Canadian Tax Highlights

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Simplified RRSP Reporting

IRS Notice 2003-75, dated November 26, 2003, describes a new reporting regime for US resident and citizen RRSP and RRIF holders applicable for tax years beginning after 2002. The onerous prior regime required the filing of IRS forms 3520 and 3520-A; the IRS-estimated time for compliance was 50 and 40 hours, respectively, compared with 5 hours or less under the new regime.

A new tax reporting form now being designed is the centrepiece of the new regime. The notice states that the information to be provided on the form will be limited to that readily available to RRSP and RRIF holders. The new form will also coordinate the reporting rules for making the Canada-US treaty election to defer US income tax on income accrued in the RRSPs and RRIFs each year, pursuant to Rev. proc. 2002-23. The new form will be attached to the plan holder's form 1040; interim reporting rules apply for 2003 form 1040s filed before the new IRS form is available. An RRSP or RRIF beneficiary who elects on a US return to defer US tax on the plan's accrued earnings must (1) attach a copy of the election to the form 1040; (2) indicate the RRSP or RRIF balance at year-end, either on the election or by attaching a copy of a statement issued by the plan custodian; and (3) report both the total amount and the taxable amount of plan distributions on lines 16(a) and 16(b) of form 1040. In general, the taxable amount is determined by using the rules applicable to annuities (Code section 72). An RRSP or RRIF beneficiary who does not elect to defer US income tax on the accrued plan income must attach to the form 1040 a statement that includes personal information, such as his or her name, social security number, and address; information on the plan, such as the custodian's name and address; the plan account number; the amount of contributions made during the year; undistributed plan earnings during the year, broken into income type such as interest, dividends, and capital gains; distributions received during the year; and the plan's year-end balance. The notice describes these reporting requirements in more detail, including where to provide such information on the form 1040. Taxpayers are cautioned to retain supporting documentation, including forms T4RSP, T4RIF, and NR4, and periodic or annual statements issued by the plan custodian. Reporting requirements for US individuals who are RRSP or RRIF annuitants are also described.

On a related subject, Canadian-resident non-citizen RRSP and RRIF holders who subsequently move to the United States and become US residents are reminded that the starting US tax basis in their RRSPs or RRIFs generally equals the amount of plan contributions plus any plan earnings that arose before the holder became a US resident. The tax basis generally does not include unrealized appreciation in plan assets. In appropriate situations, holders may be well advised to sell appreciated assets in their plans before they change their residency.

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Liberalization of NAFTA

Faced with the trade-dampening effect of a strong Canadian dollar, exporters may be interested in the recent announcement by the US trade representative that the United States is accepting proposals requesting the liberalization of NAFTA's rules of origin until Friday, February 6, 2004.

The NAFTA rules of origin are technical guidelines that Canadian manufacturers must follow in order to ensure that their products' content meets NAFTA requirements for duty-free import to the United States or Mexico. Canadian manufacturers or exporters interested in making proposals in respect of their particular goods may need to contact a customs adviser to draft a compelling case for relief that takes into consideration US trade policy issues. Proposals requesting the harmonization of the most-favoured-nation (MFN) tariff rates of the United States, Canada, and Mexico are also welcomed. If MFN rates between the three countries are harmonized at zero—as was recently done for certain computers and computer parts—exporters' reliance on NAFTA and its cumbersome rules-of-origin requirements may be eliminated.

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The US call for proposals on the NAFTA side follows from section 202(q)(2) of the North American Free Trade Agreement Implementation Act, 19 USC 3331(b), which authorizes the president to proclaim modifications to the NAFTA rules of origin set forth in the Harmonized Tariff Schedule of the United States, subject to the consultation and layover provisions of section 103 of that act.

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HOCs on Life Support

Hungarian offshore companies (HOCs) are tax-efficient financing and licensing intermediaries used by many Canadian multinationals. The accession of Hungary (and nine other countries) to the European Union, effective May 1, 2004, has placed the country under pressure to phase out the favourable HOC regime, which no longer applies after 2005 in any event.

New offshore licences ceased to be issued in 2003. HOCs set up before 2003 continue to enjoy a 3 percent corporate tax rate in lieu of the regular 18 percent rate (16 percent from 2004) and a local business tax (2 percent) exemption to the end of 2005. To compensate for these changes, ex-HOCs and regular Hungarian companies are eligible for new incentives: after 2002, only 50 percent of related-party interest income (net of interest expense), royalty income, and capital gains from stock exchange transactions is subject to tax; the non-taxable portion cannot exceed 50 percent of accounting profit.

On November 10, 2003, Hungary enacted changes to the taxation of HOCs for 2004: a corporate rate increase from 3 to 4 percent; no withholding tax on interest and royalties paid to foreign organizations (implementing an EU directive but extending it to all foreign recipients); and, as of May 1, 2004, an exemption from withholding tax on dividends paid to an EU parent that owns at least 25 percent of the HOC for at least two years (a guarantee can be provided until the holding period is met). As of May 1, 2004, a change to a HOC's majority owner results in loss of offshore status; any group restructuring, such as the incorporation of an EU intermediary, should be implemented before then. A new tax applies to adjusted net sales: 0.2 percent in 2004, 0.25 percent in 2005, and 0.3 percent thereafter. Transfer-pricing documentation required for new related-party contracts concluded after September 1, 2003 extends to all contracts after 2004. A HOC may continue to keep its books in foreign currency after 2005.

Hungary wishes to remain a location of choice for intermediary financing and licensing companies. The overall rate of tax of 10 percent (50% × 16% + 2%) aligns with new rates in other acceding countries that previously offered preferential regimes (such as the 10 percent rate in Cyprus) and in current-member countries that remain attractive to investors looking for offshore operations sites (such as the uniform 12.5 percent tax rate in Ireland).

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Government Tax Revenue

The 2003 edition of *Finances of the Nation*, forthcoming on the Foundation's Web site (http://www.ctf.ca/FN2003/finances2003.asp), continues to be the only single source of detailed information on federal, provincial, and local taxes in Canada, and on the spending operations of each level of government. It also contains interesting data on the relationship between government revenue and spending and the main economic aggregates.

The detailed analysis of tax revenue as a percentage of gross domestic product (GDP) shows a decline in personal income tax relative to GDP over the past five years. Federal personal income tax actually increased as a percentage of personal income as determined for Statistics Canada's national income and expenditure accounts until 2001, when the effect of the phased-in tax cuts surfaced: the ratio dropped from 10.7 percent to 10.5 percent of personal income, as shown in table 1. National figures for 2002 indicate a more significant drop to 9.5 percent, but figures for each province are not yet available.

The uniform federal tax structure for nine provinces and the territories forms a backdrop for a wide variation in the ratio of federal tax to personal income. Because 16.5 percent of federal tax is abated to Quebec residents

Table 1 Federal Personal Income Tax as a Percentage of Personal Income, 1998 and 2001

	1998	2001
Newfoundland	8.5	8.3
Prince Edward Island	8.8	8.6
Nova Scotia	9.5	9.3
New Brunswick	8.8	8.9
Quebec	8.6	8.6
Ontario	12.0	11.8
Manitoba	9.6	9.3
Saskatchewan	9.5	9.1
Alberta	12.1	11.6
British Columbia	10.6	10.3
National average, including territories	10.7	10.5

Table 2 Provincial Personal Income Taxes as a Percentage of Personal Income, 1996 and 2001

	1996	2001
Newfoundland	5.8	5.3
Prince Edward Island	5.2	4.7
Nova Scotia	5.4	5.3
New Brunswick	5.7	5.1
Quebec	8.8	9.0
Ontario	6.4	5.4
Manitoba	5.4	5.8
Saskatchewan	6.1	5.1
Alberta	5.5	4.5
British Columbia	6.0	4.9
National average, including territories	6.7	6.0

under the opting-out arrangements begun in the 1960s, Quebec's ratios are not comparable with either federal or other provincial income tax. With more incomes subject to the lower rates of federal tax, and a higher proportion of non-taxable income from government transfer payments, the ratio of federal to personal income was 9.5 percent or lower in the Atlantic provinces. Ontario and Alberta saw ratios ranging from 11.8 percent to 12.1 percent in the two years shown in table 1.

Provincial governments were the first to introduce tax cuts in the last half of the 1990s; these cuts were usually phased in over a number of years. Table 2 shows that, on average, provincial income taxes declined from a high of 6.7 percent of personal income in 1996 to 6.0 percent in 2001; they dropped marginally to 5.9 percent in 2002. Ontario's ratio shows a steady drop over the period 1996 to 2001 from 6.4 percent to 5.4 percent. Similar or larger reductions occurred in Saskatchewan, Alberta, and British Columbia, but each change occurred in its entirety in 2001.

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Joint Committee on Taxation Submissions to CCRA

The CBA-CICA Joint Committee on Taxation recently made submissions to the CCRA concerning a draft memorandum on the compatibility of valuation for transfer pricing and customs purposes and draft IC 71-17R5 on requests for competent authority assistance under Canada's tax treaties.

Valuation. The committee's November 24, 2003 submission recommends that the CCRA customs and income tax branches work together to determine how they can maximize consistency in their administrative practices for customs valuation and income tax transfer pricing. The draft memorandum catalogues the differences between the law and administrative policies in determining values for duty and transfer pricing in related-party transactions. The committee says that current differences in transfer pricing and customs practices cause uncertainty for taxpayers and their advisers and can produce inconsistent results. Consistency is particularly critical in the following areas.

- If the price of goods acquired from a related non-resident is at arm's length for income tax purposes, it should be accepted that the price was not influenced by the relationship between the parties for the purposes of section 48(1)(d)(i) of the Customs Act.
- In other cases, the transfer-pricing methodology and the data and assumptions used to establish an arm's-length price for income tax purposes should also be used in determining the value for duty to the extent that such use complies with the Customs Act.
- Terms used in the valuation-for-duty regulations—in particular, "carries on business" and "permanent establishment"—should be interpreted and applied in the same manner for customs and income tax purposes, subject to differing legislative definitions or rules.

The committee recommends that the CCRA prepare another memorandum after the suggested steps have been taken to confirm its commitment to consistency in customs and transfer-pricing valuation; the memorandum should address any inconsistencies that cannot be eliminated. The memorandum should also include examples like those in IC 87-2R on transfer pricing to help taxpayers and their advisers understand the practical implications of the CCRA's views.

The submission includes specific comments on how the draft memorandum deals with guidelines versus law; price setting; royalties ("functions" are irrelevant); timing of valuation; exchange rates; valuation-for-duty regulations (resident and purchaser in Canada); price reductions; purchaser in Canada versus taxpayer; post-importation payments or fees (subsequent proceeds); transportation and associated costs; tangible assists; price reduction after importation (income tax); and deductive value versus resale price.

Competent authority. The committee's November 20, 2003 submission on draft IC 71-17R5 deals with requests for competent authority assistance under Canada's tax treaties. The submission includes general comments and specific recommendations for changes to the draft IC. The committee compliments the CCRA on its efforts to provide more detailed information on this valuable service, which remains a mystery to many taxpayers and consequently is underutilized. Overall, the committee believes that the draft is a welcome improvement on the existing IC. The draft contains detailed information on the Canada-US treaty, which the committee understands generates the majority of Canadian competent authority cases. However, competent

authority requests increasingly involve other treaty countries. The committee would like to see more discussion of policy issues involving other treaty partners—for example, what normally constitutes proper notification and issues relating to differing statutes of limitations.

The submission specifically comments on topics such as the appeals process and competent authority settlements; complete competent authority requests and taxpayer cooperation; timing questions related to the filing of waivers; the continuation of tax collections during competent authority proceedings; anti-avoidance rules as a bar to competent authority assistance; competent authority proceedings without taxpayer consent; and corresponding versus compensating adjustments.

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Nowsco's White Knight

The TCC in *Nowsco* recently allowed a deduction for expenses incurred by Nowsco Well Service in defending against a hostile takeover bid by BJ Services. BJ approached Nowsco with an unsolicited merger proposal to acquire its shares. Nowsco's directors incurred substantial fees for accounting, financial, and legal advice; a significant non-contingent "hello fee" to a "white knight"; and a contingent break fee to cover the white knight's costs of a competitive bid. The break fee was payable only if a more attractive unsolicited bid was made and accepted by Nowsco, thus nullifying the white knight's offer.

The CCRA argued that the costs were not deductible because they were incurred in response to a takeover bid in order to maximize shareholder value, not for the purpose of earning income from Nowsco's business. Alternatively, the expenses were capital outlays and precluded from deduction under paragraph 18(1)(b). The TCC said that the CCRA's position was fundamentally inconsistent with the economic and business realities of the world of mergers and acquisitions: expenses incurred to maximize shareholder value are so integral to the conducting of business that they cannot be divorced from the corporate activities of gaining and producing income. Although in a companion GST case Mr. Justice Miller concluded that there was a necessary overlap between the "corporate marketplace," which mandated maximization of shareholder value, and the "goods and services marketplace," where Nowsco's daily oil and gas activities existed, the court was loath to compartmentalize the business operation of Nowsco for the purposes of an income tax analysis. If shareholders' funding of the company is lost or withdrawn, customers will be lost, staff will be laid off, and eventually the operation may shut down. Expenses incurred to maximize shareholder value to ensure continued financing are part of the general overall costs a company must incur to earn income, even though these costs have no direct link to revenue-generating activities but are related to shareholder interests. These costs are simply part of doing business in the marketplace, and thus are incurred for the purpose of earning income from business or property. Comments in *International Colin Energy* were cited as authority that the expenses were not capital outlays.

The court also commented on Nowsco's alternative argument that the expenses were deductible under paragraph 20(1)(e) as incurred "in the course of the issuance or sale" of Nowsco's shares. Many practitioners have thought that such a deduction was restricted to a sale of shares from treasury, an issue raised but not decided in *International Colin Energy*. The court in *Nowsco* found that the juxtaposition of "sale" with "issuance" must mean that a sale can be made other than by the company, because the word "issuance" is itself broad enough to cover a sale by Nowsco: the word "sale" would thus be made redundant by an interpretation that did not include a sale by the shareholders.

The potential tax leakage to the fisc flowing from *Nowsco* is considerable, and the decision will probably be appealed by the Crown. For the moment, practitioners have support for the current deductibility of period costs incurred solely for the purpose of maximizing shareholder value.

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Dividends into Capital Gains

Two recent technical interpretations involve transactions designed to allow individuals to realize capital gains on the sale of a corporation's shares to existing shareholders instead of triggering deemed dividends on their redemption; corporate funds were effectively used to pay the vendors' proceeds of disposition. Such transactions are apparently gaining popularity because the capital gains tax rate is now significantly lower than that for dividends. Previously, the CCRA appeared to be in no rush to apply deemed dividend treatment under section 84.1 when an individual sold out his or her interest to continuing shareholders via a holding corporation to obtain capital gains treatment on the disposition. In both TIs, the CCRA appears to favour a stricter approach.

In the example described in the earlier TI (2002-0166655), the vendors realize a capital gain on the disposition of their shares of Opco, a CCPC, to unrelated corporate shareholders and claim the enhanced capital gains exemption. The Opco shares' adjusted cost base (ACB) and paid-up capital

are nominal. The vendors and purchasers are unrelated. The purchasers transfer their Opco shares to a Newco, which then purchases the vendors' Opco shares for FMV non-share consideration. The CCRA said that it is a question of fact whether unrelated persons are dealing at arm's length at a particular time: the vendors and purchasers appear to be acting in concert to direct Newco regarding the sale of the Opco shares. While there may be arm's-length bargaining to determine the price for the Opco shares, the shareholders appear to be cooperating to avoid tax on the transactions. The CCRA said that Newco may be seen as merely accommodating the shareholders by so structuring the transaction; Newco has no apparent independent interest in acquiring the Opco shares, and consequently section 84.1 may apply.

In the example described in the second TI (2003-0035435), the vendor realizes a capital gain on the disposition directly to his sons of his shares in Opco, a CCPC, thus taking advantage of Quebec's capital gains tax rate (about 8 percent lower than the effective tax rate on dividends). Opco has no refundable dividend tax on hand. Opco's preferred shares are redeemable and retractable at $1 per share, with an aggregate stated capital and ACB of $100.

Each purchaser owns 100 percent of a holdco. To effect the sale, the vendor sells 100,000 Opco preferred shares to each purchaser in exchange for a promissory note issued for $100,000. Each purchaser sells the preferreds to his holdco in exchange for a promissory note of $99,900 and 100 redeemable and retractable holdco preferred shares. Each purchaser and his holdco elect under subsection 85(1). Each purchaser's ACB of the Opco preferred shares equals their FMV. Opco redeems the 200,000 preferreds owned by the holdcos, which then use the proceeds to repay the promissory notes of $99,900 and to redeem the 100 preferred shares issued to the purchasers. Each purchaser in turn pays $100,000 to the vendor in satisfaction of his promissory note.

The CCRA said that the vendor may be considered to have transferred his beneficial interest in the Opco preferreds directly to the holdcos, depending on the circumstances. As a result, section 84.1 deems each holdco to have paid a dividend to the vendor. Alternatively, the CCRA said, GAAR may apply: each purchaser and his holdco may be viewed as accommodating the vendor by structuring the transaction in this way; they have no apparent independent interest in acquiring the Opco preferreds. The transactions are thus avoidance transactions within the meaning of subsection 245(3), and subsection 245(2) may apply to redetermine the tax consequences and to recharacterize the proceeds as a taxable dividend received by the vendor.

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Partnership-Owned Insurance

Much has been written on corporate-owned life insurance and the structuring of buy-sell arrangements, but little on the structuring of a buy-sell of partnership interests with insurance held by a partnership. A brief overview of the CCRA's positions follows.

A deceased partner or shareholder in a corporate partner is deemed to have disposed of his interest or shares unless they roll to a spouse or spouse trust. The partnership receives any related life insurance tax-free. The tax consequences to the partners generally depend on the proceeds' allocation and whether the partners are individuals or corporations. The ACB of a partner's interest is increased by his share of the net life insurance received in excess of the partnership's policy ACB. The CCRA distinguishes between interests held directly and interests held through a corporation. The allocation of any proceeds to a deceased partner does not increase his partnership interest ACB, but rather yields a capital gain if the proceeds distributed exceed the deceased's ACB after death (TI 9129745). If the deceased held through a corporate partner, the CCRA says that any allocation increases that partner's ACB in the year the partnership receives the insurance proceeds (IT-430R2), and any distribution of proceeds to the corporate partner is a tax-free return of capital with a corresponding ACB reduction. The proceeds (less the cost of the policy) received are also added to the capital dividend account for distribution as a tax-free capital dividend (TI 9119795).

Assume that the partners agree that the partnership interest will be acquired for its FMV, excluding the life insurance, and that sufficient insurance exists to fund the buyout. If the deceased is a partner, the partnership agreement should provide for the proceeds' allocation to the surviving partners in order to fund their buyout of the deceased's partnership interest. The surviving partners receive the allocation and distribution tax-free, with offsetting increases and decreases in their partnership interests' ACBs. The deceased's estate realizes a capital gain on the sale of the partnership interest, either deemed on death or via the buyout following a spousal rollover; and the surviving partners' ACB in the deceased's partnership interest reflects the cost of acquisition. The deceased is taxed on a capital gain whether the buy-sell is structured as a distribution of proceeds in satisfaction of a partnership interest or as a sale of that interest to the surviving partners for the insurance proceeds.

If the deceased holds through a corporation, the estate benefits if the partnership agreement provides for an allocation and distribution of all the life insurance to the

deceased's corporate partner in satisfaction of its partnership interest. Subject to section 69, the corporate partner receives the allocation and distribution tax-free, effectively disposes of all or some of its partnership interest without corporate tax, and adds the life insurance to its capital dividend account for the tax-free distribution to the deceased's estate. The overall tax payable depends on the facts, including whether the corporate partner has other assets and whether any post mortem planning has been undertaken to avoid double tax or distribute the capital dividend. The best result is generally obtained if the corporation's shares can be rolled to a spouse or a spouse trust: there is no deemed disposition on death, the partnership acquires the partnership interest from the corporate partner free of tax, and the corporation distributes the insurance proceeds to the spouse or spouse trust as a tax-free capital dividend. The partnership interest is thus effectively disposed of and the proceeds fully distributed without corporate or personal tax. If no spousal rollover is available, the only tax is on the deceased's capital gain that arises on the deemed disposition on death; there is no need for a post mortem reorganization to obtain a bump in the partnership interest ACB under subsection 88(1) with all the attendant problems.

There may be difficulties with allocating the full amount of the life insurance to the corporate partner, but the CCRA has indicated that section 103 does not apply in such circumstances (Ruling 2001-0114863). If the corporate partner and the partnership do not deal at arm's length, the CCRA may seek to apply section 69 because the so-called FMV purchase price of the corporate partner's interest does not include the life insurance proceeds; any allocation to the corporate partner may result in a deemed increase in the proceeds and thus in the taxable capital gain.

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When a Part Is Not a Part

The recent British Columbia Court of Appeal (BCCA) decision in *330651 BC Ltd.* clarifies the meaning of "parts" and "accessories" in the context of turbine aircraft and provides interpretive assistance applicable to other BC Social Service Tax Act (SSTA) exemptions (2003 BCCA 658). The decision's emphasis on grammatical and ordinary meaning in interpreting disjunctive exempting provisions should also cast light on the meaning of "parts" exemptions in other provinces' commodity tax legislation.

Section 75(b) of the SSTA exempts "aircraft powered by a turbine and parts for these aircraft." The taxpayer modified one turbine-powered helicopter for aerial photography by installing a utility basket and camera housing and another for heli-skiing by installing a ski basket; both were modified to accept aluminum slash jaws for use in the logging industry. The modifications were so extensive that new operating certificates for the helicopters had to be obtained from the Ministry of Transport pursuant to the federal Aeronautics Act and the Canadian aviation regulations; the taxpayer thus viewed the installed items as "parts" for the helicopters and did not pay SST on their acquisition. Following an audit, the minister assessed tax, saying that the installed items were accessories and not parts because they were not required for the helicopters' basic functioning or safe operation.

On appeal to the BC Supreme Court, both parties argued that the ordinary meaning of the word "parts" should prevail and cited supporting definitions in *The New Shorter Oxford Dictionary.* The taxpayer claimed that the items became parts of and for the helicopters as a result of the helicopter recertification requirements. The minister also cited *Webster's New Collegiate Dictionary* definitions and reiterated that the items were accessories, not parts, because the helicopters could still perform their basic functions and operate safely without the items. Both parties agreed that the terms "parts" and "accessories" were not necessarily exclusive. Cullen J dismissed the appeal: "[T]he characteristic of a helicopter that brings it within the exemption of section 75(b) is that it is an aircraft powered by a turbine," and thus "as a matter of context and logic the 'parts for these aircraft' with which the section is concerned are those parts which contribute to the characteristics which make the helicopter tax exempt, in other words, those parts which render it functional as a turbine powered aircraft." Although the installed items were "undoubtedly *parts for* the helicopter in the sense that physically and functionally they can be connected to it . . . they are not parts as contemplated by section 75(b), the context of which is narrower." (Emphasis added.)

The taxpayer appealed to the BCCA, arguing that on finding that the parts were "undoubtedly parts for" the helicopters, Cullen J's analysis was complete and the appeal should have been allowed. The minister indicated that Cullen J might have meant to say that each item was part *of* the helicopter due to its physical attachment, but without citing any case law he argued that there was a distinction between "parts of" and "parts for." (The phrase "parts of" in the context of tariff classifications has been the subject of previous judicial interpretation—for example, in *Androck Inc.*, 13 CER 239 (FCA).) Low JA for the BCCA quoted extensively from the lower court judgment, noting that the interpretive issue was not illuminated by the context of section 75, which contained many unrelated sales tax exemptions, or by the scheme or object of the statute as

a whole. Accordingly, the meaning of "parts for these aircraft" was to be found in the grammatical and ordinary sense of the words in the context of section 75(b). Did items capable of attachment to turbine aircraft, without being essential to their operation, fall within the meaning of the exemption?

Without specifically addressing the lower court's finding that the items were "parts for" the helicopter or the minister's "parts of" and "parts for" distinction, the BCCA dismissed the appeal: "[I]n ordinary usage of the English language there is a distinction to be made between parts *for* machines and optional attachments or accessories to them. While it might be difficult to determine on which side of the distinction particular items fall, the items in question clearly are attachments to the helicopters, not essential or standard parts *of* them." (Emphasis added.) The items "when purchased by the appellant were not 'assembled together to make a machine' nor were they replacement parts of a previously assembled machine." Similarly, the items were not essential or integral to the helicopters when purchased, or components of the helicopters according to the dictionary definitions cited by Cullen J.

The decision, although disappointing for businesses that purchase similar "parts" for turbine aircraft, should assist in the application of other sales tax exemptions, such as Ontario's. If a provision is drafted similarly to section 75(b), its application may now depend on whether the "part" renders the machinery or equipment functional or is essential to its operation. However, a provision that includes restrictions such as those relating to design, use, or status of the purchaser may yield a different result. The decision's emphasis on the grammatical and ordinary meaning within the context of the provision itself will no doubt be important in determining the scope of BC and Ontario sales tax exemptions for "parts" used to repair or recondition exempt manufacturing and production machinery and equipment.

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NY Non-Deductibility Amended

In October 2003, New York substantially amended legislation disallowing certain related-party expense deductions. (See "NY Anti-PIC Rules," *Canadian Tax Highlights*, September 2003.) Following an outcry by corporations, financial institutions, and the tax advisory community, New York has now repealed substantially all the expense disallowance provisions that applied to intercompany financing arrangements; but it has reinforced its disallowance of royalty expenses, effective after 2002.

The initial amendments required addbacks of certain interest and royalties paid to related parties. If an amount was paid to a related party and not reported as income to New York, a rebuttable presumption arose that the transaction was a tax-avoidance transaction, and the deduction was also disallowed. However, deductions for routine intercompany financing transactions that were not motivated by tax avoidance were also disallowed, as were deductions arising from centralized treasury functions. The addback for intercompany interest expense is now generally eliminated. Interest paid in common intercompany financing arrangements unrelated to royalty-producing intangibles is once again deductible, but interest related to the sale, acquisition, disposition, maintenance, use, and management of intangible assets is still disallowed.

The new legislation expands the definition of "royalties" to include payments associated with the use of patents. The definition of a valid business purpose is amended so that the rebuttable presumption no longer arises for payments to related parties that are not New York taxpayers. Instead, new exceptions avoid royalty expense disallowance if (1) a taxpayer has a valid business purpose for a transaction and the related member ultimately pays royalties to a non-related member pursuant to arm's-length terms, or (2) the royalties are paid to a related member organized in a country that has an income tax treaty with the United States and the royalties are taxed at a rate at least equal to that in New York. The legislation also clarifies the definition of a 30 percent related party for the purposes of expense disallowance.

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Ontario Higher Tax Recipe

The newly elected Ontario government has modified some key election promises without loosening its commitment to tax changes unfavourable to taxpayers. Recently tabled Bill 2 cancels previously legislated corporate tax rate reductions otherwise effective in 2004 and subsequent years—changes that run counter to the government's stated goal of productivity and prosperity gains. Around the time Bill 2 was tabled, the Ontario Task Force on Competitiveness, Productivity and Economic Progress released its second annual report, which said that "Ontario's marginal effective tax burden is meaningfully higher than leading highly industrialized US states; this counterproductive gap is widening and various levels of government need to address this widening disadvantage." Given the significant

budgetary pressures facing Ontario and its stated position that corporate and personal taxes are already competitive, it is doubtful that, absent any windfall revenue, Ontario's recipe for prosperity will include further tax reductions.

After 2003, the small business tax rate is frozen at 5.5 percent. The general and manufacturing and processing (M & P) rates increase to 14 (from 12.5) and 12 (from 11) percent. The rate increases mean that a company with a December 31 year-end should consider accelerating Ontario taxable income into the pre-2004 period to lock in a guaranteed after-tax return of about 9.1 to 12 percent (for M & P and other income, respectively) by, for example, restricting claims for CCA, cumulative eligible capital, discretionary tax reserves, and loss carryforwards. Bill 2 also cancels legislated reductions to personal income tax rates and the modification to the individual-income surtax structure; repeals the controversial education tax credit retroactive to January 1, 2003; and eliminates the enhanced property tax relief for seniors, effective July 1, 2003.

The vast majority of Bill 2's provisions are detrimental to taxpayers, but two may provide benefits: changes to the province's small business limit and corporate surtax and the extension of the eligibility period for the 8 percent retail sales tax rebate on purchases of specified energy-efficient appliances. Before 2001, the Ontario small business deduction (SBD) allowed a CCPC to claim the lower tax rate on up to $200,000 of active business income (ABI) annually; after 2000, that limit increased to $320,000 for 2003 and was scheduled to increase to $360,000 for 2004 and to $400,000 for 2005 and beyond. Bill 2 accelerates the increases: after 2003 the annual limit is $400,000, prorated for taxation years straddling the effective date. Incorporating various federal tax provisions, the CCPC's associated group shares a business limit. However, unlike other Canadian jurisdictions, Ontario does not limit the SBD benefit to corporations with taxable capital employed in Canada under $15 million: instead, taxable income exceeding a corporation's annual limit is subject to a surtax that effectively claws back the benefit. For 2003, the non-M & P surtax rate is 4.667 percent (a rate Bill 2 maintains for subsequent years); thus, for taxation years ending on December 31, 2003, the entire SBD benefit is clawed back when the associated group's taxable income exceeds $800,000. For 2004 and subsequent years, taking into account the general corporate rate and SBD limit increases, the group taxable income range over which the SBD benefit is recaptured has been increased from $900,000 to about $1,128,519. Table 1 summarizes Bill 2's impact on ABI integration in 2003 and 2004, excluding Ontario's corporate surtax.

The combined federal and provincial SBD rate does not change in 2004, but increases in Ontario's general corporate and M & P rates result in reduced tax deferrals and higher overall tax costs. The 1.5 percent increase in the Ontario general corporate rate is offset by a 2 percent reduction in the overall federal rate, a net decrease of 0.5 percent.

Table 1 Tax on Distribution of $10,000 of ABI, Year Ending December 31

	Ontario 2003	Original legislation, Ontario 2004	New legislation, Ontario 2004
		dollars	
ABI eligible for federal and provincial SBDs			
Dividends			
Corporate tax	1,862	1,812	1,862
Individual tax	2,551	2,566	2,551
	4,413	4,378	4,413
Salary			
Individual tax	4,552	4,552	4,552
Provincial health levy	191	191	191
	4,743	4,743	4,743
Tax savings of dividend	330	365	330
Tax deferral	2,881	2,931	2,881
ABI: no SBD, no MPD			
Dividends			
Corporate tax	3,662	3,312	3,612
Individual tax	1,986	2,096	2,002
	5,648	5,408	5,614
Salary			
Individual tax	4,552	4,552	4,552
Provincial health levy	191	191	191
	4,743	4,743	4,743
Tax cost of dividend	905	665	871
Tax deferral	1,081	1,431	1,131
ABI: no SBD, full MPD			
Dividends			
Corporate tax	3,312	3,212	3,412
Individual tax	2,096	2,127	2,065
	5,408	5,339	5,477
Salary			
Individual tax	4,552	4,552	4,552
Provincial health levy	191	191	191
	4,743	4,743	4,743
Tax cost of dividend	665	596	734
Tax deferral	1,431	1,531	1,331

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.

CANADIAN TAX Highlights

Readers are invited to submit ideas or written material to *Canadian Tax Highlights*.
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Table 2 Income Tax Payable on $10,000 of Investment Income Earned Through a Corporation and Directly, Year Ending December 31

	Ontario 2003	Original legislation, Ontario 2004	New legislation, Ontario 2004
		dollars	
Portfolio dividends			
Corporate tax	3,333	3,333	3,333
Refundable tax	(3,333)	(3,333)	(3,333)
Individual tax on dividend	3,134	3,134	3,134
Combined tax	3,134	3,134	3,134
Individual tax	3,134	3,134	3,134
Tax cost with Holdco	—	—	—
Tax deferral/(prepayment) with Holdco	(199)	(199)	(199)
Capital gains			
Corporate tax	2,414	2,339	2,489
Refundable tax	(1,333)	(1,333)	(1,333)
Individual tax on dividend	1,253	1,253	1,253
Combined tax	2,334	2,259	2,409
Individual tax	2,320	2,320	2,320
Tax cost with Holdco	14	(61)	89
Tax deferral/(prepayment) with Holdco	(94)	(19)	(169)
Interest			
Corporate tax	4,829	4,679	4,979
Refundable tax	(2,667)	(2,667)	(2,667)
Individual tax on dividend	2,508	2,508	2,508
Combined tax	4,670	4,520	4,820
Individual tax	4,641	4,641	4,641
Tax cost with Holdco	29	(121)	179
Tax deferral/(prepayment) with Holdco	(188)	(38)	(338)

Note: The figures assume that (1) the individual is taxed at the top marginal tax rate, (2) the capital gains deductions for qualifying small business corporation shares or qualified farm property are not available, and (3) the taxable dividend paid is sufficient to generate the full refund of the refundable tax.

In 2004, owner-managers continue to benefit from a significant tax deferral and some tax savings on the payment of dividends in lieu of salary from underlying corporate ABI eligible for the federal and Ontario SBDs. Other ABI enjoys a tax deferral; the ultimate tax cost on distribution as a taxable dividend may be outweighed if it is deferred for a period determined by a variety of factors, such as the pre-tax rate of return inside the corporation and the differential between corporate and personal income tax rates.

Generally, the dividend gross-up and tax credit regime generates tax costs if the combined federal and provincial net corporate tax rate exceeds 20 percent. CCPC owner-managers may consider alternatives to the distribution of corporately taxed ABI, such as its distribution as a corporately taxed capital gain, which yields an effective integrated tax rate substantially lower than that for dividends. The greatest tax savings are achieved by distributions to the owner-manager that combine taxable dividends just sufficient to generate a full dividend refund to the payer corporation and then capital dividends. Table 2 summarizes Bill 2's impact on the integration of investment income in 2003 and 2004, excluding the impact of Ontario's corporate surtax. Ontario's increased general corporate rate for 2004 results in higher tax prepayments for capital gains and interest income. The overall tax costs of earning capital gains and interest income in a CCPC have increased over 600 percent since 2003.

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Foreign Tax News

Treaties

Finance will commence treaty negotiations in early March with Serbia and Montenegro; Finance is interested in hearing from affected parties, particularly with respect to concerns about the relevant tax systems. For further information, contact Parry Athenaios, Tax Legislation Division, at (613) 992-5864.

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