University of Mississippi
eGrove

Haskins and Sells Publications | Deloitte Collection

1965

Significant developments in Canadian taxation -- 1964 and 1965

Eddie D. Marchant

Follow this and additional works at: https://egrove.olemiss.edu/dl_hs

Part of the Accounting Commons, and the Taxation Commons

Recommended Citation
Haskins & Sells Selected Papers, 1965, p. 282-289

This Article is brought to you for free and open access by the Deloitte Collection at eGrove. It has been accepted for inclusion in Haskins and Sells Publications by an authorized administrator of eGrove. For more information, please contact egrove@olemiss.edu.

Significant Developments in Canadian Taxation 1964 and 1965

by EDDIE D. MARCHANT
Partner, Deloitte, Plender, Haskins & Sells, Winnipeg Office

Presented before the Haskins & Sells Annual Tax Conference, Washington, D.C.—October 1965

SINCE the discussion of this topic at the 1963 Conference, we have had two Income Tax Amending Acts in Canada and have witnessed a change in attitude and approach on the part of the Ministers of Finance and National Revenue.

While there have been many significant developments in Canadian taxation during the past two years, the time available will only permit me to mention a few of the income tax amendments that may be more likely to affect U.S. taxpayers having interests in Canada.

During the ten years preceding June 13, 1963, Canada was reputed to be a favourite haunt for those who wished to practice the mystic art of tax avoidance.

On June 13, 1963, the Government of Canada enacted Section 138A and thereby gave the Minister of National Revenue wide discretionary powers to deal with certain of the popular avoidance schemes of the day. While Section 138A often frustrates legitimate transactions, it has helped to create a more conservative tax climate in Canada; tax practitioners in Canada have therefore had to become more mature.

Amendments have also been enacted to prevent the unintended use of off-shore jurisdictions, pension plans, and Canadian trusts to avoid income taxes to non-resident beneficiaries.

Departmental officials have followed the Minister's example in adopting a hard line with all plans that have the appearance of artificiality.

WITHHOLDING TAXES AND DEGREE OF CANADIAN OWNERSHIP

In the June 13, 1963 Budget, the Minister of Finance increased the withholding tax rate to 20% on dividends paid or credited to non-residents by companies that did not have a degree of Canadian ownership. He similarly increased the tax rate for non-resident-owned investment corporations and branch operations of non-resident corporations.

In his March 16, 1964 Budget he announced that as a result of a U. S. tax cut he was able to reduce the 20% rate to 15%. He did not mention the fact that the increase of the previous year was a violation of the Canada–U. S. Tax Convention and automatically increased the

U. S. withholding rate from 15% to 30%. Nor did he mention that U. S. authorities were reluctant to renegotiate the terms of the treaty.

Rather than explain all of the 1963 and 1964 amendments to Sections 106 and 139A, some of which cancel each other out, I shall briefly review the law as it is at present.

The law now requires that every non-resident person shall pay an income tax of 15% of every amount that a person resident in Canada pays or credits, or is deemed to pay or credit, in satisfaction of:

A management or administration fee or charge
Interest
Estate or trust income
Rents, royalties, etc.
Timber royalties
Alimony
Patronage dividends (S. 106(1)(a) to (f))

No withholding tax will be paid by a non-resident-owned investment corporation or a personal corporation unless the dividend is paid out of corporate surplus accumulated before the corporation achieved special status.

Every Canadian corporation that has a required degree of Canadian ownership in the taxation year in which a dividend is paid or credited, or is deemed to be paid or credited, to a non-resident of Canada shall withhold a tax of 10% of the amount of the dividend (106(1)(a)(b)). The foregoing tax does not apply in the case of dividends paid to non-residents by a personal corporation or a non-resident-owned investment corporation as mentioned above.

Section 139A and Regulation 3100 require the use of approximately 3,500 words to define a degree of Canadian ownership. Needless to say, members of the House of Commons used even more than 3,500 words to describe the six and one-half pages, and one member awarded the Minister the honour of having created the longest sentence in the world—two and one-half pages.

Before its amendment in 1964, the definition of a degree of Canadian ownership contained in Section 139A was based on ownership of shares having full voting rights under all circumstances, and where shares were listed on a Canadian stock exchange all shares of voting stock had to be listed. This definition permitted a company to issue voting preferred shares at a nominal sum in order to qualify, and a further result was that where a company had more than one class of

voting stock but only one listed, the company was prevented from qualifying.

At the present time, if a corporation wishes to qualify it must meet the following conditions:

(1) The company must be resident in Canada.

(2) At least 25% of the directors must be resident in Canada, where the year commences after December 31, 1964.

(3) Either

(a) At least 25% of the company's voting shares and 25% of its paid-up capital represented by equity shares are owned by individuals resident in Canada or by corporations controlled in Canada; or

(b) A class of voting shares and a class of equity shares representing in the aggregate at least 50% of the paid-up capital value of all equity shares are listed on a prescribed stock exchange in Canada and not more than 75% of the paid-up capital value of the equity shares are owned by:

(i) non-residents, *or*

(ii) a corporation not having a degree of Canadian ownership.

A corporation has a degree of Canadian ownership in a taxation year if throughout any 60-day period included in the 120-day period commencing 60 days before the first day of such year the qualifying conditions were met.

ADVERTISING EXPENSES

In an effort to protect the Canadian publishing industry, the law now provides that amounts expended by a taxpayer for advertising space in an issue of a non-Canadian newspaper or periodical dated after December 31, 1965 may not be deducted in computing income if the advertisement is directed primarily to a market in Canada (Section 12A—1965). The cost of advertisements in U. S. national magazines may still be deductible since the advertisements are not directed *primarily* at the Canadian market.

MANUFACTURING BUSINESS—THREE YEARS' EXEMPTION

A new manufacturing or processing business, carried on in a designated area, is exempt from taxes on profits earned in the first thirty-six

months following the commencement of operations in reasonable commercial quantities. Individuals can qualify as well as corporations, and a degree of Canadian ownership is *not* a requirement. Capital cost allowance on buildings is accelerated from 5% or 10% to 20% straight line, and equipment from 20% to 50% straight line.

AREA DEVELOPMENT INCENTIVES ACT

The Area Development Incentives Act came into force on July 1, 1965, and creates the machinery for special grants in "designated areas."

A development grant will be paid to any applicant who proposes to establish a new facility or expand an existing facility in a designated area, and the grant will be in lieu of the thirty-six months' tax holiday under Section 71A.

A grant will be based on the approved capital cost of the facility or the expanded facility and will be calculated as follows:

(1) In the case of a new facility, the aggregate of the following amounts, with a maximum of $5 millions:
  (a) 33⅓% of the first $250,000 of cost,
  (b) 25% of the next $750,000 and
  (c) 20% of the excess above $1 million.

(2) For the expansion of an existing facility, the same formula as above, except that the approved capital cost must be reduced by 10% (minimum $10,000) of the value.

Facility is defined to be structures, machinery, and equipment that constitute the necessary components of a manufacturing or processing operation. Grants do not seem to be restricted to corporations or to companies with a degree of Canadian ownership. Grants do not decrease the capital cost of assets for depreciation purposes.

RESIDENCE OF CORPORATIONS (1965)

Before Bill C-118 became law on June 30, 1965, it was possible for non-resident shareholders of Canadian inactive corporations to avoid the non-resident withholding tax on dividends paid to them, and for Canadian shareholders of Canadian corporations to avoid taxation on the distribution of the corporation's accumulated earnings, by moving central management and control of the corporation to a jurisdiction outside Canada. It would be necessary for the Canadian shareholder to change his personal residence before extracting the surplus unless

the shares were owned by a non-resident corporation or a trust. The non-resident benefits only when he would otherwise lose the foreign tax credit on foreign income.

Under the law as it was, a company incorporated in Canada could be considered a non-resident if its "mind and management" were located outside Canada and it did not carry on business in Canada (139(4a)).

The law as amended provides that a corporation incorporated in Canada after April 26, 1965, is deemed to be a resident in Canada throughout its taxation year. A corporation incorporated in Canada before April 27, 1965, is deemed to be a resident of Canada if it was resident in Canada *or* carried on business in Canada during any taxation year ending after April 26, 1965.

If a corporation was a non-resident corporation before April 27, 1965, its status will remain unchanged so long as its management and control remain outside Canada and it does not carry on business in Canada.

TRUSTS WITH NON-RESIDENT BENEFICIARIES—SECTION 63(4b) (1965)

Before the enactment of Bill C-118 it was possible to have business income taxed at only the 15% non-resident withholding tax rate when a business was operated by a Canadian trust or estate.

After April 26, 1965, a trust or estate (except a trust or estate arising on death) will not be allowed a deduction for business income paid or payable to non-resident beneficiaries, a non-resident-owned investment corporation or another trust or estate resident in Canada with non-resident beneficiaries.

The trust will be taxed at personal tax rates (without personal exemptions) on the business income, and withholding tax will be levied against amounts paid or credited to the beneficiaries resulting in a double taxation penalty.

MANAGEMENT OR ADMINISTRATION FEE OR CHARGE

The treatment of "management or administration fees or charges" charged by a U. S. parent company to its Canadian subsidiary has, since June 13, 1963, become a problem of increasing complexity.

In order to understand the reasoning behind what might otherwise appear to be psychopathic thinking on the part of Canadian legislators, you should know that the objective is merely to tax dividends passed

across the border under the guise of management or administration fees or charges. One can hardly blame the government for being cautious after its rather traumatic experiences of the past with the artful dodgers who prowled the Canadian tax scene.

The law imposes a withholding tax of 15% upon management fees or charges paid or credited by a resident of Canada to a non-resident.

The statute provides that for the purpose of withholding tax, a management or administration fee or charge does *not* include an amount paid or credited to a non-resident for a service rendered by the non-resident with whom the payer deals at arm's length and who rendered the service in the ordinary course of his business; or a specific expense incurred by the non-resident for the benefit of the payer. In any event, the amount must be reasonable in the circumstances. If the amount is excessive, only the portion that is reasonable will not be considered a management or administration fee or charge and, therefore, not subject to the 15% withholding tax.

The Department of National Revenue has issued Information Bulletin No. 23 in order to explain their interpretation of the statute.

Bulletin 23 *implies* that for a charge to be exempt from the 15% withholding tax, it must not exceed a reasonable proportion of the expenses actually incurred by the non-resident. In other words, there must be no "profit" element in the charge.

The words *management or administration charges* are not defined in the Act and therefore must be given their normal meaning. The words should therefore apply to functions of direction, control, guidance, or supervision rather than to operational or functional activities referred to in Bulletin 23 such as accounting, advertising, transportation, insurance, and research. It would seem, however, that the Department's intention is to consider charges for any expense as falling within the ambit of the charging section.

Bulletin 23 refers to "contractual" and "contracted" amounts but the Department will not seek tax simply because there is no written contract.

Special problems may arise with certain expenses such as interest, scientific research, and depreciation. Interest costs allocated to a Canadian subsidiary will probably be taxed under a specific section that deals with interest rather than the section that deals with management fees, which results in a 15% tax cost on the whole interest charge instead of on just the excess over the cost to the non-resident. A reasonable charge

for scientific research will frequently exceed the cost to the non-resident, and the excess over cost as defined in Bulletin 23 would be taxed. Depreciation may present a problem if the Department takes the stand that, not being a cash expense, it does not represent an actual expense incurred by the non-resident. They may further claim that pursuant to another section depreciation charges can only be made in respect of assets *owned* by the taxpayer.

The usual practice is for the Department to request expense analysis of the charging company and descriptions of the bases of allocating such expenses to satisfy themselves that the particular functions represented by the various expense classifications do, in fact, benefit the Canadian company and that the bases of allocation which measure the amount of the allocation are reasonable in the circumstances.

The Department has indicated that it will consider charges imposed on a retroactive basis but not beyond a four-year re-assessment period. The Department has also been known to allow the charge to be reversed (within the four-year limit) in order to allow the taxpayer to avoid tax.

The Department has also allowed a re-allocation of expenses where the original charges were unacceptable.

Spill-over advertising (television) will not be allowed as an allocable charge but carefully supported arguments can be made for advertisements in magazines, periodicals, and newspapers. From January 1966, advertising in non-Canadian newspapers or periodicals directed *primarily* to a market in Canada will not be deductible.

It would appear that the Department of National Revenue has conveniently chosen to ignore Section 17 in determining the reasonableness of charges for management fees. Section 17(3) in effect states that when a Canadian taxpayer has paid to a non-resident person with whom he was not dealing at arm's length an amount greater than the amount that would have been reasonable in the circumstances if the non-resident person and the taxpayer had been dealing at arm's length, the reasonable amount shall be deemed to have been the amount paid or is payable therefor. This section gives statutory authority to the market-value concept that pervades the tax status of all non-arm's-length transactions in Canada. One therefore wonders at the statutory authority on which the Minister relies and is apparently basing his conclusions as represented in Information Bulletin 23.

It is our view in Canada that the storm clouds may still be just on the horizon—that is, the worst is yet to come.

The United States Office of International Operations is probably of the opinion that mere association is worth valuable consideration, and they are probably correct. When we consider that a Canadian subsidiary often uses trade names, trade marks, patents, secret formulae, know-how, engineering, and technical assistance of all kinds, in addition to the functional and operational services that the Canadian authorities are prepared to recognize, it is not difficult to imagine the kind of predicament in which our clients may find themselves.

For example, amounts declared by the Canadian authorities to be excessive will probably be deemed to be dividends to the extent of the excess and therefore subject to withholding tax. The Canadian subsidiary will therefore lose the disallowed portion of the charge as a tax deduction. The U. S. parent, on the other hand, may well lose its foreign tax credit on the grounds that the income earned from the subsidiary is not foreign-source income. It will be interesting to see how this problem develops.