A GLANCE AT SELECTED RECENT TAX DEVELOPMENTS

By Aki Chencinski, CA, TEP **

This morning's speakers were asked to address "recent developments in Canada-US cross-border issues including other federal and Ontario tax issues", without dealing with subjects covered by other speakers during the conference. The fact is that most of the presentations today and tomorrow generally address current issues. So we scoured the landscape to find current issues that may be of some interest to this group. Other sessions this morning will deal with recent federal draft legislation and current cases.

For my comments, I have chosen to ruminate on the following topics:

- This paper will primarily examine recent developments dealing with the deductibility of interest expense.
- I will briefly touch on some recent federal and Ontario developments, whether legislative, administrative or political in nature that may also have some interest to this audience.
- Finally, in keeping with our advertised cross-border theme, this paper will briefly look at some recent developments in US state tax issues.

The recent Ontario election and the expected change of direction of the new government will certainly have a profound effect on most Ontario residents. At this point we can (and will) only speculate, based on the election campaign, what tax changes might be forthcoming.

UPDATE ON INTEREST DEDUCTIBILITY

The deductibility of interest for tax purposes is certainly one of the more important issues facing both businesses and investors. Both the Departments of Finance and the Canada Customs and Revenue Agency ("CCRA") have great interest in how this subject is dealt with by taxpayers and their advisors, and ultimately by the courts.

There has been a long history of taxpayers claiming interest deductions in all sorts of circumstances and the CCRA challenging such claims.

Fortunately for taxpayers, the courts have generally been supportive of their interest deduction claims. The CCRA has been dealt a series of blows by the courts, including the Supreme Court, in the last few years with respect to its interpretation of when interest is deductible. In particular, the Shell Canada case[1], the Ludco case[2] and the Singleton

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[1] 1999 DTC 5669 (SCC).

case[3] have dramatically expanded the scope of interest deductibility. In the Shell Canada case, the Supreme Court found that high-rate interest paid by the taxpayer on a New Zealand dollar loan was deductible, even through the loan was hedged back to U.S. dollars for a future capital gain. In the Ludco decision, the Supreme Court ruled that earning income may be an ancillary purpose to the loan, and need not be the primary purpose. In addition, as long as some income (i.e. gross income) is expected, the source of income is not required to generate a profit or net income. In Singleton, the taxpayer successfully restructured his financial affairs to obtain interest deduction for a loan on his personal residence. Please refer to a paper presented in the 2002 Ontario Tax Foundation by Brian Carr[4] for a more detailed analysis of these three leading cases and other cases such as Canadian Helicopters Ltd.[5] and Tennant[6].

These cases came to several conclusions that are contrary to established CCRA administrative positions and prior case law. As a result, the CCRA had made an extensive review of these and earlier cases, as well as its administrative positions in several of its interpretation bulletins in an effort to reconcile the differences. It made several addresses in recent forums[7] concerning the issue, and released a statement of its revised administrative position on October 1, 2002 at the Canadian Tax Foundation annual conference for consultation with interested taxpayers and professionals. These events have culminated in the recent limited release of Draft Interpretation Bulletin IT-53x[8] (the "draft IT"). Once finalized, it will consolidate and replace previous CCRA positions as expressed in these other forums. When finally issued, it will also replace and cancel five other interpretation bulletins: IT-80, Interest on Money Borrowed to Redeem Shares, or to Pay Dividends; IT-203, Interest On Death Duties; IT-315, Interest Expense Incurred for the Purpose of Winding-up or Amalgamations; IT-445, The Deduction of Interest on Funds Borrowed either to be Loaned at less than a Reasonable Rate of Interest or to Honour a Guarantee Given for Inadequate Consideration in Non-arm's Length Circumstances; and IT-498, The Deductibility of Interest on Money Borrowed to Reloan to Employees or Shareholders.

Generally, the draft IT indicates that CCRA has accepted the decisions of the courts on a number of significant issues. It has also hedged its position on a number of other issues. The comments in the draft IT did not take into consideration any changes the Department of Finance may introduce in response to the court cases.

It is no secret that the Department of Finance considers certain aspects of the court decisions to be contrary to tax policy, and may address its concern through amending legislation. Finance has previously reacted to the Shell Canada decision by introducing section 20.3 [9] to prevent the deduction of excess interest on weak-currency loans. It is

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2 2001 DTC 5505 (SCC).
3 2001 DTC 5533 (SCC).
4 "Update On Interest Deductibility", tab 3 of the 2002 Ontario Tax Conference report.
5 2002 DTC 6805 (FCA).
6 1996 DTC 6121 (SCC).
7 For example, the 2002 Canadian Tax Foundation annual conference.
8 IT-53X Draft- Final Consultation Version, dated August 14, 2003.
9 Unless otherwise specified, all section and paragraph references are to the Income Tax Act (the "ITA").

expected that Finance will introduce measures to reverse at least part of the principles decided in Ludco[10]. In particular, Finance will likely try to clarify the concept of "income" under paragraph 20(1)(c) to ensure that income refers to "net" income instead of "gross" income, and prevent the creation of a tax loss by the deduction of interest expense, if there is no reasonable expectation of any income, as opposed to a capital gain.

What Is Interest

The courts[11] have generally found that interest has the following characteristics:

- It must be calculated on a day-to-day accrual basis
- The amount must be calculated on a principal sum (or a right to a principal sum), and
- The amount must be compensation for the use of the principal sum (or a right to a principal sum).

The ITA has a specific provision, paragraph 20(1)(c), which deals with the deductibility of interest. It is necessary, once an amount is determined to be interest, to decide whether the deductibility of interest is restricted to the specific wording of 20(1)(c), or whether interest may also be deductible under general principles as an ordinary expense under section 9 of the ITA.

Capital or Income

The Supreme Court in Canada in Safeway Limited V M.N.R. [12] made the statement that "in the absence of an express statutory allowance, interest payable on capital indebtedness is not deductible as an income expense." This issue has been reviewed in various subsequent decisions. The Federal Court of Appeal in the Gifford[13] case concluded that it was bound by the decision in the previous cases, and that interest is to be considered a capital expenditure. Gifford has appealed to the Supreme Court of Canada, and has been granted leave to appeal on March 27, 2003.

The draft IT retains the previous interpretation of the nature of interest expense:

> "Generally, interest expense is considered to be a capital expenditure. Accordingly, specific provisions of the Act must be met in order for interest to be deductible."[14]

The draft IT states that, pending the appeal of the Gifford case, interest could only be deductible if it meets the requirements of paragraph 20(1)(c). Under paragraph 20(1)(c), interest is only deductible under the following conditions:

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[10] In the Federal 2003 Budget, the Department of Finance announced that it would consider legislative amendments on these two issues, and potentially others.
[11] See for example, Miller v The Queen, 1985 DTC 5354 (FCCTD).
[12] 1957 DTC 1239 (SCC)
[13] 2002 DTC 7197 (FCA)
[14] Second paragraph in the Summary section of the draft IT.

1. The amount must be paid in the year, if the taxpayer normally determines income on a "paid" or cash basis.
2. The amount must be payable in respect of the year, if the taxpayer normally determines income on an accrual basis.
3. There must be a legal obligation to pay interest. Payments of interest in the absence of a legal obligation to do so, are not deductible.
4. The interest must be payable in respect of borrowed money, or amount payable on property acquired. The provision is silent on the deductibility of interest paid or payable on other types of payables.
5. Both the borrowed money and acquired property must be used for the purpose of earning income from a business or property, other than income that is exempt from tax.
6. Interest payable to acquire a life insurance policy is not deductible.
7. The amount of interest deducted must be reasonable.

The draft IT, however, has accepted two specific, and rather narrow, exceptions to the rule that interest can only be deductible under paragraph 20(1)(c). Taxpayers in the business of lending money may deduct interest expense as an ordinary expense, on funds borrowed to make loans in the course of its business.[15] It is considered to be analogous to other taxpayers borrowing in order to purchase inventory. In addition, interest on accounts payable resulting from services received, which is not addressed within paragraph 20(1)(c), is deductible.[16] The CCRA does not yet accept that interest may be deductible under general principles under other circumstances.

Should the taxpayer in Gifford be victorious at the Supreme Court, much of the draft IT may require amendment. The analysis of direct use versus indirect use of the borrowed funds and tracing versus linking may only be relevant in the general context of whether there is a general income earning purpose, and not only within the specific requirements of paragraph 20(1)(c). For example, the CCRA's position on contingent interest may not be defensible, particularly in view of the Glueckler decision, discussed in the next section. It may also be subject to challenge on its position concerning participating payments.

Retroactive Payments and Legal Obligation

A recent case, Glueckler Metal Inc. v. Her Majesty the Queen [17], arrived at a decision that may cast doubt on the validity of many of the CCRA's comments in the draft IT.

This case deals with the deductibility of expenses (including interest) that related to multiple taxation years, but paid in a lump sum in a subsequent year. The amount paid was not made pursuant to a pre-existing legal agreement.

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[15] Paragraph 4 of the draft IT.
[16] Paragraph 37 of the draft IT.
[17] 2003 DTC 431 (TCC)

As discussed previously, paragraph 20(1)(c) provides that to be deductible, interest must be either paid in the year, in the case of a cash-basis taxpayer or payable in respect of the year, in the case of an accrual-basis taxpayer. Further, in order to be deductible, the amount must be paid or payable pursuant to a legal obligation to make the payment. To an accrual basis taxpayer, such as a corporation, amounts which are not payable in a year because there is no legal agreement to make the payment, or because conditions precedent have not been met, cannot be deducted in the year of the expense. If the amounts are paid in a subsequent year, they are still not deductible, as the amounts are not payable in respect of that subsequent year. The Redclay Holdings Limited case[18] and others support CCRA's position.

It has been a long-standing position of the CCRA that similar principles apply to the deductibility of other types of expenses, either as a result of application of the "matching principle", or in the language post the Canderel[19] decision, because it gives the more accurate picture of a company's income.

In this case, the taxpayer reviewed its financial arrangements with two related companies, both referred to as "Bailey", at the insistence of its banker. Bailey provided administrative services to the taxpayer and also made a loan to the taxpayer. During the relevant taxation years (1989 to 1994), the taxpayer occasionally paid for the services and interest, but did so inconsistently. Apparently there were no formal or written agreements with respect to the taxpayer's obligations under the arrangements with Bailey. It was decided, after a review by a firm of independent accountants, that the taxpayer should make a one-time adjustment payment to pay for outstanding interest and administrative services. More than half of the amount related to interest. The taxpayer deducted the entire amount in 1994, the year of payment.

The CCRA denied the deduction in 1994 on the basis that it distorted the company's income for the year, the amount paid was unreasonable because it had no income earning purposes and the amount paid was in respect of capital. The CCRA claimed that the amount paid was unreasonable because it related to services rendered in the prior years and the services had been paid for in the prior years. The CCRA considers the payment to be made voluntarily by the taxpayer, and not deductible. Although it was not explicitly stated in the case, the CCRA took the position that the payment should not be deductible in 1994, nor should it be deductible in any of the previous years.

The Tax Court did not address the specific wording of paragraph 20(1)(c) in respect of the interest portion of the payment. It also did not address the government's position that the payments are in respect of capital. The Court approached the entire case on the basis of whether the payment was an expense incurred to earn income.

The Tax Court found that the administrative services and the loan were necessary for the successful operation of the taxpayer's business, thereby satisfying the requirement that the expense was incurred to earn business income. The Court noted that Bailey was not

[18] 96 DTC 1207
[19] 98 DTC 6100

adequately compensated for its services in prior years and the parties had agreed to rectify the situation by consulting external accountants to determine the appropriate amount of payment. Accordingly the Court determined that the fact that the taxpayer voluntarily made the payment did not negate its income earning purpose and allowed the deduction in the year of payment as it produced the most accurate picture of the taxpayer's economic position. At the time of writing, this case has not yet been appealed.

This case further illustrates the courts' willingness to consider interest deductibility outside the context of paragraph 20(1)(c). In this case, the Tax Court considers interest to be merely another business expense whose deductibility is governed under normal rules. Whether this case can be relied upon as precedent may depend largely on the outcome of the Gifford appeal.

Income Earning Purpose

Formerly, it was the CCRA's position that in order for interest to be deductible, the predominant purpose of the loan, or the property acquired, must be to earn income other than capital gain. A taxpayer must be able to demonstrate that the source of the income must be capable of generating a profit or net income. CCRA's position has been reflected in statements in, for example, interpretation bulletin IT-445[20] that a shareholder could only deduct interest on funds borrowed to lend to a corporation if he or she charged a reasonable rate of interest which was higher than the rate of interest paid by the shareholder.

The Supreme Court in the Ludco decision defeated that position:

> "Absent a sham or window dressing or other vitiating circumstances, a taxpayer's ancillary purpose may be nonetheless a *bona fide*, actual, real and true objective of his or her investment, equally capable of providing the requisite purpose for interest deductibility in comparison with any more important or significant primary purpose." [21]

The draft IT stops short of endorsing the Court's conclusions. It merely quoted the Court's comments concerning "purpose" and "income", and noted that:

> "Assuming all of the other requisite tests are met, interest will neither be denied in full nor restricted to the amount of income from the investment where the income does not exceed the interest expense, given the meaning of the term income as discussed..." [22]

This may be contrasted with CCRA's more definitive comments in its draft position paper released on October 1, 2002:

> "We also recognize and accept the Court's remarks that the use of borrowed money for an ancillary purpose of earning income can meet the test for interest deductibility (i.e. the main or overriding purpose for the use of the borrowed

[20] IT 445, paragraphs 3 and 6
[21] Ludco case, ibid, at 5514
[22] Paragraph 32 of the draft IT.

> money need not necessarily be to earn income). However, the finding of the purpose for the use of borrowed money will be a question of fact and the facts may indicate that the purpose of using borrowed funds does not give rise to an interest deduction (e.g. 722540 Ontario Inc., Novopharm Limited)."

Perhaps not surprisingly, the wording of the draft IT appears to contemplate that the meaning of the terms "purpose" and "income" may be changed in the future.

The draft IT indicates that the CCRA is prepared to continue its previous administrative position concerning investments such as common shares, which do not carry a stated interest or dividend rate. If there is a possibility of future dividends (i.e. when cash flow permits), then the income-earning objective is considered to be met. However, if the corporation has a stated policy that dividends will never be paid, and that investors can only receive a return in the form of capital gain on sale, interest will not be deductible.

The draft IT provided specific examples[23] where the CCRA considers situations when the interest deductibility may be restricted. Generally, if borrowed funds are used to purchase an investment, and the funds are returned in the form of a return of capital, all or a portion of the interest may no longer be deductible. The draft IT is not explicit as to the rationale applied by the CCRA in its analysis. The criterion to be applied appears to be whether the investment is capable of continuing to be a source of income after capital has been returned.

In the example involving a contribution of capital to a partnership, interest is found to be deductible because even though the capital has been returned, the partner still owns the partnership interest, and may expect to receive income from the partnership interest in the future. A second example deals with an investment in a unit trust. The current use of the returned capital must be determined in order to conclude whether interest remains deductible. What distinguishes this example from the previous one appears to be that the trust has no capital other than contributions from the unit holders and it cannot generate income from any other source. Once capital has been returned, the trust's ability to generate income is diminished. A third example involves an investment in common shares, interest is no longer deductible because the corporation has no assets after the return of capital.

Direct Use and Indirect Use of Funds

The draft IT acknowledges that earning income may be, under certain circumstances, an indirect purpose of the borrowed funds or debt. In addition to directly tracing the use of borrowed funds to an income earning purpose, and therefore eligible use, the courts over the years have expanded the test to permit deductibility under other circumstances.

It is generally simple to determine the direct use of funds. If a taxpayer borrows money in order to purchase an asset, the loan can be traced directly to that use.

[23] Examples 8, 9 and 10 of paragraph 22 of the draft IT.

If the funds are not used for a direct income earning purpose, interest may still be deductible, if there is a demonstrable link between the use of the funds, and an income earning purpose.

For many years, it is the CCRA's view, based on an obiter comment in the Bronfman Trust Case[24], that a taxpayer cannot restructure his/her financial affairs in order to meet the direct use test. The Supreme Court in the Singleton case found that the direct use of the loan (secured by a mortgage on his home), taken out by the taxpayer, was to contribute as capital to a partnership, and the resulting interest was deductible. The fact that Singleton had withdrawn capital from the partnership in order to purchase the home in the first instance did not detract from the direct use of the funds. The CCRA now accepts that a taxpayer may restructure borrowings and the ownership of assets in order to meet the direct use test.

An additional principle, which has been confirmed by the CCRA, is that the direct use of the funds has to be reviewed in conjunction with the current use of the funds. If borrowed funds are used to purchase an income producing asset, and the asset is subsequently sold and replaced with another asset, the new asset must be an income producing asset as well, in order for the interest to continue to be deductible, unless the interest is otherwise deductible under section 20.1 because the conditions in that section are met.

Section 20.1 provides that if a property (other than real property or depreciable property) acquired with borrowed funds has declined in value or sold for less than the corresponding debt, interest on the borrowed funds used to acquire the property will continue to be deductible.

Where the property has declined in value and has been sold for less than its original cost, the portion of the borrowed funds that can be traced to the sale proceeds (as determined under the subsection) is subtracted from the total borrowed funds outstanding to determine the amount eligible for relief. This amount is deemed to be used for an income earning purpose and the interest on that amount will continue to be deductible.

Similar rules apply in respect to borrowed funds that have been used for business purposes.

The combined effect of section 20.1 and the administrative position concerning direct and current use of funds may be illustrated as follows.

A taxpayer borrowed $1,000 to acquire an income-producing asset, Property A. Property A is not real property or depreciable property. Property A is subsequently sold for $750. The proceeds are used to purchase two properties, Property B, which is another income producing property, and Property C, which is not. The cost of Property B is $450, and the cost of property C is $300. The original loan of $1,000 is still outstanding.

[24] The Queen v Bonfman Trust, 1987 DTC 5059 (SCC)

Interest on $250 of the loan (the shortfall as a result of the sale) will remain deductible, as a result of section 20.1. Interest on $450 of the loan will be deductible, as the current use of the loan is to acquire Property B. Interest on the remaining $300 will no longer be deductible.

The CCRA had previously indicated, and confirmed in the draft IT, that cash damming is an acceptable method of demonstrating direct use of funds. If borrowed funds are segregated in a separate account, and used for eligible purposes, at the same time other funds in a different account are used for ineligible purposes, interest on the borrowed funds is fully deductible.

If borrowed funds are deposited into the same account as other funds, and used for both ineligible and eligible purposes, it is generally a problem for the taxpayer to demonstrate the direct use of the borrowed funds. Previously, where direct use cannot be demonstrated, the CCRA had generally permitted a deduction of a pro-rata portion of the interest expense. The CCRA will now [25] permit the taxpayer to pick and choose how to apply the funds from the loan. If a corporation's bank account consisted of $200 of funds from an operating line of credit, and $300 of other funds, and it purchased eligible property of $250, it may choose to consider $200 (or a lesser amount) of the purchase price to be paid from the operating loan.

The draft IT includes a number of other examples of the "linking" principle. These include deductibility of interest in a leverage buy-out situation, where interest on a loan taken out to buy shares of a corporation will remain deductible, even after the corporation is wound-up or amalgamated with the target corporation. In this situation, the assets received on the wind-up or amalgamation is linked to the original loan, and the interest on the original loan will remain deductible.

Capital Replacement

A taxpayer may borrow money to redeem shares, return capital or to pay dividends. The loans do not have a direct income earning purpose. However, if the loan replaces (or "fills the hole" left by) capital originally contributed by the shareholder to enable the corporation to carry on its business, the loan will be considered to have an indirect income earning purpose. If the original capital were not used for income earning purposes, interest on the replacement loan would not be deductible. This position is based on the Trans-Prairie decision[26].

The draft IT outlined what the CCRA considers acceptable, and incorporated many of the CCRA's prior comments as expressed in IT 80 and elsewhere. Capital will generally be legal or stated capital for corporate law purposes, although the draft IT referred to other possible but unspecified measurements of capital. If a portion of the shares are redeemed or cancelled, only a pro-rata portion of the capital may be considered for the purpose of determining the amount of the eligible replacement loan. If a corporation has a deficit, it

[25] Draft IT paragraph 20.
[26] 1970 DTC 6351 (Ex Ct).

may still borrow to return contributed capital, as the deficit will not be taken into consideration for this purpose.

The CCRA will allow the deductibility of interest on notes issued to purchase for cancellation or to redeem shares. However, it will not extend the principle to notes issued on a reduction of capital or to pay dividends, because no property has been acquired.

CCRA's position is that a corporation will only be able to borrow to pay dividends (including deemed dividends) up to the retained earnings of the corporation, computed on an unconsolidated basis with investments accounted for on a cost basis. Retained earnings generated through transactions with non-arm's length parties may be subject to adjustments.

The concept of replacement of capital also applies to a partnership that borrows to return capital to the partners.

Interest Free-Loans and Guarantees

In the Canadian Helicopters case[27], the taxpayer borrowed funds to lend interest-free to its parent corporation (Holdco). Holdco in turn made a loan to the ultimate parent corporation to acquire shares of a corporation. The Federal Court of Appeal found that interest on funds borrowed by the taxpayer was deductible as the taxpayer had a reasonable expectation of future income from the arrangement.

Although the draft IT cited this case, the CCRA may not take as liberal a view in its assessing practice. The draft IT merely restated its position previously described in IT 445. The CCRA will permit interest deduction, if the borrowed money is used to make an interest-free loan to a wholly owned corporation, or if there are multiple shareholders, each shareholder's loan is in proportion to his/her shareholding. In addition, the proceeds must have an effect on the corporation's income earning capacity. It has dropped, however, the additional conditions which are stated in paragraphs 7 and 8 of IT 445, that the corporation must have tried, but failed to borrow at the same interest rate that its shareholder could, and that no undue advantage resulted from the interest-free loan.

The draft IT noted that interest deductibility might be warranted under other unspecified circumstances.

The changes to the administrative position concerning guarantees are similar to those applying to interest free loans. If a shareholder borrows to honour a guarantee, the interest incurred continues to be deductible if a fee has been charged. The draft IT outlined other situations where interest may be deductible, if no guarantee fee has been charged. If a shareholder can show that it can reasonably expect to earn income, such as increased potential for future dividends, the interest will be deductible. It may also be

[27] 2002 DTC 6805 (FCA)

deductible, if the guarantor had access to the original loan, and used it for income earning purposes.

Shareholder and Employee Loans

In IT 498, the CCRA stated that interest incurred by an employer if it borrows money to make an interest-free loan to an employee would only deductible if the total remuneration (including salaries and interest) is reasonable in relation to the value of services provided by the employee. The draft IT has removed the condition that the amount must be reasonable, perhaps acknowledging reality that in an age of multi-million dollar compensation packages, any amount may be reasonable.

Interest on funds borrowed to make interest-free loans to shareholders continues to be non-deductible.

OTHER DEVELOPMENTS

Recent Legislative Changes

Non-Competition Payments

The two recent cases of Fortino[28] and Manrell[29] dealt with the issue of whether payments received for non-competition payments are taxable to the recipient. The taxpayers in each case received payments in consideration for signing non-competition agreements in addition to receiving proceeds in consideration for disposition of certain shares. In the Fortino case, the CCRA considered the non-competition payments to be either three-quarters taxable as proceeds received for an eligible capital expenditure, or fully taxable as income from an unspecified source. The CCRA did not plead that the payment should be proceeds of disposition at the commencement of the trial, and was prevented from making the arguments during the trial and the subsequent appeal. The Federal Court of Appeal found that the payments received by the taxpayers in Fortino are capital in nature, and therefore not taxable. Although the government was unhappy with the result of the case, it decided to wait for the Manrell decision.

The taxpayer in Manrell originally included the non-compete payments as part of the proceeds of disposition of shares, perhaps following the advice of the CCRA in its interpretation bulletin IT-330R. Following the Fortino decision, he filed notices of objection to try to have the portion of the capital gain attributable to the non-competition payment reduced to zero. Obviously, the CCRA refused, taking the position that the taxpayer had disposed of property when he agreed not to compete. The taxpayer lost his appeal at the Tax Court level, but won at the Federal Court of Appeal.

It was clear from the government's reaction to the decision that it was a matter of time before legislation would be introduced to reverse the impact of the precedents.

[28] 2000 DTC 6060 (FCA)
[29] 2003 DTC 5225 (FCA)

Meanwhile taxpayers and their advisors were busy incorporating non-competition agreements into sale transactions. The non-taxability of the payments to the recipients appeared to be clear, based on the Fortino and Manrell decisions. There were varied opinions within the tax community as to the appropriate treatment of the payments to the payers. Both of these issues were dealt with on October 7, 2003, when the Finance Minister issued a news release dealing with the tax treatment of restrictive covenants.

The announcement was not accompanied by draft legislation. The draft legislation, when introduced, may potentially have a broader scope than merely non-competition payments, as it may apply to other types of restrictive covenants.

Beginning October 8, 2003, all amounts received in respect of a restrictive covenant are taxable as ordinary income. If shares of a corporation or interest in a partnership are also sold, the amount received for the restrictive covenant may be treated as part of the proceeds of disposition of the shares or partnership interest, to the extent the restrictive covenant increased the value of the shares or partnership interest. The application of this rule may lead to surprising results, as the following numerical example provided in the backgrounder illustrates.

Each of two shareholders, Terence and Isabelle, owns 50% of the common shares of X Ltd. The adjusted cost base of their shares is nil. Y Ltd. offers to purchase all of the shares of X Ltd. for $2 million, as long as Terence, the more active shareholder, signs a non-competition agreement. Otherwise, the purchase price will only be $1.8 million. The example assumes that Terence will receive the additional $200,000 for signing the non-competition agreement and the $1.8 million will be divided equally between Terence and Isabelle.

The tax consequences to Isabelle are straightforward. The entire $900,000 received is proceeds of disposition, and she realizes a capital gain of $900,000.

Under the proposal, the additional $200,000 will be taxable to Terence as ordinary income unless all or a portion of it may be added to the proceeds on the disposition of his shares. One would normally assume that the entire $200,000 might be added to proceeds. However, in the example, only $100,000 may be added to proceeds, and the remaining $100,000 is taxable as ordinary income.

The starting point of the analysis is to determine what Terence's shares are worth, if no amount has been separately allocated to the covenant. Terence and Isabelle will receive total proceeds of $2 million, and Terence's 50% share will be $1 million. This amount is $100,000 higher than the $900,000 proceeds he receives, if $200,000 has been allocated to the non-competition agreement. As a result, only $100,000 of the $200,000 may be allocated to proceeds on disposition.

If each of Terence and Isabelle receives $100,000 (pro-rata to their share ownership) in consideration for signing non-competition agreements, there will be no difference in the tax consequence to each of them, whether the amounts are included in the share proceeds or paid separately.

Y Ltd. will be required to add the $200,000 to the cost of the shares of X Ltd. If it had purchased assets of the business instead of the shares, it would be required to treat the payment as an eligible capital expenditure.

Recent Administrative Changes

Penalty On Late Payroll Remittance

The CCRA has announced[30] that it will reduce the penalty on late payroll remittance by implementing a graduated penalty rate to replace the statutory penalty rate of 10%.

Employers who are a few days late on remitting source deductions will face a 3% penalty, if they are 3 days late or less, 5% for remittances that are up to 5 days late, 7% for remittances that are 6 or 7 days late, and the full 10% penalty rate if the remittances are 8 days or more late. The change is effective beginning in July 2003.

The reduction in penalty will not be accompanied (at least not in the near future) by a change in the penalty provision of the Income Tax Act ("ITA")[31]. For now, the CCRA is relying on its discretion under the fairness package[32] to waive or cancel a portion of the penalty. Employers, however, will not be required to formally apply for the exercise of this discretion. The reduction of penalty, obviously, may be withdrawn at any time, should the CCRA determine that it is dissatisfied with the results of this initiative.

Foreign Spin-Off Election

In the late 90's, it was increasingly common for foreign corporations, in particular U.S. corporations, to spin off a division into a separate corporation. Although a spin-off transaction was a tax-free event in the U.S., the value of the spin-off shares received by a Canadian was taxable as a foreign dividend. The amount was then added to the adjusted cost basis of the spin-off shares, and reduced any future capital gain on sale.

The foreign spin-off rules[33] were introduced in the 2000 federal budget to permit a taxpayer to make an election to not include the value of the spin-off shares in income. Instead, the adjusted cost base of the shares of the original corporation will be allocated between the shares of the original corporation and the spun-off corporation based on their relative fair market values. This election is beneficial even if the spin-off shares are sold immediately, as it converts the foreign dividend income, taxable at full rates, into a capital gain, which is only half-taxable.

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[30] CCRA News Release dated June 20, 2003.
[31] Subsection 227(9) of the ITA.
[32] Subsection 220(3.1) of the ITA.
[33] Section 86.1 of the ITA.

To be eligible for this treatment, the foreign corporation must provide the CCRA with certain information[34] within six months after the spin-off. The CCRA will not publish a full list of corporations that have complied with this requirement. The election must be filed with the taxpayer's income tax return, which may be due before the foreign corporation is required to comply. Those taxpayers who may not be aware of the spin-off transaction, or who are not certain that the foreign corporation will file the necessary information with the CCRA, may lose the benefit of the election if it is not filed on time[35]. The CCRA had repeatedly indicated that it would not allow a late-filed election under these rules.

Regulation 600 has been quietly amended[36] to add foreign spin-off to the list of elections which can be late-filed or amended. The amendment is effective April 11, 2002.

Ontario Political Changes?

Due to the recent change in government, a number of the tax measures announced or enacted by the previous government may be abolished, reversed or modified. Without a crystal ball, only time will tell what changes will be made. We can generally assume that tax rates, especially corporate rates, will remain unchanged or increase. The continued scheduled decreases of corporate tax rates enacted by the conservative government will undoubtedly be cancelled. Whether this end of rate reduction will also apply to small business remains to be seen. Further, after examining the government's "books", it is not beyond speculation that this new government will be "forced" to increase some taxes. Also in danger is the predecessor government's commitment to abolish Ontario corporate capital tax. In addition to the probable rate changes, we will comment on two specific changes, which apply to 2003. Both of these are likely to be significantly modified or abolished by the new Liberal government.

Ontario Home Property Tax Credit for Seniors

The new tax credit introduced in the 2003 Ontario budget, and enacted[37] in the summer, will benefit primarily high-income seniors, that is, those who could not claim the Ontario property tax credit because their income exceeded the minimum threshold.

Under the existing Ontario property tax credit system, seniors can claim a maximum of $500 plus 10% of their "occupancy cost" as a refundable tax credit on their income tax return. The maximum credit is reduced to the extent the senior's adjusted income for the taxation year exceeds $22,000. The maximum combined property tax and sales tax credit is $1,000.

[34] See 86.1(2)(e) of the ITA for the information required to be disclosed.
[35] Section 86.1 was not listed in Regulation 600(c) issued under subsection 220(3.2).
[36] P.C. 2002-531
[37] Bill 43, The Ontario Home Property Tax Relief for Seniors Act 2003 received royal assent on June 26, 2003.

The new credit would refund to seniors, the education portion of the actual property tax paid,[38] or 2.5% [39] of the rent paid.

The amount of refund received in the year would reduce the amount the individual is otherwise eligible for the property tax credit.

Just a guess, but don't be surprised to see this provision disappear or be significantly altered.

Equity In Education Tax Credit

This credit has been restored[40] by the former conservative government to the original implementation schedule: 20% in 2003, 30% in 2004, 40% in 2005 and 50% in 2006 and onwards.

Perhaps as a result of criticisms directed at certain aspects of this program, Ontario has tightened up the rules of eligibility for 2003. Eligible tuition fees will exclude amounts paid to an independent school if a parent receives substantial benefit attributable to the payment of the fees. Although not specifically referred to in the legislation[41] or the regulations[42] issued thereunder, home-schooling will no longer qualify for the credit.[43]

The schools will be required to provide additional information to parents and guardians of their students. The schools are now required to consult the Ontario Teachers College registry to obtain information about the standing with the College of any of its teachers who are or have been members and to provide this information to parents. The teachers are not required, however, to be a member in good standing with the Ontario Teachers College or other provincial equivalents. The schools must also disclose to the parents, the methods the schools will use to measure and report academic progress, including details of any standard tests which will be used. Parents must also be advised on how to obtain consumer rights information from the Ministry of Consumer and Business Services.

Again, don't be surprised to see the abolition or significant alteration of this legislation.

U.S. STATE TAX

Many Canadians who carry on some degree of business activities in the U.S. have noticed an increased level of attention from certain U.S. states, particularly those states which border Canada. As we are not U.S. tax practitioners, we strongly recommend that anyone concerned with these new developments should obtain U.S. tax counsel for specific advice. Nonetheless, we will attempt to highlight some recent developments in this area.

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[38] In 2003, this will only be respect of the property tax for Jul 1, 2003 to December 31, 2003.
[39] Ontario Regulation 360/03, dated September 2, 2003
[40] Announced in the Ontario Budget dated May 22, 2003.
[41] Section 8.4.2 of the Ontario Income Tax Act.
[42] Regulation 498/01, as amended by O. Reg 134/02, 84/02 and 217/03.
[43] Ontario Tax Legislation Bulletin03-06, issued in 2003.

A Canadian corporation may generate U.S. source business revenues in the course of its buisness. Some companies' U.S. related activities might be so minimal that they would not be considered to be effectively connected with a U.S. trade or business under U.S. domestic law. These companies would not be taxable in the U.S. for federal purposes. In other circumstances, the Canadian corporation may be carrying on business in the U.S. The Canada-U.S. Income Tax Convention[44] (the "Treaty") provides that these business activities will not be subject to U.S. federal level of taxation unless the Canadian corporation has a "permanent establishment" in the U.S.[45]

Many Canadians are able to arrange their business affairs to ensure that no U.S. permanent establishment exists. For Canadian purposes, the tax returns are often filed on the basis that all of the profits are allocable to Canada, and, where applicable, eligible for the Canadian small business deduction[46].

What many businesses may not realize, however, is that the individual U.S. states are not bound by the Treaty. Each of the 50 states and the District of Columbia has its own system of taxation, and many Canadian businesses may be subject to tax in one or more states as a result of nexus or connection they may have within the state. What constitutes nexus differs from state to state. Common activities creating sufficient nexus may include established bank accounts, collection activities, trade show attendance, certain drop shipment arrangements, consigned inventory, and contracted service agents. Some states have taken the position that the licensing of intangibles for use in the state is sufficient to create nexus[47]. These activities will not normally create a permanent establishment for federal purposes.

If sufficient nexus is created, a state may impose income tax and/or franchise tax on the business. The basis of taxation is generally determined by applying a three-factor (payroll, property and receipts) apportionment formula to the worldwide income of the entity. There are a number of exceptions. New Jersey, for example, has moved to a receipts only factor in determining income taxable in the state. A Canadian corporation that has no assets nor employees in New Jersey, but has nexus in New Jersey due to other factors such as after-sales service calls, may pay more New Jersey tax under the receipts only method. Michigan imposes a tax[48] on a tax-base determined by labour, capital and profit. The Canadian tax authorities take the position that this tax is a value-added tax, and will not qualify as a foreign income tax for the purpose of foreign tax credits[49]. It is, however, deductible as an ordinary business expense. Certain states impose a minimum tax, and as a result, state tax may be payable even if there is no net income.

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[44] Signed on September 26, 1980, and amended by Protocols signed on June 14, 1983, March 28, 1984, March 17, 1995 and July 29, 1997.
[45] Article VII of the Treaty.
[46] Section 125 of the ITA.
[47] For example, North Carolina holds that a company which owns a trademark has physical presence in the state because its trademark is manifested on property of its licensee in the state. See A&F Trademark, Inc. v. Tolson, N.C. Tax Review Bd., No. 381, 5/7/02
[48] The Single Business Tax.
[49] Document 1999-0015115.

Whether the state tax is creditable as a foreign tax credit will depend on how the relevant state calculates the tax, and whether the corporation carries on foreign business under Canadian rules.

As noted previously, a state may impose state income tax where there is very little actual business activities carried on in the state. If a sale is solicited from Canada, accepted in Canada, and shipped from Canada, but an employee of the Canadian corporation installed the product at the customer's location in the U.S. and/or made an after-sale service call, there may be sufficient nexus established in the state for the purpose of U.S. state tax laws. Assuming it is not a major installation, the revenue would generally be considered Canadian source income for Canadian purposes, eligible for the small business deduction. The state tax paid would not qualify for a foreign tax credit, as there would not be any foreign income earned. It may also not be considered to be paid for the purpose of gaining or producing income, and therefore not deductible.

If the corporation takes the position that it is carrying on business in the U.S., (even if a permanent establishment does not exist), the state tax paid may be claimed as a foreign business tax credit[50]. The small business deduction, however, cannot be claimed on the same income in Canada.

Certain states impose a combination of income and franchise taxes, or only a franchise tax. If the state tax is computed based on net income, it will be considered to be a foreign business income tax. If the state tax is calculated on some other basis (such as net worth, or gross revenue), it is not a creditable tax. It may be deductible, however, as a business expense[51].

The exposure to state tax may create practical problems, as the state tax may not be assessed until the tax year is statute barred for Canadian purposes. As a result, there may not be any relief available in Canada (either as a foreign tax credit, or a deduction) with respect to the state tax paid or payable. Competent authority assistance to resolve potential double taxation issues cannot be invoked since the states are not party to the Treaty.

In addition to imposing income and/or franchise tax, the states are also interested in increasing their sales tax revenue base. A Canadian who sells to a state, and has some physical presence or nexus in the state, will be required to register and collect sales tax in that state. The threshold for sales tax presence is generally lower than the threshold for income tax. In an advisory opinion issued by the New York State Department of Taxation and Finance[52], the issue was whether a Canadian company's activities in New York required it to collect sales tax on sales of its product to New York customers. The company had limited New York activities. These included transportation of equipment through the state; two trade shows a year, and one or two visits by sales representatives per year. On one occasion it hired a third-party contractor to deliver to and install its

[50] Under subsection 126(2) of the ITA.
[51] See an analysis of tax imposed by various states in Documents 9919789, 9614265, and 9620865.
[52] TSB-A-02(49)S, September 24, 2002

product for a customer in New York. The tax department ruled that interstate transportation and trade show activities were not sufficient to constitute nexus and trigger a collection responsibility, but sales tax nexus was established simply because its employees visited New York once or twice a year.

The states, hungry for income and sales tax revenue, are becoming increasingly aggressive in identifying out-of-state taxpayers. The states share information with the Internal Revenue Service and United States Customs Service, and many states share information with each other. Some of the methods which have been employed include: reviewing customs documentation to identify out-of-state (out-of-country) vendors who are shipping products into the state; reviewing lists of out-of-state vehicles registered to corporations which have received traffic tickets in the state and sending these corporations letters to determine what business they may be conducting in the state; obtaining lists of out-of-state vendors during the course of audits of local businesses. If a state sends a letter to a Canadian business to request information concerning its business being conducted in the state, and the Canadian business ignores the request, the state may proceed to arbitrarily assess an amount of tax. This assessment of tax may, in some instances, not be subject to appeal.

Although a state that assesses tax may not try to enforce collection in Canada, it may seize any property (such as inventory or equipment) physically present in the state. Generally, it is not good policy to ignore a request for information, but U.S. tax counsel should be consulted in order to frame the responses carefully.

The states' ability to impose sales tax may be expanded under the Streamlined Sales and Use Tax Agreement ("SSUTA"), which is a multi-state sales tax simplification initiative. A number of states have already passed legislation adopting the SSUTA, and others are reviewing it. If a vendor agrees to comply with SSUTA, it must collect sales tax in any state that is a member of SSUTA. The effective date of the law in many of the member states will be mid-2004.

NOW WHAT?

The preceding comments have attempted to consider a handful of tax related issues that are both current and relevant.

Clearly any changes, whether legislative, administrative or judicial, dealing with the deductibility of interest is of great interest and significance to Canadian taxpayers and their advisors. Whether the new draft IT helps to make this area of tax any more definitive for both taxpayers and the CCRA remains to be seen. Generally, I would expect taxpayers to continue to approach this issue aggressively, and claim interest deductions whenever possible. The current draft IT and the generally positive (from a taxpayer perspective) results emanating from the courts may offer some stability in this area of tax compliance and planning. This may, however, be short-lived, if Finance decides to amend the legislation dealing with interest and codify its view of the subject.

This paper has raised a number recent other federal and Ontario tax issues that will have some impact on various taxpayers. These issues may have been affected by statutory, judicial or administrative changes or results. Perhaps the more interesting issues and changes for residents of Ontario, whether individual or corporate, will flow from the recent change in government.

Finally, the comments on U.S. state tax issues were intended solely as a "warning light" for those companies (and their advisors) that do some business in the United States. Companies may choose to investigate what reporting and compliance obligations they might have in individual states, as well as federally in the United States. Alternatively, such companies may continue doing business, in various forms and various degrees, and adopt a "wait and see" (and hope) approach.

Now What? Stay tuned.