabilities occurring after June 30, 2001: the date of transfer is the key date, not the date of the original securitization transaction or the company's fiscal year-end. For many companies, the new criteria prescribed by AcG-12 for recognizing transfers of assets may signal a significant change in financial reporting unless underlying agreements are amended. Each company should carefully evaluate the efficacy of its securitizations in light of these developments and assess whether solutions need to be developed to achieve sale and off-balance-sheet treatment.

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## Bill C-22: Time To Take Action

Bill C-22 received royal assent on June 14, 2001. The bill includes tax measures from the October 2000 federal mini-budget, the February 2000 federal budget, and former Bill C-43, which died on the order paper when the 2000 federal election was called. Though many measures in the bill take effect from their original announcement, royal assent creates separate deadlines for at least 27 newly enacted provisions, including the following.

**Deadline: August 13, 2001 (60 days after royal assent)**

■ The 2000 federal budget allows tax deferral on the employment benefit from qualifying employee stock options in publicly listed shares acquired after February 27, 2000, until the shares are sold. If the shares were not sold in 2000, the deadline for making the election for the 2000 tax year is extended.

**Deadline: September 12, 2001 (90 days after royal assent)**

■ A foreign corporation distributing spinoff shares must provide information to the CCRA to establish eligibility criteria for a paragraph 86.1(2)(f) election.

**Deadline: December 31, 2001 (six months after the month of royal assent)**

■ Foreign banks wishing to operate a Canadian branch must apply for regulatory approval as required by the Office of the Superintendent of Financial Institutions (subsection 142.7(11)).

■ Individuals who abandoned Canadian residence after 1992 and before October 2, 1996 may elect to exclude from the deemed disposition on emigration any property described in the "excluded right or interest" definition in new subsection 128.1(10).

**Deadline: The filing due date for the taxation year that includes June 14, 2001 (filing due date for the year in which the amendments received royal assent)**

■ Individuals who abandoned Canadian residence after October 1, 1996 may elect to provide adequate security in lieu of otherwise applicable tax (subsection 220(4.5)).

■ Individuals who abandoned Canadian residence after 1995 must report all properties with an aggregate fair market value exceeding $25,000 (subsection 128.1(9)).

■ Corporations may elect not to have rollover provisions apply to a foreign merger that occurred in 1996, 1997, or 1998 (subsection 87(8)).

■ A non-resident-owned investment corporation (NRO) that revokes its election to be taxed as an NRO after February 27, 2000 may elect to choose a new taxation year-end and maintain NRO status until the time of revocation (subsection 134.2).

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## BALLPARK PICTURE

TONI (tax on income) is now a way of life for nine provinces, and the territories are about to follow: the traditional single-column comparison of provincial personal income tax rates—as a percentage of the federal—no longer exists. While precise comparisons of effective tax rates involve many different numbers, the broad outlines can be easily summarized. Three provinces rely on a three-rate system, much like the rate schedule used in the federal system last year. Ottawa and five provinces (and two territories) have four distinct brackets, and two provinces and one territory have five different rates.

The tables are set up according to the federal brackets, so provincial rates and surtaxes that do not fall near these federal benchmarks are excluded. A complete listing of all provincial rates is beyond easy summary. The lowest rates usually produce the lowest tax burdens, and the highest rates the greatest provincial burden. In between, the tax burden depends not only on the top marginal rate on the last dollar of income but also on the cumulative effect of the rates in the previous brackets. All in all, this year it is more pleasant to be taxed in the west than in Quebec, at least for a single person with no dependants and no pension plans or RRSPs.

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**Combined Federal and Provincial Personal Income Tax Rates, 2001**

| | Income bracket and level | | | | |
|---|---|---|---|---|---|
| | First: $30,000 | Second: $60,000 | Third: $100,000 | Fourth: Over $100,000 | Top rate |
| Nfld. | 26.6 | 38.2 | 45.6 | 48.6 | 48.6 |
| PEI | 25.8 | 35.8 | 44.4 | 47.4 | 47.4 |
| NS | 25.8 | 37.0 | 42.7 | 45.7 | 47.3 |
| NB | 25.7 | 36.8 | 42.5 | 46.8 | 46.8 |
| Que. | 30.4 | 39.6 | 46.2 | 48.7 | 48.7 |
| Ont. | 22.2 | 31.2 | 39.4 | 42.4 | 46.4 |
| Man. | 26.9 | 38.2 | 43.4 | 46.4 | 46.4 |
| Sask. | 27.5 | 35.5 | 42.0 | 45.0 | 45.0 |
| Alta. | 26.0 | 32.0 | 36.0 | 39.0 | 39.0 |
| BC | 23.3 | 32.5 | 39.7 | 42.7 | 45.7 |
| Yukon | 23.4 | 32.1 | 38.0 | 43.0 | 43.0 |
| NWT | 23.2 | 31.9 | 37.7 | 42.1 | 42.1 |
| Nunavut | 23.2 | 31.9 | 37.7 | 42.1 | 42.1 |

**Combined Federal and Provincial Personal Income Tax Payable—Single Taxpayer, No Dependants**

| | 2001 tax year income level | | | |
|---|---|---|---|---|
| | $30,000 | $60,000 | $100,000 | $200,000 |
| | *dollars* | | | |
| Nfld. | 5,543 | 23,597 | 35,008 | 83,649 |
| PEI | 5,360 | 22,516 | 33,608 | 80,978 |
| NS | 5,392 | 22,642 | 33,628 | 80,965 |
| NB | 5,335 | 22,445 | 33,075 | 79,915 |
| Que. | 6,351 | 25,243 | 36,796 | 85,511 |
| Ont. | 4,611 | 20,102 | 30,954 | 77,364 |
| Man. | 5,588 | 23,260 | 34,110 | 80,510 |
| Sask. | 5,645 | 22,336 | 32,836 | 77,836 |
| Alta. | 4,852 | 19,601 | 28,601 | 67,601 |
| BC | 4,797 | 20,320 | 30,895 | 76,595 |
| Yukon | 3,574 | 17,819 | 27,440 | 70,203 |
| NWT | 3,549 | 17,697 | 27,122 | 68,934 |
| Nunavut | 3,549 | 17,697 | 27,122 | 68,934 |
| Federal | 3,324 | 13,629 | 20,129 | 49,129 |

## PROVINCIAL LIMITATIONS

The FCA in *Markevich* recently concluded that provincial limitation laws apply to collection procedures under the Income Tax Act (the Act).

The taxpayer was unable to satisfy a 1986 notice of assessment for about $230,000. With no prospect of payment in the foreseeable future, Revenue Canada wrote off the tax debt but did not forgive it, and subsequent statements omitted reference to the amount. More than 10 years later, the CCRA advised the taxpayer by letter of its intent to renew collection action for the amount, now $770,000 with interest. The minister did not institute court proceedings to recover the debt, but rather employed so-called statutory collection powers such as registering a certificate of indebtedness with the Federal Court and, in this case, issuing a requirement to pay to third-party creditors. The taxpayer, a BC resident, argued that the collection was statute-barred, relying on section 32 of the federal Crown Liability and Proceedings Act (CLPA) and the BC Limitations Act. The FCTD dismissed the taxpayer's application for a declaration that he was not indebted to the minister and for an order prohibiting collection: the CLPA's reference to proceedings did not cover statutory collection procedures under the Act, which in any event comprised a complete code with no limitation period for such procedures.

On appeal, the FCA unanimously concluded that the matter was statute barred. In regard to the complete code argument, the Act deals with limitation periods in three ways: explicit provision or exclusion (for example, the use of words such as "at any time") or by silence, as in the case of the collection provisions. In such a context, silence implies that laws of general application, such as the CLPA, should apply. On the meaning of the term "proceedings" in the CLPA, the FCA concluded that the term most often refers to court proceedings but also covers statutory collection procedures. The FCA acknowledged that the importation of general limitation periods may pose obstacles to the fair and efficient collection of tax arrears, because different limitation periods may apply in different provinces and to different elements of a taxpayer's assessment depending on whether they were appealed, or no provincial limitation might apply. The court noted that the matter at hand was a question of statutory interpretation, and it was open to Parliament to amend the Act to effect a more appropriate result. The cause of action referred to in the CLPA is the existence of facts that support the commencement of a court action—in this case, the existence of a tax debt and the expiry of the delay period in section 225.1. Under the Act, these facts also support collection procedures, fulfilling the connection of the "proceedings" to a cause of action.

Under section 3(5) of the BC Limitations Act, any action not specifically provided for may not be brought more than six years after the right arose. "Action" is defined as "any [court] proceeding . . . and any exercise of a self-help remedy," which the FCA concluded encompassed the statutory collection procedures. Moreover, the BC legislation extinguishes the underlying cause of action—the debt—after the expiry of the relevant limitation period. Thus the minister was statute-barred in relation to the 1986 tax debt from court action or collection.

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## Source Deductions Reduced

**Lump-sum employee transfers to RRSPs.** Recent amendments to regulations 100(3) and (3.2) allow employers to transfer, without source deductions, certain lump-sum payments to an employee's RRSP up to the maximum amount that the employee may deduct as an RRSP contribution. Previously, employers were required to withhold on retiring allowance payments in excess of the portion deductible under paragraph 60(j.1) and on the entire amount of bonus or retroactive payments exceeding $10,000. Obtaining a waiver created an unnecessary paper burden: the CCRA already possessed the information on unused RRSP contribution room that supported the waiver application. The employer can now transfer the payment without withholding if it has reasonable grounds to believe that the payment is deductible: for example, a copy of the employee's notice of assessment may show unused RRSP contribution room. Some employers were structuring bonus programs to ensure that no single payment exceeded $10,000; the limit's repeal obviates the need for multiple payments and for concern over the CCRA's reaction to them.

**Support payments.** Proposed amendments to regulation 100(3) reflect an employer's new responsibility in some provinces to collect and distribute support payments. According to the CCRA's "Regulatory Impact Analysis Statement," in those provinces the employer receives instructions to withhold support payments from the employee's salary and forwards them to the province. Provincial instructions are neither a garnishee nor a similar court order: current regulation 100(3)(d) requires the employer to withhold on employee remuneration without reference to support payments, causing undue hardship for the individual. The proposal ensures that the employee's pay subject to withholding is net of such tax-deductible support payments.

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## Legislation by Powerpoint

At the International Fiscal Association conference on May 7, 2001 and a Tax Executives Institute conference the same week, a Finance official outlined potential modifications to the draft foreign investment entity (FIE) legislation as well as technical amendments to the foreign affiliate (FA) rules. The FIE comments represented only Finance's then current view, and were provided in point form without hard copy; revised draft legislation is expected shortly.

Under the June 22, 2000 draft legislation—based on 1999 budget proposals—Canadian taxpayers face current taxation on an FIE interest other than an exempt interest, which includes an interest in a controlled foreign affiliate (CFA). An FIE is generally a non-resident entity that holds at the taxation year-end investment properties representing more than 50 percent of the carrying value of its assets computed under Canadian GAAP. A lookthrough rule drills down to the assets that underlie significant share investments (25 percent of votes and value). The investor is generally taxed using a mark-to-market regime, but may qualify to elect an accrual regime. Another one-time election may be available to treat an FIE interest as a CFA interest, but both elections are available only rarely. Finance's suggested changes include the following.

- An FIE should exclude an entity whose principal business—determined by reference to accounting income—is not an investment business, which should itself exclude (1) the manufacture, development, and purchase and development of property for leasing and licensing by the entity or a related entity; (2) a real estate business; and (3) the development and exploitation of foreign resource properties and timber resources.
- An exempt FIE interest should include interests in foreign mutual funds resident in treaty countries and shares in public companies that are listed on a prescribed stock exchange and are widely held and actively traded if no tax-avoidance motive exists. (This caveat is curious. The FIE rules were purportedly introduced because the tax-avoidance test in current section 94.1 was ineffective to tax high-income individuals who enjoyed the tax advantages of offshore mutual fund investment.) An exempt interest should also include shares in an entity that holds shares or debt in a second entity whose principal business is not an investment business; the first entity must hold a significant interest in—or participate in or (have a bona fide plan to) exercise significant influence over the governance or management of—the second entity. This change would benefit holdcos that actively manage strategic investments.

■ In determining carrying value, US and European GAAP should be treated as equivalent to Canadian GAAP; consolidated financials should be permitted if legal entity financials were not made available to interest holders. Taxpayers should be permitted to elect FMV asset valuation; annual asset valuations may prove very costly and even impractical for multinationals with many investments.

■ The grace period in the investment property definition should be extended to 36 months from the original 12 for property acquired on certain debt and share issues and certain dispositions; a new exception should apply for active business income (ABI) accumulations if there is an active business purpose. The definition should also exclude property not used in an investment business and certain interest in, and debt issued by, related and other qualifying entities.

■ The accrual method and CFA elections should be more accessible. A special rule should allow an amount determined under the mark-to-market rules to be treated as a capital (not income) gain or loss if (substantially) all of it is reasonably attributable to changes in the value of the entity's capital property. (A minority shareholder is unlikely to have access to the financials and other information necessary to determine the cause of such a change.)

■ Exchange and conversion features of interests should be deemed exercised.

Finance's recommended changes to the FIE rules respond to certain submissions received and are generally relieving, but in some cases appear extremely burdensome and fail to address many issues. The FIE rules, loosely modelled on the US PFIC rules, continue to impose an extraordinary burden on Canadian multinationals entering into joint ventures, and are simply not practical. In contrast, in April 2001 the US House and Senate Joint Committee on Taxation recommended elimination of the PFIC rules to simplify their extremely complex system and unify US anti-deferral provisions under a non-overlapping regime.

Finance is also recommending technical amendments to the FA rules, including the following.

■ Excluded property should include (1) property used by the FA principally in its active business; (2) another FA's shares if more than 90 percent of its property's value is attributable to excluded property; (3) property giving rise to ABI under paragraph 95(2)(a) (currently limited to debt); and (4) foreign currency hedging agreements related to excluded property.

■ The "investment business" definition should accommodate certain limited partnership interests.

■ Property income derived from dispositions of non-capital excluded property (such as intangibles) should be included in ABI (paragraph 95(2)(a)) and be calculated using the domestic currency or a reasonable currency.

■ Certain technical changes should be made to rules on hedging gains and losses, the calculation of an FA's gains and losses (paragraph 95(2)(f)), the fresh-start rules (paragraph 95(2)(k)), and the stop-loss rules (subsections 93(2.2) and (2.3)).

■ If a non-resident corporation is an FA of one or more related corporations, at least one of which has a qualifying interest therein, each corporation should have a qualifying interest in the FA for the purposes of paragraph 95(2)(a).

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## TAX STATS: ENDANGERED SPECIES?

For each calendar year, the CCRA publishes statistics on the personal income tax system; the publication is officially entitled "Income Statistics," and is commonly known as the Green Book. First published in 1946, the Green Book is distributed to the news media, libraries, members of Parliament, officials of federal, provincial, and municipal government departments, and academic researchers. The Green Book is best known for its data on the number of high-income individuals who do not pay federal income tax for a given year, but has also been used to analyze the kiddie tax and many other tax policy issues. Recent CCRA

## JEFF MACNELLY'S SHOE by Chris Cassatt and Gary Brookins

actions lead to some concern about the Green Book's future.

■ **Long and unprecedented publishing delays.** The Green Book is normally issued in the fall of the year of its cover date: for example, the 1998 edition came out in early December 1998, but the 1999 edition did not appear until June 2000, and the 2000 edition has not yet been published. Three years ago, to quell criticism over delays, the CCRA added a publication entitled "Interim Statistics," with availability projected near the middle of the year of the cover date. Unaccountably, this publication is even less timely: the 1999 edition appeared several months late in November 1999, and the 2000 edition is one year late already. In addition, both final and interim publications provide data for a year that is two years before the cover date: 1998 data will appear in the 2000 issue of both publications. The CCRA points to the impact of heavy staff turnover in the last two years and says that the 2000 and 2001 editions of each publication will be out by year-end. In the meantime, paper copies of selected statistics are available from the CCRA by private request. Users can pay Statistics Canada's Small Area and Administrative Data Division for more prompt data; for example, some RRSP and capital gains data for the Green Book's 2001 edition have been available since October 2000.

■ **Discontinuance of a print version.** Since June 2000, Green Book data have been available only by direct request for copies of individual tables or through the CCRA's Web site. Electronic-only publication is no more expeditious, generates relatively insignificant savings of likely only $100,000 a year, and suffers three significant disadvantages.

**(1) Accessibility.** Statistics Canada reports that 11 million Canadians, especially older and low-income people, did not access the Internet last year. Although the majority of Green Book users probably do not come from this group, lowering accessibility is undesirable. **(2) Poor archiving.** The Web, still in its infancy, may not prove to be an effective system to archive data: thus academic journals with electronic versions rarely discontinue print versions. **(3) Lower public profile.** A paper-based publication attracts more public attention to data on a Web site. Quebec, for example, has not cancelled the paper version of its provincial personal income tax data.

Access through the Web has many advantages: it is rapid and free and data can be loaded automatically onto spreadsheets for further manipulation and analysis. But Web-only publication is not desirable. The low profile of the Green Book publications is also partly due to the CCRA's lack of marketing effort. Availability of a new edition is heralded only by an entry under "What's New" on the CCRA's Web site. A press release highlighting three or four newsworthy numbers would generate much more interest among the media. Burying the entire publication is easy, but dealing with controversial issues head-on is preferable.

A publication burdened by delays and a low profile does not have a promising future. The Green Book is an important public document on tax policy, like the tax expenditure account or the budget papers, and as such deserves better treatment. What is needed is a focus on timely publication, reinstatement of the paper edition to supplement Web access, and a press release to attract media attention when the data become available.

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## DIVIDENDS STILL PREFERRED

In 2001, the trend toward lower tax rates for individuals and small businesses continued unabated in most provinces and territories. The elimination of the 5 percent federal "deficit" surtax benefited all top marginal rate individuals; taxpayers in British Columbia, Alberta, Saskatchewan, and Newfoundland also benefited from aggressive reductions in top provincial marginal tax rates. In addition, the provincial battle for bragging rights to the lowest provincial small business income tax rate continued, with most jurisdictions announcing rate cuts; Alberta, Saskatchewan, Manitoba, Ontario, and New Brunswick also announced increases in provincial business limits (on different timetables and amounts). Ontario and Alberta led a number of provinces in announcing general corporate income tax (CIT) rate reductions. Ontario will stage general corporate rate reductions from its current 14 percent to 8 percent by January 1, 2005; Alberta, subject to affordability, will stage reductions from its current 13.5 percent to 8 percent by April 1, 2004.

February 2000 federal budget proposals that were accelerated in the October 2000 mini-budget reduced the general federal CIT rate on active business income (ABI) from 28 to 27 percent for 2001; the rate will drop in 2 percent increments each January 1 to 21 percent by 2004. No adjustments are planned to the 4 percent federal surtax, the 16 percent federal small business deduction, or the $200,000 maximum business limit. A separate rate change after 2000 reduced CCPCs' ABI CIT rate on income between $200,000 and $300,000 from an effective 29.12 percent to 22.12 percent, a rate already effective for income exceeding the $200,000 business limit and qualifying for the full manufacturing and processing deduction (MPD). The CCPC rate reduction and assorted provincial changes to the small business tax rates, business limits, and clawback thresholds (in Ontario) significantly increased the complexity of determining the appropriate corporate taxable income after reasonable bonuses to active owner-managers. (See "Dividends Currently Preferred," *Canadian Tax Highlights*, June 27, 2000, at 44.) Although not specifically addressed in the table, a signifi-

**Tax on Distribution of $10,000 of ABI**
**Year Ending December 31, 2001**

| | Ontario | Quebec | BC |
|---|---|---|---|
| | | *dollars* | |
| **ABI eligible for SBD** | | | |
| Dividends | | | |
| Corporate tax | 1,962 | 2,216 | 1,762 |
| Individual tax | 2,519 | 2,603 | 2,653 |
| | 4,481 | 4,819 | 4,415 |
| Salary | | | |
| Individual tax | 4,552 | 4,672 | 4,570 |
| Provincial health levy | 191 | 409 | 0 |
| | 4,743 | 5,081 | 4,570 |
| Tax savings | 262 | 262 | 155 |
| Tax deferral | 2,781 | 2,865 | 2,808 |
| **ABI: no SBD, no MPD** | | | |
| Dividends | | | |
| Corporate tax | 4,212 | 3,716 | 4,462 |
| Individual tax | 1,814 | 2,101 | 1,784 |
| | 6,026 | 5,817 | 6,246 |
| Salary | | | |
| Individual tax | 4,552 | 4,672 | 4,570 |
| Provincial health levy | 191 | 409 | 0 |
| | 4,743 | 5,081 | 4,570 |
| Tax cost of dividend | 1,283 | 736 | 1,676 |
| Tax deferral | 531 | 1,365 | 108 |
| **ABI: no SBD, full MPD** | | | |
| Dividends | | | |
| Corporate tax | 3,412 | 3,116 | 3,862 |
| Individual tax | 2,065 | 2,302 | 1,977 |
| | 5,477 | 5,418 | 5,839 |
| Salary | | | |
| Individual tax | 4,552 | 4,672 | 4,570 |
| Provincial health levy | 191 | 409 | 0 |
| | 4,743 | 5,081 | 4,570 |
| Tax cost of dividend | 734 | 337 | 1,269 |
| Tax deferral | 1,331 | 1,965 | 708 |

Note: The figures assume a top individual marginal income tax rate and, where applicable, a top health levy rate. The impact of CPP, EI, and other payroll taxes has not been considered.

cant deferral generally exists for corporately taxed income between $200,000 and $300,000; however, based on current top marginal tax rates, a tax cost exists to the extent that such net income is distributed as a taxable dividend to the owner-manager.

Similar to prior years, strictly on rates, in 2001 owner-managers benefit from a significant tax deferral and some tax savings on the payment of dividends in lieu of salary, if the underlying corporate income is ABI eligible for the SBD. If the ABI is not eligible for either the SBD or the MPD, a deferral exists in all jurisdictions except for Alberta, Saskatchewan, the Northwest Territories, Nunavut, and Yukon. Generally, a significant tax cost follows the actual distribution; the size of the cost varies by province or territory. However, a prolonged tax deferral may outweigh the ultimate cost, and that and numerous other factors should be considered when deciding an owner-manager's salary-dividend mix. Only salary triggers CPP and RRSP contribution eligibility. Payroll withholdings and remittances and (corporate and individual) instalments affect cash flow. Retention of corporate earnings may affect provincial and federal capital tax liabilities and, in Ontario, the SBD clawback. At the corporate level, an owner-manager should take heed of creditor proofing; qualified small business corporation (QSBC) status eligibility for the capital gains deferral available for eligible small business corporation (ESBC) shares; investment tax credit (ITC) availability; payroll tax exemption thresholds; workers compensation premiums; provincial tax holidays; bank covenants; and income levels for SR & ED ITCs and charitable donations. Similarly, at the individual level, shareholders (including beneficiaries of discretionary family trusts) should consider their respective CNIL balances; old age security and other income clawbacks; charitable donation income levels; alternative minimum tax; residence of other shareholders; and the application of the split tax to minor beneficiaries of a discretionary family trust.

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## NSULCs for US Persons

For Canadian tax purposes, a Nova Scotia unlimited liability company (NSULC) is a corporation; for US tax purposes, it is a partnership (more than one member) or is disregarded. The incorporation fee may not be adequate financial incentive for other provinces to adopt ULC legislation, but an NSULC hybrid presents interesting planning opportunities for Americans.

■ **Alternative to a Canadian branch.** For US tax purposes, the NSULC operating losses may be applied against the US shareholder's US profits.

■ **Purchase of a Canadian business.** An NSULC may allow a Canadian individual who sells shares of a private Canco to (1) access the $500,000 capital gains exemption and also accommodate a US purchaser's desire for an asset purchase in order to benefit from a US deduction for goodwill over 15 years; (2) incur any losses directly; and (3) claim a US foreign tax credit (FTC) for the NSULC's Canadian taxes. An Ontario target may be continued in Nova Scotia and amalgamated with an NSULC. If amalgamation occurs immediately after the sale, a Code section 338 election should be made; in any case, the assets' tax cost is bumped to FMV for US tax purposes.

■ **NSULC as Acquisitionco.** An NSULC may be the acquisition vehicle for a US purchaser who acquires shares from a Canadian vendor: the shares' adjusted cost base equals the purchase price, but the PUC is unchanged, precluding repatriation of the purchase price from the

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targetco sans Canadian withholding. An NSULC may be capitalized with a combination of shares and debt that complies with Canada's 2:1 thin capitalization rules and the funds used to acquire targetco. Targetco's original purchase price up to the NSULC's PUC may be repatriated tax-free without Canadian withholding tax. An NSULC may also facilitate an exchangeable-share transaction. USco's NSULC subscribes for targetco common shares, and the Canadian vendors exchange their targetco common shares for retractable and exchangeable preference shares that mirror USco shares. Once a retraction notice is received, the NSULC acquires USco shares with which to buy back targetco preference shares.

■ **Acquiring Canadian real estate.** An NSULC owned by a US shareholder (an S or C corp may benefit from 5 percent dividend withholding tax) may be a beneficiary of a Canadian trust taking title to Canadian real estate. The US shareholder lends to the trust under a conventional mortgage. Large corporations tax may be avoided, but a proposed amendment may render thin capitalization applicable. The US shareholder can compute the NSULC's income under US rules and claim an FTC for its Canadian taxes.

■ **Holding passive Canadian investments.** An NSULC may be an attractive vehicle for US investors with Canadian passive investments. And a Canadian-resident individual who plans to move to the United States should consider converting a passive Canadian holdco into an NSULC beforehand to step up the corporate assets' tax cost for US tax purposes and to allow a US FTC for the NSULC's Canadian tax. The use of an NSULC to hold passive investments enables a US investor to avoid timing differences and a characterization as a US or foreign personal holding company and a PFIC.

■ **International conduit.** A US resident may interpose an NSULC to access Canada's treaty network. Canada's treaties may have a more preferential treaty rate on dividends received from third countries than relevant US treaties, and generally do not have a limitation-of-benefits provision. If an NSULC owns shares of a company that carries on an active business in a treaty jurisdiction, Canada does not tax dividends received by the NSULC out of its foreign affiliate's exempt surplus. Dividends paid to the NSULC's US corporate shareholder are subject to 5 percent Canadian withholding. The NSULC may also be used for a back-to-back royalty with a third country (United States-Canada-third country), subject to transfer-pricing issues.

■ **US beneficiaries of Canadian trusts.** A US resident may be a beneficiary of a Canadian trust subject to the 21-year deemed FMV sale of its assets other than Canadian real estate. The tax may be sidestepped only for resident beneficiaries by rolling the trust property before the 21st anniversary. Alternatively, the US beneficiary may roll the trust interest to an NSULC in exchange for shares, and the trust may roll out the property to the Canadian-resident NSULC. No US tax arises because the NSULC is disregarded.

■ **Financing.** A USco can use an NSULC to finance its Canadian opco subsidiary. The NSULC borrows from a US third party and on-lends to Opco. To qualify for the withholding exemption under subparagraph 212(1)(b)(vii), the US loan must have a minimum five-year term, require repayment of no more than 25 percent of the principal during the first five years (except on default), and not bear interest that is participating. Opco pays interest owing by issuing shares. USco contributes additional capital to the NSULC to discharge its interest obligation. The loan between NSULC and Opco must be characterized as common equity for US tax purposes, not preference shares under Code section 305; for Canadian tax purposes, this may create valuation issues related to the interest paid by Opco. From a Canadian perspective, the objective is for Opco to deduct the interest expense, and the NSULC's tax position is a wash: interest income and a matching interest expense. For US tax purposes, the NSULC's interest receipt is not taxable to USco.

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# Foreign Tax News

## Treaties

After lengthy negotiations, the agreement with the **Slovak Republic** was signed by the human resources development minister on May 22, 2001. A 5 percent withholding tax applies to dividends paid to a company that controls at least 10 percent of the votes in the payer; otherwise, the rate is 15 percent. Withholding on interest and royalties applies at 10 percent. The agreement enters into force on the day the last notification is received from the two countries and applies with respect to withholding from January 1 in the following calendar year. This agreement completely replaces the 1990 agreement between Canada and **Czechoslovakia**. Full text is available from Finance at http://www.fin.gc.ca/ or from the Foundation's library.

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