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Significant Developments in Canadian Taxation

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The minister of finance of the Government of Canada was particularly busy during the last twelve months in that he has presented two budget addresses, the first on December 20, 1960 and the second on June 20, 1961.

The amendments to the Act resulting from his activity have been numerous, and a greater than usual number apply to non-residents of Canada.

The more important amendments are as follows:

WITHHOLDING TAX

Effective December 20, 1960, dividends paid by a Canadian subsidiary to its United States parent are subject to a 15% withholding tax instead of the former rate of 5%.

In order to implement this change, it was necessary to amend the Canada-United States Reciprocal Tax Convention. The increased withholding applies to all dividends paid subsequent to December 20, 1960 so that even dividends declared prior to but payable subsequent to that date are subject to the higher rate.

At the present time then, the 15% rate of withholding tax applies to all dividend payments to a non-resident except where an international agreement still prevails providing for a lower rate; e.g., the Canada—United Kingdom Tax Agreement still provides that dividends paid by a wholly owned Canadian subsidiary to its United Kingdom parent are exempt from withholding tax. As yet there has been no official announcement concerning the re-negotiation of this agreement.

Also effective December 20, 1960, certain interest payments that previously attracted a 5% withholding tax became subject to tax at 15%.

These payments fell into three main categories:

Interest on Government of Canada bonds,

Interest on bonds of the Provinces of Canada, and

Interest which was payable in a foreign currency to an unrelated lender.

In commenting on this amendment, it is to be understood that the increased withholding tax does not apply to bond issues or loans outstanding at December 20, 1960 but rather only to issues and loans subsequent to that date.

This means that an American investor investing in a pre-December 20, 1960 issue of Government of Canada bonds will incur 5% withholding tax during the life of those bonds whereas an American investor investing in a post-December 20, 1960 issue of Government of Canada bonds will incur 15% withholding tax.

For ease of identification, any security subject to the increased rate of withholding is to be marked with the letters TX preceding the identification number.

The only other significant change in this area is that Government of Canada treasury bills are now subject to 15% withholding tax on the discount factor. The discount is deemed to be the equivalent of interest and so subject to withholding tax when purchased by a non-resident.

SPECIAL TAX ON BRANCH OPERATIONS

Commencing January 1, 1961, non-resident corporations carrying on business in Canada through a branch operation are subject to a special tax of 15% as well as the usual corporate income taxes.

The imposition of this tax seems to follow naturally the increase in withholding tax on dividend distributions as otherwise there would undoubtedly be a wholesale switch from subsidiary to branch operations.

The 15% tax is applied to the taxable income earned in Canada computed in the normal manner less the following deductions:

Federal income tax,
Provincial income taxes, and
An allowance for net increases in the corporation's capital investment in Canada.

To illustrate, assume a Canadian branch of a foreign corporation has taxable income of $100,000 for the year ended December 31, 1961

and that the capital investment in Canada has increased by $25,000 during the year. The special tax would then be calculated as follows:

Taxable income		$100,000
Less:		
Taxes—Federal	$30,850	
—Provincial	11,000	
Increase in capital investment	25,000	
Total deductions		66,850
Amount subject to special tax		$ 33,150
Special tax @ 15% of $33,150		$ 4,973

This tax is payable any time before filing the corporation tax return which is due six months after the close of the fiscal period.

The method of calculating the increased capital investment in Canadian property is prescribed by regulation (Regulation 808) and is determined simply by comparing the undepreciated capital cost of depreciable property at the beginning and end of the taxation year and then adjusting for land and outstanding liabilities.

Certain non-resident corporations are exempted from this tax. The main exceptions are banks, insurance companies, and corporations whose principal business is either transportation of persons or goods, or communications.

CORPORATE RESIDENCE

Prior to the 1961 amendments, corporate residence was not defined by statute.

Canada has relied on United Kingdom jurisprudence for guidance in this area with the result that corporations have been deemed to be resident in the place where the corporation's central management and control is located. This is normally where the directors reside and hold their meetings. Under this concept, a corporation may be resident in two or more jurisdictions at one time if its central management and control is divided between those jurisdictions.

With application to 1962 and subsequent taxation years, the Act contains a definition of corporate residence so that a corporation incorporated in Canada and carrying on business in Canada at any time during its taxation year is now deemed resident in Canada for the whole of its taxation year.

The Act contains an extensive definition of what constitutes carrying on business in Canada so as to include all types of physical activity, including the solicitation of orders and the offering of anything for sale

in Canada through an agent or servant, whether the contract or transaction is to be completed inside or outside Canada.

It is to be understood that this new definition is not intended to be an all-inclusive test of residence, but rather to be a supplement to the former concept of management and control.

Accordingly, in attempting to analyze the effect of this amendment, it would appear most effective in preventing a Canadian subsidiary that carries on all its business activity in Canada from becoming non-resident in Canada for the purpose of avoiding Canadian withholding tax on payments of dividends, interest, etc.

Under the previous concept of residence, non-residence could have been fairly easily obtained by causing the company's management and control, i.e., directors, to be located outside Canada.

Under the new definition, this possibility disappears.

PENSION TRUSTS

A trust established for the purpose of administering an employees' pension plan is specifically exempt from tax.

In order to continue to enjoy such tax exemption, it is now necessary that a certain percentage of the income of the trust be from Canadian sources.

The effect of this amendment is that by the 1963 taxation year of the trust, not less than 90% of the trust's income must be from Canadian sources. For 1962, the percentage must not be less than 80% and for 1961 not less than 70%. In this regard, the taxation year of the trust is deemed to be the calendar year regardless of the fiscal period of the trust, except of course where the trust is incorporated.

Obviously, the purpose of this amendment is to force the pension trusts to direct their investment programme to Canadian securities.

For those interested in statistics, the Minister of Finance in introducing this amendment stated that the assets of Canadian trustee pension plans now exceed $3 billion and are increasing by $300 million per year.

ACCELERATED DEPRECIATION

Each of the last two budgets have attempted to stimulate the Canadian employment situation by providing for accelerated depreciation under certain circumstances.

The provision introduced in the December, 1960 budget pertains to new products.

Under this provision, assets acquired subsequent to December 31, 1960 but prior to December 31, 1962 are entitled to the acceleration, provided the assets are used in the production of a new product.

By definition, a new product is—

a) a product of a type not ordinarily produced in Canada, or

b) a product of a type not ordinarily produced in a surplus manpower area or locality. At the present time there have been eighteen areas designated as surplus manpower areas.

In order to claim the acceleration, it is necessary to make a formal application to the Minister of Trade and Commerce (note it is the Dept. of Trade and Commerce rather than the Dept. of National Revenue) and upon acceptance, a certificate will be issued stating the amount on which the allowance may be computed.

The acceleration is equal to the maximum normal capital cost allowance in the year of acquisition and can be claimed either in the year of acquisition, in the two years following acquisition, or can be spread over the three-year period. The amount of acceleration remains the same however claimed. Since the acceleration reduces the depreciation base, maximum depreciation is obtained where the acceleration is claimed in its entirety in the third year. In this regard, the advantage of deferring the claim to the third year would have to be weighed in light of all the circumstances.

To summarize, it is only assets used in production that qualify for the acceleration so that office furniture and fixtures, automobiles, etc., are excluded; also, any class of asset already entitled to a capital cost allowance rate in excess of 30% is excluded.

As for the provision introduced in the June 1961 budget, its purpose is to encourage re-equipment and modernization.

Under this provision, new assets acquired during the period June 21, 1961 to March 31, 1963 are subject to an acceleration of 50% of the normal allowance in the year of acquisition. There is a restriction on the assets subject to this acceleration however, in that only those assets in excess of a specified base are eligible.

The specified base is the lesser of the aggregate of the amounts spent on depreciable property in the last complete taxation year of the taxpayer ending before June 21, 1961 or the average for the last three years.

Since June 21, 1961, the commencement of the period, and March

31, 1963, the termination of the effective period, are likely to fall part way through a taxation year, the base is determined by considering those additions acquired in the equivalent period in the base year or years. For example, in the case of a calendar-year taxation year, additions during the period June 21, 1961 and December 31, 1961 will be compared with the proportionate additions in 1960, and only the excess will be subject to acceleration, i.e., the 1960 base will be calculated as 194/365 of the total 1960 additions.

Although new taxpayers will essentially be able to have all assets qualify for the acceleration, it has been necessary, of course, to guard against existing operations being split up into new ones for tax-defeating purposes. For example, the allowance will not be granted to a corporation that was not carrying on business prior to June 21, 1961 if it is associated with another Canadian corporation. In this regard, the first new subsidiary in Canada of a non-resident company not already carrying on business in Canada will qualify.

It is to be noted that in determining the amount of new capital expenditures that will qualify for the acceleration, it is done on the basis of aggregate assets rather than particular classes. That is, where an excess is determined, the excess is allocated to the highest-rated class first, proceeding to the lowest-rated class. The excess is not allocated to all classes proportionately to the additions.

In summary, the acceleration applies only to new equipment, which excludes all property that has been used before it was acquired by the taxpayer, and the acceleration is equal to 50% of the normal allowance in the year of acquisition.

DEFERRED PROFIT-SHARING PLANS

The Canadian Income Tax Act has recognized employees' profit-sharing plans since 1949.

Simply, the Act provides that amounts contributed by an employer are subject to deduction without limitation, that the trustee to whom the amounts are paid is exempt from tax, and that the trustee is obliged to allocate all amounts so received to beneficiaries under the plan.

It is in this latter respect that the provision is deemed most inadequate in that beneficiaries are deemed taxable on all allocations whether contingent or otherwise.

This hardship has been alleviated in 1961 for the most part by the introduction of deferred profit-sharing plans.

Under a plan so qualifying, the beneficiaries are not taxable on the amounts allocated but rather on the amounts actually received from the plan. However, under a deferred profit-sharing plan, an employer is not entitled to unlimited contributions to the employee's pension plan. This means the maximum contribution to a deferred profit-sharing plan is $1,500 minus the amount paid by the employer in respect of that employee into the company's approved pension plan.

The introduction of deferred profit-sharing plans is not intended to result in a revocation or conversion of all existing employees' profit-sharing plans, but rather to afford a company a choice of plan depending on its particular circumstances.

OTHER DEVELOPMENTS

DESIGNATED SURPLUS

A term that is used a great deal in connection with Canadian taxation is "designated surplus." Briefly, this means that where control of a Canadian company is acquired by another company, whether resident in Canada or not, the surplus of the acquired company is called designated surplus.

The penalty for distributing this surplus to a non-resident company is a 15% tax in addition to the normal withholding tax, whereas if distributed to a resident Canadian company, it attracts full corporate tax in the hands of the recipient company. Dividends normally flow between Canadian companies tax-free.

Because loopholes have been detected in the Act for avoiding the impact of designated surplus, it has been necessary to implement seemingly hasty amendments. The Minister of Finance has announced several times that the matter is under close study by the Government.

In the June 1961 budget, he indicated that the issue was continuing to be studied closely so that perhaps some definite change will be forthcoming in the next budget, presumably in the spring of 1962.

PORTABLE PENSIONS

At the present time, where an employee who is a member of a pension plan changes his employment, he is usually obliged to cash in his benefits under the plan at a substantially lesser amount than would be available in pension payments on retirement.

Because of the disruptive effect this has on the amount of pension available at retirement, the Federal and Provincial governments are

presently studying the feasibility of portable pensions that would enable employees to change their place of employment without particularly disturbing their pension position.

There has not yet been an official pronouncement about the progress being made in this respect.

Further, the Minister of Finance has indicated that the Government will supervise and control private trusteed pension plans for the purpose of ensuring that assets are being accumulated at an appropriate rate to meet the future liabilities of those plans.

It is felt that there are not proper safeguards being applied at this time.

There has been no indication on how the Government, presumably Federal, will apply these controls.

PERSONAL CORPORATIONS

Personal corporations are family investment companies used primarily as an estate-planning device.

They offer no particular advantage from an income-tax point of view in that the personal corporation income is deemed distributed each year as a dividend to its shareholders and thus taxed at personal rates rather than corporate.

From an estate-tax point of view, it can have the effect of freezing the investment valuations at the level prevailing at the time of sale to the corporation, simply by having someone other than the principal contributor as the equity shareholder.

The Minister of Finance proposed and even introduced in "bill" form some rather wide-sweeping changes in the personal corporation set-up; however the amendment has been withdrawn.

There has been no official indication concerning the reasons for its withdrawal, nor concerning the probability of its reappearing in 1962.

EXPENSE ACCOUNTS

As in the United States, Canada too is becoming increasingly concerned about the abusive use of expense accounts.

The Minister of Finance has stated that expense accounts generally will be subject to more intensive scrutiny. He has said that if such a measure proves an effective control, more stringent legislation can be avoided.

Under the Federal-Provincial tax-sharing arrangements that have been in effect for approximately fifteen years, all of the Canadian provinces except Ontario and Quebec have rented their right to collect corporate income taxes, personal income taxes and succession duties to the Federal government in return for an allocation of the amounts collected.

The last of these arrangements expires on March 31, 1962 and they will not be renewed.

This means that the Federal government is returning the right to collect these taxes to the Provinces.

Accordingly, after March 31, 1962, each of the ten Provinces will probably be imposing their own corporate income taxes, personal income taxes, and succession duties.

In this regard, in order to spare the Provinces the expense of setting up separate tax collection machinery and to contribute as much as possible to simplicity, convenience, and uniformity in the tax system, the Federal government has offered to collect on behalf of the Provinces the Provincially imposed personal income taxes and corporation income taxes free of charge provided the Provincial tax bases are identical with the Federal at all times.

Apparently this same offer could not be extended to succession duties since the Provinces do not have the constitutional power to levy an estate tax on the Federal basis. Accordingly, the Federal government has offered in this instance that any Province not levying succession duties will receive half the yield of the Federal estate tax, while an abatement of 50% of the Federal estate tax will be granted as at present to those Provinces levying their own succession duties.

The impact of this basic change cannot be determined until the individual Provinces introduce their legislation establishing rates.