Course: Advanced Taxation
Date: Winter 2003
Professor: Fraser Milner Casgrain LLP
Textbook: Courseware 2003

Although great care has been taken to prepare these notes there may be errors and omissions. These notes are no substitute for attending lectures and scrutinizing the suggested and required readings. Enjoy.

Table of Contents

INTRODUCTION **1**

THE CANADA-U.S. INCOME TAX CONVENTION (1980) 2
Article II – Taxes Covered *2*
Article V & VII *2*
THE INCOME TAX ACT 2
Structure of the Act *3*
FINANCIAL STATEMENTS 4
I. Balance Sheet *5*
II. Income Statement *5*

RESIDENCE **6**

IN GENERAL 6
COMMON LAW – MANAGEMENT/CONTROL 7
DeBeers Consolidate Mines v. Howe (1906) HL *7*
Swedish Central Railway v. Thompson (1925) HL *7*
MNR v. Crossley Carpets (1968) Exch. Ct *7*
LEGISLATION 8
Deemed Residency – Section 250(4) *8*
R. v. Gurd's Products (1985) FCA *8*
Sudden Valley v. The Queen (1976) FCA *8*
Deemed Non-Residency *8*
CANADA/US TAX CONVENTION 9
Key Sections *9*
R. v. Crown Forest Industries (1995) SCC *9*
Dudney FCA *11*
SUMMARY 11

CONTROL **12**

I. DE JURE CONTROL – CONTROL IN LAW 12
Buckerfield v. MNR (1964) Exch. Ct. *12*
Losses and Control *12*
Imperial General Properties (1985) SCC *12*
Dworkin Furs (1967) SCC *13*
Duha Printers *13*
II. DE FACTO – CONTROL IN FACT 14
CCPC – THE CANADIAN CONTROLLED PRIVATE CORPORATION 15
CCPC Sources of Income *15*
Silicon Graphics v. The Queen (2002) FCA *15*
SMALL BUSINESS DEDUCTION 16
I. Active Business Income *16*
533702 ON Ltd. (1991) TCC *17*
Crestglen (1993) TCC *18*
SPECIFIED PARTNERSHIP INCOME 18
A is the lesser of (a) and (b) *18*
B is the lesser of (a) and (b) *18*

CORPORATE TAX **19**

BUSINESS VEHICLES 19
I. Sole Proprietorship *19*
II. Partnership *19*
III. Corporations *19*
THE CORPORATE VEHICLE 20
I. Public Corporation – 89(1) *20*

© Francesco Gucciardo 2003

II. Private Corporation – 89(1)(f) ... *21*
III. Neither Public Nor Private ... *21*
FEDERAL AND PROVINCIAL TAX RATES AND SYSTEMS ... 21
Basic Federal Rate – Subsection 123(1) ... *21*
Provincial Abatement ... *21*
Corporation Surtax ... *21*
Provincial Taxes ... *22*
Capital Taxes ... *22*
TAXATION OF DIVIDENDS & INTEGRATION ... 22
The Theory of Integration ... *22*

DIVIDENDS & TAX POLICY ... 24

THE DOUBLE-TAX PROBLEM ... 24
THE CANADIAN CONTEXT ... 24
Taxation of Dividends (Dividend Gross up and Tax Credit) ... *24*
INVESTMENT INCOME ... 25
REFUNDABLE DIVIDEND TAX ON HAND ... 25
Tax Rates ... *26*
DIVIDENDS ... 26
CAPITAL GAINS ... 26
Non-Taxable Capital Gains ... *27*
Payment of Capital Dividends – 83(2) ... *27*
QUALIFYING SMALL BUSINESS CORPORATION ... 27

SHARES, P.U.C, & A.C.B. ... 29

CORPORATE LAW – STATED CAPITAL ACCOUNTS ... 29
BASIC ACCOUNTING CONCEPTS ... 29
PAID-UP CAPITAL – PUC ... 29
Exceptions ... *30*
Adjusted Cost Base ... *30*

PRIVATE CORPORATIONS ... 32

INCORPORATION ... 32
CONTINUANCE ... 32
Corporate Residence ... *32*
AMALGAMATION ... 33
WINDING UP ... 34
NON-CORPORATE ENTITIES ... 35
Limited Liability Partnerships ... *35*
Limited Partnership ... *35*
Nova Scotia Unlimited Liability Company ... *35*

OVERVIEW OF TAX DEFERRAL PROVISIONS ... 37

Subsection 85(1) ... *37*
Section 85.1 ... *37*
Section 86 ... *37*
Section 51 & 51.1 ... *37*
Amalgamations & Wind-Ups ... *37*

SECTION 85 – TRANSFER OF PROPERTY TO CORPORATION ... 38

WHAT IT IS ... 38
HOW IT WORKS ... 38
REQUIREMENTS ... 38
I. The Transferor – Taxpayer ... *39*
II. The Transferee – Taxable Canadian Corporation ... *39*

© Francesco Gucciardo 2003

III. Types of Property – Eligible Property 39
IV. Types of Consideration – Any plus One Share 39
V. The Election – 85(6) 39
Dale v. The Queen (1993) Tax Court 40
Dale v. The Queen (1997) FCA 40
Juliar et Al v. AG of Canada (2000) ON CA 40
Barnabe Estate v. The Queen (1999) FCA 41
The Agreed Amount 41
ALLOCATION OF AGREED/ELECTED AMOUNT 42
Hypothetical One 42
Hypothetical Two 42
PAID-UP CAPITAL 43
Hypothetical 43
Other Non-Income Tax Issues 43
SUFFICIENCY OF CONSIDERATION 43
Provincial Taxation Issues 44
TAX PLANNING WITH SECTION 85 44
I. The Estate Freeze 44
II. Loss Trading Among a Related Group 45
III. Crystallization Transactions 45
Policy Considerations 45

SECTION 85.1 – SHARE FOR SHARE EXCHANGES 46

IN GENERAL 46
REQUIREMENTS 46
Limitations 46
Opting Out 47

SECTION 86 – INTERNAL REORGANIZATIONS 49

REQUIREMENTS 49
Dunston - CA 49
CONSEQUENCES OF SECTION 86 50
Examples 50
Impact on the Corporation 50
SECTION 86(2.1) – PAID-UP CAPITAL 50
Example 51
Section 86(2) 51

SECTION 51 & 51.1– CONVERTIBLE PROPERTY/DEBT 52

SECTION 51 REQUIREMENTS 52
GE Capital Case 52
Section 51(3) – PUC 53
Section 51(2) – Indirect Gift 53
SECTION 51.1 – REQUIREMENTS 53

AMALGAMATION 54

TYPES OF AMALGAMATION 54
Long Form 54
Horizontal/Vertical Short-Form 54
Triangular Amalgamation 54
SECTION 87 – AMALGAMATIONS 54
Exceptions to No-Boot Rule 55
Timing Issues and Year Ends 55
Tax Accounts 56
TAX CONSIDERATIONS FOR SHAREHOLDERS 56

© Francesco Gucciardo 2003

Paid-Up Capital ... *56*
USES FOR AMALGAMATIONS ... 57

WINDING UP ... 58

Qualifying – 88(1) ... *58*
CONSEQUENCES TO PARENT COMPANY ON A WINDING UP ... 59
Consequences to the Shareholder ... *59*
Cost Amount to Corporation ... *59*
Calculating the Bump ... *61*
LOSSES ON A WINDING UP ... 61
Case Study – Winding Ups in a Corporate Transaction – Onex and Labatt ... *61*
SUMMARY ... 62
Non-Income Tax Issues ... *63*

CANADIAN RESIDENCY & TREATIES ... 64

TAXING GENERALLY UNDER PART I ... 64
Section 114 – Individuals Resident in Canada for Only Part of the Year ... *64*
Changing Residence ... *65*
DETERMINING RESIDENCE ... 65
Thomson v. MNR (1945) Exch. Ct ... *65*
MacDonald v. MNR (1968) Tax Appeal Board ... *66*
Meldrum v. MNR (1950) Tax Appeal Bd. ... *66*
Ronald Kirby v. MNR (1972) Tax Review Board ... *66*
Neil Barry McFayden v. The Queen (2000) Tax Court of Canada ... *66*
Moreau v. CCRA (2000) SCJ ... *67*
Dixon v. The Queen (2001) FCA ... *67*
CORPORATE RESIDENCE ... 67
DeBeers Consolidated (1906) HL ... *67*
Sifneos v. MNR (1968) Tax Appeal Bd ... *67*
Crossley Carpets v. MNR (1968) Exch. Ct ... *68*
R. v. Gurd's Products (1985) FCA ... *68*
Subsection 250(1) – Deemed Residence ... *68*
Section 253 – Extended Meaning of Carrying on Business in Canada ... *69*
Sudden Valley v. The Queen (1976) FCA ... *69*
Section 250(5.1) – Continued Corporations ... *69*
Section 250(5) – Deemed Non-Resident by Treaty ... *69*
TREATY RESIDENCE ... 70
R. v. Crown Forest Industries (1995) SCC ... *70*
SPECIAL ENTITIES ... 71
TREATY PURPOSES ... 72
I. Avoidance of Double Taxation ... *72*
II. Fiscal Evasion ... *72*
Important Treaty Provisions – Canada/US ... *73*
Canadian Interpretation of Tax Treaties ... *74*
Income Tax Convention Interpretation Act ... *74*

CARRYING ON A BUSINESS & DISPOSING OF PROPERTY IN CANADA ... 75

"CARRYING ON A BUSINESS IN CANADA" ... 75
Tera Exploration (1972) SCC ... *75*
CANADA/US TREATY – ARTICLE VII ... 76
Business Profits of a Resident of a Contracting State ... *76*
Distinct and Separate Person ... *76*
Computation of Business Profits ... *76*
ARTICLE V – PERMANENT ESTABLISHMENT ... 77
Paragraph 5 – Dependent Agent ... *77*

© Francesco Gucciardo 2003

Paragraph 7 – Independent Agents *77*
Analysis of Permanent Establishment *77*
Dudney (19..) FCA *78*
BRANCH TAX – PART XIV 79
Computing Tax *79*
Exemptions *79*
Hypothetical – Branch Taxes and Section 219 ..... *80*
Collection and Enforcement *80*
Ogden (19...) FCTD *80*
Section 150 ..... *80*
DISPOSITIONS OF TAXABLE CANADIAN PROPERTY 81
Taxable Canadian Property *81*
Section 116 ..... *81*
Article XIII – Canada/US Tax Treaty – Gains *82*
Summary *82*

PART XIII TAX – NON-RESIDENTS AND WITHHOLDING 83

PART XIII IN GENERAL 83
I. INTEREST – SECTION 212(1)(B) 83
I. Exempt Payors *83*
II. Exempt Recipients – 212(1)(b)(iv) *85*
III. Exempt Debt *85*
Canadian General Electric v. The Queen (2000) FCTD *86*
General Electric v. The Queen (2002) FCA *86*
II. DIVIDENDS – SECTION 212(2) 86
Thin Capitalization Rules *87*
III. RENTS AND ROYALTIES – 212(1)(D) 87

IMPACT OF COMMON "DEEMING" PROVISIONS 88

'DEEMED' INTEREST 88
R. v. Melford (1982) SCC *88*
Fleischman *88*
'DEEMED' DIVIDENDS 88
Sections 84.1 and 212.1 – Anti-Dividend Stripping *89*
'DEEMED' RESIDENT 89
INTERACTION BETWEEN PART I AND PART XIII 89
Section 215 ..... *89*
Stan Makita *90*

© Francesco Gucciardo 2003

Introduction

Income Tax Conventions Interpretation Act

This Act deals with definitional points and implications to Canada as a signatory to International Conventions.

Interpretation Act

As a federal piece of legislation, the *Interpretation Act* applies to the *Income Tax Act*. The *Act* deals generally with general information such as the interpretation of timing issues.

International Tax Conventions

Canada has approximately 80 Tax Conventions with different countries. A Tax Convention allocates what governmental authority has the power to tax a certain income. There are two basic concepts of how you tax:

1. Source; and,
2. Residency

For instance, if a Canadian resident earns income in the United States we have a conflict. A Canadian is supposed to be taxed on his/her worldwide income, but the money is earned in the U.S.

Tax Conventions are based on one of two models:

1. *OECD Model* – published with commentaries, which have become important enough that the SCC recognizes them as important extrinsic aides to interpretation vis-à-vis a particular convention.
2. *United Nations Model*

Each country generally follows one of the models – Canada generally follows the OECD model. The UN model comes into play in the context that Canada has a treaty with a developing country. Tax Conventions are amended by *protocols*. For instance, the Canada/U.S. convention ratified in 1982 has been amended by 3 protocols with a fourth being drafted.

In order for a treaty to be effective and incorporated into Canadian law it must be ratified. The Canadian government effects the convention as follows:

1. Enter into an agreement; and,
2. Enact legislation that implements the Convention into the law – to the extent that there is any inconsistency with domestic law and the convention, the convention will prevail

A Convention does two things:

1. Relieves Taxes
2. Tracks Taxes

A tax treaty cannot impose tax it only relieves tax. Without a tax convention, if you do not apportion between residency and source you would find a double tax. For instance, without a Convention between Canada and the U.S. the Canadian resident earning in the U.S. would be double-taxed. The Convention will apportion the tax burden.

© Francesco Gucciardo 2003

As businesses become international and global it also becomes more difficult for regulators to track what is happening. As such, the Conventions will generally include exchange of information provisions, which helps governments track what corporations and people are doing in other corporations.

The Canada-U.S. Income Tax Convention (1980)

Any cross-border earning must be examined in light of the *Convention* and, where applicable, the tax burdens apportioned. The Convention is divided into Articles.

Article II – Taxes Covered

This is one of the first places to look to see what taxes are covered by the agreement. Absent some explicit inclusion in an *Act*, because the 'Contracting State' is the federal government then you are not doing with provincial taxation, state taxation, and city taxation – we are only covering the federal components. However, Alberta states in its legislation that it adopts the tax conventions to which Canada has signed.

Unless a government adopts the Convention explicitly in its legislation it will be of no effect in that jurisdiction

Article V & VII

These articles deal with who can tax business income. For instance, Article VII paragraph one provides that you are only liable insofar as you have established a permanent establishment in the other jurisdiction while Article V provides a definition of 'permanent establishment'.

Article XXVII – Exchange of Information

Article XXIX – Limitation on Benefit

Page 2741 – Technical Explanation of the Convention

The U.S. treasury publishes this document – it is the American statement of what the Convention says and what it stands for. This document is not law, but instead just an interpretation/statement of the law. However, for the purposes of this course it may be treated as a helpful explanation of what the *Convention* does say.

When a protocol is introduced there is also another protocol explanation.

The Income Tax Act

Prescribed – look to the regulations. Thus, any 'prescribed' rate is set by the regulations.

Withholding Rate – a payment of a dividend, under 212(1) of the *ITA*, is charged a withholding rate. If a person is paid a dividend and is within a jurisdiction with a Convention, the withholding rate is reduced as per the Tax Agreements.

© Francesco Gucciardo 2003

Definitions – Section 248(1)

The definitions in these sections apply throughout the *Act*. Other definitions do not apply throughout – for instance section 89(1).

Structure of the Act

Part I – sections 1 – 181

Each Part has its own charging section – a section that actually imposes the Tax. For instance, under Part I, section 2:

> An income tax shall be paid, as required by this Act, on the taxable income, for each taxation year of every person resident in Canada at any time in the year

There are a number of defined terms here – 'taxable income', 'taxation year', 'person', 'resident',

There are three sources of establishing residency:
1. Common Law – where central management and control of the corporation is;
2. *ITA* 250(4) – you are resident in Canada if you carry on business within certain parameters in Canada; or,
3. *ITA* 253 – extends the meaning of 'carrying on business'

This is all subject to a potentially applicable *Convention*.

Taxation Year

For a corporation the taxation year is a fiscal year, which is deemed to end 365 years from the beginning of the fiscal year. Individuals function on calendar years – this is the major difference.

This is the 'charging section' for residents of Canada. Note also 2(3) – tax payable by non-resident persons: this is the part of the *Act* that imposes a tax on a non-resident person. Non-resident persons who are employed in Canada, carry on a business in Canada, or dispose of taxable Canadian property, will be taxed on the earnings there from. However, always remember the provisions of the Tax Convention, as the provisions of the Convention will be paramount in the event of some conflict.

"Related Sections" – these notes help you find something related to the concepts mentioned in each section.

Division A – Liability for Tax
Division B – Computing Taxes
  Subdivision A – Income or Loss from an Office or Employment
  Subdivision B – Income or Loss from a Business or Property

Section 9 – Main provision that deals with business and property income
Section 12 – Sets out specifically certain inclusions that you would include in income
Section 18 – Sets out certain deductions that you can take

If a corporation purchases a capital asset used in business, they get to depreciate that, but from a tax perspective you can claims a capital cost allowance against that. When you look at section 18(1)(b) you will see that you cannot take a deduction for capital cost except as allowed by the *Income Tax Act*. The

© Francesco Gucciardo 2003

entire regime for capital cost allowance is in the regulations – but 18(1)(b) would seem to indicate that you would not get that deduction.

Section 20(1) – Deals with certain deductions that you get to take

Subdivision C – Calculating Captial Gains and Losses
Subdivision D – Other Sources of Income
Subdivision E – Deductions in Computing Time
Subdivision H – Corporations Resident in Canada and Their Shareholders

Division D - Taxable Income Earned in Canada by Non-Residents

Section 115 & Section 116 – Taxable Income and disposition of property

Part I.3 – Tax On Large Corporations

Part XIII – Tax On Income From Canada of Non-Resident Persons

If a Canadian corporation pays dividends to a non-resident in the U.S. there is a withholding tax of 25% under the *Act* subject to the provisions of an applicable treaty. One who does not withhold the 25% is personally liable for that 25% - section 215(6).

Section 212(1) provides:

> Every non-resident person shall pay an income tax of 25% on every amount that a person resident in Canada pays or credits, or is deemed by Part I to pay or credit, to the non-resident person as, on account or in lieu of payment of, or in satisfaction of …

You have to read this section closely as 212(1)(b) provides a myriad of exceptions on interest. Also, if you are dealing with a treaty country you have to look to the treaty to see whether or not the withholding rate has been reduced.

Part XIII is a straight tax – it is an actual payment of tax, which is not like the Part I tax. Since it is a payment made to a non-resident it is a flat-tax in effect that is made subject to certain adjustments and exceptions. These taxes are paid on the gross amount without any deductions.

Under 212(1)(d) rent is subject to a withholding tax technically because rent is being paid to a non-resident.

Section 216 – Alternatives re rents and timber royalties –This provision allows the election to pay a Part I tax on a net amount.

This course will focus mostly on Parts I and XIII of the *Act* along with the Canada-U.S. Treaty.

Financial Statements

When you are looking at financials you look at them to decipher the economic effects of transactions and corporate performance. The financials also provide a basis for accountability between management and shareholders. For investors, they provide a means for providing potential investors with information. The two main financial statements are:

1. The Balance Sheet – statement of assets, liabilities, and equity at a particular point in time; and,

© Francesco Gucciardo 2003

2. The Income Statement – statement of revenue and expenses for a period of time.

I. Balance Sheet

The balance statement is a snapshot of the corporation at a particular point in time. There is a certain relationship between assets and liabilities. The fundamental calculation is that assets = liabilities + shareholder's equity. Assets – Liabilities = Shareholder's equity and Liabilities = Assets - Shareholder's Equity.

Under shareholder's equity you will usually have a section of stated capital or contributed capital (the amount of money paid by shareholders to purchase shares). The OBCA requires that these amounts are provided in the balance sheet. The stated capital is the starting point for PUC (Paid-up capital). Paid-up capital is a good thing – the amount of money that comes back to a shareholder on a tax-free basis.

II. Income Statement

The income statement is for an entire calendar year.

Revenue/Sales	$X
Expenses	$Y
Net Income (before tax)	Revenue less Expenses (Z)
Tax Paid	$T
Net Income	Z less T

Both sheets are prepared in accordance with GAAP. There has been reluctance by courts to look to GAAP for tax purposes.

Section 9 of the *ITA* deals with the calculation of taxes for the purposes of the person. Section 9 provides:

> Income — **9.** (1) Subject to this Part, a taxpayer's income for a taxation year from a business or property is the taxpayer's profit from that business or property for the year.
>
> Loss — (2) Subject to section 31, a taxpayer's loss for a taxation year from a business or property is the amount of the taxpayer's loss, if any, for the taxation year from that source computed by applying the provisions of this Act respecting computation of income from that source with such modifications as the circumstances require.
>
> Gains and losses not included — (3) In this Act, "income from a property" does not include any capital gain from the disposition of that property and "loss from a property" does not include any capital loss from the disposition of that property.

The courts have said that profits are calculated based on generally accepted commercial principles. Thus, when a corporation files a tax return, the income statement is the starting point for the calculation of taxable income. However, it must make certain adjustments to reflect what the *ITA* says. For instance, section 12 of the *ITA* sets out certain inclusions as to what should be included in the return. Section 18, on the other hand, sets out certain deductions that are allowable for tax purposes. Section 18 provides in general that only those expenses incurred for the purposes of earning income can be deducted for the purpose of the return. Section 20 of the *ITA* sets out the permitted deductions that you can actually take. Thus, start with the financial statements, which are prepared in accordance with GAAP, and then make certain adjustments and deductions as required by the *ITA* for tax purposes.

© Francesco Gucciardo 2003

Residence

In General

Subsection 2(1) is the general charging section for taxation. Subsection 2(1) provides:

Tax payable by persons resident in Canada

2. (1) An income tax shall be paid, as required by this Act, on the taxable income for each taxation year of every person resident in Canada at any time in the year.

Subsection 2(3) is the general charging provision for tax payable by a non-resident. Subsection 2(3) provides:

Tax payable by non-resident persons

(3) Where a person who is not taxable under subsection 2(1) for a taxation year

(*a*) was employed in Canada,

(*b*) carried on a business in Canada, or

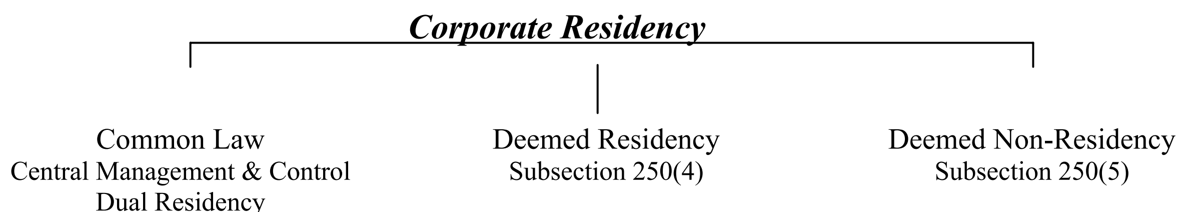
(*c*) disposed of a taxable Canadian property,

at any time in the year or a previous year, an income tax shall be paid, as required by this Act, on the person's taxable income earned in Canada for the year determined in accordance with Division D.

These subsections are subject to a determination in light of Part I Division D. This Division consists of sections 115 and 116 of the *ITA*. Section 115 deals with non-resident's taxable income in Canada and section 116 deals with the disposition by non-resident persons of certain property. One of the key terms in section 115 is 'taxable Canadian property', which is defined in section 248.

Section 116 sets out a regime that requires any non-resident who disposes of property in Canada to acquire a certificate of compliance (a 'section 116 certificate'). The certificate confirms to Revenue Canada that there is no tax owing on the disposition or that the non-resident has paid withholding taxes. The liability is on the purchaser to ensure that the taxes are remitted – without the certificate the purchaser is on the hook for a 25% withholding tax unless there is a treaty reducing or exempting the payment.

There are three ways to establish whether a corporation is resident in Canada.



© Francesco Gucciardo 2003

Common Law – Management/Control

DeBeers Consolidate Mines v. Howe (1906) HL

Facts	Holding	Ratio
o DeBeers incorporated in South Africa and carried out their business there o DeBeers did not carry out any business in the UK o The directors lived in the UK and carried out the business there	o Issue: Where was the corporation resident? o The corporation is resident in England o The court must look at where the corporation keeps house and does business, not simply place of incorporation	o The real residence is where the central management and control resides – this is a purely factual determination o A corporation is resident in the country where the central management and control actually resides.

A corporation is resident in the country where the central management and control actually resides. Thus, it does not matter where the shareholder's reside, you are always looking at the directors.

If you want to maintain non-residency in Canada ensure:

1. Meetings are held outside of Canada;
2. Bank accounts are held outside of Canada;
3. Main office is outside of Canada;
4. Any directors with signing and decision-making authority reside outside of Canada;
5. Business contracts are signed outside of Canada;
6. If you have several directors, make sure the majority are non-resident Canadians

Swedish Central Railway v. Thompson (1925) HL

Facts	Holding	Ratio
o Taxpayer company had central management and control in both the UK and Sweden o Company incorporated in the UK and the registered office was in London; cheques were signed in the UK; share transfers were done in the UK o Company actually built railroads in Sweden, declared dividends, and held meetings in Sweden	o Issue: Could a company whose business is carried on in Sweden be regarded as residing in the UK for income tax purposes? o A corporation can have more than one residence o The corporation was found to be resident in both the UK and Sweden	o A corporation can be resident in more than one country o Central management and control can be divided (corporation can keep house and do business in both jurisdictions)

MNR v. Crossley Carpets (1968) Exch. Ct

Facts	Holding	Ratio
o Tax years in question were 1961 and 1962 o An English corporation was registered in England, but carried on the whole of its business in Canada while the BOD met in England	o Issue: Whether the company was liable to pay income tax in Canada o Canada adopted all of the British tax principles o The corporation was resident in both jurisdictions o Court looked at place of exercise and paramount authority	o The court will look at the place of exercise and paramount authority, which can be divided between two or more countries

© Francesco Gucciardo 2003

Legislation

Deemed Residency – Section 250(4)

Subsection 250(4) of the *ITA* sets out deemed residency for a corporation. A corporation is resident throughout a taxation year if it was incorporated in Canada after April 26, 1965. The effect of this section is that once you are found to be resident in Canada under the common law rules are found to have been carrying on business in Canada after April 26, 1965 you will be forever resident in Canada. Note: This would make a good exam question.

R. v. Gurd's Products (1985) FCA

Facts	Holding
o A company was incorporated before April 26, 1965 o The central management and control of the company was located in the U.S. o Crush (the US company) wanted to sell its products to Iraq, but Iraq would not deal with the American company o The parent had a Canadian subsidiary incorporated in Canada o Crush products were distributed through the Canadian subsidiary to Iraq o Dividends were being paid to non-residents, which should be subject to a withholding tax	o Issue: Was the Canadian corporation carrying on business in Canada subsequent to April 26, 1965? o Section 212 of the ITA requires a Canadian payor to withhold 25% o The Canadian company was a Canadian resident o Substantial profits were earned through the sale of a product made in Canada; a bank account was held in Canada; an official agent was situated in Canada; and, the nature of the operations required the carrying on of business in Canada

The term 'carrying on business' is a defined term in the *ITA*. Section 253 provides an extended definition of the meaning of 'carrying on business'. For the purposes of the *ITA* where, in a taxation year, a person who is a non-resident person to which Part XII.2 applies, who 'offers for sale' is deemed to have been carrying on business in Canada.

Sudden Valley v. The Queen (1976) FCA

Facts	Holding	Ratio
o A U.S. corporation was interested in selling land in Sudden Valley Washington o U.S. solicited to Canadian buyers – provided advertisement to induce Canadians to visit o Some Canadian purchased the properties upon their visit – the entire contract was negotiated and executed in the U.S.	o Issue: Where was Sudden Valley carrying on business? o Sudden Valley was not carrying on business in Canada o The U.S. companies activities do not fall within the extended definition of carrying on business as defined in the ITA o Nothing was made for sale or offered in Canada	o An invitation to treat is not the solicitation of an order or offer for sale as per the extended definition of carrying on a business at section 253(b)

Deemed Non-Residency

Subsection 250(5) provides that if you are a corporation that is a non-resident of Canada by virtue of a tax-treaty you will be deemed to be a non-resident for the purposes of the *ITA*. This provision prevents the situation where a corporation would shift back and fourth depending on the tax treatments provided.

© Francesco Gucciardo 2003

Canada/US Tax Convention

The treaty overrides anything that is found within the *ITA*. Therefore, there may be a situation where a U.S. company does actually dispose of taxable Canadian property in Canada they could potentially be exempt from taxes in Canada because of the treaty.

R. v. Melford Developments (1982) SCC – Treaties are paramount to domestic law unless the domestic law is specifically drafted to override.

When looking at treaties consider that a treaty does not impose tax, but rather the purpose of a treaty is to avoid double-taxation and to prevent fiscal evasion. A treaty acts as a shield against double taxation. Most of Canada's treaties are based on the OECD model treaty. The Canada/US Convention:

Key Sections

Article I	Personal Scope – the treaty is applicable generally only to residents of either or both of the particular contracting states
Article II	Taxes Covered – all of the existing and future taxes to which the treaty will apply (Canada/US does not apply to GST except for specific articles)
Article III	General Definitions – terms that are used throughout the treaty
Article IV	Residence – sets out the criteria for determining the residence of individuals and the criteria for residence of corporations and trusts

Sometimes where you have a situation where someone can be resident in both Contracting States there are tiebreaker rules at paragraph three of Article IV. Where a corporation is resident in both contracting states it is deemed to be resident in the state that it was incorporated. Where a corporation is incorporated in one state and continued in another state in a cross-border situation it is deemed a resident in the State that it is continued.

When looking at residence under Article IV, most of the OECD treaties require a resident to be liable to tax in one of the contracting states.

LLC – Limited Liability Company – an entity incorporated in the US, but treated for tax purposes as a partnership. Essentially, a partnership is treated as a flow-through entity. The partnership is generally not taxed, but only the partners are taxed. The beauty of the LLC is that the partnership can be treated as a corporation for tax purposes.

The CCRA, however, does not regard an LLC as a resident for the purpose of the treaty. An LLC is not entitled to any of the residents under the LLC – not entitled to use the treaty as a shield to protect it from double taxation.

R. v. Crown Forest Industries (1995) SCC

Facts	Holding
o Crown Forest was a Canadian company that paid certain fees to a Bahamas corporation (Norsk) o The Bahamas Company carried on business in the US – involved in renting ships and barges o The Bahamas Company was incorporated in the Bahamas in 1962, but the only office and place of business was in the U.S.	o Issue: Was Norsk resident in the U.S. for the purposes of the Canada/US Convention? o If a resident, then the withholding tax would be 10%, if not a resident then 25% o Minister: the Bahamas company was not a resident of the U.S. and was not entitled to the benefit of the Treaty

© Francesco Gucciardo 2003

o The company only filed tax returns, on the basis of being a foreign corporation, in the U.S. – never filed in Canada or the Bahamas o The Bahamas corporation did not pay U.S. tax on the barge rental because it claimed an exemption under U.S. taxing statutes o Crown Forest was making rental payments to the Bahamas company o Section 212, under part XIII, requires a 25% withholding tax when a resident pays rents or royalties to a non-resident o Under the threat, Article XII(2) provides that a payment by a Canadian to a resident covered under the treaty for rent or royalty, the 25% rate is reduced to 10% o Crown Forest withheld 10% opposed to 25% and remitted it to CCRA taking the position that Norsk was a resident of a contracting state	o Norsk is not a resident of the U.S. o 'Liable to Tax' means liable on worldwide income o Norsk was taxable in the U.S. on a source basis o Source taxation is not one of the items from which tax liability flows in Article IV of the Treaty o Taxation at source is not a criteria similar to those enumerated in Article IV: domicile, residence, place of management, and place of incorporation results in world-wide tax liability o Crown Forest was required to pay 25% withholding instead of the 10% o When you are interpreting treaties the goal is to find the meaning of the words in issue. You need to try to determine the intentions of the drafters of the Convention because the intention of the drafters is important in considering the scope and application of the treaty.

Under Article IV, the term 'resident' means "any person that is liable to tax by reason of that persons:
1. Domicile;
2. Residence;
3. Place of Management;
4. Place of Incorporation; or,
5. Any other Criterion of a Similar Nature

The purpose of the treaty here is to avoid double tax and not to impose tax. In this case there is no need to prevent double-taxation because the Bahamas Company never paid any tax to begin with. If the Court allowed the Bahamas Company to fall under the residence article in the treaty, it would actually lead to the avoidance of taxation on the rental income – the Bahamas Company would not have been liable to tax in any jurisdiction. The U.S. Government argued that when trying to determine the goals of a tax treaty you should look at extrinsic evidence – in particular the OECD model. Practitioners have generally only looked at this case in the situation of a Canada/US issue.

The extended definition of 'carry on business' expands the common law definition. The Tax Treaty, however, requires that those activities must be conducted through a permanent establishment located in Canada before Canada can tax the non-resident under Part I of the *ITA*. Thus, a US company selling products to Canadians can constitute carrying on business under the extended definition. However, such activity can only be characterized as such if the company has a permanent establishment in Canada.

Article V	Permanent Establishment – a fixed place of business through which the business of a resident of a contracting state is wholly or partly carried on. Paragraph 2 lists what a permanent establishment may include: place of management, branch, office, factory etc., only if it lasts for more than 12 months
Article VII	Business Profits – Circumstances that income earned in cross-border business will be subject to tax in the state in which business in conducted – this is a source treatment

Business profits provided a shield preventing the resident of one contracting state to be taxed in the other unless the business is conducted through a permanent establishment. Tax liability will accrue if the income is effectively connected to the permanent establishment.

© Francesco Gucciardo 2003

Dudney FCA

Facts	Holding
○ Dudney was a non-resident and was retained by a Calgary Company to provide services ○ Dudney worked in Calgary for 300 days in 1994 and 40 days in 1995; retained to train personnel at the company's offices – he had no letterhead, business cards etc., ○ Dudney was given space at the offices to perform the contract, but was not permitted to do any other business ○ Access to the corporation after-hours was restricted and use of the phone was for business only ○ Dudney was assessed by the CCRA in respect of 1994 and 1995 on the basis that he had a 'fixed base'	○ Issue: Did Dudney have a fixed base in Canada? What is the meaning of the term 'fixed base'? ○ Court looked at whether Dudney had a fixed base regularly available to him ○ Court looked at the commentary on Article V of the Treaty and held that there must be an identifiable location with a degree of permanence through which the business of the enterprise is being carried on ○ Article V and Article XIV can be analogized – a particular location is a fixed base only if the actual business of that person are being carried on there ○ Dudney was restricted in terms of the business he could carry on in the space provided to him ○ **Ratio**: A particular location is a fixed base only if the actual business of that person is being carried on there

When a non-resident does business in Canada s/he is required to file a return, but then claim a treaty exemption. CCRA looked at the return and denied Dudney the Article XIV exemption. The question of *Dudney's* relevance is somewhat academic because in 2000 the OECD did away with Article XIII dealing with personal service. Some suggest that the next amendments to the Canada/US protocal will result in the elimination of Article XIV.

Summary

The relevant sections in this part are: 2(3); 250(4); 250(5); 253; 115; and 116. Any taxation charged under 2(3) shall be in accordance with Division D.

There is an extended meaning of carrying on business under section 253. Even a minimum degree of Canadian business activity could bring the non-resident corporation into the Canadian tax system. Note: Where a tax treaty conflicts with domestic law, the treaty will prevail. So long as there is no permanent establishment and the resident is eligible for benefits under the treaty, the treaty will prevail. We saw with *Crown Forest* that the idea of being subject to taxation for the purposes of the treaty is being liable to tax on a worldwide basis. This is the idea behind Article IV. *Crown Forest* is also relevant because the court endorsed the use of extrinsic evidence in interpreting a tax treaty, such as the OECD model. Article V deals with the concept of permanent establishment – a fixed place of business through which the business is wholly or partly carried on.

A corporation is resident where the central management and control abides (*De Beers)*. For the purposes of the *ITA* there are some deeming rules under subsection 250(4). Subsection 250(5) provides that if you are a non-resident for the purposes of a treaty, you will be deemed to be a non-resident for the purposes of the *ITA*.

If you are looking to the tax treaty and are still unsure of the provisions, the commentary and technical explanations are very helpful.

© Francesco Gucciardo 2003

Control

For *ITA* purposes, the term control is one of the most important terms. The concept is important because it will restrict certain tax benefits – it also recognizes that certain tax benefits belong to multiple taxpayers who are really one economic unit. In other words, take the small business deduction that is shared amongst related corporations. The concept of being related relates to the concept of control. If one corporation controls other corporations, the small business deduction can only be used once and amongst the entire group. The concept of control is also used to prevent tax-avoidance. Control affects:

1. The definition of private corporation – if you are 'controlled' by a public corporation, you cannot be a private corporation (this affects any favorable tax rates otherwise entitled to);
2. Canadian Controlled Private Corporation Status;
3. Capital gains exemption – certain corporations are entitled to the capital gains exemption; and,
4. The way stock options are taxed

The concept is prevalent throughout the *ITA* – it has a number of different meanings:

1. *De Jure*;
2. *De Fa*cto; and,
3. *Deemed*

I. De Jure Control – Control in Law

Buckerfield v. MNR (1964) Exch. Ct

Facts	Holding
o Not Done	o The word 'controlled' contemplates the right of control that rests in ownership of such a number of share as carries with it the right to a majority of the votes in the election of the BOD o Ownership of shares that carry the right to elect the membership of the BOD represents de jure

Consider corporation X Ltd where A has 51% of the common shares and B has 49% of the common shares. A will have *de jure* control. You can have *de jure* control indirectly. Consider corporation X Ltd. where A has 60% of the common shares of X Ltd. and X Ltd. owns 60% of the common shares of Z Ltd; A indirectly controls Z Ltd. If you find a section of the *ITA* that refers to control, you cannot rule out the fact that there can be indirect control even though the *ITA* does not say directly or indirectly.

Losses and Control

Section 111 deals with the utilization of losses and provides rules as to whether a corporation can carry forward or carry back certain losses. The concept of control in the context of losses is fairly interrelated because the *ITA* states that you cannot sell losses to another corporation so that the other corporation can use those losses. The policy reason is the prevention of companies from selling losses back fourth. However, subsection 111(5) provides that where there is an acquisition of control, losses can be carried forward to the acquiring company if the business that created the losses is carried on with a reasonable expectation of profit throughout the particular year – you must carry on the same or similar business.

Imperial General Properties (1985) SCC

Facts	Holding
o V Ltd. (the parent corporation) had 90% of the common shares and 50% of voting power	o V controlled imperial o SCC looked at more than just voting power – even though V Ltd did not own more than 50% of the shares, they still had control in the sense that

© Francesco Gucciardo 2003

o Imperial (the subsidiary) had only the power to sign resolutions	they were calling all the shots and had the right to terminate the corporate existence

Dworkin Furs (1967) SCC

Facts	Holding
o Not Done	o Control, for the purposes of the *ITA*, means de jure control

Subsequent cases have either expanded on the *Buckersfield* statement of extended it by looking at other information other than mere share ownership. *Note*: When working on a deal the first place the corporate clerk will look to in order to provide an overview of the corporation is the corporation's minute book.

Duha Printers

Facts	Holding
o Duha 1 wanted to acquire the shares of 'Outdoor' o Duha 1 amalgamates with Manitoba and incorporates Duha 2 on February 2, 1984 o The next day Duha 2 amends its articles to provide a new class of preferred shares – Class C preferred shares with voting rights o Marr's subscribes for 2000 Class C shares of Duha 2 o As a result, Marr's 2 controls Duha 2 o The shareholders enter into an agreement whereby Duha 2 would be managed by a BOD, which would be elected by the shareholders and composed of any three of the following: 1. Mr or Mrs Duha; 2. Mr Marrs 3. Mr. Q (friend of Duha and Marrs) o The USA provided that no shares could be transferred without a consent of the majority of directors o The shareholders were not allowed to sell the share, encumber or transfer them and new shares could only be issued with the unanimous consent of the shareholders o On February 9, 1984 Duha 2 buys Outdoor from Marrs Ltd. For $1 o Next day, Duha 2 and Outdoor amalgamate to form Duha 3 o Duha attempted to deduct the non-capital losses of Outdoor o MNR disallowed the losses claiming Marrs Ltd did not control Duha 2 before the amalgamation and also the entire transation was a sham transaction o In 1984, GAAR was not enacted o SCC: The losses were properly utilized	o When there is an acquisition of control, losses that the acquiring company can utilize of the target company are limited to the extent that the acquiring company must carry on the same or similar business as the target o **FCA** – Marrs Ltd. did not have de jure control of Duha 2 o *Issue*: Ought Duha 3 be entitled to deduct the non-capital losses? **1**. Did Marrs have de jure control of Duha 2 before the amalgamation? **i**. Are constating documents of a corporation the only documents to consider when determining *de jure* control? **ii**. Could a USA be looked at? If yes, did the USA in this case deprive Marrs of *de jure* control? o **Control**: It is well-settled that control of a corporation refers to *de jure* and not de facto – the general approach is to examine the share register and ascertain which shareholder, if any, has the ability to elect the majority of the BOD o It is proper to look beyond the share register when the constating documents provide for something unusual that would alter the control of the company – in determining *de jure* control, the court is not limited to a strict review of the share register o **USA**: Generally you do not look at the USA, but if there is some contractual or binding nature in the document it may be reviewed o The USA is considered to be a constating document because through it the shareholders could strip the directors of some or all of the powers entrusted to them in terms of managing the company o In this case, the USA did not result in a loss of control for Marrs – although there was a restriction on the ability of the BOD to issue new shares without shareholder consent, such a restriction was not so severe or fundamental that it could be said that Marrs lost the ability to exercise effective control

© Francesco Gucciardo 2003

In summary, we can draw five key principles from *Duha*:

1. For purposes of 111(5), dealing with the utilization of non-capital losses, the section contemplates *de jure* and not de facto control;
2. The general test for *de jure* comes from *Buckersfield*;
3. To determine the existence of such control look at a corporation's governing statute, the share register, and any specific or unique limitation on either the majority shareholder's power to control the election of the BOD or the Board's power to manage the business and affairs of the company – such a unique limitation would probably be in the constating documents or a USA;
4. Documents other than the share register, constating documents, and a USA are generally not considered to be useful in determining what control is. Thus, where *Buckersfield* emphasizes a look at the share register, *Duha* takes the principle one step forward to say that you could look at constating documents that provide for unique limitations; and,
5. If there exists any kind of limitation, the majority shareholder may still nevertheless possess *de jure* control unless there is something so fundamental in that document that would completely usurp the majority shareholder's power (something prohibiting him/her to exercise effective control). To the extent that the USA provides for something unusual, the majority controlling shareholder may still possess control.

II. De Facto – Control in Fact

Anywhere you see the term 'controlled directly or indirectly in any manner whatever' you are dealing with de facto control. Section 256(5.1) provides a definition of control in fact.

As a result of this provision, you can be deemed to be in control of a corporation even where you own less than 50% of the shares of a corporation. De facto control will be seen to exist where the controller has any direct or indirect influence that, if the controller had exercised it, would result in fact of control of the corporation.

In determining whether a person has the appropriate degree of influence is a question of fact. You would look at factors such as:

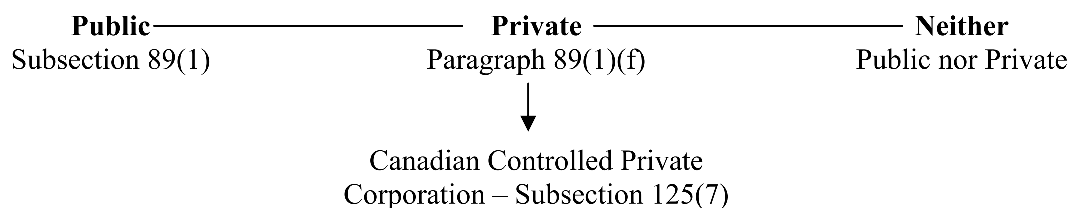
1. Control of the day-to-day operations;
2. Ability to direct BOD;
3. Whether you own a large debt of the corporation – there must be something more, such as an influence in a security agreement wither express or inferred;

There is also a concept of deemed control in the *ITA* under section 251(5). This section generally contemplates where you have a related group that is in a position to control the corporation. Although these people are not actually controlling, if they are in a position where they could, then they will be deemd to be in control. Section 251(5)(b), which deals with options and rights, if particularly interesting. Where a person has a right under a contract to acquire shares of a corporation or to cause a corporation to redeem, acquire or cancel shares, or to cause the reduction of voting rights, the effect is that the corporation is caused to be controlled by that particular person.

This is especially important in a CCPC context: if you have a non-resident looking to acquire a CCPC you run the risk of losing the CCPC status. A number of private companies attempt to, before a non-resident will acquire, is reorganize the company to avoid such a status loss. *There will be something on the exam on 251(5)(b).*

© Francesco Gucciardo 2003

CCPC – The Canadian Controlled Private Corporation



CCPC Sources of Income

The Canadian Controlled Private Corporation has two main sources of income:

1. Business Income – Active Business Income; and,
2. Investment Income – Refundable Dividend Tax on Hand (RDTOH – section 129), Part IV Tax, Capital Dividend Accounts

The definition of CCPC is found at subsection 125(7) of the *ITA*. This definition is a negative one – it tells us what a CCPC is not. You may still have non-residents who are shareholders as long as they do not control, indirectly or directly in any manner whatever.

Some of the benefits of the CCPC include:

1. Preferential tax treatment – special treatment in terms of investment income;
2. Entitlement to the $500,000 capital gains exemption; and,
3. Entitlement to the small business deduction

Silicon Graphics v. The Queen (2002) FCA

Facts	Holding
o The taxpayer in 1991 and 1992 had 305 shareholders, 233 of which were non-residents o Taxpayer tried to claim certain enhanced research and development benefits – credits provided to a corporation only available to the CCPC o A non-resident (Silicon Graphics) advanced $5 million to the Cdn. Company o The company was incorporated in 1985 – from 1985 until 1990 the company was not publicly traded and recognized as a CCPC o In July 1990, the taxpayer went public on the NASDAQ o MNR disallowed the credits claimed	o **Minister** – because more than 50% of the shareholders were non-resident, the taxpayer no longer met the statutory definition of CCPC and, therefore, was not entitled to the credits o **FCTD** – *de jure* control existed by reason of the fact that the majority of outstanding shares were held by non-residents. A common connection between non-resident shareholders is not a requirement for purposes of determining whether a corporation is a CCPC o **FCA** – *Issue*: Was the taxpayer subject to either *de jure* or *de facto* control by non-residents? No. It was not subject to either. o In order for a group of persons to be in a position to exercise *de jure* control, you need a common connection to exist between them o The non-residents did not exercise *de jure* control o In order for there to be de facto control, a person or group of persons must have a clear right or ability to affect a change in the BOD or powers of the BOD or to influence in a very direct way the shareholders who would have the ability to elect the BOD o Since there was no actual evidence at the trial level to show that the U.S. shareholders satisfied these criteria, there was no *de facto* control o *De Facto* control stayed in Canada at all times because the principle place of business was Toronto, BOD was resident in Canada, and the Toronto team was actually required to prepare a slate of people to be elected to the BOD

© Francesco Gucciardo 2003

There are three important points to take from *Silicon Graphics*:

1. A majority of shares held by non-residents who have no common connection with each other will not, in and of itself, constitute *de jure* control by non-resident. Be wary, however, because we have 251(5)(b);
2. In order for a group of shareholders to be in a position to exercise control, there must be a sufficient common connection between them; and,
3. In order for *de facto* control to exist, a person or group of persons must have the ability to change the BOD or influence the shareholders who have the ability to elect the BOD

Generally, the CCRA has endorsed and approved of the FCA's decision in this case. However, the enactment of 251(5)(b) contemplates such a circumstance. By virtue of the legislation, you would be caught under 251(5)(b) regardless of the number of shares each non-resident holds.

Small Business Deduction

The small business deduction is defined in subsection 125(1). The small business deduction allows a CCPC within income form an active business to obtain a deduction from the tax otherwise payable under Part I. There are a number of things to consider:

1. You must be a CCPC throughout the year;
2. You can deduct from the tax otherwise payable under Part I by a corporation that was a CCPC an amount equal to 16% of the lessor of: (a) – (c)

Calculation of Income for the purpose of 125(1)(a):

(i.) Active Business
(ii.) Specified Partnership income
(iii.) The losses from an active business
(iv.) Specified partnership loss

Essentially, you would add (i) and (ii) and then deduct (iii) and (iv). In effect, you are netting out the active business income against the business losses. If (i) is $100 and you have $50 of active business losses, the two get netted out, while (ii) and (iv) go together.

Consider the following sums growing out of 125(1)(a) through (c):

(a) $350,000
(b) $400,000
(c) $200,000

The least amount of the three is (c) and thus, the business would be entitled to 16% from (c).

I. Active Business Income

In order to get the small business deduction you have to look at income for the year from an active business. The definition of 'active business carried on by a corporation' is found at section 125(7). When you have active business income, there must be an actual business – this is a question of fact. It might be helpful to think of it as busy activity.

The definition tells you only what it cannot be:

1. A specified investment business; or,
2. A person service business

© Francesco Gucciardo 2003

If it is either one of these two, you will not get the small business deduction.

Specified Investment Business

The term 'specified investment business' is also defined in subsection 125(7). Specified investment business generally covers passive business activity. Essentially, if owning property is the only thing a particular corporation does and it gets back rents or interest that is considered a specified investment business. However, specified investment business does not include business carried on by the corporation in the year where the corporation employees, in the business, throughout the year *more than* five full-time employees. Also, it does not include any other corporation associated with the corporation provides in the course of carrying on an active business any kind of managerial, administrative, maintenance, or similar services which would otherwise require you to employ *more than* five full-time employees. This is because *associated* corporations would be required to share the small business deduction.

Personal Services Business

A 'personal services business' is also defined in subsection 125(7). This section is targeted at employees who seek to incorporate themselves and attempt to get a lower tax rate. A personal services business carried on by a corporation in a taxation year means a business of providing services where:

(a) an individual who performs services on behalf of the corporation (an incorporated employee); or,
(b) any person related to that incorporated employee

is a specified shareholder of the corporation and the incorporated employee.

Sazio Case

Facts	Holding
○ Sazio was a coach of the Ti-Cats in the early 1960s who incorporated his coaching services as a business	○ *Issue*: Was the income that of an individual or that of an incorporated company? ○ The income was that of the company

Note: This is a pre-'personal services business' definition case. The definition that is currently in the *ITA* would preclude any such possibility.

533702 ON Ltd. (1991) TCC

Facts	Holding	Ratio
○ There were two companies: (1) BPH Ltd in the business of installing plumbing fixtures (controlled by D) and (2) a numbered company (D held 9 shares; wife with 71 shares; and son and daughter each with 10 shares) ○ Numbered company attempted to claim the small business deduction ○ MNR denied the deduction on the basis that the income was from a personal services business	○ The customers thought that they were dealing with BPH Ltd. ○ Numbered company was only providing the services to BPH – they paid a management fee for those services (arbitrary payment) ○ The numbered company really did not sell anything, provide any services, no inventory or fixed assets, etc., no commercial operations independent of BPH ○ Wife was an incorporated employee as well as a specified shareholder ○ The numbered company income was not considered to be active business income	○ Review this case

© Francesco Gucciardo 2003

Crestglen (1993) TCC

Facts	Holding	Ratio
o Crestglen had three shareholders (Y, X, and a company) o Y held 50%, X held 25% and the other company held 25% o There were also two partnerships o Partnerships A and B owned a shopping plaza o The members of the partnership were also X, Y and the company o Crestglen provided services to the partnerships for fees o Crestglen tried to claim that this was income from an active business o MNR took the position that this was a personal services business	o *Issue*: Whether the income is derived from an 'active business' or from a 'personal services business' o Crestglen was engaged in an active business o There was a lack of employer controls; Crestglen had its own place of business etc.,	o Review tests here

Keys to look at:
1. Are there *more than* five full-time employees?
2. The types of services that are being provided

Specified Partnership Income

Not likely to be on the examination

Specified partnership income is defined in section 125(7). Partnership income is determined by the formula A + B. A + B = Partnership Income.

A is the lesser of (a) and (b)

Term (a) is equal to G – H. G is equal to a corporation's share of the partnership income. H is equal to the deductions in computing income from the partnership. Term (b) is equal to K/L*M. K is equal to the corporation's share of the active business income of the partnership. L is equal to the partnerships active business income. M is equal to the business limit ($200,000).

B is the lesser of (a) and (b)

Term (a) is equal to the total active business losses and specified partnership losses. Recall that the definition of small business deduction total losses are reflected by (iii) and (iv). Term (b) is equal to N – O. N is equal to the amount under A(a), which is G-H. O is equal to the amount determined under (b).

© Francesco Gucciardo 2003

Corporate Tax

Business Vehicles

Why would someone use particular business vehicles or entities to conduct business? There are three major ways that you could carry on business:

1. Sole Proprietorship;
2. Partnership; and,
3. Corporation

The choice is largely a business issue and tax driven. People will look at issues such as general liability and protection, the administrative ease of carrying on business, etc.

I. Sole Proprietorship

There are very few administrative steps and legal formalities in the sole-proprietorship. A lot of people choose this vehicle where they have a small business and are just starting up. For tax purposes, the sole-proprietor usually reports income on the calendar year and any business losses incurred can be offset against any other type of income. There is no fear of double-taxation in this entity, but the sole-proprietor is subject to further expanded rates. The negative point is the personal liability, which is unlimited.

II. Partnership

Provincial law governs partnerships. The partnership is a contract between two or more people who join their assets to carry on a business in common with a view to profit. The entity itself is not a separate legal entity from the partners of the partnership. For *ITA* purposes the partnership is not a person as defined by the *Act* and is, therefore, not a taxable entity. The partnership is a flow-through entity – essentially, the entity in which the income is in respect of would not be taxed. The LLC in the U.S. is still a flow-through, but it is taxed like a partnership.

The sections in the *ITA* that relate to partnerships are sections 96 through 103. Like corporations the *ITA* also allows very tax advantageous and tax-free transfers to Canadian partnerships. The key advantage to the partnership is that it provides flexibility and it avoids potential for double-taxation. Partners like that they can offset any income or losses with any other income or losses that they earn.

All general partners are jointly and severally liable. However, the recent advent of the limited liability partnership alleviates this risk. With an LLP you have one general partner with a number of limited partners. The limited partners are only liable to the extent of their contribution into the partnership.

III. Corporations

The corporation is a distinct legal entity formed by one or more persons – distinct in terms of the relation to shareholders. The corporation has the legal capacity to negotiate and enter into contracts. Most corporations are not limited in terms of the types of business it can carry on unless it is limited by the incorporation documents.

In order to be considered a corporation you must be incorporated under a specific corporate statute – the key statutes are the *OBCA* and the *CBCA*. One of the drawbacks of incorporation are the specific formalities required when it comes to incorporation:

1. Directors;

© Francesco Gucciardo 2003

2. By-Laws;
3. Shareholder Meetings;
4. Elect Officers; and
5. Much, much more!

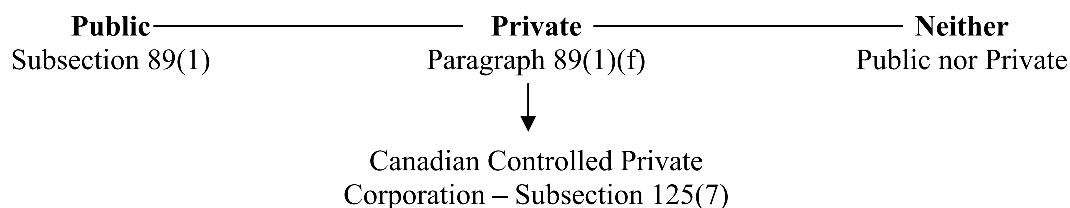
The shareholders of the corporation enjoy limited liability and are not responsible for any of the debts of the corporation. The corporation has a perpetual existence and will even survive the death of the shareholders. For tax purposes, income and expenses are claimed at the corporation level and paid on income on corporate tax rates. If a corporation decides to distribute its after-tax earnings, then the shareholders are taxed (this creates an issue of double-taxation for the concept of integration).

The Corporate Vehicle

There are a number of factors that impact upon whether a corporation pays tax and the applicable rate of taxation. Rates typically depend on the type of income earned and the type of corporation it is. There are different types of income that a corporation can earn:

1. Business Income – Active Business Income;
2. Manufacturing and Processing Income;
3. Property Income – Dividend Income, Interest Income, or Specified Investment Business Income; and,
4. Personal Services Income

Another factor that impacts the tax rate is the size of the shareholders – which is an outgrowth of the concept of control. For *ITA* purposes, the corporation can be:



I. Public Corporation – 89(1)

Subsection 89(1) provides:

> Public Corporation at any particular time means (a)-(c)
> (a) Listed on a prescribed stock exchange
> (b) If you elect to be a public corporation and have complied with regulation 4800 (number of shareholders, dispersal of shares, or if MNR designates such)
> (c) Once you are a public corporation you will always be a public corporation unless you take steps to change and not be a public corporation

Note: Any time you see the word 'prescribed' in a provision you should know that there is a regulation affecting the provision. Regulation 3200 (page 2288) enumerates prescribed stock exchanges in Canada.

The advantages of being a public company are ease of access to capital markets and also elements of valuation are simplified.

© Francesco Gucciardo 2003

II. Private Corporation – 89(1)(f)

A private corporation is defined at paragraph 89(1)(f). In general, a private corporation is one that is resident in Canada, is not a public corporation and is not controlled by one or more public corporations.

Note: Control in this context is not modified by 'directly or indirectly'. Thus, we are concerned with *de jure* control. When you see the term control 'directly or indirectly' it refers to something called *de facto* control. The leading case on control is *Buckersfield*.

The benefits of being a private corporation are the different tax rates. Within the private corporations you also see CCPC (Canadian Controlled Private Corporations) that are given further preferential tax rates. Generally, this is a policy initiative to support and promote small business in Canada.

III. Neither Public Nor Private

Consider TD Bank, which is listed on the stock exchange and wholly owns TD Securities, which is not listed and is not public. However, TD Securities is not private because a private corporation does not own it.

Section 149 deals with corporations that do not have share capital. A number of charities and private foundations fall under section 149. All of these different types of corporations have different tax rates.

Federal and Provincial Tax Rates and Systems

The tax rate that is imposed on a corporation will depend on the type of income earned by the corporation. The first step is to look at the basic federal rate.

Basic Federal Rate – Subsection 123(1)

Subsection 123(1), which is under Subdivision B, provides that the basic federal rate for corporations is, except where otherwise provided, is 38% of the amount taxable for the year. The 38 percent rate is subject to reduction – the rates at which the credits are earned may be subtracted directly from the basic federal rate

Provincial Abatement

Section 124 provides a deduction from corporate taxation at a rate of 10% - this deduction provides for a deduction of 10% of an amount equal to 10% of the corporation's taxable income earned in the year in a province. This deduction is referred to as the provincial abatement.

Corporation Surtax

A corporation is liable to pay surtax equal to four percent. The base to which this surtax is applied is 28 per cent, which results in a 1.2 percent surtax. In effect, you look at a base federal rate of 29.12.

Summary – Page xvi

Subsection 125.1(1) provides a 7% tax rate reduction from tax if you have income from manufacturing and processing income. Thus, from the general federal rate of 29.12, you deduct 7% for the manufacturing and processing deduction. Look to chart at page xvi.

© Francesco Gucciardo 2003

Provincial Taxes

Provinces tax under *Corporation Tax Acts*. Effective January 1, 2003 the basic Ontario Corporate rate is 11%. Thus, if you add the federal general rate of 29.12 and add the 11, you come to 40.12%. For manufacturing and processing, the provincial rate will be 10% as of January 1, 2003.

Capital Taxes

Capital tax is levied under Part I.3 of the *ITA* at section 181 (Large Corporations Tax). This tax is imposed on all taxable Canadian corporations and all other corporations who have a permanent establishment in Canada who employ taxable capital in Canada in excess of $10 million. The rate of taxation is 0.225%. The term 'taxable capital' is defined in section 181.2 (investments in other corporations, shares, bonds, indebtedness etc.,). When a corporation calculates its capital tax it is based primarily on what the year-end balance sheet says – the balance sheet is the most important document looked at for a corporation under the Capital Tax regime.

From this, the corporation may deduct an investment allowance, which is found at section 181.2(4) – Investment Allowance. Thus, certain investments made may be deducted from the capital. Once you come up with the total taxable capital you multiply that number by 0.225.

Note: There also is a capital tax a provincial level.

CCRA has now been clamping down on corporations attempting to do tax planning for capital tax.

GAAR – General approach

If there was a transaction, was there a business purpose behind it? Even if so or not, was there a *misuse* of the provisions of the *ITA* in order to avoid taxes?

Taxation of Dividends & Integration

Subsection 248(1) provides a definition of dividend. Essentially, a dividend is a cash payment made by a corporation to its shareholders. Normally, the dividend is paid out of the current earnings and represents a distribution by the corporation to its shareholders of the corporation's profits. For instance, SunLife might declare a quarterly dividend of 15 cents per common share.

The problem with the taxation of dividends is that earning income through a corporation may result in two levels of taxation:

1. Income of a corporation subject to tax when it is earned; and,
2. When dividends are declared and distributed, the shareholders are subject to tax

Because of this potential for double-taxation, the *ITA* attempts to alleviate this by 'integrating' corporate and individual tax systems.

The Theory of Integration

Integration tries to ensure that the after-tax return to an investor is the same whether that person holds an investment directly or through a corporation. The Carter Commission proposed this model in the early

© Francesco Gucciardo 2003

1970s – do not create a situation where there is double-tax. In order for the balancing to work, a number of key considerations must be made.

With respect to the taxation of dividends, the integration of corporate and individual tax systems is accomplished by reducing the amount of tax paid by shareholders on the receipt of dividends. The tax payable by the individual shareholder is then reduced by the dividend gross-up and tax credit mechanism. Essentially, this dividend credit and gross-up is meant to equal the amount of income earned before tax by the corporation (in reality, this does not happen).

Paragraph 82(1)(b) provides that the amount of the gross-up is 25 % of the dividend. A tax credit is then issued to the shareholder, which is equal to 2/3 of the amount of the gross-up (section 121).

Assume 29% taxable	Business Income by Individual	Business through Corporation
Corporate Income		$100
Corporate Tax Rate (20%)		$20
After Tax Profit		$80
Individual Income	$100	
Dividend		$80
82(1)(b) dividend gross-up - 25%		$20
Taxable Income	$100	

Assume 29%	Individual	Corporation
Dividend Tax Credit	$29	$29
Section 121 – 2/3 of $20	0	(13.33)
Provincial Tax Rate	14.50[1]	7.83[2]
	$43.50	$23.50 + $20 gross-up = $43.50

Integration is concerned about the individual taxpayer and ensures there is no possibility of double tax.

Why doesn't corporate integration work? You have federal and provincial surtaxes, different corporate rates, corporate rates are constantly changing and so all of these factors will lead to an imperfect integration. Sometimes you can have over-integration, which occurs where the combined tax rate or individual tax rate is lower than that used in the example. Because the rates are lower, earning income through a corporation will result in less tax.

If you are a corporate shareholder, corporate shareholders free of tax receive dividends. This is why if you interpose a holding company, you do not have to worry about tax.

[1] 50% of $29
[2] 29 – 13.33 = 15.67; 15.67*1/2=7.83

© Francesco Gucciardo 2003

Dividends & Tax Policy

The Double-Tax Problem

The reason taxes tend to get cut at the level of dividends is to avoid the issue of double-taxation. In the U.S. dividends are subject to tax in the hands of the shareholder. The problem is that the same income gets taxed twice:

1. The shareholder level; and,
2. The corporate earnings level

President Bush has announced that he wishes to cut dividend taxes, but the problem with the proposal is that while it may stimulate the economy, the government will lose a lot of money.

The Canadian Context

Canada does not face the same double-taxation problem as in the United States. The maximum total rate of taxation in Ontario is 46%. To beat out the problem we have the concept of 'integration'. The concept provides that it should not make a difference whether you make the income through a corporation or as an individual. The tax system does not, in theory, benefit or penalize you by earning as either a corporation or as an individual. Canada is one of the few countries that has a proper integrated system.

Our current system, however, has both an advantage and a disadvantage. For instance, the tax rate of a small business on active business is typically 20%. The small business is up to the limit of $200,000. However, if you had earned that personally, the tax rate would be close to 46%. This is a timing difference. Timing differences are really important and a large part of what tax people do. The idea is that paying later is much better than paying now.

There are also absolute differences – it might be better to pay the tax on a dividend when it is less than the amount that would be paid if it were earned by the individual.

Taxation of Dividends (Dividend Gross up and Tax Credit)

Section 82 provides how the income of taxable dividends is to be taxed. Section 82(1)(a)(ii) provides that if you get a dividend, you include it, along with one quarter of the dividend in your income. This is known as the dividend gross-up.

Section 121 provides that there may be a deduction from tax of 2/3 of the amount that is required from section 82(1)(b) – this is a tax credit – a deduction from the tax to be paid. This is called the dividend gross up and tax credit system.

This is the simple case where you have a company paying a dividend to the individual. There are cases where dividends are paid out to other corporations, which create the potential problem of triple, quadruple, etc., taxation.

Section 112(1) provides that were a corporation receives a dividend from a taxable Canadian corporation, an amount equal to the dividend may be deducted from its income.

Money can be moved around between corporations in a clever way without having to pay tax. A number of other countries do not have this system. For instance, in the U.S. this scheme only exists where the receiving corporation owns more than 80% of the shares in the issuing corporation.

© Francesco Gucciardo 2003

Tax is avoided in two ways:

1. The inter-corporate dividend; and,
2. The gross up and tax credit

Investment Income

Investment income is income that is passive. In Canada, the integration works very well – we generally have 'perfect' integration for investment income. Integration is perfect to the point that we look to both timing differences and rate differences. In a perfectly integrated system there would be no timing advantages and no rate differential.

Suppose Jon earns money through his tool and dye corporation, but he wants to keep the wealth, but not necessarily in his tool and dye company. Jon might set up a holding company and pay dividends to that holding company (tax free) until he decides what exactly he wants to do with that money.

Suppose the holding company makes an investment on a holding of $100, which yields $10. The holding company would pay the standard corporate rate in addition to a special tax of 6 2/3 %, which typically gets the taxes beyond the tax rate of an individual. This special tax has been established to prevent the timing difference and is found at section 123.3. Section 123.3 provides refundable tax on CCPC's investment income. This section exists purely to prevent timing differences.

Note: A non-CCPC does not get the benefit of integration, so that is why the tax is not added.

What happens when a dividend is paid either to another company or a shareholder is that the paying company gets a refund, not only of the 6 2/3 tax, but also part of the regular corporate tax that has been paid: this is called refundable tax.

The system provides:

1. Pay initial tax;
2. Once dividends are paid and integration works, the tax on the corporation that is left and the tax on the individual should equal approximately 46%; and,
3. You might get a partial refund of the corporate taxes

Refundable Dividend Tax on Hand

Refundable dividend tax on hand works through the establishment of notional accounts. The RDTOH is the amount of refundable tax. To 'pay from that account' means to either reduce or increase the notional balance in that account for tax purposes.

The rules for RDTOH are found in section 129, which provide rules relating to the dividend refund to private corporations.

The refund is equal to 1/3 of all the dividends paid. In other words, for every $3 of dividends that is paid out the government will refund one dollar, which can be done in one of two ways:

1. If the corporation has already paid the corporate tax in addition to the refundable tax, the company applies for a refund and the government will refund it; or,
2. If the corporation pays the dividend during the year, the corporation may credit the amount of tax to be paid – the tax has not been paid, so reduce it to reflect the refund

© Francesco Gucciardo 2003

However, the RDTOH is limited under section 129(1)(b) to the balance in the RDTOH – you cannot get more than what is in this notional account.

Section 129(3) provides a definition of the refundable dividend tax on hand.

There are two basic things you should note about definitions:
1. Point in time definitions – the calculation is based as if the world stood still at that particular point in time; or,
2. Period of time definitions – in order to apply, something must exist for a particular period of time

The RDTOH will only apply where the corporation was a CCPC *throughout* the year. The RDTOH is determined as 26 2/3 % of the corporation's aggregate investment income for the year (which is interest, rent, royalties – passive property income) in addition to ½ of capital gains.

When this money is paid out to shareholders you get a refund off of it.

Tax Rates

Start at section 123, which imposes a single rate of 38%. Section 124 provides a provincial abatement of 10%. The resulting rate is 28%. Note: if you live in the Territories the provincial abatement does not apply. Section 123.2 imposes a surtax of 4%: (38%-10%) + (28x4%) = 28% + 1.12% = 29.12%. When you apply the corporate tax of 6 2/3 from section 123.3, the total is: 35.79%. From this number must be added the relevant provincial rate.

Dividends

Dividends are received between corporations tax-free. However, there is a problem. Suppose a holding company receives dividends, it would receive it tax-free. Yet, if the individual received the dividend, s/he would pay 31% tax. This problem leads to a timing difference.

Part IV tax is not limited to CCPCs. The tax includes them, but includes *all* private corporations whether or not they are CCPCs. Section 186(1)(a) provides that a tax shall be paid on 1/3 of all assessable dividends. An assessable dividend is a dividend deductible under section 112.

Part IV tax is not payable if it is a connected corporation. A connected corporation is defined at section 186(4). Note: There are always exceptions.

186(1)(a) – 1/3 of all dividends from unconnected companies (other than from connected corporations)
186(1)(b) – if the payor gets a refund it gets picked up as Part IV tax
Connected is defined in 186(4) – particular corporation must have owned 10% of the issuer share capital with full voting rights

Note: Public companies in Canada are free to invest in other companies.

Capital Gains

One half of all capital gains are included in the individuals income. It is generally the same for corporations. The treatment of capital gains is split into two halves:
1. Taxable capital gains; and,
2. Not-taxable capital gains

© Francesco Gucciardo 2003

The half that is taxable will be treated identically to the treatment as if it was general income. However, the half that is non-taxable is treated differently.

Non-Taxable Capital Gains

The corporation would establish a capital dividend account. The capital dividend account is defined in section 89(1). The capital dividend account definition is a 'point in time' definition.

89(1)(a)(i) – take the total capital gain and deduct the taxable portion and then deduct the capital loss

The theory is that at any time the corporation can declare a capital dividend, which is tax-free. If a corporation declares a capital dividend, it is tax free.

89(1)(c.1)(i) – One half of goodwill will be added to the capital dividend account

89(1)(d)(ii) – life insurance is not taxable – the beneficiary of a life insurance policy would come in tax-free

In summary, review the following four items:
1. Net capital gains (net of losses) – 89(1)(a);
2. Net capital gains received – 89(1)(b);
3. One half of goodwill 89(1)(c.1)(i); and,
4. Life insurance – 89(1)(d)

(Net Capital Gains/Losses) + (Net Capital Gains Received) + (One Half of Goodwill) + (Life Insurance) – (Payable Capital Dividends)

Payment of Capital Dividends – 83(2)

A special form (Form T2054) must be filed in order to pay out capital dividends. Section 83(2) is the provision that deals with this. If the rules in section 83(2) are followed, the dividends are tax-free to *any* shareholder. As soon as an 83(2) dividend is paid, the corporation will get a reduction in their capital dividend account.

There were no capital gains in Canada before 1971. The notional value of all property was it value on V-day – the value of the property as of December 31, 1971.

Qualifying Small Business Corporation

This is similar to a CCPC that carries on an active business (not an investment). If a shareholder has held shares for two years s/he is allowed to sell those shares without having to pay capital gains on the first $500,000. Farmers have a similar provision. This is a one-time thing per individual. The sale must be made to another individual.

The definition of "small business corporation" is found at section 248(1). The definition requires that:
1. The business is principally carried on in Canada;
2. The value is derived principally in Canada

Note: "Principally" is typically interpreted by the CCRA to mean more than 50%

© Francesco Gucciardo 2003

Section 110.6(1) provides the definition of a qualified small business corporation share: for the past 24 months the share cannot have been owned by anyone other than the individual or the family. Throughout the 24 months before that time, not less than 50% value of the assets have been used in an active business.

February 12, 2003

© Francesco Gucciardo 2003

Shares, P.U.C, & A.C.B.

Corporate Law – Stated Capital Accounts

Under the *CBCA* section 26, when shares are issued by a corporation the directors have to add to the *stated capital account* (a notional account) – the value of anything received when shares are issued. For instance, if Jon purchases a share for one dollar, one dollar has been added to the stated capital account. This is based on remnants of the Victorian capital concepts and various solvency tests.

You typically need a special resolution of the shareholders to adjust the stated capital amount. The only way to increase the account is if there are retained earnings that can be shifted into the account (section 26(3) and 39).

Stated capital is a very important tax concept – it is good practice if you can have your corporate stated capital equal to the tax equivalent, which is paid-up capital.

If you follow a proper procedure (a special resolution) the shareholders can resolve to change the share capital. In a public company context this is very burdensome.

Basic Accounting Concepts

The concept of capital in accounting terms is not always the same as capital in corporate terms. Shareholder's Equity typically consists of:

1. *Share Capital* – look to the minute book and calculate authorized share value – number of shares that have been (may be) issued
2. *Retained Earnings* – an accumulation of all the company's prior earnings less dividends and taxation; and,
3. *Contributed Surplus* – the money that comes in typically from shareholders where people have added something to the company and shares have not been issued for it (a catch-all account to make the statements balance)

Warrant – the right to acquire shares in the future. The money for these warrants would not be part of the share capital because the funds are not acquired in exchange for an issuance of shares.

Paid-Up Capital – PUC

Paid-up capital is the tax equivalent of stated capital. It is a similar concept except tax rules apply rather than corporate law. Section 89(1) defines paid-up capital. Note: this is a point in time definition, which is logical considering that by issuing shares you are changing the paid-up capital.

In the Canadian system you can generally take out paid-up capital tax free: if you put money into the company you can take it out. In the U.S., however, you can take out the paid-up capital tax free, but only after you have cleaned out the retained earnings. In the Canadian system you can either pay dividends or you can take capital. In the private company context, the important of paid-up capital is that you get it back first. If a non-resident invests in Canada, s/he can get his or her capital back first. This is why paid-up capital is a key concept.

There are three important concepts to consider:

1. Paid-up Capital is equal to stated capital
2. Paid-up Capital comes out tax-free

© Francesco Gucciardo 2003

3. The corporate paid-up capital can be increased by passing a resolution

Because of the fact that you can get your paid-up capital tax-free, the *ITA* sets out a number of rules preventing you from increasing the paid-up capital.

The starting point is section 84 – Deemed dividend: "Where a corporation resident in Canada has at any time after 1971 increased the paid-up capital in respect of the shares of any particular class of its capital stock, a divided shall be deemed to have been received at that time by each person who held any of the issued shares of the particular class immediately after that time equal to that proportion of the dividend."

Exceptions

Section 84(1)(a) – Stock Dividend – instead of cash, new shares in the company are given (stock dividend is alright because it will be taxed once sold)

Section 84(1)(b) – Shifting paid-up capital – it is alright to shift the paid-up capital from one account to another class so long as the aggregate stays the same

Section 84(1)(c.3) – Addition of Contributed Surplus – if X is a shareholder who made the contribution and did not take shares back, that shareholder is allowed to increased its paid-up capital to add that amount of that share surplus

Adjusted Cost Base

This is an account that a shareholder has when s/he purchases or acquires something – it is how you calculate capital gains and capital losses.

Suppose Jon starts up a company and injects $100 in exchange for 100 shares. The paid-up capital is $1. The adjusted cost base is also $100 or $1 per share. Suppose 50 of the shares are sold for $100 to Peter. The paid-up capital of Jon's corporation is still $1 per share. However, Peter's adjusted cost base is $2 per share.

A cost-base is from the shareholder's point of view while paid-up capital is a corporate account. The paid-up capital is calculated at a point in time based on the number of shares issued and revenue generated from the issue.

Note: We did not have capital gains tax until 1972, thus the calculation of a shareholder's adjusted cost base on shares acquired before 1972 are calculated based on the value of the shares in 1972 (actually the greater of what the person paid for it or its value on V-day)

Section 53(2)(a)(ii) provides: where the property is a share of the capital stock of a corporation resident in Canada any amount received

Section 53(1)(b) provides that if you have received money as a result of 84(1) that amount shall be added to the adjusted cost-base.

There are two separate accounts that interact – adjusted cost-base and paid-up capital.

You have to capitalize on the acquisition. Any non-resident trying to make a Canadian acquisition should do so through a Canadian holding company.

© Francesco Gucciardo 2003

Section 85 of the *ITA* provides that where a shareholder transfers property to a corporation and receives shares, s/he can elect not to pay capital gains tax (subject to certain limitations). The idea is that you are allowed to get things into corporate form – if you transfer something free that appreciates you can elect not to pay capital gains tax. Section 85 is a deferral or rollover – in order to move these things around you do not immediately realize any inherent capital gain.

Thus, you are allowed to sell shares to a company and the gains are deferred. The taxes will be paid some day, it is simply deferred. Each transferor inherits the old adjusted cost-base.

When you take money out of a company it has nothing to do with the adjusted-cost base, but rather the paid-up capital. If you take money out of a company it is always a dividend. There is a rule under 84.1 that provides an increase in adjusted cost-base does not always increase the paid-up capital even though, in corporate terms, the stated capital could increase (paid-up capital is still what it was).

Original Cost: $1
V-Day: $100
Today's Value: $1,000

The adjusted cost base is $100, but the paid-up capital is still only $1. Transactions with the company are not capital gains, but dividends. This is why the qualified small business credit (up to $500,000 tax free capital gains) is not applicable to transfers from HoldCo.

Section 84(4) provides that it is only a deemed-dividend where the amount paid exceeds the paid-up capital.

Thus, the initial result of a transaction between shareholders and corporations is if you have paid out more than the paid-up capital, it is a dividend.

Section 84(3) is similar and provides if a company buys back its own share this is a dividend if that amount paid exceeds the paid-up capital. However, is this not also a capital gain in itself? The definition of 'proceeds of disposition' in section 54 provides that any amount that would otherwise be proceeds of disposition of a share to the extent that the amount is deemed by subsection 84(2) or (3) to be a dividend received.

Redemption Feature – this is where the company can call its shares. This is typically seen in preferred shares where there is a condition in the shares where the company can, upon giving notice, buy back the shares at a fixed price or a price based on some formula.

Retraction Feature – this is where the shareholder can demand a buy-back of the shares at a fixed amount or a price based on some formula.

Deemed dividends between corporations are tax-free.

© Francesco Gucciardo 2003

Private Corporations

Incorporation

In Ontario, when you want to form a corporation you simply go to the Ontario Government website and submit the appropriate forms (articles of incorporation). Ontario has the simplest incorporation procedure in Canada. The ease and speed with which a corporation can be incorporated renders relatively useless the need to hold shelf corporations. There are some qualifications:

1. Ensure that you have a name that no other corporation already has;
2. Details about the person incorporating
3. Shares (Limited)
4. Qualifications – None

If you do not have a name the office will automatically assign a number. *Note*: There is no difference between the suffix incorporated or limited (Inc. or Ltd.). Non-profit corporations are still in the letters patent system.

CBCA companies are not used as commonly by Ontario lawyers as their provincial counterparts. There are thirteen different jurisdictions within Canada, each of which is slightly different. Because the rules on guarantee may be different, or other rules may be different in particular jurisdictions, lawyers might attempt to accommodate their clients, but the issue of director's liability has slowed such practices down.

Continuance

It is possible to continue a company – form it in under the laws of one jurisdiction and make it subject to the laws of another jurisdiction (Continuance). The process of continuance is generally a matter of filing the appropriate forms:

1. File the discontinuance in the current jurisdiction; and,
2. File the continuance in the new jurisdiction

In this instance, the continued corporation is basically the same corporation subject under a new set of rules. You can only continue into a jurisdiction that will be allowed to continue in your jurisdiction. In other words, there must be reciprocity. All Canada provinces have reciprocity except for one: Quebec. If you have a Quebec corporation you cannot continue it. No province's corporation may be continued in Quebec and, in turn, no Quebec Company can continue in other jurisdictions. For this reason, Quebec lawyers tend to use the CBCA Company, as opposed to the provincial company, when they want to continue into another jurisdiction.

There is no reason from a corporate law perspective that you cannot continue a corporation outside of Canada if there is reciprocity. For tax purposes this is not a good move. In this case Canada would effectively be losing revenue. Thus, Canada deems you to have disposed of and distributed all of your assets to your shareholders the instant before you leave the country.

Corporate Residence

The general rule for residence is where the mind and management of the corporation resides. Residents for treaty purposes are typically defined in the treaty (*Crown Forest*). You can be duly incorporated (dual-residency). The starting point is subsection 250(4), which provides a provision as to deemed residency.

© Francesco Gucciardo 2003

It is very rare to come across a company incorporated before 1965 that is not resident in Canada: these are very valuable. The reason is that if they are incorporated before that date and not resident in the common law, it means that they have never been resident: you get a company with Canadian law, but not subject to Canadian tax.

Generally, a company incorporated in any Canadian jurisdiction is deemed resident for income tax purposes. In general, we do not get dual residence because the provisions of a treaty will typically override the domestic law. In other words, if you are deemed a non-resident for the purpose of a tax-treaty you will be deemed a non-resident for income tax purposes. If you are a dual-resident you are always paying the greater of.

A non-Canadian Company can become resident in Canada: In the case of a non-treaty company, move their mind and management to Canada. The definition of "Canadian Corporation" at section 89(1), however, provides that the corporation must have been:

1. Incorporated in Canada, or
2. Been resident in Canada since June 18, 1971

Section 250(5.1) deals with continued corporations. For Canadian purposes a corporation continuing into Canada is deemed to have disposed of everything the instant before it continues. This is favorable treatment because the corporation gets a fresh start and can take advantage of any appreciation in value. These rules are found at section 128.1 "Immigration":

128.1(1)– Immigration
128.1(1)(b) – Deemed Disposition (Immigration)
128.1(4) – Emigration
128.1(4)(b) – Deemed Disposition (Emigration)

Most countries, including the U.S., have consolidation for tax purposes. Suppose you have a tool and dye maker with a holding company. The financial statements that the bank looks at include both the tool and dye company and the holding company. Any transactions between the two companies get netted out to zero. For instance, if 100 shares were held over the assets in Company B – the value of those shares are not included, otherwise we would have some double-accounting.

In the U.S., so long as particular corporations are within the same consolidated group, losses and gains can be offset. In Canada, we do not have tax consolidation, which is a detriment. For this reason, among others, we may want to combine or fuse the companies, at which point the gains and losses can be offset.

There are two ways of combining companies in Canada:

1. Amalgamation – two companies combine together; and,
2. Winding-Up or Dissolution – one company disappears with all of its assets

Amalgamation

There are a number of variations: for instance, you can do a takeover in the form of an amalgamation. In the simple case, you get two companies (A and B) who combine together to become a new company (AB). The SCC has decided that these two companies both continue – neither one disappear.

What this really means is that from a legal point of view, all of the legal rights, responsibilities, and obligations of a corporation do not disappear. For tax purposes, something different happens. Both companies terminate and a new company starts. The *ITA* has a number of provisions that transfer all of

© Francesco Gucciardo 2003

the old tax attributes of the predecessor to the new corporation. Nothing much really turns on this. The one critical point is that because they are new you cannot carry back a loss. On a go forward basis you can carry forward the tax loss to AB – Section 87.

You can use amalgamations for a number of reasons. For instance, suppose you have public company X with a target it wishes to acquire. The public company can create a shelf corporation who will then acquire the target. In this way, the shareholders of the public company will not get a vote on the acquisition.

Also, because you typically only need 2/3 to vote on an amalgamation, those who do not like the resolution can be given redeemable shares and paid out in cash – amalgamation 'squeeze out'. This is done at the same director's meeting: one motion to create the redeemable shares and the next motion to redeem those shares. The risk is minimal because it is unlikely someone will bring forward an oppression remedy.

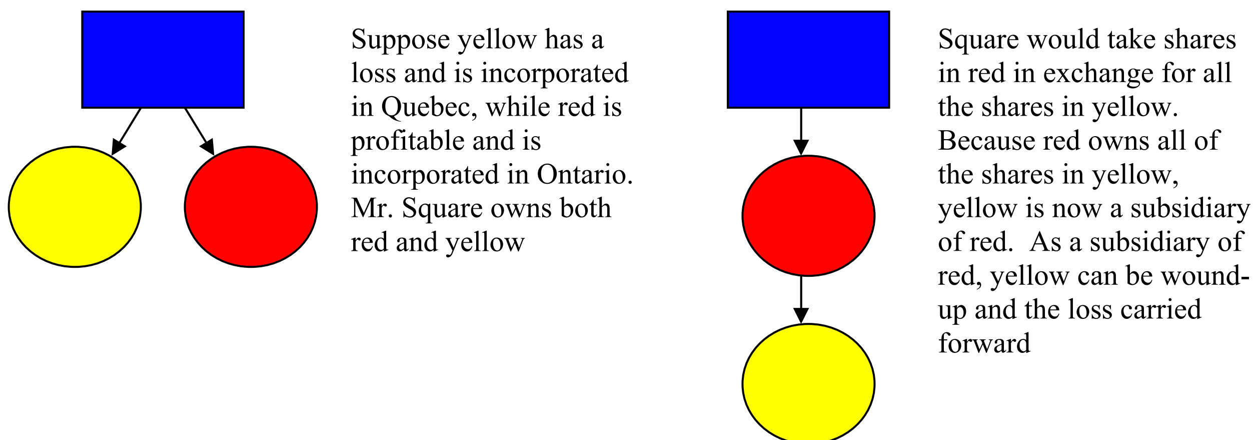
In order to amalgamate companies the two companies must be incorporated under the same statute (i.e. they both have to be Ontario corporations). This is because on a going forward basis you will need to follow the same set of rules. Companies in different jurisdictions typically follow a two-step process:

1. Continue into the same jurisdiction; and,
2. Amalgamate

There are various reasons for amalgamation: typically to use up tax losses.

Winding Up

Upon winding-up the company disappears – you can wind-up a company and distribute all of the assets to the shareholders. The relevance here is that you have to maneuver somehow that the winding-up company be a subsidiary of the other company. You cannot take advantage of any loss the year that you acquire the company.



Typically, under normal scenarios, you will tend to do an amalgamation because it is mechanically easier.

The U.S. has a slightly different regime. The U.S. does not use the concept of amalgamation as we know it – they use the term 'merger'. Although they look similar in appearance, under U.S. Corporation law there is no 'two streams become one river' approach. Not much turns on this from a liability point of

view. However, because they are new entities there would have been a disposition of all of the assets and a disposition of all the shareholders of their shares and the acquisition of new ones.

Non-Corporate Entities

The overriding reason for non-corporate entities is the avoidance of taxation.

General Partnership – Everybody is liable
Limited Partnership – Not liable, but cannot participate in management
Limited Liability Partnership – can participate in management, but treated as a general partnership

LLC – looks like a corporation and provides limited liability, but it is a flow-through for tax purposes.

The U.S. agonized over devising a set of rules – now you can literally pick your tax treatment. Most U.S. Companies would check the box to be a flow-through for tax purposes (however, there are things that the flow-through does not get). All of the above-mentioned entities have the check-the-box rules.

Limited Liability Partnerships

This is a new statutory creature that has been created especially for multi-jurisdictional professional firms. Available only to professionals once registered, the members of these partnerships are granted a certain limited immunity from liability. A partner is not liable personally for the nonfeasance and/or misfeasance of other partners except if that person is liable for those other persons under his or her own supervision and control. Each person is responsible for his or her own misfeasance and nonfeasance. Note: there is no way that a lawyer may avoid liability with dealings with the client. Most law firms are LLPs.

Limited Partnership

You put in a certain amount of money or assets and you will not be liable beyond that amount. Liability is limited to the financial sum that you have committed to the partnership. You cannot participate in management if you are a limited partnership.

Nova Scotia Unlimited Liability Company

Nova Scotia corporate statutes predate Confederation. It actually dates to the days before *Saloman* when Victorian England was experimenting with different types of organizations. One of the entities was the unlimited liability company, which never really took off. People liked the concept of limited liability and rejected the unlimited liability company. Nevertheless, after languishing in the Nova Scotia statute for 125 years it was discovered that for U.S. purposes the ULC fell into the partnership box opposed to the corporate box. For legal purposes there is a limited life of 99 years (perpetual for business purposes). In other words, you could maneuver the N.S.U.L.C. for U.S. purposes. Recall that the U.S. allows consolidation. If a U.S. company had a U.L.C. to run their Canadian operations, for the purposes of U.S. Income Tax it is still part of the U.S. consolidated group. Thus, you have a company carrying on business throughout Canada, which for U.S. tax purposes is consolidated. The preferred vehicle in Canada tends to be the U.L.C. for U.S. companies.

Little attention is paid to the fact that there is unlimited liability – they are not too worried about it. The N.S.U.L.C. is the preferred vehicle of choice for U.S. companies wishing to do business in Canada.

© Francesco Gucciardo 2003

Canada regards the U.L.C. as a corporation while the U.S. considers it a partnership. *Note*: We are likely to see this more and more (there are no Canadian tax advantages, just a pure U.S. thing). The U.S. company can write their losses off as part of the consolidation, interest can be deducted against the U.S. income.

© Francesco Gucciardo 2003

Overview of Tax Deferral Provisions

Subsection 85(1)

This section is a rollover provision that applies where a corporation receives assets and issues shares as consideration.

Section 85.1

This deals with share for share exchanges – person holds shares in one corporation and transfers them to another corporation for shares back in exchange.

Section 86

This is where you might use a reorganization of capital of a company and provides an automatic rollover where the shareholders turn in their shares and receive different classes of shares in the company.

Section 51 & 51.1

These provisions deal with convertible property – where you have shares that are converted into different shares of the same corporation or where you have debt of the corporation and convert it for shares of the corporation.

Amalgamations & Wind-Ups

An amalgamation is dealt with in section 87 of the *ITA*. Section 88 deals with the winding up of a corporation into its parent corporation.

© Francesco Gucciardo 2003

Section 85 – Transfer of Property to Corporation

There are three important things to consider about section 85:
1. What it is;
2. How it works; and,
3. What it is commonly used for

What It Is

Section 85 is the most commonly used tax planning tool that is used by tax practitioners. This is typically the biggest result of errors and omissions claims against tax practitioners. This section permits a taxpayer to transfer certain types of property to a corporation on a tax deferred basis.

How It Works

Section 85 allows a transferor of property to agree with a corporation to transfer the property to the corporation without triggering any immediate tax to the transferor. In order to make this provision apply an election must be filed with the tax return. This election provides some flexibility in allowing the individual to determine what the proceeds are going to be relating to the disposition of that property to the corporation.

Consider the four following considerations:
1. Who can utilize this election;
2. Types of property that can be transferred;
3. How is the agreed amount determined; and,
4. What are the requirements or conditions that have to be met?

Hypothetical

Suppose Karen wants to do some tax planning and wants to split off the profits of her business with a friend or relative. A tax practitioner might suggest a section 85 application. Suppose the shares of her corporation are worth $1,000,000, but she purchased them for $100,000. If Karen decided to simply transfer the shares of her company to another company, she would have a capital gain of $900,000. Thus, Karen would transfer the shares of her operating company to a new holding company and take back shares in that new holding company that are worth $1,000,000. Then, Karen would elect under section 85 and select an agreed amount of $100,000 – she is electing that her proceeds of disposition are going to be $100,000. The effect is that she would have no capital gain on the transfer of her shares.

Requirements

There are five general requirements relating to:
1. The transferor;
2. The transferee corporation;
3. The type of property transferred; and,
4. The type of consideration that is received in return
5. The joint election

Each of these five requirements is referred to in the pre-amble of subsection 85(1).

© Francesco Gucciardo 2003

I. The Transferor – Taxpayer

The transferor must be a 'taxpayer' for the purposes of this section. Section 248(1) provides a definition of 'taxpayer'.

Note: Partnerships do not apply to subsection 85(1), however subsection 85(2) provides a similar regime for partnerships – the election form etc., differs.

II. The Transferee – Taxable Canadian Corporation

The transferee must be a taxable Canadian Corporation. Canadian Corporation is a defined term found in section 89(1).

III. Types of Property – Eligible Property

Any property that was eligible property may be used. The definition of eligible property is broad and is defined at section 85(1.1):

Note: the term 'eligible property' does not include real estate inventory. Inventory is held on *income account* opposed to capital account. The other major carve-out is real property that is owned by a non-resident. This comes back to tax policy reasons, which would make it easy for people to defer paying tax on Canadian property.

IV. Types of Consideration – Any plus One Share

Any type of consideration may be received, but it must include at least one share of the transferee corporation. The type of consideration that you receive will affect the ability to claim a tax deferral. Note also that there is no type of share that is specified (either preferred or common). This provides tremendous flexibility for the parties to structure a beneficial transaction.

Any kind of non-share consideration that the corporation gets is going to be called 'boot'. To the extent that you receive 'boot' you may not be able to get a complete deferral. Where the value of the boot exceeds the initial cost of the transferred property, a full tax deferral is not possible. In other words, if you want a complete tax deferral (roll-over) they you must ensure that the boot that is received (non-share consideration) is less than the cost of the property that you are transferring.

V. The Election – 85(6)

This is really the fifth requirement – you must file an election in a prescribed three-page form and within prescribed time. The election is a joint election between the taxpayer and the transferee corporation. Subsection 85(6) stipulates the timing:

Suppose a Corporation has a December 31 year-end. The tax return of the individual must be filed by April 30 of the relevant year. The election must be filed by the earlier of the filing dates.

There is an automatic right to late-file an election. However, if you late-file after three years you generally need to beg for the late-file. The standard is to allow the late-file where it is just and equitable to do so. 'Just and equitable' includes a burnt office-building and lost documents.

© Francesco Gucciardo 2003

In terms of amended elections, you can amend an election if there is a clerical error – there is no penalty in this situation (See information circular 76-19R3 at paragraph 19). The maximum penalty for late or amended section 85 elections is directly related to the amount of the deferral up to a maximum of $8,000.

Note: The election form determines what the tax consequences of the transaction will be. The form is only for tax purposes – there are a number of other documents and forms that need to be completed in order to undertake the actual transaction.

Dale v. The Queen (1993) Tax Court

Facts	Holding
○ Father and son owned shares in a PEI corporation with a number of tax losses ○ They also owned land with a building on it and lined up a third party to buy such ○ They were expecting to trigger recapture and a capital gain ○ Section 85 was used to transfer the land and building to the PEI corporation before it was sold to the third party ○ The losses built up over the years were to be used to offset the gain in the sale of the building ○ The problem is that when they transferred the land and building, the articles of the PEI corporation did not authorize shares of the class they purported to receive – anytime shares are issued the articles must provide for the particulars ○ Realizing their error the father and son continued in another jurisdiction and sought a retro-active order authorizing the corporation to issue those shares prior to the date of the transfer – the judge issued the order ○ CCRA argued that the capital gains were triggered and the losses could not be used to offset because the shares were not properly issued	○ *Issue*: Were shares of the corporation properly received in connection with this transfer? Was the section 85 election filed valid – was share consideration issued in the transfer as required by section 85? ○ All the necessary steps were taken with the exception that they forgot to amend the letters patent of the corporation ○ Notwithstanding this omission, because they were able to correct it in another court, the section 85 requirements were met ○ The word 'consideration' for the purposes of section 85 is: (1) executed and (2) executory consideration ○ In this case we have executory consideration: as long as the shares would be issued at some time in the reasonable future, the provisions of section 85 would be met ○ This transaction was not a nullity, but simply incomplete. As long as the parties take steps to complete the transaction within a reasonable time the requirements would be met

Dale v. The Queen (1997) FCA

Facts	Holding
○ See Above	○ The CCRA is required to apply the ruling notwithstanding the fact that they were not part of the Nova Scotia ruling authorizing the issuance of the shares retroactively ○ The Tax Court does not have the authority to collaterally attack the court order of a Superior Court of a Province ○ **Dissent Note**: The shares cannot be issued at a reasonable time in the future, but must be issued at the time of the transfer

Juliar et Al v. AG of Canada (2000) ON CA

Facts	Holding
○ Husband and wife owned a couple of convenience stores ○ They transferred the stores to a new holding company and took back debt (not shares) ○ CCRA audited and did not allow an application of	○ As long as the parties intention was to minimize taxes, even though the requirements of section 85 were not met, the trial judge has the authority to issue an order that retroactively causes the corporation to issue shares

section 85 – big tax money was owing ○ Couple claimed that the accountant told them the transaction would be tax-free ○ Couple sought and got an order from the court rectifying the situation because the intention all along was to qualify for section 85 and defer the tax ○ CCRA appealed the granting of the order	○ A taxpayer may be allowed to amend documents and issue shares that reflect their true intention and rectify the record so that they can meet the requirements of section 85

Does a 'promise' to issues shares qualify for section 85? In other words, when do the shares have to be issued? The Tax Court's ruling indicates that they can be issued in the near future within a reasonable period of time. The CCRA has settled for a period of the *same taxation year* (administrative practice – not the law). The dissent at the FCA was not challenged by any of the other judges on that bench.

Note: It is possible that some time in the future the Minister of Finance will legislate against the practices of rectification and retro-active issuing to deal with section 85 specifically.

Barnabe Estate v. The Queen (1999) FCA

Facts	Holding
○ Barnabe was a successful prairies farmer – his accountants advised that he should transfer his business to a newly incorporated corporation and elect to defer the taxes ○ At times Barnabe was so intoxicated that he could not properly instruct his counsel or accountants – on one occasion he signed a blank section 85 election ○ Nine days after signing the document Barnabe passed away ○ The executors argued that the unsigned missing elections form was enough to transfer the corporation on a tax deferred basis	○ *Issue*: Did the transfer qualify for section 85 – was there a disposition allowing for the transfer of property at all? ○ Tax Ct. Judge held that there was no election and without proper legal documents there was no disposition – how could this have happened without a meeting of the shareholders etc., ○ **FCA**: Section 85 applies and the executors were allowed to file the election form ○ The meaning of taxpayer includes person and 'person' includes a person's heirs and representatives ○ There was an intention to dispose of the assets and, thus, there was a verbal agreement that was sufficiently certain to achieve a desired tax result

Note: It is quite possible that sympathy played a very major role in this decision and has limited value as a precedent. Nevertheless, it would appear that intention is almighty in the Court's eyes.

Barnabe and *Juliar* both support the proposition that the intention of the transferor will be given a great deal of weight in terms of tax deferrals.

The Agreed Amount

There are certain thresholds that have to be met relating to the agreed amount – must be at least equal to the greater of 'boot' received and the cost amount of the property and it cannot exceed the fair market value of the property.

Thus, in the example of the $100,000 cost of shares and the $1,000,000 fair market value you can choose an amount anywhere between $100,000 and $1,000,000.

The cost amount of the property in capital property refers to the adjusted cost base. If you are talking about depreciable property you refer to? Inventory is at basic cost along with everything else. ???

© Francesco Gucciardo 2003

The elected/agreed amount is critical for three things:

1. Whatever you choose is deemed to be the transferor's proceeds of disposition;
2. That agreed amount is deemed to be the corporation's cost of the property that it has just acquired; and,
3. The agreed amount is the adjusted cost base (acb) of the property (shares for instance) received

Hypothetical One

Suppose property with a cost of $10 and a fair market value of $100 is transferred. The consideration received is $100 (shares only). If you wanted to get an absolute rollover you agreed/elected amount would be $10. There is no capital gain as the proceeds of disposition is $10, but also the adjusted cost base of the shares received is only $10. The cost of the property just acquired by the corporation is also only $10.

Allocation of Agreed/Elected Amount

The agreed amount must be at least equal to the greater of 'boot' received and the cost amount of the property and it cannot exceed the fair market value of the property.

Where you receive boot that is in excess of the cost you are going to have a taxable gain. To the extent that the boot exceeds the cost, the excess portion will be the gain and everything else is going to be deferred. How does this effect the transferor?

The agreed amount is allocated to the consideration in the following order:

1. The boot up to the fair market value;
2. Any excess is allocated to the preference shares received up to fair market value;
3. The balance is allocated to common shares

Hypothetical One

Suppose you have a cost of property at $10 and a fair market value at $100 that is transferred. The consideration received is $50 in shares and $50 in debt (note: fair market value of property must be equal to the fair market value of the consideration received). In order to minimize taxes the agreed/elected amount would be $50. Thus, the deemed proceeds of disposition is $50, the corporation's cost base in the property is $50. The entire $50 is going to be allocated to the boot, resulting in a zero cost-base in the shares. As a result, in some point in the future the tax on the remaining $50 will have to be paid – if they are sold the entire selling price will be a capital gain because of the zero cost-base. The sale of the shares is the triggering event.

Hypothetical Two

Suppose you have a cost of property at $10 and a fair market value at $100 that is transferred. The consideration received is $90 in shares and $10 cash. Also, an agreed amount of $50 is chosen even though the minimum amount is $10 (this might be done in the case of depreciable capital property). You have a $40 gain in this case. The corporation acquires property at a cost of $50. The adjusted cost base of the shares received as consideration is $40 because $10 of the $50 agreed amount must be allocated to boot. The gain on any future sale is going to be the amount of the sale less the adjusted cost base.

© Francesco Gucciardo 2003

Paid-Up Capital

The starting point for paid-up capital is stated capital for corporate purposes. Thus, look at what the consideration received by the corporation was in exchange for the issuance of shares. This is added to the stated capital amount per class of shares.

Suppose you have property at a cost of $10 with a fair market value of $100 transferred for $100 worth of shares in return. If the agreed amount is $10, then the paid-up capital amount is limited to $10.

Paid-up capital is a valuable tax account. When a shareholder has paid-up capital, the company can distribute that paid-up capital on a tax-free basis. Only gains accreted above the cost will be taxed.

Subsection 85(2.1) limits the increase in paid-up capital to the agreed amount less any boot received. Subsection 85(2.1) gets complicated where there is more than one class of shares issued. Paid-up capital is allocated on a pro-rata basis depending on the fair market value.

Hypothetical

Suppose you have property at a cost of $10 with a fair market value of $100 transferred for $95 worth of shares and $5 cash. The agreed amount is $10. The agreed amount is first allocated to the boot resulting in an adjusted cost base in the shares of $5. The paid-up capital is the agreed amount less the boot ($10 - $5) or $5.

Suppose the property was transferred for $33 worth of common shares, $67 worth of preferred share. The agreed amount lower limit is $10, resulting in no gain. The adjusted cost base of the preferred is $10 while the adjusted cost base of the preferred is $10. The paid-up capital is pro-rata: $3.30 to the common shares and then $6.70 to the preferred shares.

Other Non-Income Tax Issues

You have to consider the application of non-income taxes to various situations. For instance, there are certain exemptions that apply when you transfer tangible personal property to a related corporation in terms of GST treatment. Also, you might want to consider the application of land transfer taxes in certain situations.

Sufficiency of Consideration

What happens if the consideration's fair market value is unequal? Any kind of such shareholder benefit is going to be taxed and the amount of the benefit will be added to the cost of the shares. Section 15(1) provides this rule:

It is important to ensure that the value of the property received is equal to the value of the property transferred. The opposite is also true. There is a provision in section 85(1)(e.2) that provides that where it is reasonable to regard any portion of the excess amount as a benefit, then that increase will be the agreed amount.

This rule does not apply to wholly owned corporations. This might arise where you are not entirely sure what the value of the property is that is being transferred. Valuation becomes a key issue in such cases and the CCRA might take issue. You avoid this type of dispute or challenge by inserting a price-

© Francesco Gucciardo 2003

adjustment clause in the transfer agreement: if for any reason in the future the parties or the CCRA decide that the value of the property is greater than what is stipulated, then appropriate adjustments will be made by the parties to ensure that the transferor receives what is appropriate in return. This allows for a retroactive increase in the amount of consideration received back.

Provincial Taxation Issues

In some cases you can file a separate section 85 election for provincial tax purposes – see the "Quebec Shuffle" and the Winnipeg Jets case. Since then the provinces have enacted legislation restricting the application of the shuffle.

Tax Planning with Section 85

I. The Estate Freeze

One of the most common tax planning tools is the estate freeze, which allows people to do some estate planning and allow the generation transfer of a business. When a person passes away s/he is deemed to dispose of all of his/her assets and the estate must pay tax on those gains. The older generation will attempt to freeze the value of the shares today and allow the value of the company to grow.

You would take common shares and transfer them to the corporation and take back preference shares in exchange – this could also be done through a holding company. You can take the common shares and transfer them to a holding company in return for preference shares (the shares always have the same value). The terms of the shares are typically voting, redeemable at the option of the company, retractable at the option of the holder, and the retraction or redemption amount is fixed at the aggregate value of the company at the time of the transfer.

The new generation would subscribe for shares of the holding company and pay a nominal amount for all of the common shares of the company. This is allowable because of the high redemption value of the preferred shares. The only asset of the holding company is the shares of the actual operating company, meaning the common shares are generally worthless. The value of the operating company has been frozen at a particular date. When the person dies the gain up until the date of the estate freeze will be triggered, but any gain thereafter will not be taxed. This effectively stops the tax liability by entering into the transaction.

CCRA has accepted this as being legitimate tax planning and provided bulletins and interpretations acknowledging the effectiveness of the transactions. The only lynch-pin in this scenario is the valuation of the common shares. The premise of our tax law is based on fair market value – is it reasonable to say that an arm's length third party would only pay the particular sum for those common shares? The CCRA has acknowledged that such a valuation is valid. However, you must be careful in drafting those preference share provisions ensuring they comply with the parameters provided by the CCRA in earlier transactions. The section 85 transfer in this case is where the older generation transferred shares in the operating company in the holding company for preference shares.

The Family Trust

Sometimes those shares will be issued to a family trust instead of heirs. This provides the founders with even more flexibility in terms of who the beneficiaries can be. As the company increases in value over the years the trust can be used as a way of shifting funds to the particular individuals. The money can be shifted back and forth in any was as provided in the trust documents.

© Francesco Gucciardo 2003

II. Loss Trading Among a Related Group

In the U.S. all the corporations related to one another file a single tax return. In Canada, every single corporation is required to file a tax return. The CCRA has recognized that it would be unfair in the situation where you have a single public company with a number of subsidiaries (each of which have various gains and losses) to require taxes to be paid on all the gains without being able to offset the losses. If you are in the same family of corporations you can trade losses among a related group – section 85 allows this to happen.

III. Crystallization Transactions

One of the real tax perks that exists in the *ITA* is the $500,000 capital gains exemption that arise on shares of a qualified small business corporations. The QSBC is a small business that meets a number of different requirements. Nobody is sure how long this perk will be around, but people want to ensure they get it before it goes. A way to do this is through crystallization.

If you have a company worth $1,000,000 at a cost of $100,000 you would have a gain of $900,000. Using section 85, instead of electing at $100,000 you would elect at $600,000, which would trigger a capital gain of $500,000. This gain is exempt because you have sold the shares of a QSBC. The cost base of the transfer is $400,000.

Policy Considerations

Why does the CCRA allow an individual to defer a gain until the shares of a company are sold?

1. *Facilitates Investment* – more working capital is available;
2. *Puts more money in CCRA* – inherent in any CCRA section 85 transaction is an element of double-taxation!

The cost of the property received by the taxpayer as well as the cost of the property to the corporation has the potential to be double-taxed.

© Francesco Gucciardo 2003

Section 85.1 – Share for Share Exchanges

In General

This is the provision that is used most often in a takeover bid. The share for share mechanism in this section is a very commonly used provision to get a tax deferral on the disposition of the shares of the target company.

Consider where a public company looking to acquire a target offers to issue more of its own shares as consideration for the target company – this is a very inexpensive and powerful way for a public company to expand. A tax advantage is given to a shareholder who wishes to sell its shares to a public company in this way. Note: There is no limitation on the type of corporation that can take advantage of this provision.

This section provides a rollover – in the absence of this provision, if you had a share sale you would be in a bit of a spot because you would have triggered a taxable event, but would have no cash to pay to the CCRA. It is not entirely correct to think of taxation only on cash transactions – in the absence of a section 85.1 rollover, a transaction like that described above would require the payment of taxes. This section provides that taxes only have to be paid once the shares acquired in the acquisition of the target are sold.

The shareholder is deemed to have disposed of the shares in the target company for proceeds of disposition equal to the adjusted cost base and the shareholder is deemed to have acquired the new shares for the same amount.

Suppose X owns shares in Nortel and Bell Canada decides to launch a takeover bid for Nortel. Bell Canada offers to exchange 0.4 Bell Canada shares for every stock tendered in Nortel by the shareholders. Suppose 100 Nortel shares are acquired in exchange for 40 Bell shares. The adjusted cost base in the bell shares will be $100 and the acquisition was for $100.

If you meet all the requirements of the provision, you get the tax treatment automatically – there is no election to be filed. There is no choosing of the adjusted amount nor is there any timing issue – the deferral is automatic.

Requirements

Most of the requirements are found in the preamble. In order to qualify:

1. The purchaser must be a Canadian Corporation – defined in 248(1) of the *ITA* with reference to 89(1);
2. The purchase must issue shares in its capital stock to the vendor in exchange for shares in the target company;
3. The target corporation must be a taxable Canadian Corporation – defined in 248(1) of the *ITA* with reference to 89(1) – tax exempts do not get this treatment;
4. The vendor must hold the shares as capital property

Note: You can use inventory as eligible property under section 85. If you hold your portfolio as income account you cannot use 85.1 because the shares are not held as capital property.

Limitations

Section 85.1(2) sets out limitations:

© Francesco Gucciardo 2003

a) The vendor and purchaser must, immediately before the exchange, be dealing with each other at arm's length – not all share for share exchanges get the treatment and if the two are not at arm's length, the provision will not apply;
b) The vendor or persons with whom the vendor did not deal at arm's length cannot control the purchaser;
c) The vendor and the purchaser are not able to claim the treatment if they have filed an election under either section 85(1) or 85(2); and,
d) You can only receive shares from the acquiring company – there can be no boot, if there is any boot you cannot claim the section 85.1 rollover treatment

If there is any kind of internal re-organization involved then this is not the appropriate rollover mechanism.

Note: You must be very careful to ensure that there is not other type of consideration coming back other than shares of the acquiring purchaser.

If you do not want a rollover to happen, you can opt-out by including the gain or the loss in the income for the year. In other words, while the application of the provision is automatic, the parties involved will not be forced to apply it and can opt-out.

The calculation of the cost base is either:
1. The fair market value of the exchanged shares; or,
2. The paid-up capital of the exchanged shares

The purchaser can be stuck with the fair market value or paid-up capital, whichever is less. In most cases the purchaser is stuck with the adjusted cost base equal to the paid-up capital of the exchanged shares.

Opting Out

There are reasons that a purchaser might opt-out of the 85.1 rollover because they do not want the low adjusted cost base. Moreover, you may not know what the cost base is as you might not be certain if everyone held the shares as capital property or not. Any shares acquired from a person who did not hold the shares as capital property will not gain the advantage of the rollover. For any company doing this transaction, it might create a very unsatisfactory result, which is a reason why people try to get around the application of section 85.1.

There are reasons why a seller might want to opt-out. Suppose the seller does not want to trigger the rollover, but instead wants to trigger a capital loss today so that it can be applied to other capital gains. In some situations the public company may give the target shareholders an option.

Section 85.1(2.1) – Computation of Paid-Up Capital

Deems the paid-up capital of the new shares acquired equal to the paid-up capital of the exchanged shares.

Section 85.1(3) – Foreign Affiliates

There are only two conditions aside from having to be shares of a foreign affiliate who disposes the shares immediately to another foreign:
1. The transferred shares must be capital property; and,

© Francesco Gucciardo 2003

2. The consideration must include shares of the acquiring affiliate

Before the transaction the company being sold and the company acquiring are both foreign affiliates. If you receive cash or shares from the foreign affiliate, the vendor is deemed to have received it at fair market value. The shares received in addition, the cost base is the same as that sold, but reduced by the amount of cash received. The vendor is deemed to have acquired the shares of the affiliate at the acb of the acquired shares less the cash received.

The vendor's proceeds of disposition are equal to the aggregate of:

1. The ACB of the transferred shares; and,
2. The Non-Share consideration

If you want a complete rollover, take shares. If you take boot, you will look at paying some tax. Whatever the vendor's proceeds of disposition were become the cost base for the purchaser corporation.

In 1999, the Minister of Finance introduced section 85.1(5), which allows a foreign share for foreign share exchange. What gave rise to this was the merger of Daimler Benz and Chrysler. A number of Canadian Chrysler employees were given shares in the American Chrysler for shares in the newly merged Daimler-Chrysler. The government responded by introducing legislation allowing a foreign share for foreign share exchange. Like section 85.1 you can elect out of it by reporting income or gain on the tax return, otherwise there is an automatic rollover without the need to file an election.

Note: If the vendor has lots of capital losses they might want to recognize a gain for some reason. As such, the vendor will get a higher cost base, but then you would have to go to the trouble of filing a section 85. In a section 85 you do not have to take a rollover, you can choose whether you want to or not. The classic example is a person who takes a section 85 and is entitled to the $500,000 share exemption.

© Francesco Gucciardo 2003

Section 86 – Internal Reorganizations

This section permits a corporation to reorganize its capital and allows the shareholder to receive a rollover on the disposition of a certain class of shares for another class of shares.

Requirements

Most of the requirements are set out in the preamble:

1. The shares must be capital property – if the shares are not held as capital you can still get a rollover, but most likely through the section 85 election;
2. The shares must be disposed of by the shareholder – the term 'disposition' is defined in section 248(1) and includes any redemption/cancellation of shares in whole or in part. If you do not have a disposition, would you really care? If there is no disposition there is no taxable event! You would just continue holding the share in its new form;
3. The disposition must occur in the course of a reorganization of capital of *a* corporation – we must look at the common law to decide what a reorganization of capital is. Also, note that non-resident corporations can change their share structure and Canadian shareholders can get a rollover as a result. There is no requirement that the Corporation be a Canadian Corporation. Similarly, there are no restrictions on who a shareholder can be, it must simply be a shareholder who is taxable in Canada; and,
4. The shares must constitute all the shares of a particular class of the capital of a corporation that were owned by the shareholder at the time of the disposition – if someone wanted to change the characteristics of some of the shares, but not all, you would not be able to use section 86;
5. The shareholder must receive as consideration property that includes property in the capital stock of the other corporation – you can receive anything you like as long as you receive a share of the corporation

Dunston - CA

The essential feature of a reorganization of capital is the continued identity of the shareholders holding their shares in the same proportion.

Under the OBCA shares of a company are divided into classes and classes are divided into a series. Section 248(6) of the *ITA* provides that were a class of shares is referred to in the *ITA* it means also each series within that class. The implication is that if only a series of shares within a class are exchanged you will still get the rollover treatment because the series will have the same treatment as a class as a whole. In other words, for tax purposes exchanging the shares in a series is the same thing as exchanging the shares in a class

To ensure the applicability of section 86 you usually do the reorganization by way of articles of amendment ensuring that all the shareholders holding a particular class of shares will be exchanged for the new class of shares.
Note: If you had preference shares, within the terms are automatically converted into common shares at a particular time – this transaction is likely not a disposition because the change was contemplated in the articles.

Section 86(3) provides that sections 86(1) or 86(2) do not apply where sections 85(1) or 85(2) apply. By filing the section 85 election, you would be outside the provisions of 86.

© Francesco Gucciardo 2003

Consequences of Section 86

There are a number of rules that deal with what the cost of the shares of the new shares received by the shareholder are. 86(1)(a) provides that the cost of the non-share consideration is the fair market value of that consideration. 86(1)(b) provides that the cost of the new shares is the amount, if any, by which the adjusted cost base of the old shares exceeds the fair market value of the boot received for the old shares.

Thus, if X is reorganizing and has Class A special shares and files articles of amendment and receives Class B shares along with a promissory note of $100. If the cost base of the Class A shares was $200. Under this provision, the cost of the promissory note would be $100 and the cost of the shares will be the original cost base less the value of the non-share consideration.

What are the proceeds of disposition? The formula is found in section 86(1)(c), the proceeds of disposition is equal to the cost of the new shares plus the boot received.

Examples

Suppose you had an ACB of shares of $500 and you received a promissory note of $500 and a new class of shares with a value of $750 while the fair market value of the old shares was $1,250. The cost base of the new shares is $0 because the boot received is equal to the adjusted cost base of the original shares.

1. The cost of the boot is the fair market value of the non-share consideration at the time of disposition
2. The cost of the new shares is the amount, if any, the fair market value of the old shares exceeds the fair market value of the boot
3. The proceeds of disposition is the cost of the new shares (from #2) and the boot received for the new shares

Suppose you have an ACB of $500 and you take back boot of $250 along with new shares worth $1000. The cost of the boot is $250, the cost of the new shares is $250, and since the proceeds equals the original cost base, the gain is zero.

Suppose you have an ACB of $500 and you take back boot of $750 along with new shares worth $500. The cost of the boot is $750, the cost of the new shares is $0, and since the boot is $250 more than the cost base, the gain is zero.

Impact on the Corporation

Because we are talking about issuing shares as consideration, we do not have the same tax considerations. Since there is only share consideration we do not have a tax-event. If the corporation had transferred assets, such as shares in a subsidiary etc., there might be a tax-event.

Section 86(2.1) – Paid-Up Capital

This provision is trying to prevent the creation of new paid-up capital on a reorganization. We see a reduction of paid-up capital in the new shares so that it equals the paid-up capital of the new shares. This gets a little more complicated if boot is involved:

© Francesco Gucciardo 2003

> The PUC Reduction is equal to the increase in corporate stated capital that occurs as a result of the reorganization less any amount by which the PUC of the old shares exceeds the fair market value of any boot.

Thus, if you had Class A special shares worth $100, but PUC worth $10 - you would take the $100 and grind it down by the amount of the PUC of the old shares to the extent that it exceeds the fair market value of the boot.

Example

Suppose you have an adjusted cost base of $100 in the old shares with PUC of $100 and over time the shares appreciate in value up to $500. Suppose the old shares are transferred in exchange for a $75 note and new shares worth $425. The cost of the new shares is deemed to be the amount, if any, that the ACB of the old shares exceeds the fmv of the boot. The ACB of the old shares exceeds the boot by $25.

Section 86(2)

This provision deals with circumstances where the consideration received in exchange for the old shares is worth less than the fmv of the old shares and it is reasonable to confer the difference as a benefit, then the benefit is going to be added to the proceeds of disposition and give rise to a gain to the shareholder.

Suppose you had related shareholders holding different class of shares in a company, but one person’s shares is being subject to a section 86 reorganization for shares worth less than the old shares. That benefit will be conferred upon the proceeds of disposition and contribute to a gain to the shareholder.

© Francesco Gucciardo 2003

Section 51 & 51.1– Convertible Property/Debt

Convertible property can be debt or shares and this provision permits a holder to exchange such for shares of the corporation without triggering a disposition for tax purposes. It is different from 85, 85.1, or 86 as in those cases a disposition is required – in this case you do not require a disposition.

Section 51 Requirements

The requirements for the application of this provision are:

1. The taxpayer must acquire a share of the corporation either in exchange for shares in the corporation or for a bond, debenture or note;
2. The taxpayer must hold the old shares or debt as capital property;
3. No other consideration, other than shares, can be received;
4. This section does not apply to any exchange to which section 85(1), 85(2), or 86 applies

IN order to have 51(1)(a) to apply, you just need a share for share exchange whereas 51(1)(b) is a conversion. The terms of the bond, debenture, or note must confer upon the holder the right to make the exchange. If the terms do not so state then you cannot get a rollover under 51(1)(b). In the typical debt-holding situation, however, the cost of the debt is typically equal to the principal amount and the rollover, therefore, is not required as there is no tax event there (no gain or loss on that transaction). It does become an issue if you purchase the bond, debenture, or note in the market whose price is tied to the bond's coupon. If the interest rate is very low, one might be able to purchase it at a discount – the individual would have a low cost base in the bond and would require a rollover provision if the individual wishes to convert that bank into shares of the corporation. Making those instruments convertible gives the holder that ability to convert and avoid paying tax on the for-share conversions.

You might be in a situation where there is no conversion feature in the bond and the bond's interest rate is low. The company looking for ways to save money might accept shares in their own company as opposed to finding additional financing. You might add a conversion feature to the terms of the bond through a meeting of all of the holders. The CCRA has generally accepted that the mere addition of a conversion feature should not result in a disposition of the underlying bond – this is a cut way of getting around the disposition by changing the terms of the bond by making it into a convertible bond through a meeting of the holders.

GE Capital Case

Facts	Holding	Ratio
○ Not Done	○ *Issue:* Whether the changes to the debt was so significant that a new debt was created altogether	○ The mere addition of a conversion feature should not result in a disposition, but beyond that some new debt may, in fact, be created

Note: The critical thing is to ensure that the conversion feature allows the holder of the bond to take the debt and get shares of the same company.

Holding Shares/Debts as Capital Property

This is always a question of fact and will depend on the intention of the holder at the time of acquisition. If you did not hold the shares as capital property you will have to use the section 85 election and get the rollover treatment there.

© Francesco Gucciardo 2003

Non-Residents: Section 116 provides that any time a non-resident disposes of taxable Canadian Property they have to file a notice to the CCRA and obtain a clearance certificate. Thus, if you are doing a section 86 as a non-resident, you must file for a section 116 clearance certificate. If the certificate is not received, then the receiver is liable to withhold a 25% withholding tax. However, if a non-resident did a Section 51 transaction, you are deemed not to have a disposition, in which case you are not likely to require the section 116 certificate. The CCRA does not like the use of a section 51 transaction to get out of requiring a section 116 certificate.

The other advantage of section 51 over section 86 is that you do not have to convert all of your shares. Section 86 requires that all of the shareholders turn in all of the shares of that class. There is no election for section 51. Also, you can opt-out of the application of section 51 by electing to use section 85. This might be useful for a person who wishes to trigger a number of losses so that they can be applied against a gain and vice-versa.

Section 51(3) – PUC

On the exchange of shares for other shares you cannot increase the PUC as a result of the exchange. This provision reduces the PUC. Since there is no boot there is no need to factor in boot. The PUC of the new shares is reduced to whatever the PUC of the old shares was. This PUC grind only applied when you are doing a share for share.

Section 51(2) – Indirect Gift

If you have a class of shares worth more than the class of shares received for consideration, you may be triggering tax consequences as a result.

Section 51.1 – Requirements

This is a fairly new provision (1995) that deals with debt for debt exchanges and provides where a taxpayer acquired a debt instrument in exchange for another debt instrument of the same debtor with an equal principal amount, then the cost of the new obligation is deemed to be the same as the old obligation. The conversion right must be embedded in the terms of the bond, debenture, or note.

© Francesco Gucciardo 2003

Amalgamation

Types of Amalgamation

There are four types of Amalgamations that you can accomplish:
1. Long-Form Amalgamation
2. Horizontal Short-Form Amalgamation (sister companies)
3. Vertical Short-Form Amalgamation (parent and subsidiary)
4. Triangular Amalgamation

Long Form

This requires an agreement between the amalgamating parties. In this situation none of the shares are cancelled. If you have a situation where A owns the shares in Corporation Y and B owns the shares in Corporation Z, if you amalgamate Corporation Y and Corporation Z in this form, this means that A and B (Y and Z) would enter into an amalgamation agreement stipulations:
1. How it would occur
2. A's interest
3. B's interest

After the amalgamation you would end up with YZ with A and B as shareholders. Generally, the shares of Y that A held would be converted into shares of YZ and the shares of Z that B held would so be converted.

You would file articles of amalgamation and attach the amalgamation agreement with the articles. Because of this agreement and the share conversion, the long-form amalgamation is not common.

Horizontal/Vertical Short-Form

This occurs where A owns shares in both Y and Z (likely sister companies for horizontal and parent/sub for vertical). You do not need an amalgamation agreement, but merely a special resolution of the shareholders and once you have this resolution the shares of either Y or Z, in this case, are cancelled. If Z are cancelled, nothing happens to the Y shares and Z amalgamates with Y to form YZ. Because of the cancellation of shares and resolution only, it is called a short-form.

Triangular Amalgamation

This is the rarest form of amalgamation and occurs between three companies. Suppose you have Company X with a wholly owned Subsidiary Y who wants to takeover Company Z. Consider that X is a public company and Z is a public company and X has a number of operating subsidiaries in various businesses – Subsidiary Y is in the same business as Company Z. X wants to buy Z and put it together with it's Y subsidiary. X will make an offer to all of the Z shareholders – for every Z shares X will tender some of its own shares. Under the amalgamation, Y and Z will be amalgamated, but instead of the Z shareholders getting shares of the newly amalgamated company, they are getting shares of X. Z becomes YZ and the former Z shareholders get shares of X.

Section 87 – Amalgamations

Section 87 provides the basic requirements of an amalgamation, they include:
1. Must be a taxable Canadian Corporation

© Francesco Gucciardo 2003

2. All of the property of the amalgamating corporations before the merger must become property of the amalgamated corporation (87(1)(a))
3. All of the liabilities of the predecessor corporations become liabilities of the amalgamated corporation
4. All of the shareholders who own shares in the capital stock of the predecessor corporation receive shares of the new corporation because of the merger

In the vertical and horizontal amalgamation, the fourth requirement is not met. For those amalgamations you have to look to section 87(1.1).

In the vertical amalgamation the shares that were held by the top company were not received by virtue of the amalgamation – this is why you need 87(1.1) which deems the shares to have been received as a result of the amalgamation.

The provisions of the *ITA* that deal with the triangular amalgamations are found at section 87(9).

You will not have to worry about the triangulars for the purpose of the examination. This subsection provides guidance of the applicability of *ITA* rules in a triangular amalgamation and are only applicable where the parent company is a taxable Canadian Corporation.

Exceptions to No-Boot Rule

By virtue of all of these requirements, there can be no non-share consideration (boot). If there is any kind of boot whatsoever, then you would not qualify under section 87. There are some exceptions that have been granted by the CCRA:

1. Fractional Shares – If a shareholder receives cash in lieu of a fractional share that will not throw you offside of the provisions at section 87 – as long as the cash received is less than $200 (Interpretation Bulletin-474R3)
2. Cash on Dissent – Shareholders who receive cash as dissenters will not throw an amalgamation off under section 87 – under corporation law, any time you have such a corporate event and a shareholder is dissatisfied with the amount s/he is getting, the shareholder has dissent rights and, in certain circumstances, is entitled to be paid the full fair value of those shares in cash. The dissent payment will not throw off the application of section 87

Timing Issues and Year Ends

One of the important things to notice about section 87 is that there is no election to be filed – the provisions of section 87 will apply automatically. There are also important timing considerations that will come into play. Section 87(2) provides that the amalgamation results in a deemed year-end immediately before the amalgamation. The first taxation year will be deemed to have commenced at the time of the amalgamation. Thus, each predecessor corporation has a year-end immediately before the amalgamation – this becomes an important timing consideration where a company has losses. Non-capital losses can only be carried forward seven taxation years. If you have a December 31 year-end and you amalgamate on February 1, that means that you will have a one-month year end. That one month counts as an entire taxation year for these purposes. This is a real economic cost that must be weighed in order to determine whether it is a good idea to amalgamate.

Also, when you claim capital cost allowance, the CCA is pro-rate for a short year. To the extent that a corporation owns a building over a period of time, if you have a six-month year-end you can only claim for half the year.

© Francesco Gucciardo 2003

If you borrow money from a corporation as a shareholder, as long as you repay it within two years of the end of the taxation year it will not show up as taxable income for income tax purposes. Should the amalgamation shorten this period, then the shareholder may have to include that income.

These timing issues may have a number of ripple effects on various interested parties. When a corporation is being acquired by a third party, that also triggers a year-end. Sometimes when a target company is repurchased and a buyer wants to re-organize that corporation, you might inadvertently trigger a number of year-ends within a couple of days of each other.

This is generally dealt with as follows: any time an amalgamation is being considered, try to ensure that the articles of amalgamation are filed the same day as the acquisition of control. As long as you are silent in the amalgamation documents as to the time of day the amalgamation is to occur, the amalgamation is to be effective for the entire day in which the articles are stamped. As long as the date on the articles is the date of the acquisition of control, you should have only one year end. You can synchronize your year ends so that you do not run into any timing problems.

Tax Accounts

Section 87 contemplates virtually every tax account that can impact on a corporation. Subsection 87(2) attempts to provide a complete code to determine how the various tax accounts ought to be effected. Some of the more important accounts include:

1. **Losses** – generally, you would combine the losses of the two or more predecessor corporations. The carry-forwards are the same historic time-period had for the predecessors. An exception is found in 87(2.1) that provides that where the amalgamation results in an acquisition of control, losses of the predecessor may not be carried forward. Losses incurred by an amalgamated corporation cannot be carried-back to the predecessor corporation (usually you can carry-back for three years). The exception to this rule is found in 87(2.11), which deals with a vertical amalgamation and allows you, if the Amalgamated company has losses, to carry those losses back to offset the parent corporation's income prior to the amalgamation subject to the three-year limitation rule;
2. **Cost** – The cost of the transferred property to the amalgamated company is whatever the cost was to the predecessor corporation. If the predecessor owned land that had an ACB of $1 million, after the amalgamation the amalgamated company's cost shall be $1 million as well. The historic cost for the predecessor will become the cost for the amalgamated company

Tax Considerations for Shareholders

Section 87(4) provides that shareholders that hold their shares as capital property will obtain a rollover – the shares will be deemed to be disposed of for proceeds of disposition that are equal to the adjusted cost base of the shares of the predecessor corporation (87(4)(a)).

When there are more than one class of shares that you get back on an amalgamation, you allocate the adjusted cost base to those three classes of shares based on the relative value of those classes (pro rata according to the value of the new shares).

Paid-Up Capital

In terms of paid-up capital, you pool the paid-up capital of the predecessor corporations and take the aggregate value in each class, that aggregate amount becomes the PUC amount. If there were multiple classes of shares issued, you can allocate that PUC in any way that you wish. However, if the aggregate

© Francesco Gucciardo 2003

PUC is greater than the PUC of the predecessors, 87(3) acts as an automatic grind to bring PUC down to a level making it equal to the PUC of the predecessor corporations.

Uses for Amalgamations

There are a variety of uses for amalgamations:

1. **Merging profitable corporations**;
2. **Merging corporations with losses**;
3. **Eliminating Minority shareholders** – there are many circumstances where a corporation tries to acquire the shares of another, make a takeover bid, and 95% tender their shares under the bid. There is a 5% float (typically the long-lost shareholders etc.,), the way these minority shareholders are dealt with is through a squeeze-out transaction. The acquirer will typically drop the acquired shares into a new holding company or use some other company to acquire – you would do a short-form amalgamation (requiring no shareholder approval). On the amalgamation all the shareholders would get a class of redeemable shares and the others would get 100% of the common shares. At the end of the day, the amalgamated company has 100% of the common shares being owned by the acquirer and the minority has redeemable preference shares, redeemable for the value of whatever A paid for in the original tendering process. Because of the rules there are no tax consequences for A (who has just acquired) or for the target company or for the purchase company. In terms of timing, if you do this squeeze out on the day of closing and amalgamate on the same day you will only have the one year end;
4. **Leveraged Buy-Outs** – The amalgamation can be used as an effective financing technique for an acquisition – the leveraged buy-out is a situation where you use the value of the target company that you are looking to buy to finance the acquisition. Suppose that A uses P (the acquisition company) to acquire T (Target worth $100 million). If P only has $10 million in cash and they do not want to raise the other $90 million, P may go to the bank and outline their strategy. The banker or financier or junk bond issuer will lend $90 million to the acquisition company so that it now has $100 million to make the acquisition. P would amalgamate on the same day that it acquires the shares and, as a result, you have an amalgamated company that now owes $90 million to the junk bond holders. Historically, this scheme results in the selling off of assets that are not needed in order to pay off the debt. The main benefit is that it allows you to put the debt in the same vehicle where all of the operating assets are. Note: There are interest payments that need to be paid to the bank on the debt – from a tax perspective the interest expense is going to reduce the amount of profit earned in the year. Rather than paying the government a certain amount in tax, there is a whole new class of stakeholders
5. **Altering Year-End** – If a corporation did not like its current year-end, an easy way of changing the year-end is to amalgamate. The day previous to the date of amalgamation will be the new year-end. You generally cannot change your tax-year without permission of the CCRA. Note: the CCRA would likely take a dim view if the only reason to amalgamate is to change the year-end. They would likely try to apply GARR.

© Francesco Gucciardo 2003

Winding Up

There are two types of winding up that are contemplated in the *ITA*:

1. Qualifying – where 90% of the shares of the corporation are held by the parent. This gets tax deferral treatment (88(1))
2. Non-Qualifying – all others. This is fully taxable – 88(2)

When you wind-up, the corporate assets are transferred to the shareholders, which is a taxable event. For the shareholders, they are going to be considered to have disposed of their shares and result a tax result (either a gain or loss depending on the property received versus the cost of the shares).

Qualifying – 88(1)

This generally allows the transfer of the subsidiaries assets for their tax value and there is no tax on the cancellation of the subsidiaries shares. Most of the tax attributes of the subsidiary also flow through to the parent corporation. Just like an amalgamation, you require a special resolution of the shareholders (2/3 majority vote at a shareholder meeting) and also all of the assets and liabilities of the corporation are transferred. This normally involves some kind of general conveyance to transfer all of the assets and liabilities as part of the winding up. At this time, there will be some expression of an intention to dissolve the corporation at some point in the future (dissolution). The winding up is that actual transfer and the dissolution is the actual filing of articles of dissolution where the corporation ceases to be a legal entity. In the intervening period you have an empty corporate share.

Generally, you pass the winding up resolution and declare the intention to dissolve. Before so doing you wait to see what:

1. Tax returns and implications will look like
2. File for clearance certificates – tax man does not want any dissolution until they are satisfied that there are no outstanding tax issues

There is a tax deferral mechanism in 88(1) that are similar to the vertical winding up. The assets held by the subsidiary are transferred to the parent for their historic value and there is no tax at the subsidiary level. The parent is deemed to have disposed of its shares in the subsidiary for proceeds of disposition equal to their cost.

These rules are found at section 88(1). The subsidiaries tax accounts flow through to the parent.

Basic Requirements for 88(1):

1. Both the parent and the subsidiary must be taxable Canadian Corporations (cannot be tax exempt);
2. 90% of the issued shares of each class of the subsidiary must be owned by the parent corporation at the time of winding up – more than 10% other than the parent corporation will render you unqualified;
3. The shares that are held by the minority must be owned by shareholders that deal at arm's length with the parent corporation
4. All the assets and liabilities have to be transferred to the parent corporation and there must be an expression of intent of all the shareholders that there will be dissolution (IT Bulletin 126R)
5. Like amalgamations, there is no requirement to file any election – so long as you meet the requirements, then section 88(1) will apply automatically

© Francesco Gucciardo 2003

There is nothing in the *ITA* that says when the dissolution applies – they would prefer it to occur within a short period of time so that you do not have an empty corporation sitting for years before applying for the clearance certificate.

Consequences to Parent Company on a Winding Up

Subsection 88(1)(b) is the paragraph that describes what the tax treatment is for the parent company with respect to the shares of the subsidiary that is being wound-up.

88(1)(b)(i) – The lesser of the PUC (in respect of the shares of the sub) or the tax value of the assets less the liabilities of the subsidiary that were distributed to the parent on the winding up (88(d)(i))

88(1)(b)(ii) – The ACB of the shares of the subsidiary to the parent immediately prior to the winding up

What do these formulas mean? If the ACB is greater than PUC, then the parent company will never realize a capital gain on the winding up. However, if the PUC is greater than the ACB, there will be a capital gain if the tax value of the assets less the liabilities of the subsidiary exceed the ACB.

We are trying to figure out what the proceeds of disposition are:

1. Which is greater (i) lesser of PUC or tax cost less liabilities or (ii) ACB?

If PUC is greater than ACB you could have a capital gain if the tax value of the assets is greater than the ACB. The common practice is to reduce the PUC, which is done through corporate resolution reducing the stated capital for corporate law purposes. As long as you ensure PUC is less than or equal to the ACB of the shares, you do not have to worry about triggering the capital gain.

One of the side elements of this formula is that it is impossible for the parent corporation to every have a loss triggered – a loss cannot be triggered through the qualifying winding up.

Consequences to the Shareholder

The provisions only provide the beneficial treatment for the parent corporation. The minority shareholder who receives property may have to pay tax. The proceeds of disposition are going to be equal to the fair market value of the assets on the winding up. If the value is greater than the ACB of the shares there will be a gain and conversely if less then a loss – these are ordinary principles. From the minority shareholder's perspective, the ACB of the acquired property will be equal to its fair market value on the date of receipt.

The assets that are distributed to the parent corporation is guided by 88(1)(a) are deemed to have been disposed of at cost (no gain or loss on the distribution). Unlike the vertical amalgamation, where there is a winding up that does not trigger a year-end for the subsidiary. As long as it exists without being dissolved, it will still be required to file a tax return. The section of the *ITA* that imposes an obligation to apply for a clearance certificate is at 159(2) – failure to apply for the certificate results in personal liability on the amounts owing, if any. Note: the entire area of clearance certificates is becoming controversial in itself as the waiting time for the certificate can be years, which creates are real practical problem

Cost Amount to Corporation

Paragraph 88(1)(c) provides that the parent will be deemed to have a tax cost of the properties received equal to the cost amount to the subsidiaries. There is one huge exception to this rule at 88(1)(d), known

© Francesco Gucciardo 2003

as the "88(1)(d) bump", which is a very effective tool that allows the parent company, when it receives property on a winding up, to bump the cost base of the property within certain parameters. The 'bump' will increase the ACB of non-depreciable capital property. The typical assets that are 'bumped' include shares, land, interest in a partnership (anything not depreciable).

The maximum limit that you can increase the ACB is whatever the fair market value was at the time the parent acquired control of the subsidiary. The value of the property at that precise moment is very important.

88(1)(d) will generally apply if the ACB of the parent's shares in the subsidiary is greater than the tax value of the subsidiary's property (outside basis – ACB in sub's shares, versus the inside basis – subs tax cost in the assets) – if the outside basis is higher, this is where you will have the opportunity to use the bump.

If a purchaser acquires the shares of a target and the target has various assets, such as land purchased years ago with a low cost base (suppose cost of $1 million and current value of $100 million), the outside basis is $100 million while the inside basis is only $1 million. The bump will allow you to bump the ACB of the land from $1 million to $100 million – this allows you to shift some of the outside basis to the inside. This will allow you to reduce the potential capital gain that you would realize in the future because the cost base is increased substantially.

The amount of the bump is limited to the excess of the ACB of the shares of the subsidiary over the cost amount of the net assets distributed on the winding up. The excess of any ACB on the shares in the above example is $99 million. The amount of the excess can be reduced by any dividends that are paid by the corporation to the parent in contemplation of the winding up. One of the reasons the dividends are carved out is that you could otherwise increase the amount of bump available by reducing asset value by declaring a dividend. When determining the cost amount of an asset you include any cash in that value – the payment of a dividend will reduce the amount of cash and have an impact on the size of the bump room.

There are some limitations/restrictions:

1. The bump is only available on property that was owned by the subsidiary at the time the parent acquired control and is owned continuously since that time;
2. You cannot bump 'ineligible property' – the definition of ineligible property is the most complicated section of the *ITA*

The definition of ineligible property includes any depreciable property. Any other type of transaction that involves a 'butterfly' or a divisive reorganization cannot going to benefit from bump. They do not want a parent to acquire the company from arm's length shareholders, wind the subsidiary up, apply the bump, and sell the assets back to the shareholders (this is known as the back-door butterfly).

88(1)(d.2) has an anti-avoidance provision preventing a corporate group from using the bump in an acquisition of control – corporations within a corporate group that acquire control are denied the benefit of applying bump.

To obtain the bump, the parent company has to designate the property subject to it in the tax return and claim the amount it is claiming. Because it is in the tax return, there is no relief from late filing and no ability to amend. Be careful, otherwise you can be hit with major problems.

© Francesco Gucciardo 2003

Calculating the Bump

Example One

Suppose you have just acquired shares for a purchase price of $2 million. The tax value of the net assets is $1.5 million.

ACB Shares	$2 million
Net Assets Tax Value	$1.5 million
ACB of Land	$400,000
FMV of Land on date of Acquisition	$600,000

The maximum value of the bump is the amount the ACB exceeds the tax value ($500,000). The absolute maximum property can be bumped, recall, is whatever the fair market value the land was at the date of the acquisition of control. Thus, the ACB of the land can be bumped to $600,000, a bump of $200,000.

This allows people who are doing the leveraged buy-outs, if they use a winding-up under 88(1)(d) to sell off non-depreciable assets without paying tax.

The bump rules are now available for a vertical amalgamation – 87(11) – when you do a vertical amalgamation all of the bump rule at 88(1)(d) apply.

Example Two

ACB Shares	$1,320,000	
Net Assets Tax Value	$295,000	Maximum Bump - $1,025,000
ACB of Shares (Other)	$50,000	
FMV of Shares	$800,000	Maximum Bump Room - $750,000

You can get those shares at the hands of the parent with an ACB of $800,000 without the limitation of $50,000.

Losses on a Winding Up

88(1.1) and 88(1.2) deal with the availability of loss carry-forwards on a subsidiary. The losses are available in the first taxation year of the parent commencing after the winding up. If the sub has some losses and is then would up in the parent company in the middle of a taxation year, the parent cannot use those losses until the next taxation year. This is why strategically you try to do a wind up near the end of the taxation year, perhaps the last day of the parent's taxation year.

Since there is no change in existence from the parent corporation, its loss carry-forward rules are completely unaffected on the winding up.

Case Study – Winding Ups in a Corporate Transaction – Onex and Labatt

In 1995 Onex was in the process of a takeover bid of Labatt and Labatt was in play – Labatt was a very diversified company with broadcasting assets, brewery assets, interests in sports teams, and a significant investment in a Mexican company. Because of the diversity, a number of people thought that Labatt was

© Francesco Gucciardo 2003

worth more than the current trading price by splitting up and selling the assets. Onex launched a takeover bid and in the circular, one of the assumptions that Onex was made were based on statements made in the Labatt's annual report based on how they held their assets.

You had Labatt with a 100% owned subsidiary (Labatt's Brewing) who owned 90% of the Toronto Blue Jays, then another sub (Labatt Communications) who owned 80% of the Discovery Channel and 42% of SkyDome, then a 22% interest in the Mexican Co.

Brewing and Communications stated that they owned TSN at the time. TSN was a partnership, which owned Pay-Per-View assets, the TSN CRTC license, along with the Toronto Argonauts.

When Onex was planning the takeover bid they did not know that Labatt had dissolved the partnership and had Brewing and Communications owning the assets directly under joint-ownership. At that point the partnership was dissolved. Onex planned on taking over Labatt, winding it up, and then bumping the partnership interest in contemplation of a sale of the partnership. The elimination of the taxes would allow Onex to pay a certain price (those considerations were figured into the price). However, those assets not being held by the partnership were not eligible property for the bump.

Therefore, when Onex launched the takeover bid, Labatt informed Onex that they did not hold the particular assets through the partnership. The entire Onex plan would not work. Insodoing, the management of Labatt figured the Onex bid were far too low and they did not put the assets into a corporation. Labatt used the 88(1)(d) bump as a shield against Onex's takeover plan.

InterBrew then came along and gave a higher price than what Onex was about to offer. Prior to the acquisition of control, Labatt took the assets and put them into a corporation so that Interbrew can take the bump and sell off the assets that they did not want to keep.

Summary

Amalgamations and wind-ups are the two major choices in joining corporations. There are a number of differences between the two options:

Amalgamations	Wind-Ups
• Simple approach process wise	• Require consents and notices
• Jurisdictions – need to continue into	• Jurisdictions – no need to continue into
• Corporate solvency test required	• No corporate solvency test
• Creditors don't have the power	• Creditors need to be onside
• Cannot trigger Capital Gain	• PUC Considerations and Triggering Capital Gains
• Bump is available	• Bump is available
• No requirement for clearance certificate	• Personal liability for not applying for clearance
• Triggers a deemed year end	• Does not trigger a deemed year end
• Don't need 90% shares	• Cannot wind up unless you have at least 90%
• No taxable events	• Taxable events may inadvertently trigger non-income taxes
• Employer contributions carry through – amalgamation is not a new employer	• Employer contribution to CPP starts over – employers cannot claim for CPP over-contribution
• Can result in capital tax consequences	• Can result in capital tax consequences

If you had a parent in one jurisdiction and a sub in another, as long as both the parent and sub are taxable Canadian Corporations you can wind up without needing the continuance.

© Francesco Gucciardo 2003

Non-Income Tax Issues

The amalgamation of two corporations results in no disposition of the assets, thus no GST or PST results. The winding up may inadvertently trigger PST and GST. The same holds true for land transfer taxes.

Another thing that is often forgotten is employee withholding and CPP contributions

© Francesco Gucciardo 2003

Canadian Residency & Treaties

Taxing Generally under Part I

Who is taxed on what income under the *ITA*? Section 2 is the primary charging section for Part I. Subsection 2(3) is the charging section for non-resident persons.

Note: the charging section deals with every 'person' and a 'person' is defined in subsection 248(1). The charging section includes anyone resident in Canada for any time of the year. Once you are found to be resident you are subject to tax on your worldwide income. In contrast, in the U.S. taxation is based on citizenship opposed to residency.

Note: The subsection does not define a non-resident, but through exclusion (i.e. not a resident) the non-resident is liable to taxation under this subsection. In order to determine liability, you need to determine residence of a person. Once you determine someone is not a resident and you find a link pursuant to paragraphs (a) through (c), then you move to an application of the rules under Division D, starting at section 115.

The links include:

1. Employment in Canada;
2. Carried on a Business in Canada; and,
3. Disposition of Property in Canada

Once you have established that you are a non-resident and subject to subsection 2(3), you must turn to Division D to determine what the taxable income is. Section 115(a)-(c) outlines the non-resident's taxable income in Canada.

The provision at 2(3)(a) links directly into 115(1)(a)(i). Similarly, subparagraph 2(3)(b) links directly into 115(1)(a)(ii). Finally, subparagraph 2(3)(c) links directly into 115(1)(a)(iii). The next step in the analysis is to look at treaties – there are treaty overrides and limitations that exist. For instance, a person employed in Canada or the U.S. applies to the extent that at least $10,000 is earned. Also, if you do not carry on business through a permanent establishment, then you will not be subject to the taxation. Thus, always keep in mind the treaty effect on the non-resident. The concept of taxable Canadian property that must also be dealt with – it is defined in subsection 248(1).

Taxable Canadian Property – Canada reserves the right to tax non-resident dispositions of certain types of property that Canada has an interest in. For instance, because the situs of real property is in Canada, the government reserves the right to taxation. As well, certain types of shares and business access are taxable based on the nexus or connection to Canada.

Subsection 2(3) also speaks to anytime in the year or any previous year – this catches deferred payments where someone did not get paid in that year for something that they did. This ensures that deferred payments are captured – still limited to Canadian source income.

Section 114 – Individuals Resident in Canada for Only Part of the Year

This deals with individual who are resident in Canada for part of the year and non-resident for another part. This relates to someone who emigrates or immigrates to Canada and does not apply to sojourners. Once you are found to be sojourning in Canada, you are deemed to be resident in Canada throughout the year.

© Francesco Gucciardo 2003

Paragraph (b) sets out the deductions that are allowed by a part-time resident and these amounts relate to the time that they were resident. This paragraph must be looked at in conjunction with 118.91, which deals with part-year residents. Under 118.91(b)(i) such of the deductions as can reasonably be considered wholly applicable to the time they were resident.

Section 250 deals with persons who are deemed to be resident in Canada. Subparagraph 250(1)(a) deems a person who has sojourned in Canada for a period of 183 days or more to be a resident throughout the year. Sojourning is something less than residence. For instance, if you had no ordinary, settled routine in life you may be found to be sojourning in Canada if you are found to be resident in Canada for more than 183 days.

Changing Residence

If you change residency you might trigger an application of section 114. However, more recently the taxes at 128.1 are being triggered (departure taxes). Section 128.1(1) deals with immigration to Canada while 128.1(4) deals with emigration from Canada. This provision deems a disposition and re-acquisition immediately of capital property. Thus, when you leave Canada you have a deemed disposition of all Capital property that you own and they you are deemed to immediately reacquire it. This has the effect of taxing the accrued gain that has accumulated in the asset. You pay tax on the accrued gain, but the cost-base in the property is stepped up by the reacquisition of that property because you have already paid tax on the accrued gain.

Section 128.1(1)(b) – if the taxpayer is an individual, property that is taxable Canadian property – you do not have a deemed disposition of taxable Canadian property. The reason you have carve-outs is because collection is not much of a concern for those things that have a sufficient nexus to Canada, such as taxable Canadian property at 128.1(1)(b)(i). A similar provision exists for an individual emigrating at section 128.1(4)(b)(i).

Section 226 provides guidance in respect to a taxpayer leaving Canada.

Determining Residence

Section 250(3) provides guidance as to a person who is "ordinarily resident":

Note: The definition uses the term 'includes', which is not exhaustive and, thus, the common law definition of residence is still applicable.

Thomson v. MNR (1945) Exch. Ct

Facts	Holding	Ratio
○ Thomson left Canada and rented a house in Bermuda in 1923 ○ Thomson had a house built in New Brunswick and it was available to him at all times ○ Thomson was asked to file a return as a resident and he refused to do so ○ MNR issued an arbitrary assessment pursuant to section	○ *Issue*: Is Thomson resident in Canada? ○ The question of whether a person is ordinarily resident in one country or another cannot be determined solely by the number of days that he spends in each ○ You can be resident without be present ○ You have to be resident	○ An individual may be ordinarily resident in two countries if his stay in each is substantial and habitual and in the normal and ordinary course of his routine life ○ Residency is a question of fact based on the evidence

© Francesco Gucciardo 2003

160 "Net Worth Assessment" o Thomson bears the onus to show the assessment is incorrect	somewhere – if you cannot show residence somewhere else, that is strong indicia o You can be resident in more than one country at a time o The facts are conclusive that the appellant was both residing and ordinarily resident in Canada within the meaning of section 9(a) of the *Act*	

Subsection 250(3) preserves this common law definition of residence.

MacDonald v. MNR (1968) Tax Appeal Board

Facts	Holding
o Review Facts	o MacDonald is resident in Canada even though he is present for less than 183 days o When MacDonald was not working he was present in Canada

Meldrum v. MNR (1950) Tax Appeal Bd.

Facts	Holding
o Sea Captain living in NY and sailing between NY and Halifax o Had house in N.S. occupied by married daughter o Taxpayer went for holidays of two weeks of the year o Rooms were reserved for the taxpayer in the home	o The two-week presence was not sufficiently permanent and the taxpayer was not resident in Canada o **Dissent**: The taxpayer has actually physical presence and a place of abode always available to him, which is a sufficient nexus to create residency

Ronald Kirby v. MNR (1972) Tax Review Board

Facts	Holding	Ratio
o Taxpayer contended he was only a part-time resident in one year and a non-resident in another	o The appellant had never settled anywhere or established a permanent establishment elsewhere despite physical absence o Although Kirby may have had in his mind the idea of establishing a permanent residence elsewhere, he did not in fact do so	o You can be a resident in Canada despite being physically absent on the assumption that you must be resident somewhere

Neil Barry McFayden v. The Queen (2000) Tax Court of Canada

Facts	Holding
o A Revenue Canada employee was posted in Japan, her husband went with her o The couple sold a house, two cars and a motorcycle and espoused they had not intention to return to Canada	o **Factual Resident**: The appellant's ties with Canada during the three years was sufficient enough to cause him to be considered factually resident o Returned to Canada on three occasions, owned to houses in Canada, maintained professional memberships, kept furniture in storage, maintained RRSPs o The taxpayer was ordinarily resident in Canada under 250(3) o **Deemed Residence**: As a spouse of a diplomat or public service

© Francesco Gucciardo 2003

○ Husband has trouble finding employment and returned three times to Canada	representative, who is deemed to be a resident of Canada, the husband is also deemed to be resident in Canada ○ **Treaty-Based Residence**: Taxpayer only paid on a source basis, and not on full tax liability basis – the source basis tax in Japan is not enough to cause him to be resident in Japan

Moreau v. CCRA (2000) SCJ

Facts	Holding
○ An injunction was sought stopping CCRA from withholding taxes from the pilots salary payments ○ A declaration was asked for that they were non-resident in Canada	○ The question of residence is a legal question under the *ITA* ○ The tax court has exclusive originating jurisdiction for tax based appeals ○ The CCRA is not the cause of the withholding – the *ITA* causes the withholding

Note: The pilots, although not generally physically present in Canada, must be resident somewhere.

Dixon v. The Queen (2001) FCA

Facts	Holding
○ A lawyer went to Texas for several years and moved back to Alberta to start practicing law ○ In his return, the lawyer claimed his moving expenses to move back to Canada ○ Lawyer was in Canada for greater than 183 days and wanted to argue that he was sojourning so he would be deemed a resident throughout the year, in which case he could cause the moving expenses to be deducted	○ *Issue*: ○ Upon his return to Canada he was not sojourning, instead he actually became resident by coming back to Canada ○ The court cites *Thomson*: one is ordinarily resident in the place where in the settled routine of his life he regularly, normally or customarily lives. One sojourns at a place where he usually, casually, or intermittently visits or stays

Corporate Residence

DeBeers Consolidated (1906) HL

Facts	Holding
○ Not Done	○ You are a resident where you do business ○ Business is carried on where the central management and control is ○ Since the directors met in London, that is where the real control is exercised and therefore the directing mind was in England

Sifneos v. MNR (1968) Tax Appeal Bd

Facts	Holding
○ Minister arguing company was resident in Canada because it wanted to withhold taxes of payment of dividend to non-resident ○ Sifneos is a non-resident shareholder and trying argue that the company was resident in the U.K. in which case no withholding tax would be imposed	○ Paramount authority is what is important and not the day-to-day operations ○ It is customary to have ships managed out of the U.K. ○ Ultimately, the U.K. management company looked over the ships and not the business – under the contract they were still accountable to the Canadian Board – the company is resident in Canada ○ Because a resident corporation is paying dividends to a non-resident there is an application of some withholding taxes

© Francesco Gucciardo 2003

Munich Construction

A subsidiary of a corporation is a separate legal entity – so you determine the residence of the subsidiary separate from the parent. Look to the concrete acts of management and control. In this case, we have de facto control where the corporation was controlled even though it was unlawful for the company to operate out of the UK.

Crossley Carpets v. MNR (1968) Exch. Ct

Facts	Holding
○ UK Corp registered in UK with a distribution business in Canada ○ Board met in the UK ○ Board only rubber stamped what Canadian Company wanted to do	○ A company is resident where paramount authority is exercised ○ You can have dual residence ○ Residence was here divided between the two jurisdictions

R. v. Gurd's Products (1985) FCA

Facts	Holding
○ A company was incorporated before April 26, 1965 ○ The central management and control of the company was located in the U.S. ○ Crush (the US company) wanted to sell its products to Iraq, but Iraq would not deal with the American company ○ The parent had a Canadian subsidiary incorporated in Canada ○ Crush products were distributed through the Canadian subsidiary to Iraq ○ Dividends were being paid to non-residents, which should be subject to a withholding tax	○ Issue: Was the Canadian corporation carrying on business in Canada subsequent to April 26, 1965? ○ Section 212 of the ITA requires a Canadian payor to withhold 25% ○ The Canadian company was a Canadian resident ○ Substantial profits were earned through the sale of a product made in Canada; a bank account was held in Canada; an official agent was situated in Canada through the Canadian employee; and, the nature of the operations required the carrying on of business in Canada

Subsection 250(1) – Deemed Residence

Subsection 250(1) provides the deeming rules as they relate to residence. In certain circumstances people are deemed to be resident in Canada. Subparagraphs 250(1)(a) through (g) provide the circumstances upon which persons are deemed resident in Canada. Subsection 250(4) provides guidance with respect to when a corporation will be deemed a resident in Canada.

A corporation is resident throughout a taxation year if it was incorporated in Canada after April 26, 1965. The effect of this section is that once you are found to be resident in Canada under the common law rules are found to have been carrying on business in Canada after April 26, 1965 you will be forever resident in Canada.

Note: This would make a good exam question.

Consider 250(4)(c), which provides that in the case of a corporation incorporated before April 26, 1965 if it was incorporated in Canada and if it was at any time resident in Canada or carried on business in Canada, the corporation is deemed to be resident in Canada. This subsection provides an application of the common law rules for corporations incorporated prior to April 26, 1965 or the corporation carried on business after the date.

© Francesco Gucciardo 2003

Section 253 – Extended Meaning of Carrying on Business in Canada

Where a person who is a non-resident person does any of the activities listed under 253(a) through (c), the person shall be deemed in respect of the activity of disposition, to have been carrying on business in Canada in the year.

Note: Keep in the back of your mind that the treaty is hovering over all of this. To the extent that you are not carrying on that business through a permanent establishment you will not be taxed. However, to the extent that you are dealing with a non-treaty country there is no permanent establishment requirement.

Ensure that the authorities know that you are claiming the treaty exemption. Approximately 4 years ago a provision was included requiring the filing of a T2 corporate tax return with a schedule listing such treaty exemptions.

Sudden Valley v. The Queen (1976) FCA

Facts	Holding	Ratio
o A U.S. corporation was interested in selling land in Sudden Valley Washington o U.S. solicited to Canadian buyers – provided advertisement to induce Canadians to visit o Some Canadian purchased the properties upon their visit – the entire contract was negotiated and executed in the U.S.	o Issue: Where was Sudden Valley carrying on business? o Sudden Valley was not carrying on business in Canada o The U.S. companies activities do not fall within the extended definition of carrying on business as defined in the ITA s.253 o Nothing was made for sale or offered in Canada	o An invitation to treat is not the solicitation of an order or offer for sale as per the extended definition of carrying on a business at section 253(b)

Note: There was a vendor-take back mortgage in this case, so there is interest being paid from Canadians to non-residents. Under section 212 you would have had a withholding tax. The taxpayer was trying to argue that he was a resident of Canada. Court found that they were not resident in Canada.

Section 250(5.1) – Continued Corporations

This section deals with corporations that are incorporated in one jurisdiction and continued in another. The continued corporation is dealt with as if it were originally incorporated in the continued corporation. Note also that the 250(4) deeming provision does not preclude dual residence – you can still have dual residence under the deeming provision (Crossley Carpets is an example of this).

Section 250(5) – Deemed Non-Resident by Treaty

Section 250(5) is an important provision in that it deems persons non-resident. Subsection 250(5) provides that if you are a corporation that is a non-resident of Canada by virtue of a tax-treaty you will be deemed to be a non-resident for the purposes of the *ITA*.

This provision prevents the situation where a corporation would shift back and fourth depending on the tax treatments provided.

Note: Treaty definitions of residence are different than *ITA* definitions of residence. You must go through the treaty definition.

© Francesco Gucciardo 2003

Treaty Residence

In a treaty context, residency has a different purpose than under the *ITA*. The residence provision in the treaty is a relieving provision.

Article IV of the Canada-US Treaty deals with 'residence'. The definition of a resident for the purposes of this convention is found at paragraph one.

R. v. Crown Forest Industries (1995) SCC

Facts	Holding
○ Crown Forest was a Canadian company that paid certain fees to a Bahamas corporation (Norsk) ○ The Bahamas Company carried on business in the US – involved in renting ships and barges ○ The Bahamas Company was incorporated in the Bahamas in 1962, but the only office and place of business was in the U.S. ○ The company only filed tax returns, on the basis of being a foreign corporation, in the U.S. – never filed in Canada or the Bahamas ○ The Bahamas corporation did not pay U.S. tax on the barge rental because it claimed an exemption under U.S. taxing statutes ○ Crown Forest was making rental payments to the Bahamas company ○ Section 212, under part XIII, requires a 25% withholding tax when a resident pays rents or royalties to a non-resident ○ Under the treaty, Article XII(2) provides that a payment by a Canadian to a resident covered under the treaty for rent or royalty, the 25% rate is reduced to 10% ○ Crown Forest withheld 10% opposed to 25% and remitted it to CCRA taking the position that Norsk was a resident of a contracting state	○ *Issue*: Was Norsk resident in the U.S. for the purposes of the Canada/US Convention? ○ If a resident, then the withholding tax would be 10%, if not a resident then 25% ○ *Minister*: the Bahamas company was not a resident of the U.S. and was not entitled to the benefit of the Treaty ○ Norsk is not a resident of the U.S. ○ 'Liable to Tax' means liable on worldwide income ○ Norsk was taxable in the U.S. on a source basis ○ Source taxation is not one of the items from which tax liability flows in Article IV of the Treaty ○ Taxation at source is not a criteria similar to those enumerated in Article IV: domicile, residence, place of management, and place of incorporation results in world-wide tax liability ○ Crown Forest was required to pay 25% withholding instead of the 10% ○ When you are interpreting treaties the goal is to find the meaning of the words in issue. You need to try to determine the intentions of the drafters of the Convention because the intention of the drafters is important in considering the scope and application of the treaty

The only basis for full-worldwide taxation in the U.S. in on incorporation. However, there are other concepts, such as effective connection, then you may also be taxed in the U.S. Note: the concept of taxation in the U.S. is built on source concepts and not residency. The basis upon which the U.S. corporation was paying tax in the U.S. was not included in 'any other criterion of a similar nature' – that phrase must be interpreted in the context of other preceding words – meaning tax on worldwide income and not just on a source basis.

Under Article IV, the term 'resident' means "any person that is liable to tax by reason of that persons:

1. Domicile;
2. Residence;
3. Place of Management;
4. Place of Incorporation (this is the only exposure to a comprehensive worldwide tax on income in the United States); or,

© Francesco Gucciardo 2003

5. Any other Criterion of a Similar Nature – this has been interpreted to say that it must be consistent with the itemized connections. The itemized connections expose a person to liability on worldwide income and not just the source base

This case is also important in terms of treaty interpretation concepts:

1. The goal is to find the intention of the parties that entered into the agreement and to interpret their words in context and not focusing on a literal or legalistic interpretation
2. Look at the language used, the plain meaning and go for there

It is important to establish the intentions of the drafters and you can look to certain extrinsic evidence to establish that. Model Conventions were accepted as extrinsic evidence, as was the OECD model Convention and the commentaries prepared by the drafters of those models. You could look to those things without even requiring some ambiguity. This approach to Treaty interpretation is in line with paragraphs 31 and 32 of the *Vienna Treaty Convention*.

Note: The U.S. government did not want the corporation to get treaty benefits.

Paragraphs two and three contain the 'tie-breaker rules'. Paragraph two deals with individuals while paragraph three deals with corporations.

Mutual Agreement Procedure: Representatives on behalf of each contracting state will meet and undertake to resolve issues of double-taxation that arise. In Canada, the competent authority is CCRA while the IRS is the competent authority in the U.S. Thus, you have the actual taxing authority trying to negotiate on behalf of taxpayers. The issue does not have to be resolved – the parties can agree to disagree.

If you have a dual residence, where you are incorporated will typically be where your residence is for the purposes of the Treaty.

Special Entities

Note also the existence of special purpose/type entities. You can be involved with a jurisdiction that has an entity that we do not even recognize. Consider the U.S. LLC or the difference between the partnership and joint venture in other countries. For instance, in Canada the partnership is not a taxable entity. Under section 96 you determine the income at the partnership level as if it was an individual and then allocated it to the partners is accordance with the partnership agreement. This is an issue – how do you and should you allow the partnership the benefit of the treaty? They generally do not.

Consider the U.S. LLC that is treated as a corporation in Canada, but a look-through in the United States (not a separate entity). As a result, the LLC itself is not liable to tax in the United States, instead the money is allocated to the shareholders. Because of this, Canada takes the position that the LLC does not pay tax in the U.S. and cannot be a resident as per the treaty and, thus, cannot get Treaty benefits. This is all by way of saying that there are still issues as to who should get Treaty benefits and who should not.

The protocols are under negotiation and there is a suggestion that something will be done for the LLC in this context.

There is also a question of what time residency should be determined. Watch the wording of provisions that say either: "at any time in the year" or "any previous year" (s.2) or "at the relevant time" or "during the year" or "throughout the year".

© Francesco Gucciardo 2003

Treaty Purposes

There are generally two purposes to a Treaty:

1. Avoidance of double taxation;
2. Prevention of fiscal evasion

I. Avoidance of Double Taxation

Tax Treaties do not impose tax, but rather allocate the ability to tax a particular source of income between the jurisdictions involved. There are a number of different topics to consider:

1. Dual Residence
2. Tension between taxing based on a source basis or residency
3. Cross-border issues
    a. Article XIII – provision dealing with the transportation business
    b. Articles V and VII – permanent establishments and business profits
4. Real Estate Gains – Article VI – the problem is that you will get taxed by the situs of the property as well as residency (note the definition of real property – it can include shares, income inclusions etc.,)
5. Witholding Taxes – Part XIII liabilities where you have a payment from a resident to a non-resident and the requirement of the resident to withhold a certain percentage subject to Treaty reductions – a tax treaty can alleviate times when you have to pay in some instances and reduce the amount in others
6. Tax Barring (credits) – to help developing countries, credit might be given even though the tax had not been paid – this is to encourage investment and development
7. Tax Credits against Canadian Taxes – Article XXIV – each jurisdiction agrees to give credit for tax paid in the other jurisdiction

There are also provisions that deal with tax exemption. Article XXI deals with exempt organizations that are not liable to tax. In broad and general terms this preserves that exemption.

Note: there is a permanent establishment definition in the *ITA*. The definition in the *ITA* is different then that of the treaties. The *ITA* definition is really for the purposes of allocating income amongst the provinces. To the extent that a province uses the federally determined tax base, you must be able to allocate what amounts of income have been earned within and between the provinces. In Canada, there is not much jurisprudence on permanent establishments. When dealing with the issue in the international context, there are a number of cases that (although used for the domestic issue) are being used (even though the definitions are different).

II. Fiscal Evasion

The primary way this is done is through the exchange of information under Article XXVII. There are also anti-avoidance type provisions. However, there is a real problem with treaty shopping. Companies will establish entities in a jurisdiction with favorable tax treaty treatment, which creates the potential for tax savings.

Limitation of Benefits Provision – Article XXIX A – this provision limits the extent to which a company can undertake the activity of 'treaty shopping'. The Convention requires residency in the particular jurisdiction in addition to other tests, such as residency not being motivated by the existence of the corporation. This limitation of benefits provision is really an initiative of the United States.

© Francesco Gucciardo 2003

Conversely, there is no limitation of Benefits in some of the other Canada Treaties. This article is not reciprocal and only applies to the United States, except for paragraph 7 which preserves Canada's rights to deal with avoidance type situations through GARR at section 245 of the *ITA*.

GARR was introduced in order to attack transactions that are otherwise legitimate, but whose purpose is to avoid tax liability. The tax result can be precluded or reversed. There is a big question as to whether this domestic legislative provision can override treaties. In other words, Canada is trying to rely on the domestic legislation to achieve the result of the limitation of benefits provision.

In order to get the reduced treaty withholding rates you must be the beneficial holder of the dividends. Is becomes a problem to understand what exactly the term 'beneficial owner' means.

Important Treaty Provisions – Canada/US

The following are a number of important treaty provisions that you should focus on:

1. Article I – applicability of Convention to residents
2. Article II.1 – tax on income and tax on capital (not capital gains – tax on the capital employed by the business or company – the retained earnings)
3. Article IV – residence
4. Article V – Permanent Establishments
5. Article VII – Business Profits
6. Article X - Dividends
7. Article XI – Interest
8. Article XII – Royalties
9. Article XIII – Gains
10. Article XIV – Independent Personal Services (*Dudney*) – OECD model treaty has repealed this article, but the *Dudney* decision is still very relevant and important – *fixed base*
    a. The FCA said that Permanent Establishments and Fixed Base are the same
11. Article XV – Employees
12. Article XXI – Exempt Organizations
13. Article

US Technical Explanation – the US treasury has published these as their explanation. The Canadian Department of Finance has agreed that these are good explanations. That said, the technical explanations are not law, but merely explanations and guidance. These are not determinative of the issue. To the extent that the taxing authorities go against their published positions, their case is weakened.

Note also that Tax Treaties are not automatically applicable to Provincial and State taxes – it only covers taxes imposed by the jurisdictions at the federal level. However, there are some exceptions:

1. Alberta has deferred to Federal determinations;
2. Quebec is less clear – it appears that they have adopted the federal treaties, but administratively there is a provision in the Quebec act that suggests that treaties do apply for provincial purposes, but not all purposes – they have excepted federal treaty determinations, though;
3. Ontario, under its Corporations Tax Act, has its own definition of permanent establishment, yet the province has said that it will recognize federal treaties

If under a treaty the tax base is reduced or the rate is reduced, if as a province you only charge on a percentage of the federal tax, then you will have automatically deferred to the treaty reduction.

© Francesco Gucciardo 2003

Canadian Interpretation of Tax Treaties

Gladdon Estate – treaty interpretation requires a liberal interpretation with a view to including the intent of the parties. The interpretation approach determined to be appropriate and applicable to tax treaties under Canadian law is one that uses a liberal construction, keeping in mind the object of the tax treaty, consistent with the Vienna Convention.

Tax Convention Interpretation Act – deals mainly with definitional points of conventions to which Canada is a signatory. These definitions override the tax treaty definitions. *Melford* was the cause of this enactment. In *Melford*, the SCC said that the law pertinent to the interpretation of a treaty is the law at the time the treaty was signed. As a result, the government passed the *Tax Convention Interpretation Act*, which provides that if a term is undefined in the treaty it has the meaning in Canadian law as amended from time to time. This allows the definition to evolve in accordance with domestic law.

Vienna Convention – this Convention was ratified by Canada in the mid 1970s and assists in the interpretation and approach to a Convention. The liberal approach is embodied in paragraph one of article 31 of the Convention:

> A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose

Income Tax Convention Interpretation Act

Recall that we were talking about the interpretation of the *ITA* versus the interpretation in the Tax Convention. The *Income Tax Convention Interpretation Act* deals with whose law should govern in any given context and how certain terms of a Convention ought to be interpreted. If there is an issue with the definition of an interpretation of a term it is interpreted in accordance with the law of the person whose taxes are at issue.

Consider section 3 of the *ITCIA*. This section provides that a reaction to the SCC decision in *Melford*. If you have to refer to the *ITA* for a definition, the meaning that is relevant is the meaning at the time that you are trying to make that determination and not the time that the Treaty Convention was issued.

© Francesco Gucciardo 2003

Carrying on a Business & Disposing of Property in Canada

"Carrying on a Business in Canada"

The charging section at subsection 2(3) of the *ITA* requires a tax to be paid be a person carrying on a business in Canada. Recall that the closing part of this subsection refers to Division D, which refers to sections 115 and 116 of the *ITA*.

Section 3 is a basic roadmap to Part I of the *ITA*. You calculate your income under section 3, using the rules of Part I, in accordance with certain assumptions that are identified in section 115. For instance consider section 115(1)(a)(ii). In other words, you compute your income of carrying on a business under the general rules in accordance with the sub-rules provided in section 115. 115(1)(d) deals with the deductions of losses and makes reference to section 111.

"Treaty Protected Businesses" is defined in section 248(1) is basically a business exempt from *ITA* tax because of a Tax Treaty.

There are a number of other provisions in various areas dealing with the computation of income:

1. Section 4(1)(d) – if you are carrying on business in different areas, partly in one place and partly in another, this provides guidance in terms of allocation
2. Article VII (Canada-US Treaty) – Business Profits
    a. Calculation of the income in respect of a permanent establishment

What does 'distinct and separate person' mean? *look into this*

There are other provisions in the ITCIA that deal with such issues, consider section 4. What does 'carrying on a business' mean.

Facts	Holding
o UK Corp was acting as an agent for French wine merchant o UK stopped orders, but they were in the name of the French merchant o French merchant sent the wine directly to the UK customer – transfer of title took place in France o UK Corp collected the payments on behalf of the French company and received a commission on this	o *Issue*: Whether the French corporation was a person exercising a trade within the UK o **HL**: the factors to look at are: o There was no contract to sell wine o French corporation had to accept the order – no contract prior to that time o Whether or not you are carrying on a business is a question of fact o You have to draw a distinction between trading with a country and carrying on a trade within a country o There was no carrying on of a trade within the country

Consider section 253 of the *ITA*, which provides an extended meaning of carrying on a business. What we are talking about here is business, which is defined in section 248(1) and includes a concern or venture in the nature of trade.

Tera Exploration (1972) SCC

Facts	Holding	Ratio
o Ontario Corporation was in the business of exploring for minerals	o The issue of a permanent established was focused on	o Even if you have a P.E. in Canada, only the business profits

© Francesco Gucciardo 2003

in Ireland with an office in Ontario o Management and control was in Ireland o Money was raised in Canada and shares were purchased with that money o Those shares were sold for profit and the profit was assessed by the Minister as taxable	o There being no permanent establishment in Canada, the sale was not taxable o The office was being maintained simply to comply with the *Corporations Act* and not for any other purpose o Even if it was a P.E. the profit from the share sale was attributable since the decision to purchase the shares were made in Ireland – even if you have a P.E. in Canada, only the business profits attributable to that permanent establishment can be taxed	attributable to that permanent establishment can be taxed

Note: Having an office just to comply can be very useful. You can have businesses in Canada that have offices for certain regulatory and compliance purposes. In such a case, you can use the compliance purpose to argue against the allegation of having a permanent establishment in Canada. For instance, certain financial institutions must have an office in Canada for regulatory compliance. In such a circumstance, that ought not to constitute a permanent establishment because no real business is being conducted through the office.

Section 255 sets out what is determined to be "in Canada". Section 253 deems a person to be carrying on a business in respect to an activity *and* to dispositions of property. In other words, the disposition of property in Canada is deemed to be carrying on a business. It is not limited to pure activities, but can be extended to dispositions as enumerated in paragraph (c) of the provision.

Canada/US Treaty – Article VII

Articles V and VII are, perhaps, the most important articles of the Canada/US Treaty.

Business Profits of a Resident of a Contracting State

These will be taxable only in the state where you are resident unless: You carry on business in the other contracting state through a permanent establishment

In other words, you are only taxable in Canada on the profits made through a business in another country to the extent that you have a permanent establishment. Also, you are only taxed to the extent that the income was made through the permanent establishment – the portion of the business profits attributable to the permanent establish are taxable in the jurisdiction of the permanent establishment (a nexus approach).

Distinct and Separate Person

You are only taxed on those profits that are made as a separate and distinct person.

Computation of Business Profits

This section allows for an allocation of expenses outside of the permanent establishment against the income of the permanent establishment. Nothing requires a contracting state to allow the deduction that is not allowable in the jurisdiction of the permanent establishment.

© Francesco Gucciardo 2003

There are a number of carve-outs to the allocation of business profits:

1. No profits shall be attributed by reason of the use for the mere purchase of goods for merchandise or for management services etc.,
2. You have to maintain consistency in how you attribute income to a permanent establishment from year to year – you cannot manipulate the methodology from one year to the next depending on what serves you better
3. When you have business profits that are covered by other Articles of the Convention, those other Articles prevail
4. For purposes of business profits attributed, only those profits derived from the assets or activities of the permanent establishment are taxable

Article V – Permanent Establishment

A permanent establishment means a fixed-place of business through which business is carried on in whole or in part. The term permanent establishment shall include *especially* a number of enumerated items. The list is not exhaustive because of the use of the words 'shall include' and 'especially'.

The building site or construction site can constituted a permanent establishment, but only if it lasts for more than 12 months. Drilling rigs and the like may also be considered a permanent establishment.

Paragraph 5 – Dependent Agent

A person acting on behalf of a representative of a contracting state shall be deemed to be a permanent establishment if that person has the authority to conclude contracts in the name of that resident.

This is dealing with dependent agents, opposed to independent agents. There is no definition of what a dependent agent is. There is US jurisprudence that provides you are a dependent agent if you are economically dependent on the principal. This is likely intended for a captive U.S. sales force in Canada who cannot work for anyone else. If the person:

1. Has the authority to conclude contracts; and,
2. Habitually exercises the authority to conclude contracts for the principal

Paragraph 6 – there is no permanent establishment if a person, dependent agent, or a fixed place of business is used solely for one of the itemized activities. This paragraph provides a list of exclusions for sole and exclusive use for one of the itemized activities.

Paragraph 7 – Independent Agents

A resident of a Contracting State will not be deemed to be carrying on a business in the Other State provided that agents are acting in the ordinary course of business. As long as the agent is not exclusively the agent of the principal and acts in its normal capacity, this does not cause a permanent establishment to be created.

Paragraph 8 - The fact that one controls a company in another jurisdiction does not automatically result in one having a permanent establishment.

Analysis of Permanent Establishment

In terms of trying to allocate income ask:

© Francesco Gucciardo 2003

1. Is there a Business Being Carried on in Canada – you require the carrying on of a business;
2. Is there a Permanent Establishment - Once you establishment that there is an establishment, you then have to determine whether it is permanent (there has to be some real continuous use);
3. Is there a business carried on through the permanent establishment; and,
4. What profits, if any, are attributable to that permanent establishment

There is also a definition of permanent establishment in regulation 400 of the *ITA*. Section 124 provides a reduction of the federal tax rates of 10% (the provincial rebate). The theory is that if you carry on business in a province you get the 10% reduction in order to leave some room for the provinces to tax. The concept of permanent establishment is for purposes of dealing with this and also for purposes of taxing in two different provinces – each has the right to tax based on the business carried on in each province. That said, there is a famous SCC decision of *Sunbeam* that dealt with permanent establishments in this context – the test that was used in that case is also used to argue in the Tax Convention context.

IT-117R2 – Permanent Establishments – Take a look at this bulletin for some more information.

Dudney (19..) FCA

Facts	Holding
o Dudney was a non-resident and was retained by a Calgary Company to provide services o Dudney worked in Calgary for 300 days in 1994 and 40 days in 1995; retained to train personnel at the company's offices – he had no letterhead, business cards etc, was not identified by any signs o Dudney was given space at the offices to perform the contract, but was not permitted to do any other business o Access to the corporation after-hours was restricted and use of the phone was for business only o Dudney was assessed by the CCRA in respect of 1994 and 1995 on the basis that he had a 'fixed base' o Minister: A fixed base is any identifiable location even if it is under someone else's control	o *Issue*: Did Dudney have a *fixed base* in Canada? What is the meaning of the term 'fixed base'? o Court looked at whether Dudney had a fixed base regularly available to him o Court looked at the commentary on Article V of the Treaty (permanent establishments) and held that there must be an identifiable location with a degree of permanence through which the business of the enterprise is being carried on o Article V and Article XIV can be analogized – a particular location is a fixed base only if the actual business of that person is being carried on there o Dudney was restricted in terms of the business he could carry on in the space provided to him o **Ratio**: A particular location is a fixed base only if the actual business of that person is being carried on there

Canada could only tax Dudney if he had a fixed-based regularly available to him and to the extent that profits could be attributable to that fixed base. There is little difference in the meaning of a fixed base and a permanent establishment – for this reason the court looked to the OECD commentary, which referred to the principles laid out in Articles V and VII. FCA took the *Crown Forest* approach to interpretation and look to extrinsic materials. The FCA found that it must be the business of the person that is being carried on in the permanent establishment – it was not Mr. Dudney's business that was being carried on. Indicia:

1. Use made of the premises;
2. Legal right to control the use of the premises;
3. The right to come and go;
4. Objective identification of the premises as the person's place of business;

FCA: Dudney did not carry on the business, but rather only had access during office hours to do administrative tasks – he did not conduct his own business there.

© Francesco Gucciardo 2003

Branch Tax – Part XIV

Branch Tax is dealt within Part XIV of the *ITA*. Now that we are dealing with a new Part, we should consider that there is a new charging section. In the case of Part XIV it is contained at section 219.

In other words, the corporation that is not a resident shall pay a 25% tax on a certain calculated amount. This is a tax on non-residence who carries on a business in Canada through a branch operation (the branch is neither a separate entity nor a subsidiary). Under Part I of the *ITA* the tax would be the same by a non-resident who carried on a business in Canada through a subsidiary or a branch.

If you have a subsidiary, the subsidiary makes profit, and it wants to pay it back to the parent company in the U.S. by way of dividends, as soon as you have a dividend payment you have a withholding Part XIII tax. If you carry on a business through a branch operation, the profits simply accrue to the financial statements of the U.S. company and there is no withholding tax.

This being the case, Part XIV under 219(1)(a) imposes a tax on a corporation's taxable income earned in Canada for the year. The branch tax imposes a tax on net after-tax income that is not re-invested in Canada – amounts that are paid out and go to the head office outside of Canada. Thus, it is based on taxable income earned in Canada (Canadian source taxable income less certain deduction).

However, you have to look at section 219.2 at the same time. If the corporation is a resident of a treaty country, the 25% branch tax is reduced to the rate that is applicable on dividends paid to a company who owned 100% of the shares. In other words, the branch tax rate is reduced to the dividend withholding rate. This makes sense because the playing field between a subsidiary and branch is attempted to be leveled.

Note: This applies only in the case of a parent who is resident in a Treaty Country. No Treaty then you pay the full 25% withholding tax.

Computing Tax

You start with taxable income earned in Canada and apply a number of deductions:

1. Section 219(1)(h) – you can deduct provincial and federal income taxes that you have paid;
2. Section 219(1)(j) – an amount in respect of investment property in Canada – whenever you see the word 'prescribed' in the *ITA* you go to the regulations. Regulation 808 itemizes a number of items that you can deduct and includes things such as cost of land use, cost of amount of depreciable property in Canada used for the carrying on of business, cost of inventory in respect of businesses carried on in Canada (it is the amount, in effect, that the company does not pay out as dividends)

Exemptions

There are a number of entities that are exempt:

1. 219(2) – Where the principal business is transporting goods etc., not-for-profits etc.;
2. 219(4) – Non-resident insurers that carry on business in Canada;

We always have to keep in mind any of the Treaty problems that may arise. Under the Canada/US treaty in Article 10 paragraph 6 the branch tax rate is reduced to 5%. As well, there is a cumulative exemption of CDN$500,000 (you do not pay on the first $500,000).

© Francesco Gucciardo 2003

Hypothetical – Branch Taxes and Section 219

Suppose you have a branch operation in Canada with revenue of $300,000 and expenses of $200,000. The revenue is $100,000 and its paid $35,000. The net after-tax income is $65,000 (which is the amount under 219(1)(a) less the amount of 219(1)(h). The balance sheet shows an inventory of $30,000, assets of $20,000 and cash of $10,000. The difference between the $65,000 and the $60,000 is what would be subject to the branch tax – 219(1)(a) less the amount of 219(1)(j).

Collection and Enforcement

Just like a resident or domestic person there are normal self-assessment rules. The CCRA has a variety of collection powers, but in the context of dealing with non-residents there are potential issues relating to how you get the money.

Ogden (19...) FCTD

Facts	Holding
o Amounts were paid to sponsor Elvis Stojko figure skating show to Stojko's management company o The sponsors of these shows did not withhold and remit 15% of the payment o Under 227 of the *ITA* they were held liable for that amount o Minister assessed the payors for 15% of the payments that ought to have been withheld o Payors argued this was not a service and that there was no liability under the Canada/US Tax Convention because there was no permanent establishment	o Court rejected the arguments of the Defendant o The organizations sponsoring the shows had a requirement to withhold the 15% even if Stojko was not liable to tax – that amount must be remitted in a timely manner – they failed to do that and were forced to do so o In addition, penalties were imposed (in most cases there is a due diligence defense, which the court rejected) o Organization did not produce any evidence of due diligence o **FCA** – upheld the decision of the FCTD

Section 153 – this is the withholding requirement under Part I of the Act and refers to payments on account of tax – these are the source deductions on our normal pay cheques received in Canada. Section 153(1)(g) provides that any person paying fees, commissions, or other amounts for services shall withhold some payment in accordance with the prescribed rule (see regulation 100).

Regulation 100-110 – this deals with withholding rates on employees.

Regulation 105 – every person paying to a non-resident person a fee or commission in respect of services shall withhold an amount equal to 15% of such payment. This provision requires every Canadian resident person paying an amount to a non-resident person in respect of services to withhold 15%. At the end of the year that non-resident person is to fill out a Canadian tax return (s/he can insert that 15% at the end and if not liable to tax, s/he will get a return and if liable a cheque will be required). You can apply up front to get a waiver. Note: Enforcement obligations are imposed on domestic persons.

Section 150

This is the obligation in the *ITA* to file tax returns – shall be filed to the Minister for each taxation year:

1. For corporation within 6 months of the end of the year – even if claiming a Treaty exemption

© Francesco Gucciardo 2003

This is a relatively new provision and requires that the non-resident person file a tax return (normal T2 return) together with schedule 91 detailing the income earned in Canada and then ultimately claim a treaty exemption. Prior to the introduction of this provision, the CCRA had no way of tracking who was claiming the Treaty protection.

Article XXVI – Collection
Article XXVII – Exchange of Information

These provisions are much more liberal than most other Tax Conventions. Canada can go to the U.S. and ask for specific information about specific taxpayers. If the State does not have the information the State has to use the rules permitted to obtain that information. The same applies for a State seeking information from Canada. There are also spontaneous exchanges of information where information will spontaneously be disclosed about residents of another jurisdiction.

Dispositions of Taxable Canadian Property

Recall that paragraph 2(3)(c) deals with disposition of taxable Canadian property. This section traces into Section 115(1)(a)(iii) – taxable capital gains from dispositions described in paragraph (b). Paragraph 115(1)(b) refers to taxable capital gains and allowable losses from dispositions of taxable Canadian property.

Taxable Canadian Property

The term 'taxable Canadian property' is defined in section 248. The list generally includes:

(a) Real Property Situated in Canada
(b) Business Property
(c) Designated Insurance Property
(d) Canadian Private Company Shares
(e) Non-Canadian Private Company Shares if in the last 16 months the value derives principally from specified Canadian assets
(f) Public Canadian or Non-Canadian if the non-resident owner and persons not arm's length to that person owned greater to or equal to 25% in the last five years

"Principally" is interpreted as greater than 50% by the Ministry.

To the extent that a non-resident person disposes of any of those things, they are subject to tax on them. Recall that 115(1) starts out in accordance with section 3. These amounts are being treated as capital gains and, thus, are treated by the capital gain rates and not the regular taxation rates.

Section 116

This section is the regime that is set up to enforce payment of the amounts that are covered by section 115. This section sets out an administrative procedure to ensure the non-resident complies with the obligation of reporting the transaction and applies whenever a non-resident is involved. It does not matter if the purchaser is resident or non-resident. The section applies even if there is no taxable capital gain or if the transaction is subject to Treaty exemptions – you still have to notify the Minister *and* you have to withhold and remit the amounts.

© Francesco Gucciardo 2003

The reality is that CCRA does give some administrative concessions if you can show that there is a Treaty Exemption in some amount – it might turn into a cash-flow consideration. There is possibility to not to have to withhold and pay the amount if you properly show a Treaty exemption – but timing is a problem. Some section 116 applications take years – so be careful!

There are basically two procedures in this Act:

1. **Pre-disposition Certificate** – carried out under 116(1) and provides that on a proposed disposition of taxable Canadian property you notify the Minister with certain information (name, description, estimate of proceeds, and amount of adjusted cost base in property). If you submit to the Minister 25% of the difference between the proceeds and adjusted cost base, the Minister will issue a certificate stipulating an amount equal to the proceeds of disposition. Thus, if you sell for than amount or less, then there is no requirement to withhold. Note: The 25% rate is derived from a 50% rate on one half of the disposition;
2. **Post-disposition** – under 116(5) the purchaser is liable on tax to a non-resident equal to 25% of the cost of the property – this is the enforcement tool. Under 116(3) the non-resident must give notice to the Minister within 10 days of the disposition. Under 116(4) a similar 25% tax payment by the purchaser is called for – it must be withheld and provided even if there is no gain

The person who is supposed to withhold is given a cause of action against the non-resident. There is a due diligence defense available for the purchaser. Section 116(6) contains enumerated excluded property where you do not require the section 116 certificate.

Since we are still in Part I of the *ITA* we have to take into account the Tax Treaties

Article XIII – Canada/US Tax Treaty – Gains

Gains from the alienation of property other than referred to in paragraphs 1 through 3, then you are only subject to tax on gains in the country of residence. To the extent that you are Treaty exempt, you still have to be wary of 116. If you are looking at a non-arm's length transaction, you might not be too concerned about enforcement. If it is a arm's length transaction you should always get the 116 Certificate.

Paragraph One – Gains on real property may be taxed by the jurisdiction where it is sited
Paragraph Two – Personal Property forming part of the business property of the permanent establishment or fixed base (independent personal services) can be taxed in the sourced state
Paragraph Three – expanded definition of real property situated in the other contracting state to include shares if the value of those shares is derived principally from real property situated in Canada

To the extent that another article deals with income, recall, the other article will govern.

Summary

We have covered inbound activity to Canada:

1. Corporate Residence and Treaty Taxes
2. Carrying on a Business in Canada
3. Disposition of Taxable Canadian Property

There is an FCA decision to the General Electric Case that affirmed the Tax Court Case – review this Case.

© Francesco Gucciardo 2003

Part XIII Tax – Non-Residents and Withholding

Part XIII in General

Part XIII tax is imposed on certain types of income that are not taxed under Part I. Part XIII must be considered whenever there is a payment coming from a Canadian source to a non-resident. There are instances when even payments from a non-resident of Canada can be caught under this Part – the nexus is not whether the person paying is resident, but whether the source of the payment is in Canada.

Part XIII is a completely self-contained tax – it is not referenced at all in sections 2 or 3 of the *ITA*. Note also that Part XIII tax is the actual tax liability – it is not a payment on account of tax (such as section 116 – a regime is set up to have tax withheld and remitted by the seller of the taxable Canadian property). In other words, the withholding amount under Part XIII is the actual tax liability.

Part XIII imposes tax on non-residents earning property income from Canada – it is mostly for passive receipts of income. Part XIII tax is not imposed in respect of activities carried on in Canada by a non-resident – those things are taxed under Part I as either carrying on a business in Canada under section 2, or under section 153 in respect of services performed in Canada by a non-resident (Regulation 105 specifies the withholding rate for these services). Part XIII applies to receipts of money from Canada mostly from the holding of property in Canada of some kind.

Note also that Part XIII tax, pursuant to subsection 214(1), is imposed on gross receipts. This means that there are no deductions. Thus, if you incurred some interest expense in buying some asset held in Canada, such an expense cannot be deducted in determining the taxable amount.

"Taxable Canadian Property" is a hybrid – the income for the capital gains portion of the disposition is taxed under Part I. However, any amounts made from the taxable Canadian property by a non-resident is subject to taxation under Part XIII.

There are three main income sources of income caught under Part XIII:
1. Interest – 212(1)(b)
2. Dividends – 212(2)
3. Rents and Royalties – 212(1)(d)

I. Interest – Section 212(1)(b)

Section 212(1)(b) provides that every non-resident shall pay a 25% tax on amounts paid by a resident in Canada. Note: While the preamble of 212(1) says that a person resident in Canada 'pays or credits', in certain circumstances non-residents are deemed to be residents.

The provision provides a number of carve-outs to the interest subject to the income caught. These exceptions can be categorized into three categories: (1) Exempt Payors, (2) Exempt Recipients, and (3) Exempt Debt.

I. Exempt Payors

Sections 212(1)(b)(ii)(A) and (B) exempt from withholding tax if the interest is payable on a bond that is guaranteed by the government of Canada, subject to a number of technical conditions. As a general rule, federal government backed instruments are exempt from the withholding tax. Section 212(1)(b)(ii)(C)

© Francesco Gucciardo 2003

provides a broader provisions than just 'bonds', but includes also debentures, notes, mortgages etc., In other words, most instruments of debt that is:

(I) Guaranteed by the Government of Canada
(II) the debt of the Government of a province or agent thereof
(III) the debt of the Municipality or public body performing Government function (such as Indian band)
(IV) the debt of any corporation or commission for which 149(1)(d) to (d.6) applies – where not less than 90% of the share capital is owned by the Queen
(V) the debt of an educational institution or hospital if the repayment is *guaranteed* by the government

Issued after April 15, 1966.

Note that there are differences depending on the type of debt that is being dealt with. For instance, debt that is guaranteed by the federal government body is only exempt where:

1. It is guaranteed by the federal government; or,
2. If in respect of a hospital or educational institution is guaranteed by the provincial government

This means that other debt guaranteed by the government is not part of the exception – you must draw a distinction between debt of or debt guaranteed by and then apply the distinctions.

Note: Where a list includes the word 'or', only one of the conditions must be satisfied. Where a list includes 'and', all of the conditions must be satisfied.

Article XI – Canada/US Treaty

Under Article XI of the Canada/US Treaty, to the extent that the interest payments are being made by a resident of Canada to a U.S. resident, you must consult the treaty. If there is an interest payment from a resident of one contracting state to a resident of another contracting state then the relief in this Article may apply.

This essentially caps the withholding rate of interest to 10%. Thus, where the *ITA* says 25%, the Convention reduces the withholding rate to 10%. Paragraph 3 provides that notwithstanding paragraph 2, interest arising from a contracting state shall be exempt if certain enumerated conditions are met. In addition to the exceptions set out in section 212(1)(b) there are exceptions in the tax treaty. Thus, even if under Canadian law interest is subject to withholding tax, if the recipient of the interest is a resident of the U.S. you will want to look at paragraph 3 to see of the interest is exempt from the withholding tax because of the treaty. Article XI paragraph 3(c) in particular exempts interest that is beneficially owned by a resident in the U.S. by other political subdivisions and local authorities. This exemption is potentially broader than the specific provisions in 212(1)(b) because it contains other political subdivisions and local authorities.

Paragraph 4 of Article XI provides a definition of 'interest' (there are controversies at time as to what interest is and is not).

Paragraph 5 provides that paragraph 2 and 3 do not apply if the interest arises in connection with a fixed-base or permanent establishment. To the extent that the interest arises under a fixed-base or permanent establishment, those articles of the Convention prevail over Article XI of the Treaty.

Note: In order to get the relief, the requirement of residency is on the recipient because they are trying to get the relief. The U.S. treaty is somewhat more liberal than what a standard OECD treaty would be. For

© Francesco Gucciardo 2003

instance, some of the points in the U.K. treaty are not as liberal as they are for the U.S. For exam purposes, have a look at Articles V, VII, X, XI, and XII. The expectation will be that you will have looked at those Article in particular and be able to apply them.

II. Exempt Recipients – 212(1)(b)(iv)

This exempts withholding on interest payments to foreign tax-exempt charities and pension funds. This is only the case if those entities get the certificate referred to under 212(14), which provides that the Minister may provide a certificate of exemption. This provision requires the entity to be at 'arm's-length', which is a defined term under the *ITA* (this is a question of fact).

Another exempt recipient is a foreign sovereign (Information Circular 77-16 discusses the particulars of foreign sovereignty)

III. Exempt Debt

Section 212(1)(b)(iii)(D) provides that interest paid on foreign currency deposits with a Canadian financial institution is exempt. The deposit must be with a prescribed financial institution, which is defined by regulation 7900. Under 212(1)(b)(ix), interest paid on Canadian currency deposits with foreign branches of Canadian financial institutions is exempt. Under 212(1)(b)(viii), mortgage interest secured by real property situated outside of Canada is exempt from the withholding. This allows you to finance vacation properties outside of Canada and not be subject to withholding taxes. There are some exceptions:

1. To the extent that the holding of the real property is the business that is being carried on in Canada, the exemption is not applicable;
2. The exemption only applies to *real* property

Section 212(1)(b)(vii) provides relief for international medium-term corporate debt. There are various requirements in order for the exception to apply:

1. The transaction must be arm's length – intracorporate indebtedness does not qualify;
2. The debtor must be a corporation resident in Canada
3. The corporation may under no circumstances be obliged to pay more than 25% of the principal amount within five years from the date of issue (voluntary repayments are acceptable), except:
    a. Where the loan agreement provides that the repayment of greater than 25% is a result of an event of default;
    b. If the lender exercises a right under the terms of the agreement to convert the debt obligation into some prescribed security (Regulation 6208 stipulates that a 'prescribed' security is – typically a common share). Thus, if the debt is convertible into common shares within the 5-year period, then the debt may still qualify for this exception; or,
    c. The death of a person

This allows Canadian businesses to access international capital markets on a medium-term basis. This provision was put into play to allow Canadian to access that market and not be penalized by the fact that they would have to withhold on the interest payments being made. When dealing with debt in this context, the reality is that the payor of the interest ends up paying the tax consequences. Unless this provision is applicable, foreign lenders will gross-up the interest rate in order to account for the withholding.

Note: the post-amble of 212(1)(b) provides a number of other requirements. For the purposes of the paragraph, where an interest is payable and any or all of the interest is contingent or dependent on the use

© Francesco Gucciardo 2003

of property in Canada, the interest shall be deemed not to be interest described in subparagraphs 2-7, and 9. For our purposes, this means that if in the loan agreement the payment of interest is contingent on cash-flow, commodity prices, payment of dividends to certain shareholders etc., the interest shall be deemed not to be interest for the purpose of paragraph 7. The thought is that interest ought not to be contingent on those types of enumerated things in order to be subject – because it is not a fixed rate of interest set with periodic payment, but rather is contingent; such payment is more akin to royalty or rental payments. The provision is not even applicable.

Canada/US Treaty Article XI

Article XI paragraph (3)(d) exempts cross-border credit sales under certain conditions. The exemption is only available if the interest is beneficially owned by a resident of the other contracting state and is being paid in respect to a sale on credit by a resident in the other state of equipment, merchandise, or services, except where the sale is being conducted by related persons.

Canadian General Electric v. The Queen (2000) FCTD

Facts	Holding
o A farm equipment company transferred a debt to someone else and they failed to withhold the prescribed amount under the Treaty o The Minister assessed the taxpayer o The debt was assigned to someone else because there was a sale of the business	o The plaintiff has properly be assessed for failure to withhold tax as per section 215 o The evidence shows that the original notes were so materially altered by new agreements, that completely new obligations were created o The rate of interest, maturity, and principal amount of each note was change o The changes in those notes were sufficient to create a completely new debt obligation o The exception contained in 212(1)(b) cannot apply because the sale of the notes created a new debt obligation which became payable within 5 years of the issue

General Electric v. The Queen (2002) FCA

Facts	Holding
o Same as above o Taxpayer argued that there was no novation of the debt – it was still the existing debt and, thus, the 5-year period remains intact commencing for the original issuing date of the debt	o *Novation* – where an old debt obligation has been replaced by a new one o There was no novation because you require an extinguishment of the original debt before the replacement of it o The only issue is whether a new obligation is created, which decreased the amount of principal payable and the amount of interest payable o The fundamental terms (debtor, principal, date of repayment, and interest) were all changed but one – a new obligation was created within the meaning of 212(1)(b)(vii) – even though there was no formal novation, a new debt was created

Contingent Interest and Novation – these two combined mean that revolving and operating lines cannot be caught under the provisions. Also, these also must be third-party debts.

II. Dividends – Section 212(2)

Subsection 212(2) provides that every non-resident shall pay an amount of 25% of any amount paid as on account of a taxable dividend or a capital dividend. A taxable dividend is defined in subsection 89(1).

© Francesco Gucciardo 2003

Thin Capitalization Rules

Interest and dividends are both subject to Part XIII withholding tax. However, interest under Part I is deductible under Part I of the *ITA*. As a result, if there weren't some rules in place, a foreign-owned corporation resident in Canada could strip out profits by interest. The foreign corporation could get a deduction for the interest domestically under Part I and, in effect, take out the money that they wanted to take out by dividends through interest. However, dividends are taken out on after-tax income and not deductible to the corporation. Thus, there is an incentive for a U.S. corporation to capitalize a Canadian subsidiary with debt and not with equity. In this context, the 5-year 25% rule does not apply because this is not an arm's-length transaction. There is a rule at subsection 18(4), referred to as the thin-capitalization rules, that limit the amount of interest that can be deducted to a debt:equity ratio of 2:1. Thus, to the extent that interest has accrued on the debt which exceeds the 2:1 debt:equity ratio, that portion of the interest is not deductible (the ratio used to be 3:1 prior to 2000). The other condition is that the debt is owed to specified shareholders (shareholders with a 25% interest or more). The effect of this rule is that it stops the withdrawal of profits through interest – this discourages thinly capitalizing Canadian corporations.

This deals with Part XIII tax only indirectly – you cannot thinly capitalize a Canadian company and deduct the extra expense incurred in order to do it.

III. Rents and Royalties – 212(1)(d)

This provision relates to rents, royalties, and similar payments made by a resident to a non-resident of Canada. The provision enumerates a number of payments that apply to the provision, but there are a number of carve-outs commencing at 212(1)(d)(vi) – under these categories the rent or royalty will not be subject to the 25% withholding. For instance, 212(1)(d)(vi) excludes any royalty made for any copyright work or similar work relating to the production or reproduction of any literary, dramatic, musical or artistic work.

Subsection 214(1) provides that the amounts payable under 212 are payable on the gross amount without any deduction on those amounts whatsoever. In the case of rent with respect to real property or 'timber royalties', there is an election provided under section 216 of the *ITA*. The person may make an election to be taxed under Part I opposed to Part XIII. For instance, if a student is renting a unit in Windsor from a landlord who is an American resident for $1,000, the student is supposed to withhold $250 from the rental amount. However, if an election is made by the landlord under section 216 to be taxed under Part I, the landlord can then deduct all of his/her expenses and be taxed on a net basis as if s/he were resident in Canada. The election will be based on whether a net income calculation would be beneficial over the gross calculation.

Article X – Canada/US Treaty

If the Treaty applies, note that a withholding rate is typically reduced. Article X deals with dividends and reduces the withholding to an amount of up to 5%. There are a number of requirements in order to qualify, such as retaining ownership of at least 10% of the stock in the company. In all other cases, the amount is reduced to a rate of 15%.

Note: The Treaty also provides other complete exemptions (recall Article XI paragraph 3(c) in the case of exempt payors). Article XXI speaks to exempt organizations – in the context of discussing rates for organizations who qualify, the rate is 0%.

© Francesco Gucciardo 2003

Impact of Common "Deeming" Provisions

'Deemed' Interest

Certain amounts under the *ITA* are deemed to be interest for the purposes of the *ITA*. The most common is contained in subsection 214(15), which deals with stand-by charges and guarantee fees. This provision imposes Part XIII tax on guarantee fees paid to a non-resident or on fees agreeing to make money or land available to non-residents of Canada. These fees are where someone guarantees the fees of another entity.

R. v. Melford (1982) SCC

Facts	Holding
○ A tax treaty was entered ○ Subsequent to the Treaty, 214(15) was introduced and guarantee fees were paid to a non-resident ○ Minister argued that guarantee fees are deemed to be interest and, thus, ought to be subject to withholding tax	○ Taxpayer successfully argued that the amendment to the *ITA* subsequent to the entering into the Treaty ought not to apply

The parliament of Canada subsequently enacted legislation at section 3 of the *Income Tax Convention Interpretation Act* to the effect that any term in a Treaty is to be considered as per the definition of the term in the *ITA* from time to time, as opposed to the time of entering into the Treaty.

Section 214(2) deals with situations where the income of a capital part of the debt is mixed (you might have certain discounts, for instance). This refers to section 16(1)(b), which requires an allocation of those mixed amounts. In other words, you cannot co-mingle payments and get out of the requirements to pay withholding tax – the part that is deemed interest is deemed interest.

Fleischman

Facts	Holding
○ Individual owed the other money ○ The second didn't think he would ever be able to collect ○ They agreed to an amount of $100,000 to satisfy the entire debt ○ $10,000 was paid then followed by other amounts	○ What were the payments for? Interest or principal? ○ It is a question of fact as to whether a payment is being made on interest or principal ○ If a payment is made and there is no allocation as to what the payment is for, then if the debtor does not specify the creditor may and vice-versa ○ Since there was no allocation as between principal and interest, it was up to the parties to decide – since both parties agreed that this was a payment on principal, then the Minister could not interfere

'Deemed' Dividends

Section 214(3) subjects to Part XIII tax certain amounts that would be subject to Part I tax if they had been paid to residents of Canada. The most common example is that under section 15 of the *ITA* if there are benefits conferred on a shareholder that are not dividends (any transfer of wealth from a corporation to a shareholder), the transfer of wealth is taxable as a shareholder benefit. Also, if the shareholder receives a loan with no interest, there is a benefit conferred. For the purposes of a non-resident receiving those amounts, section 214(3) deems those amounts to be dividends.

© Francesco Gucciardo 2003

Sections 84.1 and 212.1 – Anti-Dividend Stripping

Such provisions prevent a non-resident from withdrawing from Canada on a tax-free basis any amount in excess of the paid-up capital in a non-arm's-length transaction. 212.1 deems a dividend to be paid by the purchaser corporation to the non-resident to the extent that non-share consideration exceeds the paid-up capital. Once you have deemed a dividend, section 212(2) will apply.

'Deemed' Resident

Certain payors may be deemed to be resident while certain recipients may be deemed to be non-residents to make Part XIII work. Paragraphs 212(13)(a) and (f) deem certain non-resident payments to a non-resident person subject to Part XIII by deeming the non-resident payor as resident. Even though a non-resident person is making the payment, they are deemed to be a resident, which is then caught under 212(1).

Under 212(13.2), where a non-resident carries on a business in Canada, manufactures, processes goods, etc., and pays to another non-resident amounts that are deductible in calculating Canadian source income, the person is deemed to be resident and, therefore, subject to Part XIII.

Section 212(13.1) deals with partnerships and the application of any such deeming provisions. Where a partnership pays a non-resident, the partnership is obliged to withhold and vice-versa. A non-Canadian partnership is basically a partnership where all the partners are not Canadian. Thus, where a person in Canada pays an amount to a non-Canadian partnership, the partnership is deemed a non-resident and the obligation to withhold arises.

Interaction Between Part I and Part XIII

Section 214(13)(c) provides that the governor-in-council can prescribe regulation: Where a non-resident carried on business in Canada, what portions of that amount are payable and liable to the withholding.

In other words, the governor-in-council may dictate the allocation of Part I and Part XIII tax. The regulation at issue is regulation 805. Thus, you pay Part XIII tax except amounts enumerated in regulation 805, such as permanent establishments, and are, therefore, liable to Part I. You do not pay Part XIII tax on a permanent establishment – the Permanent Establishment Treaty Article trumps Article XI as do regular carrying on business provisions.

Regulation 802 provides that amounts payable under Part XIII for carrying on a business in Canada are those amounts other than those included in Part I for carrying on a business in Canada.

Section 215

Section 215(1) provides that when a person pays, credits, or provides an amount under which income tax is payable, the person shall not deduct or withhold from the amount and shall, forthwith remit that amount. This provision puts the obligation on the payor to withhold.

Section 215(6) provides that the failure to withhold and remit renders the payor personally liable to the withholding and if the amount is subsequently remitted, this section gives the payor a right of action to recover the amount from the payee.

© Francesco Gucciardo 2003

Section 227.1 makes the directors of a corporation jointly and severally liable for the amount for the failure to deduct and remit the necessary amounts. This is one of the administrative sections of the *ITA*. Section 227.10 provides that the Minister may at any time assess Part XIII tax – there is no limitation period! In the case of a non-resident, 227.10.1 the Minister may assess at any time a Part XIII tax. The question then becomes how to enforce this amount.

Section 227(6) and (7) provide a scheme whereby if a non-resident pays a Part XIII tax and they feel they have paid too much, there is a system that allows for the request for a refund. This might arise where the payor retained 25% and there was actually a reduced treaty rate.

When talking about Part XIII tax, you are talking about withholding of tax liabilities. The other withholding we have spoken of is in terms of 116, which is really a repayment of Part I liability.

Stan Makita

Facts	Holding
o A pension based on services over 20 years was being paid out	o Witholding is imposed unless the person is not employed or occasionally employed in Canada o The proper guage for occasional employment was to take the number of times played in Canada over the entire career o In the off-season the players had to stay in shape and make public-appearances, which should be considered in the determination of occasional employment

© Francesco Gucciardo 2003