C A N A D I A N **T A X** *H i g h l i g h t s*

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US Earnings Stripping

Bill Thomas, the chair of the US House of Representatives Ways and Means Committee, introduced proposals in the American Job Creation Act of 2003 to, inter alia, amend earnings-stripping rules applicable to Canadian and other foreign-controlled multinationals. If enacted, the earnings-stripping limitations could substantially increase the disallowed amount of related-party and guaranteed interest paid by US subs of Canadian companies, effective for a taxpayer's first taxable year after December 31, 2003.

■ The proposals (1) eliminate the current 1.5-to-1 debt-to-equity safe harbour; (2) reduce the adjusted taxable income (ATI) limitation for interest on related-party debt to 35 percent for the taxpayer's first taxable year beginning after December 31, 2003, and to 25 percent thereafter; (3) maintain the 50 percent of ATI limitation on interest guaranteed by a foreign related party; (4) replace the current unlimited carryover period for disallowed interest with a 10-year carryover (all pre-effective-date disallowed interest is deemed to have a 10-year-remaining carryover period); and (5) eliminate any carryover of excess limitation relating to unused interest deduction room from prior years.

The Thomas proposal differs significantly from President Bush's budget proposal, which contained a safe harbour: a debt-to-asset test allowed a safe harbour interest deduction for interest on debt not in excess of specified ratios based on the value of a taxpayer's assets. Thus, Canadian companies with high hard-asset values that may have averted Bush's harsher earnings-stripping proposals need to evaluate the impact of increased limitations in the Thomas proposal. In addition, the Thomas proposal does not include the complex worldwide ratio test that could have resulted in the permanent disallowance of interest expense on US debt in excess of worldwide leverage.

■ Other provisions in the bill are aimed at assisting US companies and manufacturers—for example, reduced depreciable lives on manufacturing equipment; an extension to December 31, 2005 of the 50 percent bonus depreciation measures included in recently enacted legislation; and a reduced tax rate of 33 percent applicable to certain corporations with income under $10 million that falls to 32 percent in years beginning after 2009.

■ The bill provides for a six-month period in which only 20 percent of a dividend repatriating a USco's controlled foreign corporation's earnings to the United States is subject to US income tax, if the repatriated earnings are invested in the United States. Eligible dividends are generally dividends received from such companies in excess of the previous three-year base period's annual average. Senator Orrin Hatch's legislative proposals of July 28 contained a similar rule. The impact of these stimulative proposals could be significant for Canadian subs of UScos that are generally understood to be flush with earnings and, in some cases, with cash. Canadian subs that participate in this dividend window may pay large dividends out of excess cash or borrowed funds.

The Thomas bill is the first step in a complex and uncertain legislative process; debate of the bill by the full Ways and Means Committee is expected when Congress reconvenes after its August recess.

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In This Issue

P3 Outsourcing

Governments often finance the costs of construction of new buildings with 100 percent equity and no debt component, even though the cash flows from the project and the availability of a government credit make it possible to obtain another source of debt financing beyond the bond market. Private sector involvement and expertise is often compelling from a cost-saving perspective if services need to be procured and large construction projects need to be managed efficiently to mitigate cost overruns. Increasingly, provincial governments are seeking financing from the private sector as a solution to funding pressures associated with big-ticket projects such as hospitals, roads, and other infrastructure. This area will continue to evolve to meet the needs of the public and private sectors. The tax aspects of such deals continue to play an important role in achieving the benefits desired by governments and investors alike.

Since the mid-1990s, public-private partnership (P3) arrangements for health care have been the norm in the United Kingdom, where the private sector designs, finances, builds, and manages the construction of a new hospital facility and then operates and provides certain non-clinical services within the overall facility on a long-term contract basis. Hospital officials are thus freed to concentrate on health-care issues. Arguably, this results in a more efficient health-care system. P3 financing has found its way into the Canadian health-care system, which is under increasing pressure to meet health-care needs that will only become more acute as baby boomers age.

Typically, a special purpose development entity (SPE) is formed to own and build the facility. Debt is raised from lenders willing to take construction risk, from either Canadian or foreign sources. Foreign-source debt must be structured to satisfy the 5/25 rule, eliminating Canadian withholding tax on interest paid. An arranger is hired to raise the private financing. Ownership of the land may be held by the SPE or retained by the province if the two enter into a ground lease, the terms of which may be influenced by land transfer tax considerations. Once the project is completed to government specifications, it can be sold to a second SPE (SPE 2) that has been capitalized to support the associated debt, etc., with a suitable amount of equity provided by private investors that favour investments in infrastructure projects underpinned by a government credit. SPE 2 can issue additional tranches of debt to achieve a suitable blended rate of financing. SPE 2 contracts with third parties for the provision of, inter alia, employee services. In a hospital project, non-health-care employees usually fulfill the various administrative functions necessary to operate the hospital. SPE 2 enters into a long-term contract to provide services and earns business income from bundled services that also consist of the use of the building, equipment, and employee services. The fees earned are typically based on use, and are conditional upon SPE 2's meeting certain thresholds of quality control. Capital cost allowance on the building and other assets owned by SPE 2 to provide the bundled service may be claimed on an unrestricted basis if the assets are not leasing/rental property. At the end of the contract term, the government may acquire ownership of the facilities through a call option mechanism.

Some assets already owned and operated by a province lend themselves to private sector refinancing, but the economic viability of such transactions depends upon the situs province and may hinge on the availability of provincial sales tax relief. GST must also be considered. On certain projects, US cross-border financing may also be available. Typically, a Usco that pays current US corporate income tax forms a wholly owned Canadian sub, a Nova Scotia unlimited liability company (ULC). Using a ULC as the Canadian lessor vehicle also solves a main impediment to cross-border leasing, in that Canadian withholding tax often applies when rent is paid by the Canadian lessee to a non-resident. If withholding tax applies to the gross rent, such a lease will not be economical to the parties involved. Certain payments of rent, such as payments to US residents on aircraft and software, are exempt from withholding tax. However, a cross-border lease involving, for example, a municipal waste treatment plant is subject to Canadian withholding tax if a Canadian lessee paid a US lessor rent payments. If the ULC is the lessor, the Canadian withholding tax issue is solved: the lease payment is made by the Canadian lessee to another Canadian taxpayer, the ULC. The lease must also be structured to qualify as an operating lease for tax purposes. If the deal is structured properly, USco can claim US depreciation benefits—ULC is a disregarded entity, and USco is thus considered the assets' owner for US tax purposes—and the municipality can end up with cash in its pocket equal to a present value benefit of 3 to 5 percent, depending on the type of asset involved. The deal is also structured so that the municipality does not lose control of the asset.

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US "Check and Sell" Regs

Cross-border tax practitioners know well the many US tax-planning opportunities offered by the US entity classification (check-the-box) regulations: certain non-corporate entities such as US or Canadian limited partnerships may elect to be taxed as corporations, and certain foreign corporate entities such as Nova Scotia unlimited liability companies may elect to be taxed as partnerships or disregarded entities. Recently issued IRS Notice 2003-46 announced the withdrawal of proposed regulations dealing with "check and sell" or "extraordinary" transactions and removed a cloud of uncertainty over a use of the check-the-box rules. Withdrawal of the check-and-sell regs is a step toward providing increased certainty to practitioners who are attempting to structure cross-border transactions.

The proposed regs were issued in November 1999 in response to an IRS concern that it may be inappropriate for a taxpayer to elect to convert an entity from a corporation to a disregarded entity before its intended disposition merely to alter the disposition's tax consequences. In general, under the regs such an election for a foreign entity was ignored if certain conditions were met and the entity was sold within 12 months of the election. Practitioners' concerns that the regs were overly broad and that they undermined the certainty promoted by the entity classification regs prompted the IRS to withdraw the regs.

However, the notice warns that the regs' withdrawal does not imply that the IRS no longer considers elections in such situations to be potentially abusive; rather, the IRS will use other existing legal principles, such as the substance-over-form doctrine, as its weapons of choice to evaluate such transactions. The notice also states that the IRS and Treasury continue to examine the potential use of the entity classification regulations to achieve results that they believe are inconsistent with the policies and rules of Code provisions or US tax treaties. The notice cites two examples. The first involves a USco that owns a foreign sub (Subco 1), which in turn owns another foreign sub (Subco 2). The Subco 2 stock will be sold, and in an attempt to gain subpart F benefits, Subco 2 checks the box to be disregarded (and is thus deemed liquidated into Subco 1) prior to the sale; Subco 2's sale is considered a sale of Subco 1's assets. Gain from the sale of stock is generally treated entirely as subpart F income, but whether a gain from an asset sale is considered subpart F income depends on the type of income produced by the asset. The second example involves a USco that owns two sister foreign subs. USco wishes to contribute the stock of Subco 1 to Subco 2, a transaction that may trigger the filing of a Code section 367 gain recognition agreement that USco may prefer not to file. In an attempt to avoid the filing, Subco 1 is liquidated into Subco 2 immediately after the contribution—for example, via Subco 1's check-the-box election to be disregarded—thereby converting the contribution into a C or D reorganization for which no filing may be required.

In several instances over the last several years, the scope of cross-border use of the check-the-box rules has been eroded. For example, Code section 894 denies reduced treaty withholding tax rates for certain payments made to hybrid entities such as US LLCs if the income is not currently taxed to the entity or to its owners under the laws of the foreign country such as Canada. Recently issued "domestic reverse hybrid entity" regs also deny treaty benefits and recharacterize interest as dividends with respect to certain payments from US reverse hybrids (for example, US partnerships that elect to be taxed as corporations) used in cross-border financing structures. Uncertainty also exists with respect to certain Canadian limited partnerships that elect to be treated as corporations for US tax purposes: although in most cases the IRS should respect the check-the-box election, the question remains whether the entity may be denied treaty benefits based on a literal reading of the treaty's language.

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Golden Years

Preliminary statistics from the CCRA for the 2001 tax year show that senior Canadians continue to play an important role in the federal and provincial revenue system.

Of the nearly 15 million individual income tax returns filed in that year and paying tax, 2.2 million, or 14.8 percent, belonged to individuals aged 65 and older; a further 5.5 percent—5.7 percent of all returns—were from those aged 60 to 64. The two groups collectively provided 18 percent of all federal income tax paid in 2001. Taxpayers aged 65 and older accounted for 13.5 percent of all assessed income in that year; their slightly younger counterparts accounted for 5.7 percent. The seniors reported all of the old age security income, but they accounted for only 74.7 percent of all Canada and Quebec pension plan income. Those who presumably opted for early retirement—from the group aged 60 to 64—accounted for 15.6 percent of the universal pension plan benefits reported on 2001 income tax forms; those with disability or survivor status accounted for a further 9.6 percent.

The statistics confirm that participation in the labour force diminishes with age. While those aged 60 to 64 submitted 5.5 percent of all taxable income tax returns, they accounted for only 2.8 percent of all employment insurance premiums claimed and only 3.5 percent of income from employment, including commission income. A substantial part of employment income came from

Individual Income Tax Returns Filed in 2001, by Age, as a Percent of All Returns

	Age of taxpayers			
	Under 20	20 to 60	60 to 65	Over 65
	percent			
Number of returns	1.6	78.0	5.5	14.8
Assessed income reported	0.5	80.3	5.7	13.5
Employment income	0.6	94.3	3.5	2.9
Retirement income				
Old age security	0.0	0.0	0.0	100.0
CPP and QPP	0.1	9.6	15.6	74.7
Other pensions	0.0	18.1	17.6	64.3
Employment insurance premiums	0.9	95.6	2.8	0.7
RPP contributions	0.0	96.0	3.1	0.8
RRSP contributions	0.1	89.9	6.5	3.6
Federal tax paid	0.2	81.6	5.9	12.2

those over 65, although most was attributable to those aged 65 to 69.

The table shows the importance of RRSP savings for those close to retirement. Although those aged 60 to 64 accounted for 5.5 percent of all taxable returns and 3.5 percent of employment income, they provided 6.5 percent of all RRSP contributions claimed in 2001.

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CUSTOMS: PURCHASER IN CANADA

The Canadian International Trade Tribunal (CITT) recently dealt with Canada's relatively new "purchaser in Canada" customs rule. Essentially, the rule requires that a purchaser in Canada must be found before transaction value can be used to value goods imported to Canada under section 48 of the Customs Act. The phrase is defined by regulation. An importer that wishes to so qualify and enjoy the consequent (and usually relatively lower) value for duty and duty impact must adhere to a fairly high threshold in establishing its presence in or nexus to Canada. The CITT decision in *AAi. Foster Grant of Canada* measures the purchaser-in-Canada threshold; it may support a threshold that is surprisingly high and may represent a rather restrictive view of who satisfies the requirements (June 13, 2003, Appeal no. AP-2001-094). *Foster Grant* may eventually lead to an even more aggressive audit approach by Canada Customs in this controversial area—or the decision may be overturned on an appeal.

On the facts, Foster Grant of Canada (FG Canada) imported sunglasses, accessories, and costume jewellery that it purchased from its parent company, Foster Grant Inc. (FG US). FG Canada did not maintain a Canadian inventory of the goods; it pre-sold the goods in Canada, then purchased the goods from FG US and arranged for their direct shipment into Canada to the ultimate Canadian customers. FG Canada attempted to use its purchase price as its transaction value for the goods, a practice that would have led to duties being applied on the cost of the goods to it. On assessment, the CCRA took the position that FG Canada had so little presence in Canada that it was not a purchaser in Canada. The CCRA suggested that FG Canada's ultimate selling price to its Canadian customers was the more appropriate value for duty, a position that resulted in significant additional duties.

The issue on appeal centred on whether FG Canada was a purchaser in Canada as defined in section 2.1 of the Value for Duty Regulations. The CCRA Customs Branch took the position that for persons that do not maintain an inventory of unsold goods in Canada, the regs require that the importer either (1) be a resident in Canada, which requires a corporate entity to carry on business here and have its management and control situated here, or (2) have a permanent establishment in Canada through which the person carried on business.

The CITT ultimately found that, on the facts, FG Canada did not carry on business in Canada, placing emphasis on the fact that FG Canada's employees "did not have direct access to funds with which to conduct business" because its revenues "were immediately transferred" to an FG US account to which FG Canada had no access. In the CITT's view, "These banking arrangements clearly undermined [FG] Canada's ability to carry on business, since its employees in Canada had no capacity to pay for the goods and services required for the Canadian operations. Nor did they have the capacity to pay for the goods purchased from their parent in the United States." Furthermore, the CITT concluded that FG Canada's president had no real authority over the bank accounts and had little control even over Canadian payroll. In the end, the CITT concluded that the fact of these "core business functions" being performed outside Canada detracted from FG Canada's argument that it was carrying on business in Canada; on balance, the CITT concluded that FG Canada did not carry on business in Canada.

The CITT decision can be understood as an indication of the importance, for customs purposes, of how day-to-day management decisions are made and whether a Canadian subsidiary actually has practical control over its management decisions by way of access to the funds that make such decisions possible. On the other hand, the decision poses a surprising contrast to income tax jurisprudence that traditionally has set a relatively low threshold to test whether a person carries on business in Canada. There was evidence that FG Canada's contracts for the sale of the goods were negotiated and concluded in Canada, a factor that from an income tax perspective might be a strong indication that business was being carried on in Canada. In addition, FG Canada had between 85 and 100 full- and part-time representatives and leased premises in Toronto; the premises included offices, a showroom, and storage space. These factors did not play a major part in the CITT decision, which may have paid too much attention to Customs' view of the phrase "carrying on business." Perhaps the FCA will ultimately resolve the question of whether and how the meaning of "carrying on business" under the Customs Act differs from the meaning of that phrase under other federal legislation, such as the Income Tax Act and the Excise Tax Act.

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ONTARIO CMT ISSUES

Ontario is the only jurisdiction in Canada that has a corporate minimum tax (CMT). The Ontario 2001 budget said that "the government will also review certain targeted taxes, such as the Corporate Minimum Tax . . . to ensure that such measures are still appropriate." Ontario Finance may be leaving CMT on the back burner in anticipation that this tax may be fundamentally changed or even abolished. We hope that Ontario will move quickly to lower the CMT rate and address deficiencies such as those described below, or to abolish the tax altogether.

A corporation is liable for Ontario CMT if its total assets at the end of the taxation year (including assets of any associated corporations) exceed $5 million, or if total revenue for the taxation year exceeds $10 million (section 57.2(1) of the Ontario Corporations Tax Act (OCTA)). In general, CMT equals a corporation's CMT base times its Ontario allocation factor, multiplied by the CMT flat rate of 4 percent (section 57.3(1) of the OCTA). A corporation's CMT base is essentially its adjusted net income for the year less eligible losses.

A corporation's adjusted net income is generally the corporation's net income (before income taxes) for GAAP purposes (except that the consolidation and equity methods of accounting cannot be used), adjusted for certain amounts. For example, dividends that are deductible under section 112 of the federal Income Tax Act are included in net income.

No loss carryback. For CMT purposes, a corporation's eligible losses are essentially net losses from a prior taxation year. Eligible losses may be carried forward for 10 years, but cannot be carried back to reduce a corporation's Ontario CMT base of a prior year. As a result, a corporation that has paid CMT in a prior year may never be able to recover it. Assume that Holdco, a group holding company, is an Ontario corporation that earns tax-free intercorporate dividends from subsidiary corporations that carry on active businesses. Holdco and its associated corporate group have aggregate assets and revenue above the $5 million asset and $10 million revenue thresholds; Holdco is thus subject to CMT. In 2001, Holdco realized a capital gain of $1 million for income tax purposes. Holdco's taxable income is $500,000, and its adjusted net income for CMT purposes is $1 million. In 2001, Holdco's regular corporate income tax of $62,500 (12.5 percent of $500,000) exceeds CMT payable of $40,000 (4 percent of $1 million). In 2002, Holdco realized a capital loss for tax purposes of $1 million, and it had no other source of income. The capital loss is carried back to 2001 for income tax purposes, reducing 2001's taxable income to nil. Thus, Holdco's regular corporate income tax payable for 2001 and 2002 combined was nil. Holdco's adjusted net loss for CMT purposes was also $1 million in 2002. However, under the current rules, that 2002 CMT loss of $1 million cannot be carried back to reduce the 2001 CMT income. Thus Holdco recovers only $22,500 ($62,500 regular income taxes paid less CMT of $40,000) instead of the entire $62,500 paid in the 2001 year for regular income tax and CMT combined. Note that the $40,000 CMT paid will be creditable against regular Ontario corporate income tax for 10 subsequent taxation years. In addition, Holdco may carry forward its 2002 loss of $1 million against CMT for 10 subsequent years.

However, such compensating offsets are cold comfort if Holdco is not expected to have income in future years against which it can benefit from the CMT loss carryforward and the CMT credit against further regular Ontario corporate income tax. The inequity in not providing a loss carryback mechanism in the CMT regime is further illustrated if the timing of the capital gain and capital loss in the example above is reversed. If the capital loss is realized in 2001 and the capital gain is realized in 2002, Holdco is not subject to CMT in the year the gain is realized, and Holdco may carry forward the 2001 loss to reduce the 2002 CMT income of $1 million to nil. Economically, Holdco is not better off in the first scenario than in the second, and therefore as a policy matter it should not bear a higher tax burden contingent merely upon the timing of gains and losses when its overall gain for the two-year period is nil. Similarly, if the capital gain and the capital loss occur in the same year, no CMT is payable.

Because of this flaw in the CMT, a corporation like Holdco—with a capital loss realized in a year subsequent to a gain year—may have to consider disposing of an asset with an inherent loss in the same year it recognizes the capital gain, or in an earlier year. This option may not be practical from a business investment perspective. Holdco may also consider generating other types of income, such as interest income, or merging with a subsidiary corporation that is expected to be profitable in the future, so that loss carryforwards may be applied to reduce CMT income in future years. Though this option is not as extreme as disposing of other assets, any reorganization may be costly and complex. The need for either alternative mitigating action could be obviated if Ontario allowed corporations to carry back CMT losses.

CMT rate increases as a percentage of regular tax. Ontario has been reducing regular corporate income tax rates since 2000. In contrast, the CMT flat rate has remained unchanged at 4 percent since 1996. Before 2000, therefore, the CMT rate compared to and as a percentage of the regular corporate income tax rate was approximately 26 percent (4 percent divided by the 15.5 percent regular corporate income tax rate). For 2003, the Ontario regular corporate income tax rate is reduced to 12.5 percent and is slated to decrease to 8 percent in 2006. Thus, comparatively speaking, the CMT rate as a percentage of the regular corporate income tax rate increased to 32 percent in 2003 and will increase to a staggering 50 percent in 2006.

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Integration Update

Now that all 2003 federal and provincial budgets have been tabled, the status of integration in Canada for 2003 can be reviewed. The federal government and most provinces have lowered their corporate tax rates or plan to do so. Personal tax rates seem to be holding steady, with few changes announced for top marginal rates for 2003 and 2004. Overall there is still an absolute tax cost to using a corporation to earn income, other than active business income (ABI) eligible for the small business deduction (SBD). In the latter case there is still a tax deferral if SBD-eligible ABI is left in the corporation and not immediately paid out as dividends to the shareholder.

Theoretically, the Canadian tax system is designed so that income earned in a corporation and distributed to the shareholder as dividends attracts the same amount of income tax, both corporate and personal, as it would if it had been earned directly by the individual. The so-called integration mechanism uses several specific rules and provisions in the Act to attempt to achieve this result. Originally, this theoretical model of integration was based on an assumed 50 percent personal tax rate and an assumed 20 percent corporate tax rate on ABI. However, corporate and personal income tax rates have changed over the years, and adjustments have been made accordingly to achieve results that are as close as possible to this theoretical model. The actual rates for corporate and individual taxpayers do not, of course, match the theoretical rates; this produces results that are more or less skewed from perfect integration, as the table illustrates.

The tax cost of using a corporation to earn income in 2003 (other than ABI eligible for the SBD) has generally decreased from 2002 as a result of falling federal and provincial corporate tax rates and steady top personal tax rates. Alberta, Saskatchewan, and Ontario are lowering their small business rates; Alberta, Manitoba, and Ontario are reducing their general active business rates. As well, some provinces are matching their corporate M & P tax rate to their general corporate ABI tax rate, reducing the difference in the tax costs of earning those types of income.

Tax Savings (Cost) of Flowing Income Through a Corporation

Type of income	BC	Alberta	Ontario	Quebec
	percent			
ABI eligible for the SBD (up to $225,000)	0.1	1.9	2.3	0.5
ABI between $225,000 and $300,000	(6.1)	(5.0)	(3.9)	(5.5)
ABI eligible for the M & P credit	(12.2)	(11.4)	(7.7)	(5.5)
General ABI	(13.6)	(12.9)	(10.1)	(6.9)
Investment income	(4.3)	(2.2)	(0.4)	(3.6)
Capital gains	(2.0)	(1.1)	(0.1)	(1.7)

The tax savings or cost of flowing different types of income through a CCPC for British Columbia, Alberta, Ontario, and Quebec is shown in the table. For example, the high tax cost of 13.6 percent associated with earning general ABI in a CCPC in British Columbia is calculated as the difference between the combined corporate and personal tax rate of 57.3 percent (37.6 percent corporate tax and 19.7 percent top marginal personal tax rate on the dividend) and the top marginal personal rate of 43.7 percent. Results for other provinces may be calculated in the same way.

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Safe Income May Be Phantom

The FCA decision in *Kruco* affirms the lower court's decision that in determining the amount of safe income of a private corporation to which a dividend can be attributed, "income earned or realized" is computed in conformity with paragraph 55(5)(c): no adjustment is made for income not supported by cash inflows (2003 FCA 284).

Kruco held about 33 percent of the shares of Kruger. Kruger repurchased those shares for about $99 million, giving rise to a deemed dividend of almost that amount under subsection 84(3). Kruco applied subsection 55(2) and reported a portion of the repurchase proceeds of about $17 million as a capital gain (that is, proceeds of $25 million less ACB of $8 million). On appeal to the TCC, Kruco contested three negative adjustments made by the CCRA to Kruco's calculation of the safe income of Kruger and its subsidiaries. In total, the CCRA's adjustments reduced Kruco's share of safe income and increased its capital gain by $24.2 million.

Two of these adjustments related to ITCs that reduced the capital cost or undepreciated capital cost of property under paragraph 13(7.1)(e) or subparagraph 13(21)(f)(vii) or were included in income under paragraph 12(1)(t). The CCRA's reduction of Kruger's safe income related to the ITCs was essentially an application of Robertson's rule no. xx:

> There should be a deduction for any amount included in taxable income that does not represent actual income earned by the corporation and which is not included in the deductions under xviii) above, for example, phantom income.

According to the CCRA, the reduction in capital cost allowance claims and the direct income inclusion attributable to the ITCs created phantom income for tax purposes for which there was no corresponding actual cash inflow. The CCRA made corresponding downward adjustments to safe income that reduced by $23.5 million the safe income attributed to Kruco's shares.

The TCC allowed the appeal in part, concluding that those downward adjustments related to the ITCs were not justified. The TCC said that the CCRA had gone too far in reducing safe income by the phantom income created by the ITCs. In *454538 Ontario Ltd.*, the TCC held that "income earned or realized" for the purposes of subsection 55(2), deemed by paragraph 55(5)(c) to be "income for the period otherwise determined" (with specific exceptions), is income determined pursuant to the provisions of division B of part I of the Act; it is a "creature of the Act" and not disposable income in an accounting sense ([1993] 1 CTC 2746). Adjustments to income earned or realized to reflect a variety of items that may be viewed as artificially reducing or increasing accounting income go beyond the limited exceptions provided for in paragraph 55(5)(c).

The FCA held that the TCC came to the correct conclusion and based its finding on a summary of the TCC's reasons. The FCA said that paragraph 55(5)(c) establishes an amount that is deemed to be a private corporation's "income earned or realized." Once such income is computed under this provision, the amount must be analyzed to determine whether the income remains disposable, but an inquiry into whether it was ever on hand or disposable is precluded by the fact that the amount of this income is fixed by a deeming provision. The CCRA's proposed adjustment attempts to alter that amount. In short, it is not open to the CCRA to modify what Parliament has deemed to be a corporation's "income earned or realized" for the purposes of subsection 55(2).

The FCA added that a reduction of income by reference to cash outflows is acceptable if the event that triggers the cash outflows occurs after the income's computation in conformity with paragraph 55(5)(c), but before the dividend is paid. Consequently, safe income is reduced for dividends and taxes paid by the corporation whose safe income is calculated. On the basis of the FCA decision, one may speculate that losses realized by a corporation should reduce safe income because they constitute cash outflows after the computation of income of earlier periods. The FCA did not, however, elaborate on what constitutes a time subsequent to the determination of income under paragraph 55(5)(c).

The FCA decision in *Kruco* appears to put into question several positions adopted by the CCRA in relation to the calculation of safe income. It remains to be seen whether Finance will now step in to "clarify" what is meant by "income earned or realized."

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Non-Residents in Real Estate

Recent substantial investment by US residents and other non-residents in Canadian rental properties and development projects warrants a review of the factors that influence the choice of holding vehicle to minimize Canadian taxes on profits and withholding taxes, maximize foreign tax credits in the home jurisdiction, avoid provincial capital taxes and federal large corporations tax (LCT), and provide limited liability.

Canadian corporation. A Nova Scotia unlimited liability corporation (NSULC), a corporation for Canadian tax purposes, is treated as a limited liability corporation for US tax purposes, thereby effectively deeming a US purchaser to own the property directly. This may be desirable if the NSULC is not taxable on the income as a result of deductible expenses, such as interest and capital cost allowance. Depending upon the manner in which the NSULC is capitalized, Canadian thin capitalization rules may disallow otherwise deductible interest paid or payable on debts owed to a specified non-resident.

Ten percent withholding tax applies on interest payments to US residents; a domestic exemption applies for interest paid on certain five-year non-participating debt to an arm's-length non-resident lender. A treaty exemption from withholding tax applies to interest or dividends paid to an unrelated US pension fund.

Withholding tax applies on dividends paid to a US corporate shareholder at 15 percent, or 5 percent if it (not a corporate partnership) owns at least 10 percent of the payer's voting stock. A US LLC shareholder suffers 25 percent withholding because it is not eligible for treaty relief; a new Canada-US treaty protocol is being negotiated to remedy that problem.

A non-resident-controlled Canco cannot benefit from the small-business low tax rate or from a dividend refund for dividends paid out of investment income. Such a corporation is taxed at the top Canadian rate, about 37 percent in Ontario. A Canadian principal business corporation whose principal business is real estate may claim capital cost allowance in excess of net rental income, carry any loss back three years or forward seven years, and shelter any capital gain on a sale. In contrast, a non-resident trust cannot carry forward a non-capital loss to offset a gain on sale.

A Canco that holds real property is exposed to provincial capital tax and LCT. Deductions for interest and capital cost allowance may ward off income tax, but substantial capital tax and LCT may arise. LCT is being phased out over five years commencing in 2004, and in the interim applies only to a corporation (or associated group) with aggregate taxable capital exceeding $50 million. Ontario has announced plans to eliminate its capital tax.

If Canco disposes of property, one-half of any capital gain and the full amount of recaptured depreciation are taxable. One-half of a capital gain may be paid via a tax-free capital dividend to a Canadian shareholder, but will attract withholding tax when paid to a non-resident. The aggregate corporate and withholding tax on a capital gain realized in a corporation controlled by a non-resident and distributed varies from about 22 percent (5 percent withholding) to 39 percent (25 percent withholding) of the capital gain. Similarly, the aggregate corporate and withholding tax on recaptured depreciation or inventory gain realized in a corporation and distributed as a dividend varies from about 40 to 52 percent.

Shares of a Canadian private company are taxable Canadian property (TCP). No treaty relief applies if the company primarily owns Canadian real property. On a sale of shares, the non-resident vendor must obtain a section 116 clearance certificate and pay tax based on the gain.

Non-resident corporation. A USco that carries on business in Canada must file a part I federal income tax return and pay branch tax. The treaty relieves branch tax on the first $500,000 income; any excess is taxed at 5 percent, except in the case of a US LLC. A US resident's S corp can benefit from one tax level, paying tax at about 37 percent on business income plus any branch tax that may be credited on the shareholder's US return. Unlike an LLC, an S corp benefits from the treaty. A USco is subject to provincial capital tax and LCT. Rather than pay withholding tax on gross rentals, a USco that earns income from property may file a section 216 return and pay part I tax on net income (although at higher rates than those that apply to business income).

Interest paid between non-residents is subject to withholding tax if the debt is secured by a Canadian real estate mortgage or if the non-resident deducts the interest in computing taxable income earned in Canada, excluding rental income under a section 216 election and including business income, recapture, and capital gains. A non-resident pension plan lender of a debt secured by a mortgage may apply for a withholding tax exemption (form NR6A). Absent treaty protection, the shares of a non-resident corporation whose value is derived primarily from Canadian real estate are TCP: a section 116 certificate and prepayment of tax at 25 percent on an inventory gain or recapture is required on the share's sale, and the non-resident vendor is taxable. The fourth Canada-US treaty protocol provides relief for US-resident shareholders of a USco that owns Canadian real estate.

Interest paid between non-residents is subject to Canadian withholding tax if the debt is secured by a mortgage on Canadian real property or if the non-resident deducts the interest in computing "taxable income earned in Canada," which does not include section 216 net rental income.

The issues connected with choosing a trust or partnership vehicle for investment will be discussed in next month's issue.

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Holdco in Spousal Trust

In determining the FMV of investment holding company shares bequeathed to an exclusive spousal trust, it is important to note the timing difference between the valuation required upon the deceased's deemed disposition of the shares and that required upon the spousal trust's acquisition.

Paragraph 70(5)(a) deems a deceased to have disposed of the shares immediately before death for proceeds equal to their FMV unless the shares are passed to a spouse or spousal trust, in which case the deemed proceeds equal the deceased's adjusted cost base (ACB). The spousal trust is deemed under subparagraph 70(6)(d)(ii) to have acquired the shares at the time of death at the same ACB. When the surviving spouse dies, the spousal trust is deemed to dispose of the shares at the FMV. Accordingly, when the holdco's shares are valued as of the time the spousal trust acquires them on the deceased's death, consideration should be given to the taxes that will eventually be payable by the spousal trust when the surviving spouse dies. In order to fund such taxes, the trustees, in the exercise of their fiduciary obligation, should ensure that the corporation declares a dividend to the trust in an amount sufficient to ensure that the after-tax proceeds will permit the trust to pay the taxes. Therefore, the valuation of the shares received by the trust at the time of the first death should recognize the notional appropriation of sufficient funds by the holdco to provide for the payment of the dividend on the second death. The life expectancy of the surviving spouse is of course a factor in determining the shares' FMV when the trust acquires them.

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FOREIGN TAX NEWS

China

The Council of Economic Planning and Development proposed to extend tax holidays and reallocate government-controlled funding to venture capital businesses (VCBs) in order to fund new high-tech ventures and to curb recent losses. To be eligible for tax breaks, VCBs must be designated new important strategic industries. After holding the stock for three years, shareholders of initially issued stock can claim investment tax credits at the rate of 20 percent against business income tax and 10 percent against personal income tax. As well, a five-year business tax holiday is available to VCB corporate organizations.

Greece

Draft legislation presented by the finance minister provides for a planned special tax regime to attract foreign investors. Individually tailored contracts provide 10 years of tax stability with fixed tax rates based on percentages of invested capital or turnover and profits. Parliament is expected to finalize the legislation shortly, effective September 2003.

France

Finance is preparing to propose tax breaks to lure foreign executives and expatriates to France to establish French headquarters. The tax breaks include a 35 percent reduction of income tax and reductions in corporate taxes, perhaps to be effective next year. In the meantime, the European Union is urging France to end its special tax regime for establishing headquarters in France, claiming an unfair advantage to France with a negative impact on competition within the European Union. (See “Foreign Tax News,” *Canadian Tax Highlights*, August 1996 and October 1996.)

United Kingdom

Members of Parliament urged the government to introduce tax credits for private firms that invest in developing countries in order to stimulate economic development there and offset investment risks. As well, one MP is urging the government to join the Europe-wide aviation tax to help curb air pollution, saying that biofuels that produce fewer greenhouse gases should receive large tax breaks.

Russia

The ministry has released detailed recommendations for the application of the Tax Code to the taxation of foreign companies, including the taxation of foreign corporate profits operating under a permanent establishment (PE) and the taxation of foreign companies’ Russian-source income not connected to a PE in Russia. Detailed definitions set out criteria for a PE, profits from a PE, and Russian-source income without a PE.

Canada’s Tax Treaties

In force (79)

Algeria
Argentina
Australia
Austria
Bangladesh
Barbados
Belgium
Brazil
Bulgaria
Cameroon
Chile
China (PRC)[1]
Croatia
Cyprus
Czech Republic
Denmark
Dominican Republic
Ecuador
Egypt
Estonia
Finland
France
Germany
Guyana
Hungary
Iceland
India
Indonesia
Ireland
Israel
Italy
Ivory Coast
Jamaica
Japan
Jordan
Kazakhstan
Kenya
Korea, Republic of
Kyrgyzstan
Latvia
Lithuania
Luxembourg
Malaysia
Malta
Mexico
Moldova
Mongolia
Morocco
Netherlands
New Zealand
Nigeria
Norway
Pakistan
Papua New Guinea
Peru
Philippines
Poland
Portugal
Romania
Russia
Singapore
Slovak Republic
Slovenia
South Africa
Spain
Sri Lanka
Sweden
Switzerland
Tanzania
Thailand
Trinidad & Tobago
Tunisia
Ukraine
United Kingdom
United States
Uzbekistan
Vietnam
Zambia
Zimbabwe

Signed but not yet in force (9)

Belgium[2]
Gabon
Italy[2]
Kuwait
Lebanon
Senegal
United Arab Emirates
United Kingdom
Venezuela

Under negotiation/ renegotiation (18)

Armenia
Azerbaijan
Barbados
Bolivia
China (PRC)
Colombia
Costa Rica
Cuba
Egypt
Greece
Ireland
Mauritius
Mexico
Oman
Romania
Saint Lucia
Turkey
United States

[1] This convention does not apply to Hong Kong. [2] This will completely replace the existing treaty.

Source: Finance Canada: http://www.fin.gc.ca/.

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