Canadian Tax Highlights

Editor: Vivien Morgan, LL.B.

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SPC Benefit Eliminated

The CRA's administrative policy of not assessing a shareholder of a single-purpose corporation (SPC) a taxable shareholder benefit has changed: new acquisitions of any property (including real estate) by an SPC may subject an SPC shareholder to a taxable benefit under subsection 15(1). Grandfathering rules apply for existing property and transfers to spousal trusts. (See *Income Tax Technical News* no. 31, May 25, 2004.)

"Single-purpose corporation" is an undefined term that the CRA uses to describe a corporation whose shareholder is not subject to the shareholder benefit under subsection 15(1) if certain conditions are met. Among other conditions, the corporation's only objective must be to hold a residential real property in the United States for the personal use or enjoyment of the shareholder. These arrangements are often used to avoid US estate tax on the property. The CRA's administrative policy for SPCs established to hold US-based real estate arose when Canada abolished estate taxes in 1972 and terminated its estate tax convention with the United States. At that time, a Canadian resident who owned US-based property was significantly limited in the relief he or she could obtain from US estate taxes thereon; the lack of relief was not considered appropriate, given that Canada did not levy an estate tax on US residents.

In the CRA's view, these US estate tax problems were generally resolved by amendments to the Canada-US treaty that came into effect on November 5, 1995 (see article XXIX B). As a result, the CRA says that it is inappropriate to continue the administrative policy of not assessing a taxable benefit under subsection 15(1) when the taxpayer is a shareholder of an SPC established to hold US-based real property. Effective immediately, the administrative policy no longer applies to any property acquired by an SPC or to a person who acquires shares of an SPC, unless the share acquisition is the result of the death of the individual's spouse or common law partner.

Wayne Tunney
KPMG LLP, Toronto

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Partnership Treaty Benefits

At the International Fiscal Association's Canadian Branch tax seminar in Montreal on May 10, 2004, rulings officials provided some guidance on the CRA's future policy direction concerning treaty benefits in a partnership context.

The CRA reiterated the position it announced in a January 26, 2004 technical interpretation: the CRA is looking at previous rulings given in regard to interest paid to reverse hybrid partnerships in order to determine whether they should be entitled to treaty benefits in view of OECD model treaty commentary. The CRA currently looks through a partnership to its members to determine whether a given tax treaty applies, regardless of the manner in which the partners' country of residence treats the partnership for tax purposes. For example, in a typical synthetic NRO, a Canadian partnership with US partners is entitled to treaty benefits even if the US-resident partners "checked the box" for US tax purposes to treat the partnership as a corporation. According to the CRA, its current position is at odds with the OECD commentary to article 1, which addresses the entitlement to treaty benefits if one jurisdiction treats partnerships as fiscally transparent and the other treats them as taxable entities. Because Canada has not entered a reservation to the commentary, the CRA says that it is reviewing its position and will announce its conclusion in an issue of *Income Tax Technical News*; grandfathering may apply to existing structures. Notwithstanding the CRA's review, there are alternative financing structures that preserve the benefits of a reverse NRO. In a separate panel discussion at the same seminar, a Finance representative said that if there was any uncertainty in regard to that issue, the Canada-US treaty could be modified to clearly deny treaty benefits in such circumstances. This is one more item to watch for in the next Canada-US protocol.

The IFA seminar also addressed the dividend withholding rate on payments to partnerships. The CRA's longstanding policy allows treaty benefits on dividends paid to partnerships if the partners are resident in a treaty country. However, the reduced withholding rate for significant holdings does not apply, because the partnership, not the partner, owns the shares in the Canadian-resident payer, and therefore the non-resident partner cannot be said to have significant holdings in the payer. Instead, the higher dividend withholding rate for portfolio holdings applies. In a 2003 ruling, US-resident members of a partnership that held shares in a Canadian subsidiary subscribed for new voting preferred shares in order to directly hold the requisite 10 percent ownership of the sub and thus qualify for the 5 percent treaty withholding rate, both for dividends paid directly to the partner on the preferred shares and for dividends paid to the partnership on the common shares. CRA officials at the seminar did not believe that this structure was abusive, but indicated that, in light of that ruling, the CRA's longstanding position of not looking through to consider the partners to be the shareholders will be re-examined; the CRA said that a ruling request on the point would be welcome.

Albert Baker
Deloitte & Touche LLP, Montreal

BC Probate Fees

A recent amendment to the British Columbia Probate Fee Act extends the reach of BC probate fees to intangible personal property outside the province if the deceased was ordinarily resident in the province immediately before death. Until the rule's constitutionality is resolved by a legal challenge, the change is likely to have a significant impact on some common estate-planning techniques employed by British Columbians.

The amendment responded to the decision of the British Columbia Supreme Court (BCSC) in *Bloom* (2004 BCSC 70) regarding the situs of publicly traded securities held by the deceased through an account with the Bank of Nova Scotia Trust Company and recorded in the book entry system maintained by the Canadian Depository for Securities Limited in Toronto. The Probate Fee Act required payment of a fee based on the gross value of the deceased's real and personal property "situated in British Columbia." The BCSC agreed with the deceased's niece, who applied for a grant of letters of administration with the will annexed, that the securities were not situated in British Columbia and thus their value should not be included in the estate for probate fee purposes. The court concluded that existing case law did not provide a clear rule for determining the situs of shares held in the book entry system, and, as indicated by the SCC in *National Trust*, the answer should be deduced on the basis of analogy and existing principles. The closest analogy available, and the one that arose most naturally from the existing common law tests, suggested that securities share a situs with the records of the financial intermediary on whose books the interest appears: the trust company's securities department was in Toronto, and thus the securities' situs was not British Columbia.

No doubt anticipating *Bloom*'s impact on revenues, the provincial government moved quickly to amend the Probate Fee Act and bring extraprovincial securities back within the tax net: the amendment received royal assent on May 20, 2004, retroactive to January 30, 2004, the date of the court's judgment. Under the amendment, the value of a person's estate for probate purposes includes all the deceased's real and tangible personal property situated within the province, and, if the deceased was ordinarily resident in the province immediately before death, all his intangible personal property, wherever situated.

It has been common practice for British Columbians who want to avoid probate fees on investment assets to transfer those assets to an Alberta corporation in exchange for shares and sometimes debt. Established common law rules fix the shares' (and properly structured debt's) situs in Alberta, thus excluding them from the estate's value for probate fee purposes. This structure no longer protects a deceased who was ordinarily resident in British Columbia immediately before death; alternatives such as alter ego trusts or joint spousal or common law partner trusts for clients aged 65 or older should be considered.

Many practitioners have expressed doubts about the amendment's constitutional validity. In *Eurig Estate*, the SCC held that probate fees are a tax (see "A Tax by Any Other Name," *Canadian Tax Highlights*, November 1998). Section 92(2) of the Constitution Act limits the provincial power of taxation to "direct taxation within the Province." In the context of provincial succession duties, it is generally settled law that the provincial power of taxation in respect of property passing on death is limited to the taxation of (1) real or personal property situated within the province; (2) extraprovincial personal property that passes from a deceased who died domiciled within the province to a successor also domiciled or resident there; and (3) a successor (heir) to property wherever situated who is resident or domiciled within the province. The amendment exceeds these parameters and is specifically directed at extraprovincial personal property without any requirement that the successor be resident in, domiciled in, or otherwise connected to British Columbia, although it is required that the deceased have been ordinarily resident there at death. However, the Privy Council in *Provincial Treasurer of Alberta v. Kerr* ([1933] AC 710) said that a province cannot impose taxation in respect of personal property situated outside the province on the death of a person domiciled within the province: it is doubtful that substituting a connecting factor of ordinary residence for domicile can improve the province's position.

Unfortunately, the relatively low rate of probate tax, the cost of a constitutional challenge, the limitations on recovery of unconstitutionally collected taxes, and the increasing inclination of federal and provincial governments to enact retroactive legislation to repair badly drafted or ill-conceived laws are all disincentives to litigating this issue. It may be some time before the courts test the amendment's validity.

Ian Worland
Legacy Tax + Trust Lawyers, Vancouver

Provincial Fingers Crossed

The provinces' budgets for the fiscal year 2004-5 present a mixed picture; already hurt by a series of disasters in 2003-4, their finance ministers took a cautious approach in forecasts for the coming year. The table summarizes the bottom lines for the provinces for the previous and current years. (Some of the figures were adjusted to compensate for differences between the various accounting systems.)

In total, spending is expected to increase by 3.8 percent in 2004-5. Continued low interest rates and reduced borrowing requirements should produce an increase of only 2.6 percent in debt charges, while program spending is forecast to rise by 3.9 percent. The budget speeches were marked by a common concern about controlling spending while accommodating needs in key areas such as health care.

Total revenue should increase by 5.5 percent as provincial revenue collections rise by 5.2 percent, and transfers from the federal government should increase by 7.1 percent (as estimated by the provinces). There were no major personal income tax cuts in this year's budgets, but Nova Scotia enacted some cuts that had been promised previously. Several provinces cut corporate income and capital tax rates, but several were forced to raise capital taxes. Saskatchewan and Ontario budgets introduced major increases in retail sales tax and health-care levies.

Provincial Surpluses and Deficits

	Adjusted surplus or deficit (–)	
	2003-4	2004-5
	$ million	
Newfoundland	–150	–325
Prince Edward Island	–85	–33
Nova Scotia	15	–30
New Brunswick	–123	2
Quebec	–267	0
Ontario	–6,222	–2,239
Manitoba	–70	3
Saskatchewan	–214	–158
Alberta	3,327	303
British Columbia	–1,644	100
Total	–5,264	–2,552

In aggregate, provincial revenues fell short of spending by an estimated $6.0 billion in 2003-4. The current fiscal year will see a significant improvement as the aggregate deficit drops to $2.6 billion. The table shows that seven provinces were able to improve their bottom line for 2004-5, and three converted deficits into surpluses.

David B. Perry
Canadian Tax Foundation, Toronto

BC Directors' Liability

British Columbia has joined the other retail sales tax provinces in adopting directors' liability provisions in its consumption tax statutes, but it extends liability to anyone whom the tax authorities deem to be a director.

The absence of directors' liability provisions has been a significant obstacle to the collection of tax assessments against defunct corporations. In the past, tax authorities tried to fill the legislative gap by using common law remedies: because tax collected is held in statutory trust, the misuse of the trust funds was said to entitle the beneficiary to redress for breach of trust. In *D'Sena* ([1995] 5002 ETC), the BC Court of Appeal (BCCA) held a director personally liable on that basis. A sole shareholder-director, said by the BCCA to be the company's "operating mind," filed social service tax returns that falsely claimed that no sales had been made and no tax collected. The director had withdrawn the funds for his own purposes; the court held that he knowingly put the Crown at risk to its prejudice by failing to remit collected tax, and it held him personally liable for the unremitted tax.

Emboldened by this success, the province began routinely informing directors of corporate debtors that they "may" be liable for unpaid tax, and advising that collection action would begin shortly. But some situations clearly fall outside the scope of *D'Sena*'s fact pattern, such as assessments that are made for tax not paid even though non-payment does not give rise to any trust relationship. A letter to the province explaining the limitations of the *D'Sena* case was often sufficient to end the matter.

British Columbia has now plugged the gap via Bill 34. As of May 13, 2004, new sections 102.1 and 102.2 of the Social Service Tax Act augment the provincial sales tax legislation. (Motor fuel, tobacco tax, and hotel room tax legislation has been similarly augmented.) Section 102.1 is modelled after the directors' liability provisions in the federal Income Tax Act and Excise Tax Act: directors are jointly and severally liable with the corporation for taxes that the corporation has failed to collect or remit but not for taxes that the corporation has failed to pay, and the province has two years to assess the director after he or she ceases to hold office. The director may raise a due diligence defence. However, the provision differs from federal and other provincial legislation: the province can pursue a director before remedies against the corporation have been exhausted. Simply registering a certificate of the debt in the BC Supreme Court is enough to allow collection, regardless of whether execution of the certificate (akin to a judgment) has been unsuccessful. Despite the flexibility under the Social Services Tax Act, the province's Bulletin GEN 010 says that directors will be pursued only as a last resort.

Much more troubling is new section 102.2, which allows the Ministry of Provincial Revenue to hold liable a person "who was not a director of the corporation" but who "performed some or all of the functions of a director of the corporation." The relevant functions are not described in the legislation, but Bulletin GEN 010 lists a number of activities considered to be directorial, including "supervising any functions delegated to officers and employees." Section 102.2(3) restricts the ministry from finding that a person exercised such functions based solely on the person's participation in corporate management (1) under the direction or control of a shareholder, director, or senior officer; (2) as a professional providing professional services to the corporation; (3) as a trustee in bankruptcy; or (4) as a receiver, receiver-manager, or secured creditor enforcing a debt obligation. However, the word "solely" suggests that a decision may nevertheless be based in part on these factors. This new provision creates tremendous uncertainty for corporate personnel and will take many persons by surprise, especially those with no knowledge of, or responsibility for, tax collection and remittance matters. Furthermore, which persons should now obtain coverage under directors' liability insurance for such potential liability?

Arguably, the province could have achieved the same object without enacting section 102.2. Federally, the CRA and the courts have been able to ensure that liability attaches to persons acting unofficially in the capacity of directors, without the need for a legislative deeming rule. The courts have recognized that in addition to de jure directors (persons legally appointed to the board), there are de facto directors (directors in fact). A person who is assessed federally as a de facto director can at least argue that he or she is not a director; but if the Commissioner of Social Service Tax decides that a person is a director, then he or she is deemed to be a director "for the purposes of this Act." The exercise of the commissioner's discretion presumably is subject to review and is likely to be subject to a "reasonableness" test, but a court cannot substitute its decision for the commissioner's.

The answer for some deemed directors may lie in the "unwitting" director defence as described in *Perricelli* (2002 GTC 306), a GST directors' liability case that involved a person who was found to be neither a de jure nor a de facto director. The TCC noted, however, that even if Mr. Perricelli might have been a director, he had reasonable grounds to believe that he was not. In such circumstances, little could be expected of him:

> To attach liability to a director who has shown he did not believe he was such, is to hold such a person to the same standard as a director who knew or ought to have known he should and could take positive steps to prevent the failure to remit. This is an unrealistic expectation of the unwitting director. If you do not believe you are a director and there are reasonable grounds for accepting that belief, then you should be relieved from liability by subsection 323(3) of the Act.

Moreover, the provision is retrospective. The ministry may now assess directors (deemed or otherwise) who bore no liability for taxes at the actual time that the failure to collect or remit occurred. In an apparent effort to encourage voluntary disclosure, an exception is made for taxes that were the subject of an assessment before the end of the six-month period following the new provisions' coming into force. Directors are not liable for taxes that were "the subject of an assessment" before November 13, 2004.

Terry G. Barnett and Kimberly L. Cook
Thorsteinssons, Vancouver

RRSPs and Creditors on Death

The Ontario Court of Appeal (OCA) rendered a decision in *Perring* in June 2004 that dealt with the treatment of RRSP proceeds after the RRSP owner's death when a creditor launched a claim against the estate. The OCA held that RRSPs do not form part of the estate but instead devolve directly to the designated beneficiary and that a creditor has no recourse to repayment from the RRSP proceeds in the designated beneficiary's hands when the estate cannot pay its debts. Tax practitioners and investment planners will find this case of interest because judicial opinion on the issue in Ontario and other provinces has diverged. *Perring* puts RRSPs on similar footing in Ontario with the proceeds of a life insurance policy: both devolve directly to the designated beneficiary, not via the estate, and are thereby beyond the reach of creditors. Whether other provinces will adopt a similar approach remains to be seen.

The appellant was a creditor of the deceased, whose will named his wife, the respondent, as the estate's executrix and sole beneficiary. The wife was also the designated beneficiary of two RRSPs both in the will and in separate designations filed by two financial institutions that were the RRSPs' administrators. The wife received the

RRSP proceeds ($117,000) in May 1998. After the estate filed an assignment in bankruptcy in April 1999, the trustee in bankruptcy demanded that she pay the RRSP proceeds to the estate; she refused, collapsed the RRSPs, and kept the net proceeds. The creditor sought to obtain payment of the outstanding debt owned by the estate out of the beneficiary's RRSP proceeds.

The appellant argued that the trial judge erred by not holding that RRSP proceeds devolve to a designated beneficiary through the estate, relying on section 2(1) of the Estates Administration Act and on the proposition that, at law, the designation of a fund's beneficiary is a testamentary disposition and thus the fund devolves first to the estate—which is subject to the claims of creditors—before it can be paid to a designated beneficiary. The appellant cited the SCC's decision in *MacInnes* ([1935] SCR 200) as authority for the proposition that a document made outside a will that designates a beneficiary to a profit-sharing fund is a testamentary document. The appellant also pointed to legislation in British Columbia and Prince Edward Island that specifically excludes RRSP proceeds from an estate (and, in the latter case, from the claims of the estate's creditors); the Ontario Insurance Act (section 196) also specifically excludes insurance proceeds from the insured's estate. Without comparable legislation for RRSP proceeds, the appellant argued, they should first fall into the estate.

The OCA said that the appellant's argument could not lead past section 2(1) of the Estates Administration Act because section 53 of the Succession Law Reform Act (SLRA) has been interpreted as a statutory exemption to the general rule. The trial judge concluded that the legislature intended to exclude from a deceased's estate any RRSP proceeds designated to a beneficiary; SLRA section 72(1)(g) lists a number of transactions before the deceased's death that are deemed to be included in the estate for the purpose of dependants' relief orders. The court reasoned that the deeming rule's existence implies that the listed transactions are not otherwise testamentary dispositions, and thus their proceeds would not normally form part of a deceased's estate: section 72(1)(g) would be meaningless if, inter alia, RRSP proceeds were already included in a deceased's estate. The OCA concurred: RRSPs are specifically included in the section 50 definition of "plan," the benefit of which may be made payable to a designated beneficiary, and section 53 excludes RRSP plans from the owner's estate. The section 72 inclusion of RRSPs in the estate's value is only for the purpose of dependants' relief. In this statutory context, there was "no basis to suggest that the legislature was in doubt about an issue over which it maintained legislative control." The OCA also concurred with the trial judge's refusal to follow part of the decision of the Manitoba Court of Appeal in *Clark*—that RRSP proceeds in the designated beneficiary's hands remain answerable for the deceased's debts over and above the estate's resources—saying that there is no legal or equitable basis for that conclusion.

John Jakolev
Goodman & Carr LLP, Toronto

Partnerships and Large Corporations

■ The TCC recently heard *Whealy* (2004 TCC 377), which dealt with whether a partnership existed. Following a series of transactions, the taxpayers became partners in a previously constituted foreign partnership with real estate assets. That partnership then purchased small interests in oil and gas properties and within 38 minutes sold the real estate at a substantial loss, which the taxpayers sought to deduct in subsequent years. The partnership's only remaining assets, the oil and gas properties, realized relatively insignificant gains and losses during the following years. The taxpayers argued that they carried on in partnership the business of selling natural gas. The TCC referred to the SCC's decision in *Backman* and *Spire Freezers* (heard together), which determined that for Canadian income tax purposes, a valid partnership (foreign or domestic) exists only if the relation that subsists between persons is one of carrying on a business in common with a view to profit. The taxpayers in *Whealy* were not partners because they did not carry on any business and did not have a view to profit from an interest in the old partnership. "There was no prior asset or business of the old partnership [that the taxpayers] were required to manage or operate." The taxpayers were merely co-owners of tiny interests in two gas wells; they were not partners with respect to those wells.

■ In *Canadian Forest Products* (2004 TCC 405), the TCC held that outstanding cheques are not included in taxable capital for the purposes of a corporation's part I.3 large corporations tax (LCT) liability. The CRA argued that outstanding cheques at year-end exceeding cash on hand constituted a loan or advance from a bank within the meaning of "capital" (paragraph 181.2(3)(c)) and thus fell into taxable capital for LCT purposes. The TCC agreed with the taxpayer that the ordinary meanings of the words "loan" and "advance" were determinative: on the facts, there was no loan because there was no liability to the bank. Although the outstanding cheques were presented in the taxpayer's financial statements as liabilities under GAAP, GAAP was not relevant. It is not yet known whether the CRA will appeal.

■ The SCC recently denied the taxpayer's request for leave to appeal a procedural matter in *Potash Corporation of Saskatchewan* (2003 FCA 471). The case illustrates that it is critically important that a large corporation file a complete and accurate notice of objection to a tax assessment: issues or arguments that are not spelled out in a large corporation's original notice of objection cannot be raised later (subsections 165(1.11) and 169(2.1)). The taxpayer, PCS, filed a motion before trial to amend its notice of appeal filed with the TCC to include additional items of income in its resource profits for the purpose of calculating the resource allowance. The TCC allowed the amendment, but the FCA said that contrary to what was required, PCS did not reasonably describe in its notice of objection the items of income that it sought to include in its appeal to the TCC. Because leave to appeal has been denied, the FCA's procedural decision will stand, and the taxpayer cannot amend its notice of appeal to the TCC.

Paul Hickey
KPMG LLP, Toronto

Tax Planning for Aging Parents

■ **Powers of attorney.** Each parent should have a power of attorney for management of property and one for personal care. The former permits the holder to deal with the grantor's assets in the event of mental incapacity or if the grantor's investments require a signature while he or she is wintering abroad. Spouses may name each other and then alternates in either the same or a separate document; parents with substantial assets or in a second marriage may wish to name each other and one or more children to act jointly or jointly and severally. Often the named persons are also named as executors in the will. If there are concerns about the power of attorney's being abused, it is preferable, for example, that in a letter to the law firm that drafts the document the grantor direct its release only after the receipt of written instructions from the grantor (or a letter and follow-up conversation with a physician if confirming mental incapacity). The power of attorney for personal care (a living will) authorizes the holder to make personal or health-care decisions for an incapacitated grantor. Wishes regarding "heroic measures" or life support are often set out in a separate letter addressed to the personal-care attorneys.

■ **Probate fees.** Probate is generally required for assets such as bank accounts, brokerage accounts, and personally held real estate located in the province. Planning to avoid the 1½ percent Ontario probate fees may include naming beneficiaries to life insurance policies and pension plans, which go directly to the beneficiary. Joint ownership (not tenancy in common) of bank accounts, residential property, brokerage accounts, and shares of private companies allows the survivor to acquire the asset directly, not under a will, and defer probate fees until the survivor's death. The normal rules regarding dispositions and attribution must be considered in restructuring ownership; for example, changing an asset to joint tenancy may trigger a disposition at FMV of one-half of the asset or attribution if a spouse is the transferee. Assets in trust—an ordinary inter vivos trust, a spousal trust, an alter ego trust, or a joint and last survivor trust—are not subject to probate fees. Dual or multiple wills may avoid probate and thus probate fees for shares and debt of a private company. The shares may be transferred by the directors without a probated will and either the shares or the debt (and maybe assets such as an art collection) may be passed under a secondary will that is not probated. Both that and the primary probated will must be properly drafted and executed; the secondary will must be executed later and cannot revoke the primary will.

■ **Wills.** A will simplifies the administration of the estate and ensures that all property is distributed according to the testator's wishes. A number of tax-planning advantages can be achieved with a will, such as the deferring of gains via a spousal trust and the deeming of charitable donations to have been made in the year of death. Each testamentary trust may facilitate income splitting via a separate tax year-end and graduated tax rates. A single-purpose will in a foreign country where real estate is held may avoid the complexity of translating and certifying a Canadian will to transfer it.

If the parent has performed an estate freeze of an investment company with substantial refundable dividend tax on hand from investment income, a trust coupled with an increase in paid-up capital of the preference shares or their redemption over time generates a corporate tax refund and reduces or eliminates tax on death. The post mortem sale of a holdco's assets may give rise to tax even though tax was paid on the gain on the shares at the shareholders' death: the will should instruct the executors to wind up the holdco within the estate's first taxation year, triggering tax in the holdco on the distribution but allowing a carryback of a capital loss on the shares' redemption. The estate is taxable on any resulting taxable dividend (in Ontario, at 31 percent). If the estate transfers the shares deemed disposed at death to a newco for a promissory note equal to their FMV on death and one common share, the newco can wind up the holdco and increase the tax cost of non-depreciable capital property (the capital gain on death suffers a net Ontario rate of 23.2 percent).

■ **US assets.** A Canco may hold US securities to avoid US estate tax. Special planning for a US personal residence may include multiple family co-tenants or a Canadian limited partnership. If a spouse is terminally ill, an estate's entitlement to the unified and marital credits under the Canada-US treaty may be enhanced if all Canadian assets are transferred inter vivos to the spouse; treaty relief is reduced if the estate owns non-US assets.

■ **US persons.** Parents with a US-citizen or US-resident child should plan to minimize tax consequences and complexity. For example, a parents' Canadian holdco may be converted to a Nova Scotia unlimited liability company without current Canadian tax. This will deflect the subsequent application to the child of the US subpart F, foreign personal holding company, and passive foreign investment company rules. If one or both parents are US citizens, estate planning is more complex. A non-US citizen should not leave assets outright to a US-citizen spouse, whose death will attract US estate tax, but rather should provide the spouse under the will with a life interest, remainder to the children. Life insurance on a US citizen held in a trust avoids US estate tax.

■ **Donation of marketable securities.** Rather than gifting, say, 50 percent of a holdco's shares to charity and the remainder to children, an individual may gift half of the underlying marketable securities to charity and the holdco shares to the children. Assume that Holdco owns $1 million in marketable securities listed on the TSE; both the shares and the underlying marketable securities have a nominal tax cost. Holdco is wound up. If the charity receives Holdco shares, the estate has net proceeds in Ontario of, say, $385,000 and the charity $446,000. Under the other alternative, each nets $500,000.

Jack Bernstein
Aird & Berlis LLP, Toronto

DIVIDEND DILEMMA?

The new Ontario government's May 18, 2004 budget—the last of the 2004 provincial budgets—included a significant personal tax increase (the Ontario health premium) and increases in a variety of fees and excise taxes and in spending. Previous general corporate (CIT) and manufacturing and processing (M & P) tax rate increases are now effective. For 2003 and later years, the small business rate is frozen at 5.5 percent. (See "Ontario Higher Tax Recipe," *Canadian Tax Highlights*, January 2004.) However, 2004 will see lower taxes in other provinces. Crediting small business as integral to job creation, provincial governments of various political stripes lowered the CCPC 2004 tax burden on active business income (ABI). Alberta, Saskatchewan, and New Brunswick have lower small business rates, and New Brunswick has the lowest in Canada—2.5 percent—after June 2004. Small business rate 2004 income thresholds also increased in all jurisdictions except British Columbia, Saskatchewan, and Quebec. After 2003, Manitoba's CIT and M & P rates fell from 16.0 to 15.5 percent; after March 2004, Alberta's CIT and M & P rates fell from 12.5 to 11.5 percent. Quebec's 1.6 percent youth-fund surtax expired on March 15, 2003, resulting in a marginally lower CIT on a year-over basis. Future corporate tax rate reductions are planned or proposed in all three prairie provinces and Yukon, although after 2003 the Northwest Territories increased its CIT and M & P rates from 12 to 14 percent.

Excluding the indexing of brackets and non-refundable tax credits, only Nova Scotia and the Northwest Territories made changes to personal income tax rates that affected the top 2004 marginal rates on ordinary income and interest, up from 47.34 percent for 2003 to 48.25 percent thereafter in Nova Scotia, and from 42.05 to 42.55 percent in the Northwest Territories.

The results of the recent federal election have created much uncertainty about the overall fiscal direction of the federal government, which delivered a variety of personal and corporate tax relief between 2000 and 2004. The new Liberal minority, supported by the NDP, may commit to major spending initiatives. Nevertheless, after 2003 the general federal CIT rate on ABI decreased to 21 percent (it is now equal to the federal M & P rate.) The 4 percent federal surtax and the 16 percent federal small business deduction were not changed, but after 2003 the maximum small business limit increased from $225,000 to $250,000, and is further scheduled to increase to $300,000 after 2004. A separate but complementary rate reduction effective for 2001 through 2004 (the CCPC rate reduction) reduced CCPCs' ABI CIT rate on taxable income between the federal small business limit and $300,000 to 22.12 percent, the rate that currently applies to taxable income subject to the general federal CIT rate or the federal M & P rate. The CCPC rate reduction is eliminated for the 2005 and subsequent taxation years. The CCPC rate reduction, combined with assorted provincial changes to small business tax rates, business limits, and clawback thresholds (in Ontario only), significantly increased the complexity of determining the appropriate corporate taxable income after reasonable bonuses are paid to active owner-managers. A significant tax deferral generally exists for corporately taxed income between $250,000 and $300,000 (or higher, depending on the provincial small business limit); but at current top marginal tax rates, a tax cost exists if such income is distributed to the owner-manager as taxable dividends.

Effective after 2003 and for future taxation years, a preferential M & P tax rate is no longer available federally and is available provincially only in Ontario, Saskatchewan, Newfoundland and Labrador, Prince Edward Island, and Yukon.

Tax on Distribution of $10,000 of ABI
Year Ending December 31, 2004

	BC	Alberta	Quebec
		dollars	
ABI eligible for federal and provincial SBDs			
Dividends			
Corporate tax	1,762	1,637	2,202
Individual tax	2,602	2,014	2,559
	4,364	3,651	4,761
Salary			
Individual tax	4,370	3,900	4,624
Provincial health levy	0	0	409
	4,370	3,900	5,033
Tax savings	6	249	272
Tax deferral	2,608	2,263	2,831
ABI: no SBD, no MPD			
Dividends			
Corporate tax	3,562	3,387	3,102
Individual tax	2,033	1,593	2,264
	5,595	4,980	5,366
Salary			
Individual tax	4,370	3,900	4,624
Provincial health levy	0	0	409
	4,370	3,900	5,033
Tax cost of dividend	1,225	1,080	333
Tax deferral	808	513	1,931

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. The provincial health levy represents the employer portion of any applicable provincial health levy. For Ontario figures, see "Ontario Higher Tax Recipe," *Canadian Tax Highlights*, January 2004.

As in prior years, strictly on rates, in 2004 owner-managers benefit from a significant tax deferral and some tax savings on dividends paid in lieu of salary from underlying corporate ABI eligible for the federal and provincial small business deductions (SBDs). Other ABI enjoys a tax deferral in all jurisdictions. Generally, a significant tax cost attaches to the distribution of corporately taxed income as a taxable dividend that varies by jurisdiction; that cost may be outweighed by the deferral benefit if the distribution is deferred sufficiently, depending upon 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, under the current dividend gross-up and tax credit regime, tax costs arise when the combined federal and provincial net corporate tax rate exceeds 20 percent—for example, if federal and provincial SBDs do not apply. However, alternatives to a distribution of corporately taxed ABI may include the distribution of ABI retained earnings as a corporately taxed capital gain. Because 50 percent of capital gains are taxed, the effective integrated tax rate on a corporately taxed capital gain is substantially lower than the top rate on Canadian dividends received by individuals. Thus, tax savings can be realized if distributions to the owner-manager combine efficient taxable dividends (amounts just sufficient to generate a full dividend refund for the payer) and capital dividends for the excess.

Numerous other factors should be considered. Only salary triggers CPP and RRSP contribution eligibility. Child-care expenses are deductible only against earned income. Payroll withholdings and remittances and corporate and individual instalments affect cash flow. Retention of corporate earnings may affect provincial and federal capital tax liabilities and, in Ontario, the SBD clawback. At the corporate level, an owner-manager should heed creditor proofing, qualified small business corporation status, eligibility for the capital gains deferral for eligible small business corporation shares, investment tax credit (ITC) availability, payroll tax exemption thresholds, workers' compensation premiums, provincial tax holidays, bank covenants and income levels for SR & ED ITCs, and charitable donations. At the individual level, shareholders (including beneficiaries of discretionary family trusts) should consider their respective cumulative net investment loss balances, old age security and other income clawbacks, charitable donation income levels, alternative minimum tax, income thresholds for provincial health premiums, the residence of other shareholders, and the application of the split tax to minor beneficiaries of a discretionary family trust.

Louis J. Provenzano and Donald E. Carson
PricewaterhouseCoopers LLP, Toronto

Canco's US Compliance Issues

Recently implemented IRS rules have compliance ramifications for Canadian companies that do business in the United States.

■ The rules requiring a taxpayer to have a taxpayer identification number (TIN) were tightened. A Canco whose US customer asks it to supply a TIN may simply say that it does not have one and hope that the customer will not press the issue, but such a reply might be viewed with suspicion and could result in damage to the business relationship. However, if Canco does apply for a TIN, it places itself on the IRS's radar with respect to tax filings. Alternatively, Canco may view the TIN requirement as the impetus to incorporate a US sub or affiliate to transact its US business activities.

Transacting US business through a USco eiminates the need for Canco to file a US tax return, which it is required to do even if the Canco is treaty-exempt from US taxation,

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as discussed below. A separate US sub may also help isolate the US activities from the Canadian with more precision by requiring two sets of books and records. It may also help with immigration issues, because a US affiliated corporation often allows access to a broader range of visas for Canadian employees who want to work in the United States. A separate sub may allow for less disclosure and even for a better tax result in the states in which the business is operated, and it may provide greater liability protection for the business operations. From the US customers' viewpoint, a separate US company that enters into contracts in the United States may appeal to post-9/11 patriotism.

■ The IRS's increased emphasis on compliance issues may have been the result of (as recently disclosed by an IRS official) the agency's intention to more closely examine the form 8833 ("Treaty-Based Return Position Disclosure") for foreign corporations that take treaty-based positions, with a view to highlighting permanent establishment (PE) and withholding tax issues. Form 8833 must be filed by a non-US corporation engaged in business activity if it claims an exemption from US taxation on the grounds that it has no US PE, typically because it has no US office or other physical presence. If the IRS successfully determines that there is a PE and the relevant return is then filed, the Canco may lose the ability to claim deductions—because the return was filed late—and thus may be subject to US tax on its gross revenues. One common matter of concern is whether a person who works in the United States solely for the Canco constitutes a PE of the Canco merely by working out of his or her home. As more businesses begin to use employees who work out of their homes, this issue is likely to eventually come to the IRS's attention; but the IRS has not yet issued any authority on the topic.

A Canco engaged in a US business will be confronted with increasing challenges from US tax authorities as computer systems improve, recordkeeping requirements become more detailed, and US customers become more aware of additional compliance issues for non-US companies. A Canco that does business in the United States should seek counsel from its advisers on both sides of the border to ensure that it is operating in the most protective manner.

Carol A. Fitzsimmons
Hodgson Russ LLP, Buffalo

Foreign Tax News

Republic of Korea

The National Tax Service says that its tax audits are designed to encourage compliance and that they apply to both domestic and foreign corporations. The needs of foreign corporations are catered to in order to improve the investment environment. The audits of "relatively honest" corporations will be conducted in the tax office, and the time for field audits will be minimized. Absent a clear indication of tax evasion, corporations audited within the previous two years are exempt from further audit, the number of documents they must submit will be minimized, and transfer-pricing audits will be bundled into routine corporate audits.

Carol Mohammed
Canadian Tax Foundation, Toronto

Sale-of-Business Planning

The following clarifies the CRA's position on the application of GAAR to the facts in document no. 2003-0029955, which dealt with the extraction of corporate surplus and a capital gains exemption. (See *Canadian Tax Highlights*, June 2004.) It was impossible to take a definitive position in the given situation, since the potential application of subsection 245(2) requires a review of all the surrounding facts and circumstances. However, as a general comment, the CRA confirmed that if (1) the selling shareholders and the purchaser are dealing at arm's length, (2) the selling shareholders receive a cash amount from the purchaser's own funds in return for their Opco shares, and (3) Opco's assets continue to be used in an active business by Opco or by another entity within the purchaser's corporate group, then subsection 84(2) or 245(2) normally does not apply.

Stephane Prud'homme
Income Tax Rulings Directorate
Canada Revenue Agency, Ottawa