Canadian Tax Highlights

Editor: Vivien Morgan, LL.B.

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IRS Hybrid Structure Regs

The IRS issued final regs that foreclose the use of certain popular cross-border financing structures effective June 11, 2002. The regs modify and finalize proposed regs of February 2001 and represent the final guidance associated with the IRS's concern over the availability of treaty benefits for items of US-source income paid to hybrid entities—entities fiscally transparent in one country but not in the other country—under Code section 894. The regs deal with domestic reverse hybrid entities (DRHEs): US entities treated as corporations under US law but as fiscal transparencies under the laws of the party that claims treaty benefits. The most common DRHE used in Canada-US financing structures is a US limited partnership that elects to be a corporation for US purposes under the check-the-box rules. The IRS believes that such entities have been used to manipulate the US tax-treaty network to obtain inappropriate tax-advantaged financing.

Assume that a DRHE receives a payment from a related US company that is treated as a dividend under the laws of the United States or of the foreign country and makes a deductible payment (for example, interest) to a foreign parent that otherwise qualifies for treaty-reduced US withholding tax and is subject to little or no tax in the foreign country. Under the final regs, the DRHE's outbound payment of interest is recharacterized as a dividend for purposes of the Code and the applicable tax treaty to the extent of the foreign parent's proportionate share of the dividend paid to the DRHE by the US sub. When the proposed regs were issued in February 2001, commentators raised several issues: for example, the regs erode the simplicity encouraged by the check-the-box regs; the IRS lacks authority under domestic or treaty law to recharacterize as dividends payments that are clearly interest; and the IRS has been given too broad a discretion to deem certain structures to be covered by the regs when they were not specifically within the scope of the regulations. Furthermore, the regs apply whether or not a tax-avoidance motive exists and even if the applicable treaty withholding rate on dividends is lower than that on interest, as is the case under the Canada-US treaty where the Canadian parent qualifies for the 5 percent dividend withholding rate. The IRS was generally unimpressed with these concerns, and accordingly few changes were made to reflect them in the final regs.

The regs apply to certain currently used cross-border structures, including certain types of so-called tower structures that involve US limited partnerships, Nova Scotia ULCs, and US limited liability companies. However, certain other DRHE structures should remain outside the scope of the regs, including certain DRHEs that borrow from US or Canadian unrelated banks rather than the Canadian parent, and certain DRHE structures that borrow from a sister Canadian corporation that does not directly own any shares of the DRHE rather than the Canadian parent itself.

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FIEnally?

Revised draft foreign investment entity (FIE) legislation of August 2001 included many positive changes. Implementation was deferred to 2003, and Finance received many submissions related to a number of continuing concerns. At the IFA tax seminar on May 13, 2002, a Finance official answered questions and outlined contemplated changes. The comments were tentative only, and may not be reflected in draft legislation that will be released by late summer 2002 at the earliest.

■ Finance is considering the "reintroduction" of an imputation regime to address difficulties in valuing investments in private companies under a mark-to-market regime. The cost of the investment multiplied by a prescribed rate would be included in income annually, unless mark-to-market treatment was elected. The imputation regime may or may not replace "mark-to-market" as the default regime. In addition, taxpayers with more than 10 percent votes and value may still elect to consider FIE investments to be controlled foreign affiliates subject to the FAPI rules rather than the FIE rules.

■ Finance may re-examine the impact of taxation under the mark-to-market regime, which includes the full increase in value in income even if the property is capital property. Finance had concluded that the exceptions in the draft legislation were sufficient, but it is open to reviewing the matter.

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■ Taxpayers that do not wish to be taxed on a mark-to-market basis can theoretically elect the accrual basis, which requires significant information, ensnares income otherwise exempt under the foreign affiliate rules, and creates problems in determining the income of foreign corporations under Canadian tax rules. Finance is currently considering the possibility of eliminating the accrual basis method.

■ Finance indicated that the next redraft will evidence more linkage between existing definitions such as "excluded property" and "investment business" in the foreign affiliate rules and the FIE definitions.

■ It is not anticipated that the requirement to use Canadian GAAP or substantially similar principles in determining the carrying value of an FIE's assets will be dropped: concern exists that certain countries may adopt or use incompatible forms of GAAP.

■ Finance continues to favour the use of "purchased goodwill" in determining the carrying value of assets for the purpose of determining whether or not an entity is an FIE. However, a broader acceptance of consolidated financial statements is being considered.

■ The omission of relief from double taxation of investment in a foreign affiliate that subsequently distributes dividends out of exempt surplus was unintentional and will be corrected.

■ The rules are not focused on the area of perceived abuse—offshore investment funds—but rather use a broad-based approach that, inadvertently or not, in some circumstances captures investments in foreign affiliates already subject to the foreign affiliate regime. This approach reduces the competitiveness of Canadian companies in foreign joint ventures. Finance has indicated that it prefers the broad-based approach because of concerns that abusive structures may be implemented to circumvent the rules.

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TRANSFER-PRICING AUDITS ET AL.

CCRA officials responded to questions about a range of issues, including transfer-pricing audits and competent authority, at the International Fiscal Association (IFA) tax seminar held in Toronto on May 13, 2002 and at a CCRA and Professionals Consultation Group (CG) seminar held in Toronto on June 11, 2002.

Transfer-pricing audits. At the CG seminar, CCRA officials gave examples of typical deficiencies in taxpayer-prepared contemporaneous documentation discovered during transfer-pricing audits:

■ Documentation is not prepared pre-audit, causing delays and making it difficult to gather older information due to staff changes and problems locating documentation.

■ Management fees are allocated on the basis of sales instead of time spent. The services provided are not clearly documented.

■ A distributor claims startup or market penetration losses, but there is no supporting budget or market study.

■ Documentation is incomplete and does not properly support the transaction.

The CCRA gave examples of particular triggers that may prompt a transfer-pricing audit, such as a history of losses or low levels of profit, transactions with companies located in tax havens, changes in the level of charges and/or profitability, and significant levels of intercompany transactions. The CCRA also gave examples of targets for particular attention and review by a transfer-pricing auditor:

■ A significant increase in royalty rates charged by US parents to Canadian subs, a trend noted, for example, in the "big box" retail operations and franchise operations.

■ A Canadian manufacturer treated as a contract manufacturer; for example, on the sale of its products to a US distributor, it receives a routine level of profit and the balance of any profit is attributed to the distributor. A contract manufacturer's return is usually calculated on assets employed or as a markup on its costs; it is assumed to have negligible intangibles and negligible risks. On several reviews, the manufacturer in question had substantial risk and valuable manufacturing knowhow.

■ The other side of the coin is a Canadian sub that distributes products manufactured by its US parent and is treated as a stripped-down distributor: it is assumed to have negligible intangibles and nominal risks and therefore is allocated a routine level of profit. Several CCRA reviews indicated that the Canadian distributors in question had developed valuable marketing and selling intangibles and had substantial risk.

■ Very valuable intangibles may be transferred to an affiliate in an offshore tax haven; the affiliate receives substantial royalties related to the intangible. Issues surround the value of the intangible and whether the affiliate can effectively perform the services that maintain the intangible's value.

Competent authority. At the IFA seminar, the CCRA commented on its soon-to-be-updated IC 71-17R4, "Request for Competent Authority Consideration Under Mutual Agreement Procedures in Income Tax Conventions." The IC will inform taxpayers about the services they can expect from the competent authority (CA) and clear up confusion regarding the requesting of CA assistance.

■ Under article XIII(8) of the Canada-US treaty, a US resident's gains on the alienation of property in the course of a corporate reorganization may be deferred if the taxpayer makes an agreement with the CA. The new IC explains how to request such an agreement.

Timing differences in the Canadian and US recognition of income from S corporations can subject Canadian-resident shareholders to double tax. Treaty article XXIX(5) allows a taxpayer to enter into an agreement with the CA and avoid this mismatch. The new IC explains such an agreement's typical contents and how to request one.

The Canada-US treaty facilitates the coordination of differences between US estate taxes and Canadian income taxes at death. The new IC explains how US residents can use article XXIX B(5) to enter into an agreement with the Canadian CA to access the rollover provisions under subsection 70(6) of the Income Tax Act.

Treaty article XVIII(7) allows taxpayers, under rules established by the CA, to elect to defer income accrued in a pension plan. The new IC identifies the Canadian CA rules that must be met before the election is valid for Canadian tax purposes.

The complete questions and answers from the IFA seminar are available on the IFA's Web site at http://www.ifacanada.org/govtroundtable.html.

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Marking Time

All the provinces and territories have now delivered their 2002 budget statements, giving a clear indication of their treasurers' and finance ministers' intent for the 2002-3 fiscal year. The events of last fall and last winter's prevailing gloomy economic outlook led most budget makers to design a plan to survive the year.

Aggregate provincial revenues are expected to increase by 1.4 percent during the current year. The budgets limit total spending to a 2.5 percent increase. The table shows that the resulting aggregate deficit at the provincial level could balloon to $4.2 billion, up from the preliminary figure of $2.1 billion for 2001-2.

Although five provinces expect to end this year with a surplus or a balanced budget (Nova Scotia, Quebec, Ontario, Alberta, and Nunavut), only four (Nova Scotia, Saskatchewan, Alberta, and Yukon) expect to improve their performance over 2001-2.

As a consequence of unbridled but misplaced optimism in the late 1980s, most ministers of finance now err on the side of caution when predicting financial results. This year, the potential for better-than-predicted results emanates from that natural caution compounded by the changes evident in economic forecasts. In December 2001, the Toronto-Dominion Bank, for example, saw real economic growth for 2002 at 1.2 percent, but revised its prediction to 3.5 percent by June 2002. The same swing was evident in all forecasts from public and private sources. Thus, the bottom line for provinces with early 2002 budgets should be significantly better than originally forecast.

Because of their deteriorating financial outlook, three provinces—Newfoundland, Ontario, and Alberta—postponed personal and corporate income tax cuts planned for 2002 or 2003. All of the provinces and two of the territories (excluding the Northwest Territories) raised tobacco taxes in their budgets or when the federal government raised its levies at the time of the Ontario budget. Three increased taxes on motor vehicle fuel. Personal income tax reductions of some type took place in all provinces except Newfoundland, Prince Edward Island, and Alberta. The corporate tax burden was lowered in six provincial budgets. Spending on programs was held to less than 2.9 percent—less than inflation plus population growth—in all provinces and territories except New Brunswick, Ontario, British Columbia, the Northwest Territories, and Nunavut. The table, with figures adjusted for comparability, reflects an expected 1.0 percent decline in debt charges in the current fiscal year.

Adjusted Surplus or Deficit (–)

	2001-2	2002-3
	$ million	
Newfoundland	–47.3	–135.2
Prince Edward Island	4.9	–11.6
Nova Scotia	–106.4	1.4
New Brunswick	107.1	–58.7
Quebec	0.0	0.0
Ontario	58.0	0.0
Manitoba	24.7	–83.1
Saskatchewan	–410.3	–225.0
Alberta	35.0	724.0
British Columbia	–1,964.0	–4,400.0
Northwest Territories	159.6	–12.1
Nunavut	50.7	1.6
Yukon	–49.3	–41.5
National total	–2,137.3	–4,240.2

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Nailing Down a Settlement

In the general goodwill that follows an agreement to settle, the parties may be reluctant to request that the agreement be immediately reduced to writing. Sometimes that reluctance may reflect the absence of consensus ad idem. Before the parties go their separate ways to consider and finalize their positions on final details, it is critical that a settlement in principle be reached and agreement on the essential elements articulated be reduced to writing to the satisfaction of both parties, or at the very least confirmed in writing by one party. The hazards of not doing so were crystallized in the recent FCTD decision in *MacDonald.*

In *MacDonald*, the taxpayer held partnership interests in various general partnerships in Calgary (the Odessa partnerships), that experienced significant losses in the economic downturn in the early 1980s. The minister denied the losses, and the taxpayer appealed after unsuccessfully attempting to settle. The trial in the TCC began in November 1995; on the second day, a new attempt to resolve the appeal was made. A verbal settlement agreement was reached and the trial was adjourned. Crown counsel drafted minutes of settlement and sent them to the taxpayer's lawyer, who advised that the drafts did not accord with his understanding of the settlement's terms. At the end of January 1997, the Crown informed the taxpayers that it was withdrawing from the agreement and would not be bound by its terms. The taxpayer's action in contract to enforce the settlement was dismissed by the FCTD.

The court found that there was never any binding agreement between the parties. The parties had agreed on the quantum of partnership income, but not on the methodology for allocating the losses. The court concluded that the allocation issue would have been an essential term of the agreement, and as such it could not be severed from the other matters that were the subject of the action. The court also rejected the taxpayer's suggestion that the original trial should be recommenced on the issue of a formula for loss allocation only: the allocation issue was essential to the whole agreement, and thus the TCC must rehear the matter in its entirety.

Reducing to writing the fundamentals of a settlement arrangement minimizes the risk of later disputes about whether a settlement was in fact reached. If a letter is immediately sent outlining the terms of the agreement, the onus lies on the other party to agree or deny that the terms therein accurately reflect all the parties' understandings. The delineation of the points of agreement often also smoothes the resolution of peripheral issues. If settlement is sought but acceptance is not certain, the letter to the CCRA or Justice should expressly state that the offer is open until a specific time and that acceptance must be confirmed in writing, either by separate correspondence or by signing and returning the letter. This practice conforms with both the CCRA and Justice policies and practices regarding the finalizing of settlements.

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Quebec Corporate Rollovers

Measures introduced in the 1997 Quebec budget ended Quebec tax-avoidance transactions predicated on the ability to file different elections for federal and Quebec rollovers of property to a corporation. Some exceptions apply.

Assume that a corporation (Oco) with a PE only in Ontario wishes to sell an appreciated asset to a third party. Oco rolls the property to a related corporation with a PE in Quebec (Qco) for both federal and Ontario tax purposes: the agreed amount is the property's ACB, and federal and Ontario income taxes are deferred. Oco and Qco do not elect a rollover for Quebec tax purposes, and the property's tax cost to Qco is its FMV on the transfer date. Because Oco has no Quebec PE, it pays no Quebec income tax on the transfer. Qco realizes a capital gain only for federal tax purposes on a later sale of the property if there has been no change in its FMV since the transfer. Changes to the Quebec Taxation Act ensure that if the parties have discretion over the amount of the transferor's proceeds and the transferee's acquisition cost, the parties cannot elect different amounts for federal and Quebec tax purposes; nor can a rollover be elected if it is not filed under federal rules. However, certain exceptions permit different elected amounts if justified by a difference in tax attributes: (1) the parties meet a criterion based on the proportion of business carried on in Quebec or, in the case of an individual, related to residency; (2) the difference between each party's proportion of business carried on in Quebec is below a set percent during the taxation years of the transfer and ending in the preceding 24 months; and (3) if federal subsection 13(21.2) applies on a transfer of depreciables.

1) An exception exists if at least 90 percent of the parties' businesses is carried on in Quebec for the taxation year of disposition. Individuals must reside in Quebec at the end of that taxation year. The excess federal elected amount over the Quebec elected amount must be at least substantially justified by the property's higher federal cost amount, or by another reason that the Quebec minister of revenue considers reasonable. In an unexpected change in Bill 78 (tabled April 10, 2002) for post-October 31, 2000 transfers, the specific justification mentioned is now a difference between federal and Quebec cost amounts.

2) An exception announced in *Information Bulletin* (IB) 2000-10 (December 21, 2000, effective for post-October 31, 2000 transfers) and now in Bill 78 applies to transactions that do not directly or indirectly result in total or partial avoidance of provincial tax to the parties or a third party. The Quebec elected amount may differ from the federal elected amount if for each party's taxation years of the transfer and ending in the preceding 24 months the difference between each party's proportion of business in Quebec does not exceed 10 percent (25 percent if the minister's approval is obtained and other conditions are met). If the parties do not carry on a business in Quebec in those preceding 24 months, additional conditions apply. Specific rules apply if a party is the continuation of a third party following a merger, windup, or any other reorganization in those 24 months. Furthermore, the elected amounts' difference must be at least substantially justified by a difference in the federal and Quebec cost amounts, or by any other reason the minister considers reasonable.

3) IB 2001-6 (July 5, 2001), applicable to rollover elections filed thereafter, deals with situations in which a federal election cannot be made because subsection 13(21.2) limits the transfer of losses between affiliated persons on a disposition of a depreciable with an FMV less than its capital cost and its proportional UCC. Higher Quebec than federal depreciation rates apply, for example, to new and used computer hardware and manufacturing and processing equipment used in Quebec; as a consequence, their FMV may exceed the

Quebec UCC, and failure to elect triggers recapture. A Quebec election is now permitted in this limited case if the criteria relating to the proportion of Quebec business and the justification of differences in tax attributes are also satisfied. Bill 78 does not incorporate this exception.

Bill 78 should be monitored for changes to the exception for transactions that do not create provincial tax avoidance and to the requirement that any excess federal elected amount over the Quebec amount be justified by a higher federal cost amount. If no exception applies, there is no discretion in the choice of the Quebec elected amount. Ontario and Alberta have also adopted measures to prevent this type of tax planning.

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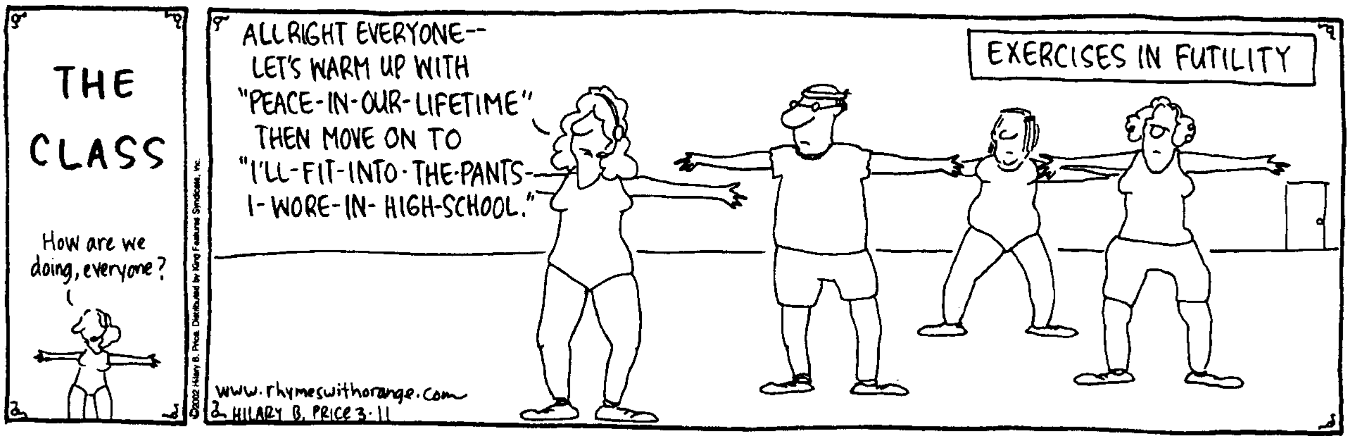
Non-Resident Services Update

Independent contractor. In *Wolf*, an engineering consultant was hired by a consulting firm to provide services in Canada from premises owned by Canadair Limited. The taxpayer sojourned in Canada for more than 183 days annually, but his family, bank accounts, and stockbroker were in the United States. The TCC found that he was a dual resident and had a permanent home available in both countries; under the Canada-US treaty's tie-breaker rules, he was a deemed US resident because he had closer personal and economic relations in the United States. The TCC concluded that he was an employee—some control was exercised over his work, and his working hours and days were integrated with Canadair's operations—and he was thus not treaty-protected. The FCA recently concluded that he was not an employee, and said that the traditional tests should be applied cautiously and adapted as the workforce becomes more specialized: "[T]he control test . . . is often inadequate because of . . . increased specialization. . . . The court in *Wiebe Door* . . . essentially stated that the control test, while still important, is no longer . . . conclusive. . . . [T]he total relationship of the contracting parties [must be examined] in order to determine 'whose business is it?' " The taxpayer was a temporary worker with "no job security, no union protection, no educational courses he could attend, no hope for promotion. The profit and risk factors were his" (2002 FCA 9).

■ In *Dudney*, the FCA concluded that a service provider's use of third-party-owned premises did not constitute a fixed base regularly available to him. Dudney had a US office and picked up voice-mail messages there; he had no business cards or letterhead, and he was not identified as working at the Canadian premises. The FCA considered the actual use made of the premises, whether and by what legal right the person exercised or could exercise control thereover, and the degree to which the premises were objectively identified with the person's business. The court rejected the minister's argument that a fixed base was a broader concept than a PE, but the CCRA still says that *Dudney* is limited to defining a fixed base (2000 DTC 6169).

Withholding. Generally, a non-resident is taxable in Canada only on Canadian-source income: business income is taxable under part I, and passive income is subject to part XIII withholding tax at 25 percent or a reduced treaty rate. Withholding allows the CCRA to enforce tax collection from non-residents. The resident payer is designated as the CCRA's agent to remit tax withheld and is liable for tax, interest, and perhaps penalties on a failure to withhold and remit. In addition, a 15 percent reg 105 withholding tax applies to fees, commissions, and other amounts paid to non-residents with respect to services rendered in Canada. This is not a final tax, but is held on account of the non-resident's potential part I liability. After 2000, a 23 percent withholding is required on amounts paid, credited, or provided as a benefit to a non-resident individual actor or a corporation related thereto in respect of film and video acting services provided in Canada by the non-resident; the tax is treated as paid on account of part I tax if the non-resident elects to file a timely part I return.

RHYMES WITH ORANGE ® by Hilary Price



■ In *Cheek*, the TCC concluded that a US resident's fees earned as a radio broadcaster for the Blue Jays games in Toronto were exempt from Canadian tax: he was a radio journalist, not a radio artiste who by "some skilful and creative performance can attract an audience to hear that person . . . himself" (2002 DTC 1283).

■ The CCRA's 2000 "Guidelines for Treaty-Based Waivers Involving Regulation 105 Withholding" sets out withholding-waiver application procedures if a treaty exempts income not connected with a fixed base or PE. Withholding is mandatory without a waiver, and may impose a significant burden: it may exceed profit if, for example, a US resident subcontracts consulting work to another non-resident and retains only 10 percent of the fees. Although it is not specifically stated, a taxpayer with no Canadian PE may be automatically denied a waiver if the listed criteria are not met. If no waiver is granted, tax withheld should be refunded if the non-resident files a part I return because the business profits are not attributable to a PE.

■ At a CCRA Toronto Tax Centre conference on February 27, 2002, the CCRA advised that a 15 percent withholding tax must be withheld on the fees, commissions, and other amounts paid to a non-resident carrying on business through a branch unless a reg 105 waiver is obtained and the tax withheld credited to the part I account.

■ *Ogden Palladium* dealt with the failure to withhold under reg 105. Marco Entertainment, a USco, produced the 1996 Elvis Stojko figure-skating show. Each taxpayer owned a stadium where the show took place. Marco paid a licence fee for the stadiums' use; the taxpayers controlled the shows' ticket sales and paid net revenues to Marco without withholding. Marco had no waiver. The taxpayers argued that Stojko provided the services to Marco, which as producer provided them with no services in Canada. The court disagreed and said that the producer provided services for the benefit of the public, distinguishing the decision of the Ontario Court (General Division) in *Livent*, which held that a ticket purchaser acquired a right to attend and watch a performance, not to obtain services. The taxpayers were obliged to withhold on payments for or in respect of services rendered in Canada, even if Marco had no Canadian PE. Penalties were upheld because the taxpayers did not show that they had attempted to satisfy their withholding obligations. The taxpayers appealed to the FCA (2001 DTC 345 and [1998] 42 OR (3d) 501, respectively).

Ogden implies an obligation to withhold even if the non-resident does not actually or indirectly perform services in Canada. For example, a non-resident independent contractor who performs services outside Canada may subcontract to another non-resident to perform the services in Canada, a fact that may be extremely difficult for the resident payer to ascertain. However, *Ogden* appears to say that to avoid penalties the payer must take positive steps to ascertain whether services are being performed in Canada—a much higher standard than that applied to, say, the withholding agent on rental payments from real property made to a non-resident. In *Wright*, the non-resident elected to file a part I return and pay tax on net income and was thus not liable for part XIII tax; accordingly, the TCC absolved the agent from liability for interest (2001 DTC 437).

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MANDATORY CERTIFICATE REVISED

In order for an individual taxpayer to qualify for the disability tax credit, paragraph 118.3(1)(a.2) requires that he or she file a certificate signed by a doctor certifying that the taxpayer suffers impairment as defined: a "severe and prolonged mental or physical impairment" that markedly restricts the individual's ability to perform a "basic activity of daily living." In *MacIsaac*, the FCA determined that production of a positive certificate was mandatory and not directory; without a doctor's certification that the individual suffers the defined impairment, an individual cannot access the credit (2000 DTC 412). In *Buchanan*, the minister sought judicial review of a TCC decision to the effect that the individual was entitled to the credit even though the certificate filed by the taxpayer stated that the individual did not suffer in the defined manner (2002 FCA 231).

On review, the minister argued that the TCC judge ignored the FCA's prescription in *MacIsaac* that the certificate requirement was mandatory. Buchanan's counsel argued that the TCC's decision simply recognized that the doctor's viva voce evidence clearly showed that he had misunderstood the questions set out in the tax certificate: the TCC concluded that the certificate should be corrected so that it read as a positive certification based on the doctor's assessment of the taxpayer's impairment, combined with the correct interpretation of the definition of "impairment" in the relevant provision. The FCA acknowledged the authority in criminal law jurisprudence that a certificate can be corrected on the basis of viva voce evidence and placed that proposition squarely within tax jurisprudence. The FCA ultimately concluded that although a court must be faithful to the words of the Act that require the positive certificate of a doctor, on the basis of viva voce evidence the TCC may determine that a negative certificate should be treated as positive certificate—a decision consistent with both precedent and common sense. The judge may therefore direct the minister to treat the certificate as positive if, on the basis of his or her viva voce evidence, it appears that the doctor should have issued a positive certificate if he or she had applied the correct legal test. Alternatively, the evidence of a different doctor might be used, although practically speaking a second opinion may not be available.

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PROVINCIAL PIT RATES

The trend on the part of the federal government and many provincial governments to reducing their personal tax rates during the last few years seems to be changing in 2002. For example, the June 17, 2002 Ontario budget announced a postponement of one year for personal and corporate tax rate reductions planned for 2003. The 2002 budget reduction in Newfoundland's dividend tax credit rate to 5 percent from 9 percent effectively increased by 44 percent its tax on dividends received after March 20, 2002.

Combined Federal and Provincial Top Marginal Rates for Individuals

	2002			2003		
	Salary and interest	Capital gains	Dividends	Salary and interest	Capital gains	Dividends
BC	43.7	21.9	31.6	43.7	21.9	31.6
Alta.	39.0	19.5	24.1	39.0	19.5	24.1
Sask.	44.5	22.3	29.0	44.0	22.0	28.3
Man.	46.4	23.0	35.1	46.4	23.0	35.1
Ont.	46.4	23.2	31.3	46.4	23.2	31.3
Que.	48.2	24.1	32.8	48.2	24.1	32.8
NB	46.8	23.4	32.4	46.8	23.4	32.4
NS	47.3	23.7	31.9	47.3	23.7	31.9
PEI	47.4	23.7	32.0	47.4	23.7	32.0
Nfld.	48.6	24.3	36.1	48.6	24.3	37.3

Some provinces' top individual marginal tax rates for dividends are not consistent with their rates for salary and interest: provinces such as British Columbia, Manitoba, and New Brunswick impose a proportionally higher rate for dividends. Overall, Alberta has the lowest personal tax rates for dividends and Newfoundland has the highest. Individuals may want to re-evaluate their personal tax planning and the types of income they earn to help minimize their tax burden. To assist in this planning, the table shows top provincial marginal rates for individuals for 2002 and 2003, as of June 20, 2002.

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PROMISES TO KEEP?

Citing unprecedented weakness in corporate income tax revenues, a marked slowdown in personal income tax revenue growth, and mounting funding pressures for health care, education, and environmental initiatives, Ontario's 2002 budget departs significantly from former Premier Mike Harris's budgets. Ontario's initial response to the September 11, 2001 terrorist attacks was to accelerate to October 1, 2001 various corporate and individual tax rate reductions originally scheduled for January 1, 2002. But facing the prospect of a revenue lag and increased expenditures, the provincial government changed direction: it hiked various

Corporate Tax Rates

	General rate		M & P rate	
Effective date	Previously announced	Revised (2002 budget)	Previously announced	Revised (2002 budget)
	percent			
Oct. 1, 2001 . . .	12.5	12.5	11.0	11.0
Jan. 1, 2003 . . .	11.0	12.5	10.0	11.0
Jan. 1, 2004 . . .	9.5	11.0	9.0	10.0
Jan. 1, 2005 . . .	8.0	9.5	8.0	9.0
Jan. 1, 2006 . . .	8.0	8.0	8.0	8.0

Individual Tax Rates (Before Surtax)

		2003		
Taxable income*	2002	Previously announced	2002 budget	2004
	percent			
Up to $31,893	6.05	5.65	6.05	5.65
$31,893 to $63,786	9.15	8.85	9.15	8.85
Over $63,786	11.16	11.16	11.16	11.16

* Brackets will be indexed for 2003 and 2004.

tobacco taxes and delayed by one year the implementation of a host of corporate, personal, and property tax reductions. And, because delays to legislated tax rate reductions are considered de facto tax increases, Ontario's much-vaunted taxpayer protection legislation must be amended.

Barring changes in a fall economic update, tax rate changes originally legislated to take effect on January 1, 2003 are now effective January 1, 2004. The impact of the delay will be felt not only by current Ontario-resident individuals and corporations, but also by potential investors. In addition, the impact on the value of future tax assets and liabilities for corporate accounting purposes must be considered. The tables illustrate, respectively, the impact of the delay on Ontario's general corporate and manufacturing and processing (M & P) rates and on personal income tax rates before surtaxes. The scheduled elimination of Ontario's first-tier surtax bracket was also delayed until January 1, 2004.

Notably, the previously announced scheduled changes to Ontario's CCPC small business rate and its corresponding small business phaseout (surtax) range were not delayed. However, because the province's general corporate rate reduction was delayed, the Ontario corporate surtax rates for each of regular and M & P income increased beyond their previously scheduled amounts. Other exceptions to the one-year delay apply to scheduled reductions in the provincial mining tax and in retail sales tax on auto warranty repairs and auto insurance premiums.

The budget mentioned possible future tax reductions, such as the elimination of Ontario's individual surtax and corporate capital tax. However, on the basis of the announced rates, Ontario's top marginal tax for individuals on ordinary income and capital gains in 2002 and 2003 remains the highest of provinces west of Quebec. Moreover, the

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budget did not contain measures to eliminate or fix the flawed corporate minimum tax or to address deficiencies associated with the province's $5 million capital tax deduction. (See "Ontario Capital Tax Deduction," *Canadian Tax Highlights*, March 26, 2002, at 22.) It is hoped that Ontario will address these and other competitiveness issues in the near future.

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Foreign Tax News

United States

The IRS is soliciting comments on a proposed multilateral transfer-pricing documentation package developed by the Pacific Association of Tax Administrators (PATA) to accurately and expeditiously meet transfer-pricing requirements in all PATA countries (Australia, Canada, Japan, and the United States). Go to the IRS Web site (http://www.irs.gov) and click on "business," then on "international business." Comments on the proposal may be sent to the IRS before July 31, 2002.

Isle of Man

A standard zero tax rate will be adopted for all businesses to resolve the dispute with the United Kingdom and the European Union over its exempt companies legislation and to comply with the EU code of conduct. The Isle of Man is willing to address all issues of concern and will adopt the European Union's proposed savings directive relating to the automatic exchange of information on cross-border interest payments as long as third-party jurisdictions do so too. The Isle of Man's main sources of revenue are VAT and income taxes.

Japan

Corporations can now file consolidated tax returns for a parent and its wholly owned—directly or indirectly—subsidiaries. The consolidated group can carry over losses for five years and carry forward losses from five years prior to consolidation; for subsidiaries to carry over, they must be owned by the parent in those prior years. To offset anticipated revenue losses, consolidating groups will be assessed a 2 percent surcharge for two years.

Afghanistan

Tax-free incentives to stimulate the economy encourage foreign firms to establish Afghani businesses. A foreign company that establishes local jobs may repatriate 100 percent of profits. Joint ventures with local firms will be encouraged.

Thailand

New transfer-pricing guidelines based on international practices enhance transparency and facilitate the calculation of tax liabilities for domestic and foreign corporations. Another new program encourages companies to set up regional operating headquarters (ROHs) in Thailand, with a reduced 20 percent tax rate on service fees and offshore royalties and a full exemption for offshore dividend revenues and payments.

Spain

To improve measures that fight tax avoidance and fraud, and to encourage globalization of Spanish companies and attract foreign investment, amendments to the Nonresidents Income Tax Act are proposed effective January 1, 2003. A site or building constitutes a PE only if it lasts for more than six months. Non-resident partners of a resident partnership are deemed to operate under a PE. Under the "payer liability" mechanism, a resident payer of income to or representing a non-resident is jointly liable for related tax; royalties include the use of or the right to use any copyright of literary, artistic, or scientific work, patent, trademark, etc., and information relating to industrial, commercial, or scientific experience. The tax exemption of interest derived by non-residents does not apply if the majority of the payee company's votes are held by non-EU residents and the recipient has a substantial interest in the payer company. Branch tax is lowered to 15 percent on after-tax profits paid by a Spanish PE to its parent. Withholding tax on Spanish-source dividends, interest, and capital gains from participation in Spanish investment funds is reduced to 15 percent. Several other measures are proposed to simplify withholding taxes on residence changes.

European Union

The Council adopted a regulation to allow multinationals to do business throughout the European Union as international entities and avoid compliance burdens in different jurisdictions, effective October 8, 2004.

Turkey

Companies responsible for management and operations in designated technology regions are exempt from all taxes and charges on certain transactions. Software and R & D operations are exempt from income and corporation tax for 5 years; fees paid to software writers, researchers, and R & D personnel are tax-exempt for 10 years; and grants and donations to individuals and entities engaged in R & D activities in technology regions are tax-deductible.

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